



**STRATHCLYDE BUSINESS SCHOOL**

**An explorative study of performance management in  
the German cooperative banking sector in response  
to regulatory and market forces**

by

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A thesis presented in partial fulfilment of the requirements for the degree of

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## Abstract

The effects of the Subprime Crisis in 2007, which evolved into the still continuing economic crisis, have caused worldwide financial damages in excess of USD 1,6 trillion until 2009 alone according to banks' estimates and renewed awareness for the way financial institutions are run and regulated. It has captured the interest of regulatory standard-setters in their efforts to adjust their supervisory frameworks in order to improve financial stability forcing bank executives to re-think and adjust their business models in order to adapt to the new regulatory environment. Several studies and other publications have been produced on this topic. However, these are limited by their focus on banks in general, especially large-scale and shareholder-oriented banks with sufficient information publicly available.

This project contributes to current debates by analysing the impact of the new regulatory measures, Basel III, as well of other competitive forces on the German cooperative banking sector being the smallest of the so-called Three Pillar System, consisting of ap. 1.100 individual banks (primary banks) with 30 million customers and 17 million shareholders (members) plus two central institutions organized within the Cooperative Financial Services Network. Particularly, the aim is to explore and identify how primary banks react and adjust or have to adjust their *modus operandi* in order to stay competitive given the special characteristics and limitations within their network. Considering tangible as well as intangible assets, this is done via a multi-level research design using a number of methodologies and referencing a range of information and informants while taking advantage of the privileged status of having hands-on access to real-life subjects, i.e. cooperative banks, to gather relevant practical data.

This research has concluded that the effect of Basel III on cooperative banks is not as severe as commonly assumed when the entire banking sector is regarded. Especially with regard to equity, being the focus of the majority of literature, evidence suggests a low impact, with liquidity issues, having been of secondary attention, representing higher pressure. However, no need to conduct material reorganisations has been identified upon analysing current data and historical performance. Giving the

dependence on interest income, the on-going low interest level in connection with limitations on conducting maturity transformation poses the biggest threat to performance requiring primary banks to carry out new thinking.

A number of key topics have been researched and also implemented as part of this project. One of the main findings in this context was that there is in fact a well-developed awareness of issues and challenges, however, a lack of willingness to change. This is regarded a problem associated with core principles of adherence to cooperative values and the *regional principle*, a principle of the cooperative banking sector that requires primary banks to operate within a practically limited area. However, evidence and research suggests that there is high potential for performance improvements by introducing structured concepts and the enhanced use of the cooperative network. Quantitative and as well as qualitative instruments tested, such as a financial model for regulatory compliance or the BSC to improve operational improvements, have been successfully tested. With regard to the ideas and strategies proposed to improve competitiveness some will argue that it is not feasible. However, this research confirms that the economic and regulatory environment leaves no choice but to change the old-established way of operation. It forces banks, especially smaller ones, to react and fight with no time to lose.



## Acknowledgement

Performing this doctoral project while being a full-time employee has been an extremely demanding, interesting and sometimes frustrating journey. Despite the difficulties it has been an unique experience in terms of combining practical experience and expertise with academic methods. It has helped me gaining personal as well as professional fulfilment and see things from a different angle, i.e. not only from the outside-in, being the core of my regular work as an external auditor, but also from the inside-out, being the major experience from this research.

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# 1. Research Introduction

## 1.1 Setting the scene

This research looks at bank business model adjustments of small and medium sized banks and aims to make a contribution to practice and academia by focussing on cooperative banks that are by far the most significant banking group in Germany in terms of number of institutions, even though the smallest of the three banking pillars<sup>1</sup>.

The newly found attention of practitioners and academics is the result of the still ongoing financial crisis, originally starting out as the subprime crisis in 2007. The Subprime Crisis 2007 was the climax of a development characterized by a lack of ethics, insufficient awareness for stakeholder needs or requirements and insufficient consideration of long-term goals. In the subsequent months, a number of banks and financial institutions had to fight for economic survival. In this context, the cooperative banking business model is considered to be the most resilient in times of crisis (Birchall/Hammond Ketilson, 2009), proved to perform well during the recent crisis (Oliver Wyman, 2012) and remains solid according to preliminary numbers for financial year 2012 by the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken* (in the following: "BVR")<sup>2</sup> (BVR, 9 July 2013). Despite this fact, cooperative banks have to be in full compliance with the regulatory measures decided upon, i.e. Basel III, which represents a never seen before challenge to the way banks and especially cooperative banks, due to their small size, are managed.

*"Small banks fear for their survival"* (Handelsblatt, 17 February 2012)

The overall aim of this research is to explore what has been and is experienced by cooperative banks in terms of strategic and financial management and what responses are available and necessary to provide for future performance.

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<sup>1</sup> See section 4.1 with regard to the Three Pillar System

<sup>2</sup> National Association of German Cooperative Banks, see [www.bvr.de](http://www.bvr.de)

## 1.2 Research origin

The interest in the research topic has originated from the researcher's professional employment and belief in a continuous potential for improvement. Since 1999, he has worked in the professional practice of a Big Four audit company with a sole focus on financial service organisations. As a qualified auditor he has been responsible for the obligatory year-end audit, voluntary and compulsory special audits and advisory projects. As milestones, he followed the introduction of an extended Basel Accord (Basel II) in 2004 and followed the consequences of the Subprime Crisis beginning in 2007 with professional interest and duties as it has developed into the most powerful change driver for both, regulators and bank managers.

As part of his work he is in continuous and close contact with a variety of clients and stakeholders in financial service organisations. For year-end audits he has worked for a number of large-sized German banks in Germany, the UK and the USA. Being an essential part of every financial service audit practice, he has worked on numerous projects and audits as imposed by the *Bundesanstalt für Finanzdienstleistungsaufsicht* (in the following: "BaFin")<sup>3</sup> that have brought him across the world and into contact with other foreign supervisory authorities. Advisory projects, i.e. work in connection with M&A in the financial sector, helped to develop his awareness for models in an Ex Ante-view as opposed to the typical Ex Post-view of audit work. In summary, he has been able to observe the response and reactions of clients and reflect on conditions and factors that influence performance and value management as well as the decision making process. However, he did not feel adequately resourced and equipped with the knowledge he had, i.e. he felt a gap between what is necessary to broaden the perspective of clients and his own and what has been available through practitioner literature and seminars. The overcoming of this gap took place during an overburdened work-schedule, i.e. the completion of this project took place during full-time employment, which helped putting practical relevance into the research progress (see chapter 9 for a reflection).

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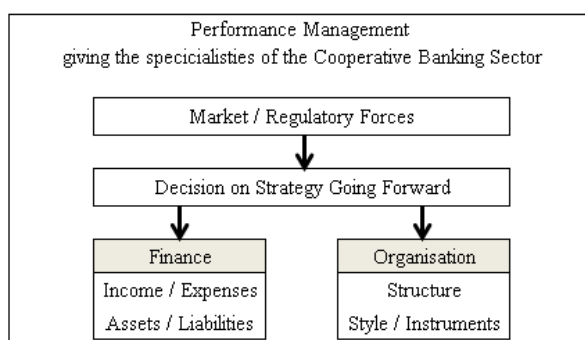
<sup>3</sup>Federal Financial Supervisory Authority in Germany



The special focus and interest on the cooperative banking sector was originally founded in 2001, when the researcher acted as an advisor to the successful merger of former cooperative central banks DG Bank and GZ Bank (Handelsblatt, 7 December 2006). After working for the newly merged DZ Bank as an auditor for many years as well as working for several cooperative banks as special auditor, the researcher again worked on the proposed, yet completed, merger between DZ Bank and the second cooperative central WGZ Bank in 2009/2010 (Handelsblatt, 27 February 2009). During these two ventures the researcher was in regular contact with cooperative banks, however, not or hardly involved in the definition of business strategies. As part of this researcher's career move towards a more advisory driven occupation, the professional focus currently is on small and medium sized banks asking for strategic and operational advice. Direct practical experience could be gained in this context through the existing client base that included a number of small and medium sized cooperative banks being clients for compulsory annual audit services.

The researcher's experience and professional orientation also represented the basis of this research, i.e. it helped designing a conceptual and broad framework that helped to focus on relevant areas. The overall idea and approach to this topic was the expectation that financial regulation is evolving and soon will bring up new issues beyond Basel III to consider. While not clear at the beginning of this project, it is assumed that income / expenses related issues will become more prominent with regulators in the future. Hence, not only assets / liabilities are considered and incorporated in this work, but also and especially ways to enhance profitability. The conceptual framework can be summarized as follows:

**Figure 1: Origin of the conceptual framework**



As can be taken from the figure above, there are four areas to focus on, i.e. market and regulatory forces, strategy, finance and organisation. The overall box represents the specific context the elements are analysed within, i.e. performance management giving the specialities and constraints of the cooperative banking sector. The aim of this research is to identify context-related activities as performed by individual cooperative banks that are induced by market, organisational and regulatory forces to achieve sustainable performance. It hereby follows the definition of bank strategic management by Rolfes (2008) stating that “bank strategic management is the aggregated term for an integrated income and risk oriented business model of financial institutions”.

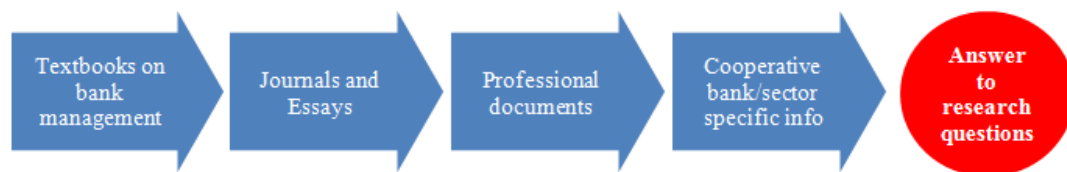
Aiming specifically not to follow an advanced theoretical PhD route and to combine academic and professional practices, the aim of this research is also to design solutions for cooperative banks that this author can apply to existing and potential clients. At the beginning of this project it was evident that compliance with requirements will be a long-lasting task with tremendous potential and need for advisory services. This especially relates to future capital and liquidity planning procedures. Hence, it was envisaged to design quantitative models that can be used to implement Basel III and market driven performance improvement initiatives. Due to the still on-going adjustments of regulation and importance, the focus was set on the design of a financial model for *equity/capital* adherence (section 6.1.4). Even though not described in all detail, the development of this model comprised a major part of this project. Description of the outcome in this work is in no relation to the work behind the model. Still, this author takes confidence in the fact that, in the context of the DBA with its practical relevance, the audience does acknowledge the scope of input required in order to make it operational and presentable as part of a real-life project that serves client needs. Regarding *liquidity*, the same financial model is used as basis, however, as per the end of this project (end of 2013), exact parameters were still vague with regulatory adherence being compulsory at a later stage (see section 5.4.1.3). Hence, only preliminary calculations were made with the optimization of the model postponed to 3rd quarter 2014.

### 1.3 Preliminary literature analysis

The link to existing literature plays a vital role in the design and structure of this research. The banking industry and especially the German banking industry is very special compared to other industrial sectors. It is essential to outline the mechanisms and limitations in order to derive at comprehensive and usable findings.

The first step in identifying relevant literature as part of the research design process, therefore, was to identify key concepts and theories that were deemed necessary to support the research questions this author had in mind and also to provide for more focus in the thesis structure. The idea was to filter and narrow existing information down to the focus of this project. The literature in this context was aggregated in the following clusters.

Figure 2: Literature logic



#### 1.3.1 Textbooks on bank management

Unsurprisingly, this source of literature is vast. A simple search on the website of a leading online bookstore lead to more than 18.000 search results. This author based on his previous studies as well as professional insights into literature applied by bank managers concluded that there are two main subclusters that are covered by authors usually considered to be best practice.

Field	Title	Author
Bank Operation	Ertragsorientiertes Bankmanagement	Henner Schierenbeck
	Gesamtbanksteuerung	Bernd Rolfes
Accounting	Handbuch Bankbilanz	Paul Scharpf
	Bankbilanzierung nach HGB und IFRS	Hartmut Bieg

Also due to language but mainly due to national specialities, no books in foreign languages have been identified to be in use by experts in Germany, neither have additional books been identified to be of additional use to this project with regard to the fields stated above. All textbooks, in this author's conclusion in regard to this project, have two limitations:

a) They are descriptive. Textbooks usually describe standard scenarios, i.e. they only provide insights on how to do things right. Ideas on how to do things better are usually not considered.

b) They are general. Textbooks usually assume the existence of a shareholder oriented bank that is run on a stand-alone basis, leading to a large range of options. Cooperative banks are stakeholder oriented banks organised in a national network.

Due to these limitations, textbooks are mostly considered for thick descriptions with additional conclusions to be drawn by this author in connection with other literature of other clusters.

### **1.3.2 Journals and Essays**

Due to the specialised nature of cooperative banks, a review and search for relevant academic sources was conducted. At the starting point, the *Journal of Banking and Finance* was identified and considered to be a reliable source of information based on previous experience. Articles considered being helpful concern the analysis of performance issues among banks and banks in different countries as well as the description and analysis of regulatory issues. Additional journals with banking relevance were also reviewed including *Journal of Banking Regulation*, *Banking and Finance Review*, *Journal of Money, Credit and Banking*, *Global Journal of Finance and Banking Issues*, *Review of Banking & Financial Law*, etc. The identified lack of these information was concluded to be the non-existing focus on cooperative banks in particular. This fact, coming as no surprise to this author, confirmed the perceived lack of literature in this field. The reason for this was concluded to be the specialty of the German cooperative banking in the overall banking market with a strategic set-up

that is not comparable to other banking systems anywhere in the world. The journals mentioned before, having an academic focus, focus predominantly on internationally accepted and common rules of operation.

Following up further on academic papers, a good source of information was identified to be Working Papers that were published by one special department of the *University of Münster* (Germany), which focuses on the cooperative sector in general, i.e. cooperative banking is one of several working groups. Several working papers have been identified to be useful in order to provide further coverage of cooperative banks. A review of these papers, however, also pointed to the fact (and limitation) that level and content is highly academic and also theoretical. As with most existing literature, it lacks practical relevance and identification of the need for action and associated measures for improvement.

Next to the review of academic journals, attention was paid to German journals and magazines with a focus on banking in general. The journals reviewed included *Die Bank* as main resource, *BankPraktiker*, *Zeitschrift für das gesamte Kreditwesen*, *Bankmagazin* and *Bank+Partner*. Compared to the international journals, the German ones clearly had a stronger focus on the domestic market. They also cover all major banking trends and helped identifying and describing impact drivers. However, the same finding as with the international journals applies, i.e. the lack regarding the cooperative banking sector from an overall banking perspective.

### **1.3.3 Professional documents**

The third pillar of literature investigated and applied were documents/studies by professional organisations, which were defined as all organizations being non-academic. Following this definition, identified organisations included private companies, e.g. consulting and audit companies such as McKinsey, Deloitte, etc., as well as supranational organisations, e.g. European Central Bank, Deutsche Bundesbank, ILO, CEPS, International Monetary Fund, etc.

Both sources, especially the private companies, show a high practical context and applicability to this project. The perceived gap is the missing focus to the specialities of the cooperative banking sector. However, the ideas and suggestions provided were identified to be a suitable starting point for the remediation action to be derived.

#### **1.3.4 Cooperative bank and sector specific documents**

The availability of literature on corporative banks has been identified to be rather limited. The best sources regarding the cooperative banking sector are without a doubt the documents made available by the BVR. These documents are in general rather analytical, describe structure and standing of the cooperative banking network. Examples include the *Consolidated Accounts* for the network as well as other reports regarding influencing drivers.

Additional information was also identified to come from daily newspapers with a focus on financial news, being *Handelsblatt*. Covered here are predominantly the two central institutions as well as the network in general. Also, regulatory issues are illustrated on a very high level. Individual cooperative banks and their situation are not outlined. In addition and even though cooperative banks or the sector is discussed including challenges faced, there is no indication regarding measures for improvement in order to overcome the challenges.

One vital document in this cluster is the actual *Cooperative Act*. Introduced in 1889, it governs the cooperative sector in general. It comprises 167 sections with compulsory regulations on how to act within and as part of the cooperative network, i.e. there is no distinctive reference to the cooperative *banking* sector in particular but rather general obligations. The analysis and interpretation of this Cooperative Act is essential for the outcome of this project since this illustrates the differences to shareholder oriented banks.

With regard to cooperative sector literature, a good source of information was the *Zeitschrift für das gesamte Genossenschaftswesen*. As a journal on the cooperative sector in general, there is only a small focus on the cooperative *banking* network.

The search for books on the cooperative banking sector was primarily conducted via key word search on relevant search engines by German university libraries and online book stores. Next to the official publications by the before mentioned *University of Münster*, there was only a handful of books that focus on staff management, marketing and comparisons with the savings bank sector.

### 1.3.5 Basel III specific documents

In summary, the Basel III standard is a voluntary framework developed by the Basel Committee on Banking Supervision (in the following: "BCBS") being part of the Bank for International Settlements (in the following: "BIS"). The BCBS has issued several publications on this topic on standards, guidelines, sound practice and implementation. The BCBS has also put together a "compilation of documents that form the global regulatory framework for capital and liquidity"<sup>4</sup>.

While undoubtedly associated with this research, literature does not assist sufficiently in dealing with the distinct phenomenon of the Basel III impact but rather builds the principles for actions and options to take. When referring to studies, these can be distinguished into academic and practical<sup>5</sup>. Academic studies mainly investigate the impact of Basel III on macroeconomic variables such as reaction of banks in terms of interest rates and loan volumes offered on a cross-country basis (e.g. Cosimano/Hakura, 2011; Mahapatra, 2012; Santos/Elliott, 2012). Practical studies usually also incorporate a European or international perspective, however, go a step further by suggesting options on how to respond and deal with operational issues of implementation (e.g. McKinsey, 2010; 2011; 2012; Morgan Stanley/Oliver Wyman, 2010-2013). No work on Basel III has been identified that comprehensively deals with impact on the German cooperative banking sector that also attempts to provide a framework to deal with the three identified most important themes *strategy*, *income* and *cost* on an integrated basis. Especially the implication for cooperative banks of small size in terms of total assets, which lack necessary scale, is considered to be worthwhile investigating.

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<sup>4</sup> see [bis.org/bcbs/basel3/compilation.htm](http://bis.org/bcbs/basel3/compilation.htm)

<sup>5</sup>see chapter 5 for additional impact studies from a micro-economic and macro-economic perspective

## 1.4 Research questions and structure

Following up on the work of Cormack/Benton (1996), two types of research questions can be distinguished, being interrogative and declarative. An interrogative question typically is a question that points to a gap in knowledge, while a declarative question typically is a statement further defining the study purpose. With reference to this work, the overall research theme and purpose is of declarative nature. However, in order to derive at this theme, interrogative questions as stated are asked comprising all individual elements of the research field.

The research questions were developed in the course of the researcher's professional employment and interest. This approach follows the statements by Carson/Fairbairn (2002) who state that "research questions are not grasped out of thin air but are the choice of the researchers in the field. Questions are developed from a particular theoretical perspective that a researcher chooses, and answers to these questions relate directly back to the research's theoretical perspective; the choice of research question will have a direct influence on the answers received". In this context, following James (1993), this author did "not arrive empty minded in the field".

The actual research questions represent the result of a "pinpoint exercise", i.e. the questions were first drafted by this author, discussed with several practitioners and then fine-tuned to provide for a maximum of practical relevance while applying and developing theories/knowledge to eventually make a contribution to both theory and practice in the chosen field of operation.

Having not only linked the research questions to a theoretical perspective, the entire structure was built around the provision of a certain outcome. This outcome, usually referred to as *output*, represents the envisaged answers that will be used by the author as core topics in his professional life.

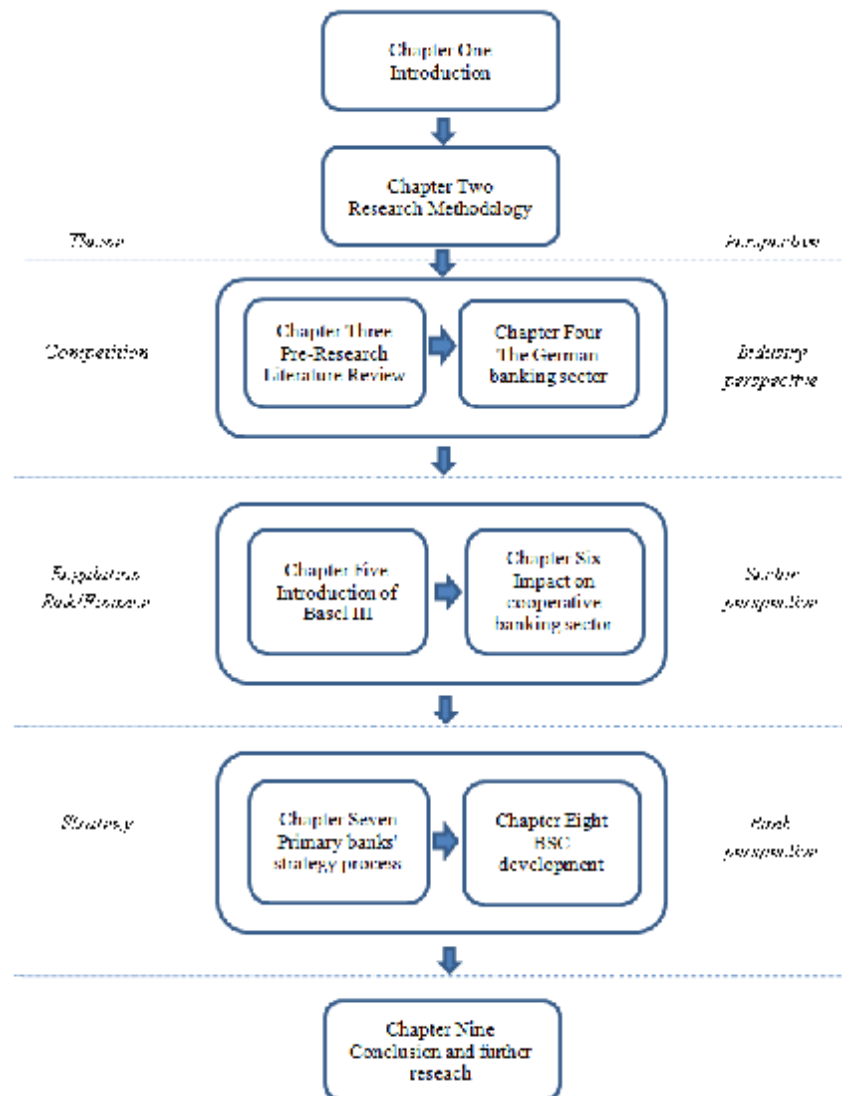


Figure 3: Research questions and expected output

Research Question	Output
Are the cooperative banking strategy and the shareholder value concept two contradicting approaches from the perspective of performance management?	Conclusion on performance feasibility
Is the cooperative banking model an economically viable business model from a German and European perspective?	Economic reasoning for existence of cooperative banks
What is Basel III, what does it mean to the financial services industry and what is the applicability to cooperative banks?	Conclusion on regulatory relevance
What responsive actions can be taken by cooperative banks to maintain sufficient financial performance in the future?	Identification of strategic options available plus Basel III data model
What is the set-up of the management process of cooperative banks, what methods and instruments are used and where is potential for improvement?	Indicators for strategic improvement
Is the Balanced Scorecard a comprehensive tool that can be used in cooperative banks to enhance their performance?	Blue print Balanced Score Card

In order to provide for more structure and focus and also deemed to elevate the quality of this project, research has been divided into three *themes* with two chapters each. The structure was specifically set up, so that each chapter can address one research question raised. While focussing on individual chapters, the research questions are aggregated in accordance with the research themes. Also based on the origin of the research as outlined in section 1.2, this research narrows down the focus in the process from an industry perspective looking a competition (Theme One) to a sector perspective looking at regulation in terms of risk and finance (Theme Two) to a bank perspective looking at strategy (Theme Three).

Figure 4: Overview of thesis layout



### *Theme One (Competition)*

Due to the very unique structure of the German sector with a very high number of banks and branches, tough competition and low profit margins, it has been decided and deemed necessary to further analyse this sector and, in particular, the cooperative banking sector from the perspective of bank theory and to identify sustainable competitive advantages. This analysis builds the ground for the identification of impact on and response of cooperative banks, i.e. it highlights what is going on and what is possible in terms of performance management going forward. The conclusions need to be brought into a competitive framework, i.e. the cooperative banking sector needs to be compared. The comparison to be conducted needs to encompass two dimensions: performance in the light of the German market composition (micro level) and contribution to the overall financial stability (macro level).

### *Theme Two (Regulation Risk/Finance)*

Setting not only the ground and framework, but especially outlining the restrictions and limitations of the cooperative banking sector, it leads to further questions building up this. With the previous research questions focusing predominantly on conditions already occurred and in place, i.e. the here and now (Ex-Post), it is essential to consider the future direction of market and regulatory forces. The financial crisis has elevated the awareness for proper regulation and enforced the status of the BCBS as the most influential standard-setter in the financial world. One term has been and still is at the forefront of any decision-maker's agenda: Basel III (or the Basel III Accord). Basel III is the latest reform measure by the BCBS in order to provide for more resilient banks and banking systems. It incorporates a number of instruments and parameters to be adhered to but predominantly focuses on capital. It hereby continues to build upon the previous Basel Accords but goes way beyond requirements to date. While major international banks are still negotiating with standard-setters regarding the starting date as well as individual requirements, medium-sized banks are preparing for the implementation and ask professional advisors for advice.

In this context, it is essential to transfer requirements of the Basel Accord to the real professional world, which is more complex and not as straight-forward as non-professionals commonly believe. The basis of this is the understanding of the status and relevance of capital within a financial institution. Reflecting on the previous crisis, regulators refer to capital as a key element in restoring confidence. The Financial Stability Review by Deutsche Bundesbank (2011) stated: “However, in times of systemic stress, markets cease to make broad-based distinctions because, supposing an exogenous shock actually triggers a systemic crisis, it is almost impossible ex ante to forecast the position of an individual bank. In such a scenario, the task of restoring confidence is not merely the responsibility of an individual bank but also a call to arms for the system as a whole. Given the high degree of interconnectedness and the risk of contagion, this challenge demands not just an adequate capitalisation of national banking systems but also convincing solutions that are coordinated across Europe.” Capital adequacy in this context serves as internal buffer to cushion risks employed and financial stress. Being a professional advisor, this researcher could not find sufficient information on the response of cooperative banks and what needs to be done in order to comply with regulations. The approach to this topic entails a thorough analysis of the proposed Basel III framework first before moving on to identifying the impact on cooperative banks and, even more important, possible responses.

### *Theme Three (Strategy)*

Upon understanding the effects of regulatory and market forces on the cooperative banking sector, it is essential to evaluate and transfer this understanding to an organizational level in order to identify idiosyncratic effects and determine future direction and strategy development. Porter (1996) says strategy is “about being different. ... It means deliberately choosing a different set of activities to deliver a unique mix of value”. Given the scope of regulation, numerous change initiatives are to be addressed that will adjust the way strategic decisions are made. Strategy development in the pre-crisis area had become increasingly bottom-up and emergent. In the here and now, strategy as expressed in banks’ business models need be

adjusted top-down. Johnson/Scholes (1993) broaden the definition of strategy and say: “Strategy is the direction and scope of an organisation over the long term: ideally, which matches its resources to its changing environment and in particular its markets, customers or clients so as to meet stakeholder expectations.”

The approach to this question entails the analysis of the current strategic management process in cooperative banks. Existing literature is limited with regard to the Status Quo, hence, an analysis needs to be conducted to identify improvement potential before moving on to the next step. The next step involves the investigation of real life settings. In particular, it is tested how the Balanced Scorecard (BSC) can be used and if the statements made by individual authors (e.g. Kipker, 2004) regarding the non-applicability of a basically single set of indicators holds true.

## 2. Research Methodology

Chapter 2 describes the approach to this Project and outlines the research approach, research design, research methods, data collection and analysis, data quality and research philosophy. It also explains the linkages between the themes and chapters as visualized by the arrows.

This researcher acknowledges the idea of Crotty (1998) who stated that there is no one way to approach a project. Rather, it is various theory elements and their mixture that provide for the most appropriate way to approach the research questions.

### 2.1 Philosophical considerations

Prior to conduct research, there are several questions that need to be considered (Gill/Johnson, 2010), especially 'What to research?' and 'How to research?'. The central question, however, is 'Why research?'. The reasons why this researcher chose this topic were outlined before. Also, before starting to research and given the topic and envisaged outcome, this researcher decided that a combination of various methods, being quantitative and qualitative, was going to be necessary. However, next to practicalities this researcher acknowledges that the question of 'Why research?' also requires a philosophical solution.

Burrell/Morgan (1979), proving the most comprehensive framework on research philosophy, stated that every researcher needs to consider assumptions regarding two dimensions, i.e. the nature of science and the nature of society. This research, as assumed by this researcher, concentrates on society, which involves an *objective* or *subjective* approach as outlined by Burrell/Morgan (1979). Other authors referred to these approaches as phenomenology and positivism (Easterby-Smith et al, 1991) or positivism and interpretivism (Hughes/Sharrock, 1997). These approaches involve assumptions regarding ontology (reality), epistemology (knowledge), human nature and methodology.

As outlined before, ontology refers to reality and to consideration regarding what is studied as well as the researcher views reality, hence influencing all other assumptions. Epistemology considers what the basis of warranted knowledge about our chosen domain is. It implies that reality is out there, hence, objective, and to be discovered with related knowledge transferable to others. While human nature deals with the status of man being either controlled or the controller, methodology deals with tools available to researchers.

There have been numerous discussions about the question whether there is a right perspective. Some sort of consent has been achieved regarding the stance that a right or wrong approach does not exist. E.g. Hughes/Sharrock (1997) state that guidance to the right philosophical stance cannot be provided.

This researcher concurs with the opposing view of a single appropriate way, i.e. he cannot state to be following one approach only. Instead he concurs with authors such as Patton (1990), Brannick/Roche (1997) and Gill/Johnson (2010) who urge the usage of a multi-method methodology, i.e. qualitative and quantitative methods, in order to improve results. Only in this application, research problem and methodology can be properly matched and the envisaged aim of this researcher be achieved.

While trying to illustrate the fundamental importance of theory in relation to practice, reference is made to Kolb et al. (1979) and his experimental learning cycle that distinguished between processes of *inductive* and *deductive* learning. Transferring these conclusions to management research, *deduction* as outlined by Gill/Johnson (2010) "entails the development of a conceptual and theoretical structure prior to its testing through empirical observation of the facts 'out there' in the world through data collection." *Induction*, on the other hand, moves from the 'plane' of observation of the empirical world to the construction of explanations and theories about what has been observed, i.e. in contrast to deduction theory grounded in observation is the outcome of induction.

With regard to this project, this author concludes that there is no clear cut separation between *induction* and *deduction*. The reason for this approach is derived from the organisation of the German banking market and the nature of cooperative banks (see section 4.2). While private banks follow strict market principles as part of their shareholder value strategy, a clear cause-effect relationship as incorporated in deduction can be expected. Cooperative banks do not follow strict market principles, hence, their behaviour cannot be predicted to the same extent as private banks. The reasoning used in this project, hence, is similar to that of *abduction* as discussed by Charles Peirce and outlined in Richter (1995). Here, it is stated that „Deduction proves that something must be; Induction shows that something actually is operative; Abduction merely suggests that something may be”.

The same logic applies to the mixed use of the conceptual pair of "*Erklären*" and "*Verstehen*" as originally discussed by Max Weber and outlined in Bryman/Bell (2007). In reference to Outhwaite, Gill/Johnson (2010) define *Erklären* "as necessary responses to the action of empirically observable, measurable and manipulable stimuli, causal variables or antecedent conditions. Since subjectivity is excluded from *Erklären* (German word for explain), it is typically excluded from social science. Behind this is the rationale that human action has an internal logic of its own which must be understood in order for researchers to be able to make that action intelligible and explicable. The aim of social science is to access and describe this internal logic through a separate approach called *Verstehen* (German word for understand). However, it needs to be stated that some level of subjectivity is present in all forms of enquiry.

Both alternatives for concept and reasoning are and need to be applied in order to derive at the desired outcome. In reference to the thesis layout in section 1.4, the following broad distinction can be made:

- Chapter 3 focuses on the observation and understanding of the cooperative banking sector and its management principles in contrast to relation to other or private banking groups as a starting point for further considerations. Hence, an inductive and *Verstehen* approach is applied.



- Chapter 4 and 5 primarily focus on the hypothesis that cooperative banks need to adjust their strategy with regard to finance and organization in response to regulatory and market forces in order maintain competitiveness (with a focus on Basel III). Hence, a deductive and *Erklären* approach is applied by testing the hypothesis through observation of the empirical world, i.e. via data collection using research methods.
- Chapters 6 - 8 focus on data collection and analysis processes to develop theories by understanding the subjective dimensions and operations of the cooperative banking sector in the context of the conclusion of the previous chapters. Hence, an inductive and *Verstehen* approach is applied.

The distinction above follows a pre-defined research plan that is outlined hereafter.

## 2.2 Research Design: the methodological continuum

Research design, as described by Yin (2003) is a *logical* plan for getting from an initial set of research questions to be answered to some set of conclusions. In this regard, it is the structure or design that is needed by social research before data collection and analyses starts. The aim of the research design is there is sufficient evidence gathered to answer the research questions. In summary, the research design illustrates the path of the answer to the following question: What evidence is needed?

Kirshenblatt-Gimblett (2006) state that research design and research method are different issues even though many researchers confuse research design with research method: "It is not uncommon to see research treated as a mode of data collection rather than as logical structure of the inquiry. But there is nothing intrinsic about any research design that requires a particular method of data collection..... How the data are collected is irrelevant to the *logic* of the design."

Approaching this project, this researcher, when designing his research, had a clear overriding goal, i.e. bringing transparency into the challenges of the cooperative banking sector and options available to deal with them. The envisaged transparency was broken down in research questions and expected output as defined in section 1.4.

Upon defining what this researcher needs to know and needs to obtain as a deliverable from the research process, suitable methods for acquiring this output were designed.

In summary, the overall research design or logical plan, which builds upon and enhances the research questions in section 1.4, is illustrated as follows:

**Figure 5: Overall Research Design**

Research Question	Output		Strategy	Data collection method	Data source
Are the cooperative banking strategy and the shareholder value concept two contradicting approaches from the perspective of performance management?	Conclusion on performance feasibility	➔	Evaluation Research	Document analysis for qualitative evaluation	Academic Textbooks; Cooperative sector specific documents
Is the cooperative banking model an economically viable business model from a German and European perspective?	Economic reasoning for existence of cooperative banks	➔	Time Series	Secondary data analysis	Official statistics; Organizational data
What is Basel III, what does it mean to the financial services industry and what is the applicability to cooperative banks?	Conclusion on regulatory relevance	➔	Evaluation Research	Document analysis; Secondary analysis; Interviews	Academic articles; Organizational documents; Regulators
What responsive actions can be taken by cooperative banks to maintain sufficient financial performance in the future?	Identification of strategic options available plus Basel III data model	➔	Evaluation Research; Action research	Focused groups; Interviews; Observation	Cooperative bank managers/staff
What is the set-up of the management process of cooperative banks, what methods and instruments are used and where is potential for improvement?	Indicators for strategic improvement	➔	Survey	Questionnaire	Selected sample of primary banks
Is the Balanced Scorecard a comprehensive tool that can be used in cooperative banks to enhance their performance?	Blue print Balanced Scorecard	➔	Case Study, Action Research	Focused groups; Interviews; Observation	Cooperative bank managers/staff

The first step in designing this research project was the strategy to have two major elements to be considered from a cooperative banking perspective that consist of

- the analysis of regulatory and market forces as well as
- responsive actions in terms of finance and organisation.

Given the background of the researcher and the aim of this research, the design had to be flexible, i.e. a combination of research methods was necessary. In particular, the aim regarding research approach was to move from a desktop approach over discussions with interview partners to a field study or project since a great deal of research needed to be conducted in real-life settings. The aim is also the rationale behind the thesis layout (section 1.4) moving from theoretical contexts to on-site field work.

The figure above starts with outlining the initial thoughts, ideas and aims that were considered upon the introduction of the phenomenon that gave rise to this research project (Basel III and changing competitive landscape). After defining the research questions, new and existing theoretical data and literature were gathered and synthesised to provide for a new or adjusted model, the adjusted balanced scorecard for the cooperative banking sector. This aimed at answering the research questions by describing, explaining, and identifying phenomena and as-is situations in the industry, sector and entities.

## **2.3 Choice of research strategy and methods**

### **2.3.1 Individual considerations**

The actual choice of research strategy (and methods) was mainly influenced by the researcher's *professional experience*, the *objective of the project* and *access to data*. These practical considerations were then translated into methodological dimensions, i.e. it was considered, whether *qualitative* or *quantitative* methods were more appropriated to derive at the expected output.

### **2.3.1.1 Professional occupation**

As outlined in section 1.2, this researcher has been in full-time employment since 1999 and occupied a senior management role in a financial services audit department during the course of this research. This status helped elevate this project and enhance validity of research on three levels. *First*, due to the experience available the research questions could be adjusted with a high level of practical relevance for this researcher as well as other professionals working in this field. *Second*, due to his position it was possible to gain hands-on access to cooperative banks and management staff that would otherwise, e.g. for regular research students, not be possible. *Third*, it provides for professional judgement of research findings. Professional experience itself is considered to be a supporting role only, since the research to be undertaken has not been part of this researcher's responsibilities nor has it been discussed with banks in particular prior to this project.

### **2.3.1.2 Objective of this study**

The objective of this study is to explore the performance and strategic management process within a specific context, i.e. the way German cooperative banks deal with today's challenges, which are mainly and directly influenced by the regulatory Basel III framework but also by the overall competitive environment in the German banking market. The nature is on discovering how cooperative banks react to this development and identify factors and indicators how to improve the status quo. There is no focus on a special hypothesis to be tested. This research is based on

- the understanding of what is going on in the German banking sector, compared to existing literature, and the identification of where the cooperative banking sectors stands,
- the identification of the impact of Basel III on individual cooperative banks,
- exploring how the strategic management of individual cooperative banks can be adjusted to deal with the new competitive and regulatory landscape, especially by looking at options and initiatives available and not available.

The objective in this context is also a clear distinction to the otherwise theory-driven content of a PhD thesis. The study was meant to be a combination of theory and practical applicability with a focus on field studies with the parties directly concerned, i.e. regulators, network representatives and cooperative bank managers. The objective was to create the foundation for future projects of this researcher with other cooperative banks that place a premium on practical and hands-on experience and approaches. In detail, this researcher wanted to be on "eye-level" when talking to other cooperative bank managers with a well-developed knowledge of challenges of primary banks.

### **2.3.1.3 Access to data**

The researcher's main interest is to investigate a cause-and-effect relationship. The cause represents challenges on a banking sector level. Access to relevant information with regard to statistical data on an aggregate and also macro-economic level is therefore essential, especially in order to provide the ground for the *as-is* situation. Combining different statistical and sector specific data sources with bank theory is seen as an essential part.

While statistical data is available on an aggregate level only, it is essential for the purpose of this research to get individual cooperative bank information and hands on experience from cooperative bank or network executives in order to narrow down the focus on the typical primary bank. Gaining access to these individuals and getting information from them was also elevated by the researcher's professional employment. Next to having been in contact with several people in the course of past projects, the researcher's personal network also allowed for getting in touch with cooperative bank executives that have relevant information for the purpose of this project.

Reference is made to the limitations of data access. Several attempts to get in touch with the Cooperative Network Academy<sup>6</sup> have been made, however, direct contact

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<sup>6</sup> Akademie Deutscher Genossenschaften ADG, see [www.adgonline.de](http://www.adgonline.de) (German only). The Academy is provider of development trainings for cooperative bank staff with a focus on practical training for individual banking topics, e.g. securities, personnel, etc.

and the opportunity to visit individual seminars aimed at primary banks were declined due to the fact that this researcher was not part of the cooperative network. Also, participation or access in online discussion groups with rather general orientation was declined.

### **2.3.2 Methodological considerations**

#### **2.3.2.1 Quantitative vs. qualitative research**

Referring to Bryman/Bell (2007), *quantitative* research can be summarized as "entailing the collection of numerical data and exhibiting a view of the relationship between theory and research as *deductive*, a predilection for a natural science approach and as having an *objectivist* conception of social reality". By contrast, *qualitative* research as described by Bryman/Bell (2007) can be constructed as "a research strategy that usually emphasizes words rather than numbers in the collection and analysis of data". It "predominantly emphasizes an *inductive* approach to the relationship between theory and research, has rejected the practices and norms of the natural scientific model and of positivism in particular in preference for an emphasis on the ways in which individuals interpret their social world and embodies a view of social reality as a constantly shifting emergent property of individuals' creation". Both methods have several strengths as well as limitations. Hughes (2013) provides a well developed overview of both approaches that deals mainly with data quality issues.

In order to provide for quality in the research process, certain *quality requirements* need to be fulfilled. According to Lamnek (2005), these quality requirements serve as targets and milestones. Due to different intentions, different requirements are applied to quantitative and qualitative methods. While a number of precisely defined criteria have been defined for quantitative research, the transfer of these or acceptability in general for qualitative research is considered limited (Steinke, 1999). There is no generally accepted concept for qualitative research, which, according to Tashakori/Teddlie (2003), is due to the fact that qualitative researchers were not keen to deal and argue with quality aspects of their work. Three of the most prominent criteria regarding quality and evaluation of methods are *reliability*, *validity* and

*replication* (Bryman/Bell, 2007), while especially reliability and validity are further referred to by most authors as applicable to both research methods.

*Reliability* is evaluated using the concept of “repeatability” and, as Bryman/Bell (2007) describe, refers to the question whether measures are consistent, accurate and stable, which is more of an issue in connection with quantitative research.

Bortz/Döring (2006), in this context, distinguish two types, objectivity and intersubjectivity.

- Objectivity, usually connected to quantitative research, is explained as a “personal consensus”, meaning that different researchers investigating the same issue using identical methods must derive at comparable or similar results. It requires a high degree of transparency and standardisation to eliminate subjectivity. With reference to the quantitative part of this research, the criterion is met by applying analytical methods to statistical data aggregated.
- Intersubjectivity, usually connected to qualitative research, tries to establish a similar or comparable basis in the data collection process, e.g. interview questions regarding the research object are adjusted to individual interviewees’ experience and knowledge. With reference to the qualitative part of this research, the application of this criterion is not entirely possible and realisable. While Theme One as well as Theme Two fulfil the criterion by analysing current, static and historical data, the action research element of Theme Three has limitations. The establishment of similar or congruent interview situations is not possible due to the continuous changing and enhancing knowledge of the experts as a direct consequence of the concretion and extension of regulatory requirements. However, criterion fulfilment is tried to be established as far as possible using a pre-defined concept and framework on a level that allows for the adjustment of individual elements by focussing on the main implications looking forward.

*Validity* is usually regarded the most important quality criterion and, according to Bryman/Bell (2007), concerned with the integrity of the conclusions that are generated from a piece of research. Regarding quantitative research, writers often further distinguish between internal and external validity (e.g. Lamnek, 2005). *Internal* validity deals with the issue of causality and with the question “whether a conclusion that incorporates a causal relationship between two or more variables holds water” (Bryman/Bell, 2007). *External* validity deals with the issue of generalisation and with the question “whether the result of a study can be generalized beyond the specific research context” (Bryman/Bell, 2007). Regarding qualitative research, writers usually refer to ecological validity, which is concerned "with the question of whether or not social scientific findings are applicable to people’s everyday, natural social settings".

Regarding this research project, validity as well as safeguards for achievement were established as outlined hereafter in reference to McMillan/Schumacher (1997). Having a focus on qualitative research, internal validity was deemed to be achieved via the research design, external validity via the perceived and envisaged extension of findings based on data sources.

#### *Internal Validity ("credibility")*

The focus was on establishing the cause-effect relationship. In order to fully encompass and most appropriately comment of this relationship, professional occupation and opportunities to get in direct touch with cooperative bank personnel were applied. Based on this focus, the research design was drafted in order to provide for a high degree of mutual understanding.

Field work was carried out on a persistent and prolonged basis in order to enable a match between results or findings and reality as experienced by this author. As outlined, a step-by-step research design was designed to narrow the scope of work down from a general to an individual bank level.



Interviews with real bank managers and other professionals concerned with this issue were conducted with quotes taken down during the process that are provided in this work. Situations and professionals that were made contact with were all documented to provide for an audit trail. As practiced by this author, documentation was mainly done via hand-written records.

Frequent checks with real life bank managers and other professionals were conducted in order to provide for accuracy and the achievement of a "round" process. The process of regular interaction with these participants also provided for the accuracy of findings.

#### *External Validity ("transferability")*

As mentioned before, there was regular and in-depth contact with cooperative banks. This was achieved via this researcher's role as a statutory auditor. While this enables direct contact it should be stated that professional duties and care was applied, especially independence. It should also be stated that subjectivity in this context was reduced. It is also pointed out that this research was not based on this researcher's experience but rather on the lack of experience in this specific field that was envisaged to be bridged. Also, research audience is expected to have no problem in judging this author's conclusions and opinions giving the logical approach supported by economic principles.

Participating banks were all primary banks and fit very well characteristics of normal cooperative banks. Due to the uniform business model of the cooperative banking sector as well as the identical pressure coming from external forces, transfer of findings from the field study banks can easily be achieved to all primary cooperative banks that are bound to the cooperative mission.

In terms of quantitative data used and applied, transferability is provided giving that specialised or public data was used as provided by specialised institutions.

*Replication* is usually applied when it is assumed that original results do not match other evidence (Bryman/Bell, 2007). More important, replicability is necessary. With regard to the quantitative part of this work, replication as well as replicability is established via the reference to available data using established mathematical models within a time-series analysis. With regard to the qualitative part of this work, replication is limited (see reliability for arguments).

Next to the outlined three criteria, reference is often made to *generalisation*, i.e. the transfer of findings to the real world. Regarding quantitative research, generalisation is usually connected with representativeness, which is provided if the sample used in research has comparable characteristics to the population, resulting in a possible transfer of findings of the sample (Brosius/Koschel, 2001). To achieve this, probability sampling is usually applied by using a process of random selection in order to eliminate bias. With regard to this research, representativeness is limited. As outlined in Theme Two, the sample was chosen by defined criteria and consists of banks that are not entirely representative to the population. Statistical representativeness is not claimed, however, the findings and conclusion can and should be regarded as ‘indicative of broader trends’ as also suggested by Scase/Goffee (1989). Regarding qualitative research, generalisation is usually not established since participants are specifically chosen. Tashakori/Teddlie (2003) state: “For most QUALs, generalisation to other individuals, settings, and times are not desired.” However, as Lamnek (2005) points out, generalisation can be established via the use of “typical” cases and participants. With regard to this research, generalisation could be established via the selection of participants that all have an in-depth knowledge of bank management and/or regulation as well as decision-making powers (in terms of strategy and Asset-Liability-Management) in order to transfer the findings to the population.

Overall, quality criteria reliability, validity and generalisation could be established to a sufficient degree in order to provide for adequate research quality.

While this author believes and concludes that limitations of research approaches have been reduced to an acceptable minimum on a stand-alone basis, he further deemed it appropriate to incorporate a structural enhancement by applying a combination of methods. By doing so, this author agrees with Bryman (1988) who argued for a "best of both worlds" approach and a combination of both strategies.

### 2.3.2.2 Mixed methods research

According to Bryman/Bell (2007), the term mixed methods research is used as a simple shorthand to stand for research that integrates quantitative and qualitative research within a single project. In this context, Hammersley (1996) proposed three approaches, being *triangulation* ("use of quantitative research to corroborate qualitative research findings or vice versa"), *facilitation* ("one research strategy is employed in order to aid research using the other research strategy") and *complementarity* ("two research strategies are employed in order that different aspects of an investigation can be dovetailed"). As outlined before, Bryman (1988) advocates *triangulation* by referring to it as "the use of more than one approach to the investigation of a research question in order to enhance confidence in the ensuing findings".

This author concluded that this approach is the most appropriate one giving the research topic and questions defined. He took confidence in this approach by comparing his approach with other prominent examples or research projects, which include:

- Kanter (1977): As a consultant, participant-observer and researcher in a case study of a single organization (Indsco), she used a postal questionnaire survey, semi-structured interviews, content analysis of appraisal forms, group discussions with employees, participation in meetings, participant observation, internal reports and conversations in offices, social gathers, etc.
- Truss (2001): As part of a longitudinal design on Hewlett Packard, she used questionnaires, focus groups, semi-structured interviews and secondary data.

## **2.4 Research strategies and data collection methods**

Having realized that a mixed methods approach is required to derive at the expected outcome, Bryman/Bell's (2007) book *Business Research Methods* was consulted to derive at and pick the most suitable strategy and method.

### **2.4.1 Research Question 1**

The intention of Theme One, which starts off with research question 1, is analysing the cooperative banking sector and distinguishing it from other banking sectors. As emphasised by Bryman/Bell (2007), the aim is to "seek explanations for similarities and differences" and to "gain a greater awareness and a deeper understanding of social reality in different national contexts" as well as the German context. This is done via a *comparative* research design.

This research includes a *cross-sectional* as well as *cross-national* perspective, thus making reference to Hantrais (1996) suggesting that such research occurs when researchers set out to examine particular issues or phenomena in two or more countries with the expressed intention of comparing their manifestations in different settings by carrying out secondary analysis of national data or new empirical work.

#### **2.4.1.1 Evaluation research**

Giving the research question designed, the most appropriate concept in terms of research strategy was identified to be evaluation research that is "concerned with the evaluation of such occurrences as organizational programmes or interventions" (Bryman/Bell, 2007). In this context it fulfils a specific purpose. The occurrence implied represents the potential measures to be taken by cooperative banks in order to improve performance. The concept of evaluation research is adjusted in a sense that it is applied to evaluate feasibility of performance measures. The outcome measurements required for this strategy are, hence, bank performance indicators such as operating profit or net income.

Bryman/Bell (2007), in reference to Greene (1994, 2000), discussed the problems in conducting qualitative, however, stated the "importance of an in-depth understanding of the context in which an intervention occurs and the diverse viewpoints of the stakeholders". Also, other authors, such as Pawson/Tilley (1997) favour a strategy which, as Bryman/Bell (2007) outline, builds upon "principles of critical realism that sees the outcome of an intervention as the result of generative mechanism and the context of those mechanisms. A focus of the former element entails examining the causal factors that inhibit or promote change when an intervention occurs". With regard to this research, this represents the exact starting point as a basis of further potential measures by contradicting strongly held beliefs. The causal factor is rooted in the cooperative mission with intervention being the regulatory and market forces.

#### **2.4.1.2 Document analysis**

*Document or Content analysis* refers to the search for underlying themes in the materials being analysed. The extracted themes are usually illustrated, e.g. with quotes from newspapers or magazines. The process through which themes are extracted is usually left implicit, even though authors such as Turner (1994) and Altheide (1996) advocate a structured approach.

Due to the special nature of the banking industry, there is a vast amount of written documentation. In order to understand the special role of cooperative banks and in reference to section 1.3, *textbooks* on bank management as well as *cooperative sector specific documents* are deemed relevant. Both clusters are first to be illustrated and explained. Subsequently, an analysis of the distinctive characteristics of cooperative banks is conducted.

In reference to Gray (2004), specific criteria and categories were identified in advance before the analysis process started. The intention behind this is to narrow the focus down, i.e. start with commonly agreed upon bank concepts and focus these to the cooperative sector. On a macro level, this approach starts by analysing documents explaining the very reasons for the existence of banks and how they can be categorized. This follows an analysis of the cooperative banking framework and

the overriding principle, being *member promotion*, as the basis for future management scenarios. In detail, *performance management* is analysed from a cooperative point of view in order to identify possible performance drivers.

### **2.4.1.3 Relevant literature**

As outlined before, there are two main sources of documents. Required for the analysis are specific literature on bank management and bank economics. Examples include Süchting/Paul (1998), Hartmann-Wendels (2010) and especially Diamond (1984), whose theory is still in place these days. Overall, the role of banks in the economic world has not changed significantly over the past 25 years, just the level of attention towards them. Required for the analysis of the situation of cooperative banks are in particular relevant publications by cooperative institutions, either national or international. Next to quantitative and historical data this refers especially to the Cooperative Law. Of utmost importance is the Corporative Act, which represents the legal operating framework. In a combined effort, both document sources need to be analysed and interpreted.

## **2.4.2 Research Question 2**

### **2.4.2.1 Time series analysis**

Aiming at analysing and interpreting quantitative data, a statistical modelling method was deemed required. Gordon (1992) described four methods of statistical modelling, being time series analysis, regression analysis, multi-equation models and simulation modelling. Time series analysis in this context refers to methods for analyzing time-series data in order to derive at meaningful statistics and other data characteristics. It compares values of a single time-series at different points in time.

Osborn (2010) illustrated three time series patterns, i.e. *trend* (change in level), *seasonality* (over the year) and *cycles* (e.g. recession). With regard to this research, trend and cycles are the focus. While exploring, statistical and visual approaches are used, supplemented by graphs.

Regression analysis as a means to predict future development is intentionally not applied in a quantitative manner. Per definition (Jupp, 2006), regression analysis is a "body of statistical techniques in which the form of the relationship between a dependent variable and one or more independent variables is established so that knowledge of the values of the independent variables enables prediction of the value of the dependent variables or likelihood of the occurrence of an event if the dependent variable is categorical". The aim of this study is not to forecast the development of the cooperative banking sector from a quantitative perspective, i.e. the objective is rather descriptive. However, the formal relationship between things is investigated, being the cooperative banking model as a stakeholder oriented approach as a dependent variable and several key performance indicators as independent variables.

Also, in order to investigate a sufficient time span, it is deemed necessary to apply a 10-year time horizon at least in order to find out how the cooperative banking sector performed during the time of financial crisis.

#### **2.4.2.2 Secondary data analysis**

In reference to Bryman/Bell (2007), secondary data analysis is "the analysis of data by researchers who will probably not have been involved in the collection of those data, for purposes that in all likelihood were not envisaged by those responsible for the data collection". Usual limitations associated with this approach were predominantly deemed non-applicable by this author, i.e. this researcher has been familiar with the data and is no stranger to the complexity of data. Also, data quality is deemed high, given that basically all data comes from regulated sources.

Giving the research question, it is required to analyse a number of key performance indicators that can be derived from aggregated financial statement data. Key performance indicators in the financial service industry can either be taken either from the financial statements directly or as calculated ratios.

Secondary data was identified to be needed for the quantitative analysis of the *German banking sector*, also in order to provide comparison with European

counterparts and especially to highlight the status of the cooperative banking sector within the German banking sector. Necessary were data collected by other researchers or institutions for other purposes than research, i.e. official statistics and other accounts kept by organizations.

### **2.4.2.3 Official statistics and organizational data**

Given the professional background of this researcher as well as the insights gathered during pre-studies, the "home" of data sources was widely known. In connection with the three characteristic problems described by Hox/Boeije (2005) the following was derived:

- 1) Locating data: Tracing data that meet the necessary requirements was approached by looking at bank specific supervising institutions (e.g. Deutsche Bundesbank, European Central Bank) and umbrella organizations (Bunderverband deutscher Banken, Deutscher Sparkassen- und Giroverband, Bundesverband der Deutschen Volksbanken und Raiffeisenbanken).
- 2) Retrieving data: All data necessary was available and accessible via the Internet and official websites of the before mentioned institutions and organizations. The data by the European Central Bank and Deutsche Bundesbank was the only data that was able to be downloaded as data files in Excel format (Statistical Data Warehouse). The *European Central Bank* collects data that form the basis for the level of monetary development. Data collected are on country levels and financial statement level. The *Deutsche Bundesbank* collects data based on segmentation by business model, i.e. there is separate data for cooperative banks, however, only aggregated and not on individual bank level. All other data was available in the form of documents only that had to be converted and input manually in Excel for relevant analyses.

In addition to the official statistics by agencies, there are also publications by *non-governmental departments*. In order to further elaborate on the financial performance of individual German banking or bank groups, publications by



banks or their umbrella organizations is collected, analysed and interpreted. The combination of both data sources has been deemed necessary and appropriate in order to find evidence for the sustainability of the diverse German banking sector as a whole and the cooperative banking sector in particular.

- 3) Evaluating data: The data provided by the institutions and organizations do not primarily aim to answer specific research questions.

While the data referred to above was only necessary and available on an aggregate basis, having the benefit that the data is not based on a sample, additional data on a more granular basis was required for the quantitative analysis of the cooperative banking sector in particular. In particular, data for individual banks were necessary, leading to the need for further secondary data sources. Individual cooperative banks are not required by law to publish *annual accounts* on their websites. However, aggregate data have to be published with the *Bundesanzeiger*, the general German company registry. While there is only web content available, the download of data is not possible. Reference to this data was made when deemed necessary in chapter 6.

In order to allow for a coherent and efficient way of collecting data, the specialised database *Bankscope*<sup>7</sup> was consulted. Setting the filter to cooperative banks in Germany by the last financial accounts available resulted in 1.651 banks. Of these, data per December 2011 was available for 960 banks. For the purpose of this work, data for banks per December 2012 (16 banks, including central institutions and other specialised institutions) and before 2011 (691 banks) were excluded since they are not considered primary banks. For only 362 of the 960 banks, Tier 1 ratios were available, however, no composition. While it was clear to this researcher that additional data was to be collected manually due to the lack of comprehensive data and the lack of publication requirements, focus had to be applied. For further analyses, hence, only cooperative banks with total assets between EUR 200 million and EUR

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<sup>7</sup>see [www.bvdinfo.com](http://www.bvdinfo.com); Database was accessed at Frankfurt School of Finance & Management, being the only University in Germany identified to have this database, on 10 November 2012 and 14 May 2013 to identify new data available

500 million were selected, resulting in 115 banks with average total assets of EUR 318 million as outlined by Bankscope.

Additional documentary data collection was necessary to provide for regulatory data of individual banks. In Germany, every bank is subject to the publication of the *Offenlegungsbericht*, i.e. the disclosure report on regulatory compliance in accordance with section 26a Banking Act. The report typically comprises 7-10 pages and is available online via the bank's website<sup>8</sup>. For the identified sample, disclosure reports were downloaded, aggregated and analysed (see chapter 6).

### 2.4.3 Research Question 3

The intention of *Theme Two*, which starts off with research question 3, is to analyse the drivers and map the change expected in terms of financial development to illustrate the development of certain key variables or performance indicators as impact of current regulation and competition. Bryman/Bell (2007) refer to this approach as *evaluation research*, i.e. research "concerned with the evaluation of such occurrences as organizational programmes or interventions. The essential question that is typically asked by such studies is: has the intervention (for example, a new policy initiative or an organizational change) achieved its anticipated goals?"

As outlined in chapter 4, the German banking sector and cooperative banking sector in particular entails a number of specialities. Being one of the Three Pillars in German banking, the cooperative banking sector entails a somewhat hybrid position, i.e. it is not run on a pure shareholder view but not entirely public either. Due to its decentralized structure, cooperative banks are small and the amount of information provided on individual or group of entities is limited. The aim of this research and contribution to knowledge is to analyse the status quo in the light of the central phenomenon (Basel III) and to identify impact and options available to build upon for future performance achievements by applying relevant instruments and concepts. The problem with this approach is that while individual cooperative banks are rather

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<sup>8</sup> Even though the reports are required to be published online by section 26a Banking Act, most banks do not provide the link directly on their website. Locating the report is only possible via Google search by "name of the bank" and "Offenlegungsbericht".

similar in terms of business model, the financial, strategic and regional setting in which they operate is different. Applying standard methods to improve performance as usually discussed in public with reference to private banks without accounting for the special nature of these banks would result in pre-decisions that might not be realisable and pre-interpretations that might not be applicable.

#### **2.4.3.1 Evaluation research**

As with research question in section 2.4.1, *evaluation research* is deemed to be the most suitable research strategy in order to derive at relevant answers. To understand possible responses by cooperative banks, it is essential to, first, understand the reason and rationale behind the proposed regulatory framework. This is of essential importance, giving that regulatory frameworks do not distinguish between different business models when deciding upon it.

Next to the discussion of regulatory theory and the development of previous frameworks it is necessary to provide a thick description of facts. The aim is to provide a focused view on the applicability of the Basel accord and a comprehensive set of arguments in this regard.

#### **2.4.3.2 Document analysis and secondary data analysis**

In reference to sections 2.4.1.2 and 2.4.2.2, document analysis and secondary data analysis are deemed relevant data collection methods in order to gather sufficient evidence. This method, being predominantly a desktop approach, grounds in the fact that there are actual written requirements on what to do leading to the ground for discussions and basis for further collection methods.

In order to derive at conclusions regarding the impact of regulation on cooperative banks, it is also essential to analyse previous initiatives from a performance perspective on cooperative banks. In reference to section 2.4.2.2, secondary data needs to be evaluated to assess the impact of Basel II also as part of a time series analysis.

### 2.4.3.3 Interviews

Next to the before mentioned analysis of documents and statistical information, data collection occurred via interviewing being both, *unstructured* and *semi-structured* (Bortz/Döring, 2006). This was deemed necessary in order to narrow down the focus and provide a bridge from theory to cooperative banking reality. Also, since research took place during full-time employment as an auditor in the financial service industry, contacts were used in order to exploit existing research opportunities.

Unstructured interviewing tends to be very similar in character to a conversation (Burgess, 1984), which was deemed an appropriate approach when dealing with this question, since this researcher already had substantial professional expertise and could talk with the interviewees on an advanced level. There were only a few questions formulated in order to allow the interviewee respond freely, bring up new questions in the course and allow for flexibility during the interview. An interview guide was developed in order to provide for a schedule. Used were predominantly open questions in order to allow for respondents to answer in their own terms.

### 2.4.3.4 Literature and interviewees

Core literature to be considered is Basel III specific documents as outlined in section 1.3.5, i.e. manuals by the Basel Accord setters, the Bank for International Settlements. Providing the technical details and standards on what regulations have to be complied with, these are enriched with relevant knowledge by practitioners.

Interviewees on this research question were predominantly cooperative bank managers in order to gather field experience and insights on how regulation is viewed and dealt with in practice. It was agreed that no individual names are to be stated in order to provide for anonymity.<sup>9</sup> Theoretical sampling was applied in order to cover this researcher's interest. All interviews were conducted in German and translated into English by the researcher. Duration of the interviews was between 45 and 120 Minutes, with notes taken during the course.

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<sup>9</sup> For the interview guide and list of interviews conducted refer to Appendix 10.2

#### 2.4.4 Research Question 4

Research question 4 was approached via *field research*, i.e. information were predominantly collected outside in "natural" settings, i.e. directly at the cooperative bank sites.

##### 2.4.4.1 Evaluation research

Contemplating the strategy regarding research question 4, evaluation research was again deemed to be a match in terms of the overall dimension. The actual approach to the research question in terms of strategy can be described as two-fold:

One, an exploratory approach was applied to identify actions and options available to cooperative banks. This strategy was inspired by the *grounded theory* approach as originally outlined by Glaser/Strauss (1967) and referred to by most other researchers in reference to qualitative research. In their work they argue that in contrast to the speculative and a priori nature of deductive theory, theory that inductively develops out of systematic empirical research is more likely to fit the data and thus is more likely to be useful, plausible and accessible especially to practising managers (Tenbrunsel et al., 1996, Partington, 2000). Strauss/Corbin (2008) refer to *grounded theory* as "theory that was derived from data systematically gathered and analysed through the research process". As the quote implies, grounded theory is theory that is inductively generated out of the systematic analysis of data gathered by the researcher. Collected data is organized (through what is usually called coding) to conceptually categorize variations in the data in terms of observed patterns, thereby creating indicators of particular phenomena the researcher is interested in. This involves the careful scrutinization of data to generate initial descriptive categories of the phenomena of interest that share particular distinguishing characteristics by constructing the uniformities and differences underlying and defining emergent categories. Successive categorical schemes are usually generated through a series of re-readings and re-codings of data to further develop the categories. While this iterative process entails some data reduction since these involve "selecting, focusing, simplifying abstracting and transforming the raw data" (Miles/Huberman, 1994), the overriding aim is to develop a scheme of saturated categories that are exhaustive of

all the data available. By looking at patterns, the generation of hypothetical explanations and options regarding the phenomena of interest are looked for. In this process, data collection and analysis proceed simultaneously.

Second, an explanatory approach was applied to evaluate the actions and options identified in step 1. Here and by evaluating the options, the aim was not only to provide pros and cons as well as limitations and support drivers, but also means and suggestions on how ways to achieve success and make things happen.

#### **2.4.4.2 Action research**

In combination with evaluation research, an *action research* approach was applied. This goes back to the work of Kurt Lewin who originally conceptualized action research as a means of contributing to the betterment of society by enabling the resolution of social problems. In his view, the main feature of action research was that it should be focused on problems and their resolution (Lewin, 1946).

French/Bell (1984), being more specific, stated that action research is the "process of systematically collecting research data about an on-going system relative to some objective, goal, or need of that system; feeding back these data back into the system; taking action by alternating selected variables within the system based both on data and hypotheses, and evaluating the results of actions by collecting more data".

Following up on this, Reason/Bradbury (2006) described action research as a "participatory, democratic, process concerned with developing practical knowing in the pursuit of worthwhile human purposes, grounded in a participatory worldview. It seeks to bring together action and reflection, theory and practice, in participation with others, in the pursuit of practical solutions to issues of pressing concern to people, and more generally the flourishing of individual persons and their communities".

This researcher, building on his professional status and employment and confirming that this technique is variably used in social science in connection with management research, together with contacts collaborated in the diagnosis of a problem and in the development of a solution. Elaborating further on Eden/Huxham (1996), it also

incorporates a connection with theory, which is established via Theme One and further elaborated on when describing the status quo and presenting the finding on the following two Themes. This also follows Geertz (1973), who recommends the provision of thick descriptions of social settings. This also represented the first stage or step in the action research cycle in reference to Gill/Johnson (2010) applied to this method.

As outlined in section 1.2 it was envisaged to design quantitative models to improve performance. In the course of setting up the research design, it was deemed appropriate to include this quantitative element in this chapter.

#### **2.4.4.3 Focused groups and interviews**

The *focused group* method was applied, i.e. interviews were held with several people on a specific topic (Bryman/Bell, 2007). An important issue was to reveal how the group participants view the issues with which they were confronted gathered previously as part of the evaluation research/grounded theory approach. The setting for the extraction was rather structured, i.e. there was a project plan as discussed with management before and agendas for the individual workshops.

This researcher acknowledges the fact that disadvantages for business researchers are often stated. Blackburn/Stokes (2000) state that it was difficult to convince research audiences of the significance of their focus group research. Cowley (2000) suggested, therefore, that a professional Code of Conduct is needed. Given the ethical codes this researcher is obliged to as a certified auditor it is assumed that qualitative focus groups are brought in.

#### **2.4.4.4 Observation**

Due to the researcher's professional employment, another source of data was his access to cooperative banks. In this course, a vast number of observations could be made. As described by Bryman/Bell (2007), the types of observation applied were non-participant, unstructured and simple/contrived. This researcher did not participate, did not apply an observation schedule and is not observed by those being

observed, hence having no control over the situation (Webb et al., 1966). The advantage was seen to get direct information as information were collected during daily employment duties at cooperative banks as well as other financial institutions.

Special attention while conducting the observation was given to the *Hawthorne effect* (often referred to as observer effect). Roethlisberger/Dickson (1966) described "the phenomenon in which subjects in behavioural studies change their performance in response to being observed". This author sees an appropriate use and direct reference to this effect. In summary, this author has not noticed that subjects have changed behaviour due to the fact that an external advisor or auditor was present. While no concrete evidence for this observation can be provided, it is assumed that this is due to the fact that this researcher was known as a statutory auditor who fit into the daily routine on a regular basis.

#### **2.4.4.5 Cooperative bank managers/staff**

Interviews and workshops were conducted with partners that are directly concerned with actions to be taken, i.e. a direct matching was envisaged (see Appendix 10.2). Predominantly, these partners comprised staff of cooperative banks. With all staff there was a direct professional relationship, i.e. advisory or audit work was conducted with and for these managers and their banks. Research activities were conducted directly on the client sites with prior preparation in this researcher's office.

### **2.4.5 Research Question 5**

#### **2.4.5.1 Survey**

With regard to methodology, a cross-sectional design was required. Bryman/Bell (2007) referred to this as the "collection of data on more than one case and at a single point in time in order to collect a body of quantitative or quantifiable data in connection with two or more variables, which are then examined to detect patterns of association".



The overall aim of this research question is the analysis of behaviour, opinions and internal processes. Observation and experience have certainly been considered as strategy, however, due to the limitation of having practical insights in only a low number of cooperative banks, it was deemed necessary to enhance this number (or sample).

#### 2.4.5.2 Questionnaire

In order to analyse the strategy process in cooperative banks, an empirical analysis by means of a questionnaire was deemed the most appropriate way in order to collect information of primary cooperative banks (chapter 7). The aim was to identify the status quo as a starting point and then identify interconnections. In contrast to the secondary data referenced to above, this exercise comprised the collection of raw or primary data from the source.

The nature of the questionnaire follows prescriptive strategy formation, which divides strategic management into *strategy analysis (and choice)* and *strategy implementation (and control)* (Johnson/Scholes, 1993). With regard to strategy analysis, the aim is to identify on which data cooperative banks make decide upon strategic directions and which concepts are used in order to provide for a common ground for further adjustments. With regard to strategy implementation, the aim is to identify how strategy is communicated, which structures are used for this and how the implementation is controlled. Before sending out the questions, these were discussed with managers from cooperative banks.

The questionnaire comprised 24 scaled questions that were presented by direct contact or sent via post to a pre-defined bank sample (see section 7.2). Within the scope of a *univariate analysis* each of the questions referred to *nominal* or *categorical variables*, i.e. variables that cannot be rank ordered (Bryman/Bell, 2007). Analysing one variable at a time, frequency tables are applied to show number and percentage belonging to each of the categories for the variable in question. Statistical software, e.g. SPSS, was not used given the scale of the project and the flexibility needed while using different data processing sources.

### 2.4.5.3 Selected sample of primary banks

The most relevant questions asked in this context and considering the key points according to Bryman/Bell (2007) were:

*How large should my sample be?*

*How do I cluster the sample?*

*What are time and cost considerations?*

*Where do I get information for selecting the sample?*

*How can I deal with the issue of low or non-response?*

A structured approach was deemed to enhance data quality. Finally, a two-step approach was applied to achieve this goal and comply with data collection requirements. The sample comprised responses from direct contact and postal contact (refer to section 7.2.2 for further details).

## 2.4.6 Research Question 6

### 2.4.6.1 Case Study and action research

In order to derive at the envisaged outcome, a *case study* design is applied. Yin (1989) describes case studies as "an empirical enquiry that investigates a contemporary phenomenon within its real life context, when the boundaries between phenomenon and context are not clearly evident, and in which multiple sources of evidence are used". It strongly follows Eisenhardt (1989a) who stated that "case study is a research strategy which focuses on understanding the dynamics present within single settings" and that "case studies typically combine data collection methods such as archives, interviews, questionnaires, and observations". The case studies applied in chapter 8 were specifically chosen to represent the platform of the previous empirical findings within the Themes, thereby combining all previous methods and findings to provide for a firmer empirical grounding.

Yin (1993) described three types of case studies, being exploratory, explanatory and descriptive. Two of these types are applicable to this research, being explanatory and descriptive. While explanatory cases try to link an event with subsequent effects and

investigate causality, descriptive cases try to illustrate events and their relevant context.

Selecting the cases is considered an important aspect of building theory. In total, two cooperative banks were considered to be sufficient given the basically unchanged business model and scope of products and activities. This researcher wanted to avoid random sampling and opted to choose banks that reflected the selection of specific cases being part of certain bank size groups in terms of total assets. Also, it was aimed to build upon the data access stemming from being an auditor, hence utilizing clients and contacts as allowed by domestic regulations.

Overall, two banks were chosen with direct contact to this research (see section 8.2). These two banks represent average and typical primary banks in terms of business model and are expected to be benchmarks for virtually all institutions in the bandwidth between up to EUR 1.000 million in total assets representing the majority of institutions for which generalization is supposed to be accomplished.

There are also elements of what a number of researchers call *quasi-experiments*, i.e. "studies that have certain characteristics of experimental designs but that do not fulfil all validity requirements" (Cook/Campbell, 1979). Since it does not take place in laboratory conditions and since the focus is on real-life circumstances, naturally occurring events and subjects cannot be randomly allocated to experimental and control groups. This does not mean that control and experimental groups are not used. Rather, control and experimental groups are identified in the field in terms of whether or not they have experienced the notional experimental treatment or independent variables. When investigated behaviour and findings have been derived, the attempt is made to compare these with similar groups who have not experienced that event. Given these characteristics, it has been concluded that this strategy is useful at evaluating the proposed innovation.

In order to round this topic up, this observational study is enhanced via a longitudinal element. In reference to Pettigrew (1990), it is envisaged to find out and understand how cooperative banks deal with issue of BSC and if there is added benefit perceived.

#### **2.4.6.2 Data collection and data sources**

Data collection and data sources comprise the same approaches as with research question 4 (refer to section 2.4.4). Approaching this question also as part of a field study, most of the research took place at the same locations either simultaneously or consecutively.

## **Theme One: Competition**

*“What is impossible for the individual, can be achieved by many.”*

(Friedrich Wilhelm Raiffeisen)

Theme One investigates the state, status and role of cooperative banks in Germany as well as from a European perspective. In a first step, it investigates the compatibility of cooperative banks with value and performance management, i.e. it provides the limitations and boundaries from a qualitative perspective to be considered for further activities. In a second step, the performance of the sector is investigated from a quantitative perspective, i.e. the economic development within the German market. In order to further understand the relevance and importance of the sector, comparisons with EU countries on an overall banking level (not only cooperative banks) are conducted.

### **3. Pre-Research conceptual implications**

Chapter 3 entails a critical re-evaluation of the overall governing structures of the cooperative banking sector and its role in the banking landscape. In particular, it is envisaged to identify headroom for the enhancement of performance management and interaction of cooperative banks with customers as part of their role as financial intermediaries. Hence, the following topics are discussed and evaluated:

- Section 3.1 describes the dominant business model of cooperative banks in contrast to other, mostly private, banks from a bank theory perspective. This also serves as a basis for understanding performance and performance differences as analysed in chapter 4.
- Section 3.2 analyses the cooperative banking business model by applying and combining economic theories that are based on micro- and macro-structural factors. Special attention is paid to intangible resources deemed to be the major success factor of the sector. The aim is to identify distinguishing characteristics and sources of competitive advantage in terms of quality that are to be further investigated in terms of quantity in chapter 4.
- Section 3.3 uses findings of previous sections to identify and suggest an overall framework that can be applied by cooperative banks in order to measure and manage performance.

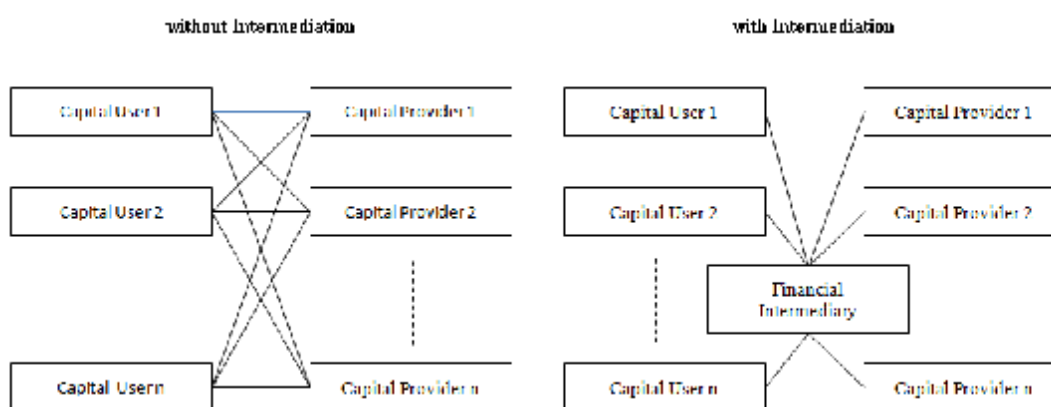
### 3.1 Applicable theory: Bank management

#### 3.1.1 Financial intermediation

In order to understand the changing role of banks and financial institutions, a reflection of their function, purpose and competences over time is to be carried out.

Banks and other financial institutions are subject to the theory of financial intermediation, which is based on an economic mechanism as, for example, outlined by Süchting/Paul (1998). In a simple model, there are economic units (e.g. private individuals) that consume less than their income and want to save or invest this surplus. On the other hand, there are other economic units (e.g. companies) that want to invest more money than available. A direct interaction between the surplus units and the deficit units is, however, unrealistic due to different objectives of the units. Private individuals usually want to invest small amounts in a safe way, while companies require large amounts for investments that are subject to certain risks. Due to these conflicting objectives, intermediation is needed that not only passes capital on but transforms the quality of it.

Figure 6: Concept of Financial Intermediation



Explaining the reasons for the existence of financial intermediaries, Canals (1997), on an international level, and Baxmann (2010), on a German level, referred to the *transformation function*, i.e. one financial asset is transformed into another financial asset. Hartmann-Wendels et al. (2010) as well as Berger et al. (2010) provide specific examples of this function in a banking context, e.g. the transformation of

many small deposits into larger loans (amount or batch transformation) or short-term deposits into long-term loans (maturity transformation), the provision of deposit security, while transforming these into riskier loans (risk transformation) and the allocation of money to countries other than where they originated (geographical transformation). In this context, banks are in direct competition with the capital and money markets acting also as intermediaries providing transformation services.

The role of banks in this context needs to be critically evaluated. Economic theory, in the classic view, describes a concept of *perfect competition*, characterized by many sellers/buyers, sale of identical products (perfect substitutes), perfect information, no barriers to entry/exit and no transaction costs (Stigler, 1961). In this concept, there is no need for banks as intermediaries since all services offered by the intermediary can be tracked via direct financial connections.

Since, in perfect competition, there is no reason for the existence of intermediaries, theoretical assumptions need to be adjusted for real-life deficiencies and market imperfections. Hellwig (1994) discusses two aspects, i.e. the existence of *transaction costs* and *asymmetric information*, both being the central elements of the neo-classic economic theory. In reference to transaction costs, the execution of many small-sized transactions as well as the simultaneous search for business opportunities and partners leads to a high degree of inefficiency. Writers have analysed different costs in this context, e.g. Gurley/Shaw (1960), who focussed on payment costs reductions and costs relating to the administration of assets and liabilities or Benston/Smith (1976), who focussed on costs for initiating businesses. While of high practical relevance, the aspect of asymmetric information has drawn more attention in the past two decades.

Individuals do not possess and have access to information required to ensure optimal decision-making. This lack leads to insecurity, costs for finding, negotiating and monitoring transactions, market entry barriers, etc., and consequently costs to decrease this asymmetry and costs of transactions arising from sub-optimal, i.e. inefficient, transactions. Based on these concepts, the reason for the existence of banks can be explained by the provision of specialisation advantages, information



and experience advances, scale effects, diversification potential, all being more efficient than capital and money markets.

Despite this preliminarily theoretical ground for the existence of banks, there is an important element of criticism that has drawn a lot of attention during the financial crisis, being the question: How does the customer know that he receives the right information of the intermediary? Leland/Pyle (1977) analysed the issue of incentives of banks to produce reliable and quality information and concluded that banks can and do manipulate information to benefit themselves or certain capital providers, but also see the necessity to be regarded a professional market participant with a high reputation.

Diamond (1984) provided one of the most comprehensive concepts that is still used today for explaining the existence of banks by dealing especially with the cooperation and incentive problems induced by the before mentioned information asymmetry. He discussed one of the most important problems of capital providers, being the fact that they cannot observe the development and result of the project being financed with their capital. To overcome this lack of information, it would be possible to implement project monitoring measures, which were inefficient, if carried out by all capital providers. These monitoring costs can be reduced by delegating this function to an intermediary. Since this intermediation creates new incentive problems, Diamond (1984) concluded that the costs of the contract between capital providers and intermediary, so called delegation costs, can be reduced, if the intermediary is diversified, i.e. finances several independent projects at the same time.

While the bulk of literature refers to the role of banks as intermediary (see also Williamson, 1986; von Thadden, 1995; Breuer, 1994/1995; Fama, 1980; Kareken, 1985; Ramakrishnan/Thakor, 1984; Diamond/Dybvig, 1983), the impact of financial innovation, which has significantly increased since the early 1990s, has not found the same degree of attention yet.

Intermediation refers to traditional banking, which has been subject to significant changes over the past two decades, often referred to as *disintermediation*.

Edwards/Mishkin (1995) have analysed this development in the US market, while Howells/Hussein (1997) provided evidence for the UK and Allen/Santomero (2001) for the international market. Bossone (2001) explains this with “the impressive growth of commercial paper markets and the money market mutual funds thrift industry, the increasing ownership of banks by securities firms and commercial enterprises, and the proliferation of quasi-monies or money substitutes offering transaction services comparable to bank deposits. Correspondingly, banks have had to diversify their activity from traditional deposit/lending to nonbank intermediation and financial services provision”. In a first step, this meant that banks only acted as guarantors in case of market interruptions, which led to a change from on-balance to off-balance sheet items with income being substituted from position related interest income to transaction related commission income. In a second step, banks or issuers waived their obligation to provide guarantees leading to the complete disappearance of transactions in the balance sheet and notes. Disintermediation was seen to be an innovative mean for the limitation of risk with the creation of one-time income only. In retrospect, academics foresaw the inherent risk of development. Edwards/Mishkin (1995) wrote that “banks may respond to their shrinking intermediary role and diminished profitability by taking greater risk ... either by pursuing strategies in their traditional business lines or by seeking out new and riskier activities”. Hence, elevating the need for new and advanced methods in terms of risk management (Scholtens/van Wensveen, 2000).

Another characteristic or side effect of this development was the breakup of the traditional value chain. Baxmann (2005) described how the separation of elements lead to new business models with various companies and non-banks specialising on individual elements. Financial Times<sup>10</sup> defines business model as "the method or means by which a company tries to capture value from its business. The model provides the basic template for a business to compete in the market place, it provides a template on how the firm is going to make money, and how the firm will work with

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<sup>10</sup> accessed via [www.ft.com/lexicon](http://www.ft.com/lexicon)

internal players (firm's employees and managers) and external players (stakeholders such as customers, suppliers, and investors)". Wilson et al. (2010) in reference to technological change and deregulation and the subsequent financial crisis point to the need for a re-evaluation of business models highlighting the necessary focus on governance types and ownership structure.

While literature agrees that there is not one single party to blame for the crisis, the author, based on his non-academic observations, concludes that the critics of the disintermediation process proved to be right. Allen/Carletti (2006) showed that the transfer of risk in general can, when effectively used, has a positive effect on an economy. However, it was the combination of factors mentioned before that sparked the financial crisis.

### 3.1.2 Classification of banking activities

Economic literature on banking typically distinguishes two types of activities (refer to Puri (1996) and Drucker/Puri (2006) for comprehensive studies):

- **Commercial banking** incorporates deposit and lending activities as well as other services such as payment transactions.
- **Investment banking** incorporates activities with regard to securities trading or securities in general.

In a simplified view it is assumed, that in commercial banking capital providers only possess own capital, which is invested in financial assets. Capital users possess own and borrowed capital that is invested in long-term and short-term assets. Without the financial intermediary "bank", capital providers would directly hold own and borrowed capital of the capital users. *Commercial banks* take over the role of the financial market by taking on deposits and other funds while further distributing these funds to capital users in the form of loans. This process is reflected in the bank's balance sheet, where *Liabilities* represent capital origin and *Assets* represent capital usage. The more commercial banking oriented the bank is, the higher the share of non-bank related positions is. This process can best be observed in the real world with reference to banks, which do not follow a pure shareholder concept.

The role of a bank also includes promoting the trade of contracts in the financial markets, being part of investment banking activities. Financial markets is the generic term for a number of definitions. In the *Money Market*, short and medium term financial contracts are traded. Distinguished is between primary and secondary market, i.e. in the primary market trade occurs between banks and non-banks while in the secondary market trade occurs between banks only. In the *Capital Market*, long-term financial contracts in the form of equity products (e.g. shares) and debt products (e.g. bonds) are traded. Primary and secondary markets also exist, i.e. in the primary market new products are traded (e.g. IPO, bond issuance), while in the secondary market existing products are traded (e.g. loans). Next to providing advice and support in the financial markets, investment banks also conduct own trading, i.e. proprietary trading, where the bank's own money is used to achieve a gain instead of a commission with client money involved.

While banks that focus on either of the two main elements are considered specialized banks, *universal banks* have emerged conducting both commercial and investment banking activities (for excellent research regarding the development, refer to Canals (1997)). In the USA, after the banking crisis in the 1930s, the Glass-Steagall Act was introduced which called for the separation of both activities, i.e. the split-up of universal banks, since the impact of losses from proprietary trading on client money was considered too risky. In 1998, the US president Bill Clinton declared "the Glass-Steagall law is no longer appropriate". In 1999, it was repealed through the Gramm-Leach-Bliley Act of 1999. In the aftermath of the financial crisis, US economist Paul Volcker argued that the use of client money by banks for speculative investments, which did not benefit their customers, played an important role in the development. He proposed a ban of these activities as well as further limitations regarding the ability to take on risk. His proposal, known as Volcker Rule, was incorporated in a specific section of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into federal law by President Obama in July 2010 (Johnson, 10 June 2010).

With regard to the German cooperative banking sector, there are two perspectives:

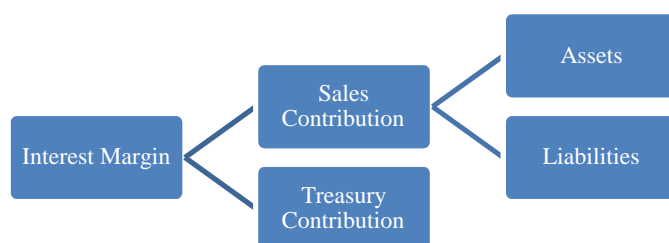
- a) The business model of cooperative *primary* banks is focused on being pure financial intermediaries with commercial banking activities. Risk is kept low with banking activities being regionally limited. It is especially this concept that forms the centre of the cooperative banking principle.
- b) The business model of the cooperative *central* banks is characterized by a higher orientation towards desintermediation and investment banking activities. Due to their size the two central institutions are actively engaged in the financial markets.

Preliminary conclusion is that primary banks do follow a traditional banking model that has never or only very limited contributed to financial crises. Subsequently, elevated regulatory requirements are not considered to be required (see section 5.5).

### 3.1.3 Bank calculation (qualitative)

In the light not only of the recent regulatory reforms, but also of the increasingly competitive situation, pressure on margins has become a centre of attention, especially among smaller banks and cooperative banks. In reference to Schierenbeck et al. (2008), profit margins of individual bank products are usually calculated using the *market interest rate model*. With regard to interest income and margin, the market interest rate method distinguishes between the *sales contribution* (Konditionsbeitrag), being further divided into assets and liabilities, and *treasury contribution* (Strukturbeitrag).

Figure 7: Interest margin elements



*Sales contribution (Assets)* is defined as the difference between the interest rate that a customer has to pay (e.g. for real estate financing) and the rate payable by the bank for refinancing in their function as intermediary. *Sales contribution (Liabilities)* is defined as the difference between the interest rate that a customer receives (e.g. for deposits) and the rate receivable by the bank from investing excess funds not used for customer financing, e.g. in bonds and other securities.

*Treasury contribution* is defined as the profit that is achieved by using short-term funds to finance long-term loans, i.e. profit can be maximised if loans with higher interest rates are granted on a long-term basis which are refinanced with short-term deposits typically showing low interest rates. Reference is made to the subprime crisis, where money market liquidity dried up, hence, stopping short-term refinancing. However, while the risk of illiquidity is not further considered as part of this research, the interest rate risk is of concern giving the fact that assumptions about the interest rate development in, for example, ten years are just speculation. Exact information regarding the distribution of interest income are not publicly available. Recently, it was stated that BaFin is thinking about enforcing additional measures for banks that do exploit maturity transformation, hence, causing significant interest rate risks (Deutsche Bundesbank, 29 March 2012).

Experts assume that two thirds from the net interest income from cooperative banks are attributable to maturity transformation, i.e. treasury contribution (Tagesspiegel, 30 November 2010) pointing to the pressure on profit margins. According to initial discussions with interview partners in 2011, the biggest problem for cooperative banks is sales contribution (liabilities), which has developed towards zero or even negative. Interviewee P1 stated:

*"More and more of our security investments in the past reach maturity. These were done in times when interest rates were high. Upon maturity we need to reinvest these funds, however, giving the current interest level, less income is achieved".*

P1 was approached with several ideas by this author on how to deal with this development.

a) Compensate liabilities margin with asset margin

*"Heavily increasing loan volume is tempting and would certainly help balancing the erosion of the liabilities margin. However, experience and empirical data has shown that lowering standards in loan granting in order to achieve scale will eventually result in higher provisioning. In the medium and long run, this effect will revert any asset margins achieved. Above all, it would not fit to our strategy of achieving stable growth".*

b) Offer zero deposit rates or, in extreme, negative rates

*"As a bank that is close to customers and placing a premium on stability, it is not realistic to completely refrain from providing interest".*

c) Increase treasury contribution

*"Today, we are using every opportunity given to maximize this effect giving the support and opportunities within our network".*

Preliminary conclusion is that cooperative banks do not make a larger deal of profit with customer transaction but rather with maturity transformation. While this currently is a risky, however, solid stream of income, this also means that an increase in the overall interest level will lead to higher, since variable, refinancing costs, while loan rates, fixed on long-term, will stay lower. Also, it is assumed that the new Basel III accord will have an impact on cooperative banks due to the envisaged aim to lower maturity transformation.

### **3.2 The cooperative bank business model**

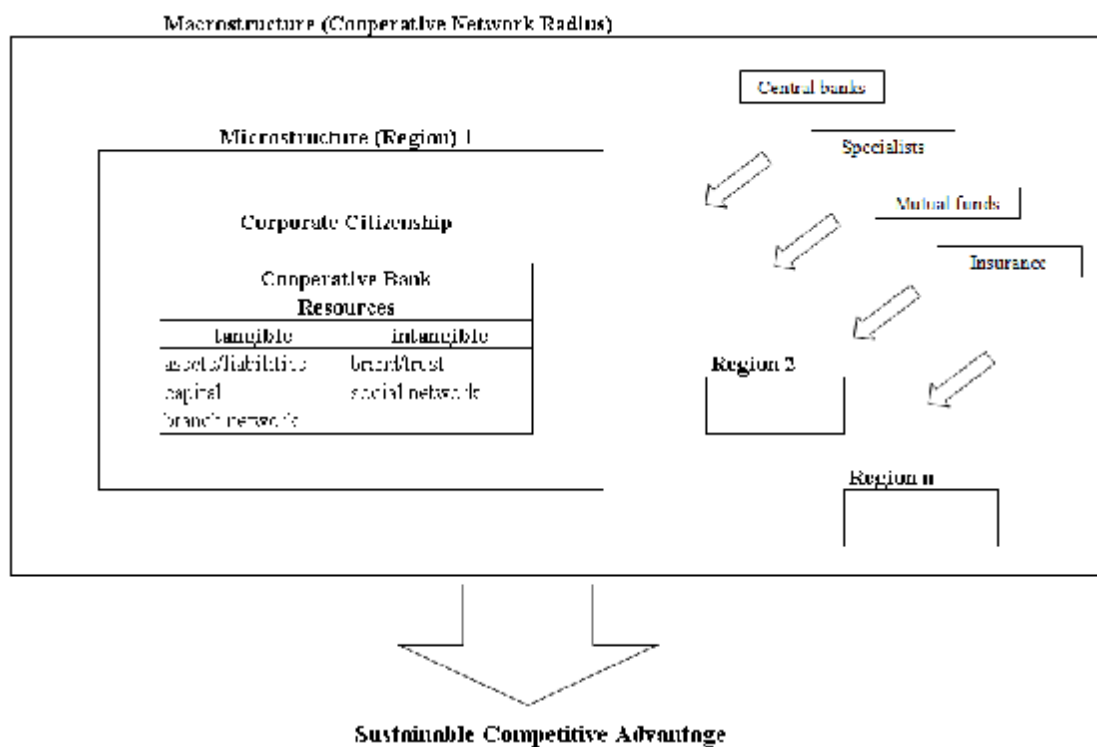
Before discussing what needs to or can be adjusted in terms of performance management, it is essential to carry out an analysis of the *modus operandi* of the German cooperative bank and sector and identify critical success factors and sources of perceived competitive advantage. The aim of this section, hence, is to explain the cooperative bank business *model*, i.e. in other words: What is a cooperative bank?

Reviewing relevant literature, it became evident that there is no binding definition, at least not from a legal perspective. Referring to the statement of one cooperative bank manager during the course of this project:

*"A cooperative bank is a bank that offers financial products to improve the situation of its members and other customers within its region via utilizing resources from the cooperative banking network while not focussing on profit maximization"*

This statement was broken down in logical blocks and brought into an operational framework, hereby serving as a reference point for further analyses. Applying academic theories as deemed relevant and appropriate, the following framework was drawn upon by this author:

**Figure 8: Cooperative bank business model**





## 3.2.1 Microstructure

### 3.2.1.1 Foundations of organization

The cooperative bank is a hybrid between a bank in the meaning of the German Banking Act, applicable to all banks in Germany, and the German Cooperative Act<sup>11</sup>, applicable to all banks in the legal form of a cooperative ("eingetragene Genossenschaft" or "eG") and, thereby, supplementing legal requirements with cooperative values. Further detailed in section 3.2.5, the overriding aim is to promote the business of owners (members) with profit maximization ruled out by statute.

The individual cooperative or primary bank is operating as a *universal bank* as outlined in section 3.1. As highlighted by Götzl/Gros (2009), cooperative banks are bound to the *Regional Principle*, i.e. each cooperative banks has a narrow market or area of operations in which no other cooperative bank may conduct business. In practice, this means that the German banking market is loosely made up of as many regions as there are cooperative banks, i.e. ap. 1.100. Giving that the *regional principle* is not part of the Cooperative Act in a legal sense, it is not to be regarded as a stiff rule with a region being congruent with public administrative districts.

As further analysed in section 3.2.2, it became evident that this principle has been compromised due to granularity within the primary banking sector. While there can only be one *Volksbank* or *Raiffeisenbank* in one region, there can also simultaneously be one Sparda-Bank (of the twelve) and one PSD-Bank (of the fifteen) and one of the several profession related banks.

Governance structures are uniform and regulated by the Cooperative Act requiring three bodies. The *board* consists of at least two people and is set up by the supervisory board. The *supervisory board* consists of at least three people and is elected by the general assembly. The *general assembly* consists of all members who have one vote regardless of their capital shares.

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<sup>11</sup> The Cooperative Act was set up in 1889 and is accessible under [www.gesetze-im-internet.de](http://www.gesetze-im-internet.de)

### 3.2.1.2 Corporate citizenship

However the region is defined, the cooperative bank considers its role to be a vital element within it. Referring to academic theories, this can be interpreted as *Corporate Citizenship*, i.e. the interaction of companies within (regionally limited) societies. Schrader (2003) described three levels of *Corporate Citizenship*, being the direct support of civil individuals, the support of local legislations in order to enhance the greater good and the direct structuring of all actions by other companies. Taking into account the definition of a cooperative bank as stated by the cooperative bank manager, a direct match or link can be concluded. In light of the cooperative values, the cooperative bank as corporate citizen conducts business that is often referred to *social banking*. Reifner (1997) described *social banking* as "the development and improvement of financial services in a way that allows for the maintenance and improvement of profit making economic structures of economically underprivileged regions, groups and areas".

This refers to the profit making oriented model of cooperative banks in contrast to the profit maximizing oriented model of private banks, which has its roots in the origin of the cooperative banking model itself, dating back to the 19th century, when farmers and other small-sized enterprises did not want to rely on private money lenders charging interests of up to 730% (Lanzerath, 2001). In 1864, Friedrich Wilhelm Raiffeisen founded the first cooperative bank, *Heddesdorfer Darlehnskassenverein*, to overcome this problem of the then existing capital market and promote "*social inclusion*". In order to qualify for receiving money, people had to become members, i.e. buy a share of member capital (Aschoff/Henningsen, 1995). The idea of becoming a member appealed not only because members were eligible to receive better loan conditions, being as low as 10%, but also receive dividends on their member share of 5%-7%. Credit worthiness was achieved through the joint-liability of all members, i.e. creditors could address each and all members when payments were due. Members came usually from the village community, i.e. all members knew each other. It was this close connection that kept *information costs* as well as *transaction costs* low allowing cooperative banks to charge lower interest rates. At the end of the day, cooperative banks were not founded to enable access to

fresh money but rather to protect businesses from usury. Referring back to bank theory in section 3.1, cooperative banks were acting as pure financial intermediaries. Being characterized by a high degree of decentralisation, the idea of an autonomous bank became very popular in Germany with about 2.000 banks existing in 1889 and even about 23.000 banks in 1932 at its peak (Martin, 1994).

The two factors mentioned before can be considered in a combined view applying theories by Knorr Cetina. Knorr Cetina (2003) in reference to a number of other authors on economic sociology views (financial) markets "as embedded in social relations and social networks", whereby markets in the context of cooperative banks can also be regarded as the financial relationship within the region. Further applied in this context by this author is the theory of *social capital* as, for example, outlined by Putnam (1993). Putnam described social capital as the ability and willingness for cooperation, arising from the inclusion in social networks. In particular, he concluded that the combination of the three elements networks, trust and norms will result in the benefit of all actors (Win-Win Situations) and enhanced achievement of goals. Via social inclusion into the network, actors become trustworthy. Putnam also outlines a progressing erosion of this social capital explained with the decreasing involvement of citizens in social institutions such as sport clubs, family or church events, which eventually leads to the erosion of the greater good.

One of the most important functions of cooperative banks is the supply of financial products giving market imperfections. As outlined before in the context of social banking, this refers to the support of regions and market actors. By doing so, cooperative banks enable actors to take part in credit and capital markets and to participate in the economy. E.g. it is an essential part to be owner of a current account in order to achieve social acceptance and a certain living standard. Also, the support of small and medium sized companies, being core clients of cooperative banks, can be regarded as social banking since these also provide for the majority of

jobs locally. This leads to the improvement of social capital and, via enhanced network relations, to lower risks of economic interaction and transaction costs<sup>12</sup>.

### **3.2.1.3 Resources: tangible and intangible**

While the concept of *Corporate Citizenship* refers primarily to the linkage between bank and the region, the concept of *resources* can be regarded as being actually one step before. Analysing the value creation process from different actors' perspectives, Chen et al. (2014) distinguish between *tangible* and *intangible* resources.

Tangible resources have been distinguished by this author to consist of assets and liabilities, capital and the (physical) branch network. Assets as well as liabilities consist primarily of loans to local private individuals and small entities, while liabilities consist of respective deposits. Capital consists of equity with a number of cooperative banking specialities. Assets and liabilities are analysed in great detail as part of descriptive statistics in chapters 4 and 5. As can be taken from there, the financial condition has been better than generally assumed with performance being better than that of private and public banks. This development can be explained by the plain vanilla financial instruments and services offered to customers, which are not materially subject to market volatilities and, hence, provided for a stable performance that also did not suffer from the financial crisis in 2007/2008.

The other material tangible assets can be regarded as the physical branch network being with ap. 13.000 branches the most dense by far among all banking groups in Germany. Further quantitative analyses in this context are conducted in chapter 4. However, in a qualitative context, the branch network can be identified as being one

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<sup>12</sup> As outlined in section 3.1.1, banks, in a purely banking context, are financial intermediaries and also are (or have been) the key player in making payments transactions. Schuster/Wagner (1996), in an economic context, also highlighted money creation, stabilization of the economy, performing of fiscal measures as proposed by Deutsche Bundesbank and the government as key task of banks. By providing loans to companies, economic effects are achieved in the form of the enhancement of the economic scope of these companies, hence, leading to investments and better economic indicators (.g. GDP).

of the main instruments or elements of the social network helping to achieve or improve social capital as outlined in the previous section, furthermore identified to be a competitive advantage outlined in section 3.2.3.

With the major academic and practical attention focussing on tangible resources, it is intangible resources that are perceived to be looked at further for the identification of competitive advantages. Lev (2001) defines an intangible asset as "a claim to future benefits that does not have a physical or financial (a stock or a bond) embodiment". He further distinguishes three major nexuses of intangibles, being *discovery*, *organizational practices* and *human resources*. Given the cooperative banking business model, the third nexus, human resources, is considered to be of lower priority. Evidence regarding the creation of unique compensation and personnel policies has not been gathered. With regard to the cooperative banking sector, it is a combination of nexus one and two. Cooperative banks benefit from their brand and their ability to keep it alive via marketing and PR activities. This includes, from a theoretical perspective, fostering cooperative values and especially reliability as described in section 3.2.5. In addition, they have a unique organizational design implemented via the cooperative financial network as described in section 3.2.2.

Further elaborating on this topic, Meritum (2002) considers intellectual capital, i.e. the "combination of the human, organizational and relational resources of an organization", whereby human capital "is defined as the knowledge that employees take with them when they leave the firm", structural capital as "the knowledge that stays within the firm at the end of the working day" and relational capital as "all resources linked to the external relationship of the firm, with customers, suppliers or R&D partners".

The theoretical statements above need to be further analysed reflecting the special nature and mechanism of the German cooperative network. In this regard, the perspective needs to be focused. Chen et al. (2014) states that literature regarding intangible assets concentrate on either the manager's perspective or the capital market actor's perspective. The latter, referenced to the actor-network theory by Latour (1993), is described as embryonic. In this author's opinion, the actor-network theory

does not apply to the banks under investigation, i.e. primary banks. Primary cooperative banks, due to their regional focus and business model, are not engaged in the financial market and are typically in no contact with analysts or fund managers, i.e. there is no interrelation or interaction.

Regarding *relational capital*, the cooperative idea is highly related to image and the brand "cooperative bank", i.e. it is important that the cooperative bank stands for something else in contrast to shareholder oriented banks. However, due to the structure of the cooperative financial network, primary banks have limited power to influence brand and awareness. Brand management is responsibility of the BVR, i.e. the network. Hence, when discussing ways to improve performance, ways with regard to relational capital are limited for primary banks from a top-down perspective. However, from a bottom-up perspective, primary banks are in the driver seat. It is up to the primary banks to live up to the brand awareness and transfer the brand image to the social market in which they are positioned. Via the demonstration of cooperative values in connection with sound and prudent financial acting, i.e. tangible resources, cooperative banks have been able to achieve a USP. As outlined before, cooperative banks were perceived to survive the recent financial crises in proper shape. While other banks, predominantly private banks, clearly lost customer trust and lacked financial performance, cooperative banks have been able to enjoy both, stable or even increasing performance and trust results as surveyed among private individuals in Germany (Bain & Company, 2012).

*Structural capital* is a major asset of the cooperative financial network. The BVR does provide a platform for standards, e.g. further education centres, standards for organizational documentations, IT systems and cultural values being also part of the relational capital. It is the existing granularity of primary banks, i.e. their high number with regional focus, which provide opportunities in terms of benefiting from an optimization of structural capital. In reference to Chen et al. (2014), interaction on a regional level provides potential to "reduce transaction costs, to make the intermediation process and risk management more effective, and also to optimize the deposit or loan portfolio".

*Human capital* is deemed to be an underestimated issue among cooperative banks. No literature has been identified that deals with human capital issues among primary banks. An explanation for that could be that the cooperative model, so far, has not required an elevated level of individual know-how. Products and services, mainly developed by other specialised network entities, did not require creativity, flexibility or team work, but rather a certain amount of formal training. Considering Holland (2010), the issue of knowledge and learning failure, investigated in context with the financial crisis, is not deemed to be applicable to primary banks. As outlined before, the business model of primary banks focuses on plain-vanilla commercial banking that does not require an advanced risk or knowledge management in technical or quantitative terms. It is the inclusion in the social network, which, benefits risk management in qualitative terms. Regarding primary banks and intangible resources or activities, it is the (intangible) ability of staff to adjust to a changing environment and additional operational need, e.g. higher centralisation of skills and enhanced sales skills.

### **3.2.2 Macrostructure**

As outlined in the cooperative bank business model, individual primary banks are part of a network in terms of macrostructure. In Germany, this network is referred to as the *Genossenschaftliche Finanzgruppe Volksbanken Raiffeisenbanken* (Cooperative Network), which is managed by the BVR as the umbrella organisation. In 1972, all German cooperative banks were united to make up the organisation. The BVR is part of other cooperative networks, e.g. the European Association of Co-operative Banks (EACB)<sup>13</sup> on a European level or the International Confederation of Popular Banks (CIBP)<sup>14</sup>.

In this context, a network "is an arrangement of nodes tied together by relationships which serve as conduits of communication, resources, and other coordinating instances that hold the arrangement together by passing between the nodes. Cooperations, strategic alliances, exchange, emotional bonds, kinship ties, "personal

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<sup>13</sup> See [www.eacb.eu](http://www.eacb.eu)

<sup>14</sup> See [www.cibp.eu](http://www.cibp.eu)

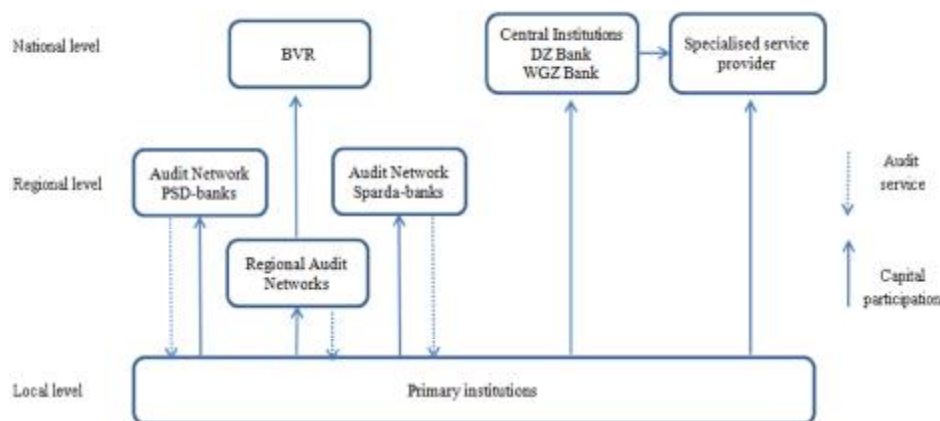
relations", and forms of grouping and entrenchment can all be seen to work through ties and to instantiate sociality in network relationships" (Knorr Cetina, 2003).

The rationale is that the network partners (central banks, specialists, mutual funds, insurance companies, etc). provide subsidized services, hence achieving cost synergies while maintaining their benefits of being local partners (Martin, 1994). The individual primary bank is independent within the network, i.e. it is not subject to instructions by other network members including the central institutions.

Schierenbeck (1988) highlighted the *subsidiarity principle*, i.e. with the highest achievable degree of decentralisation, each primary bank is supposed to offer and handle all bank services by itself independently.

The financial cooperative network today, in a narrow sense, consists of local cooperative banks, called *primary banks*, and the two central institutions as well as several network specialists. In a wider sense, several non-banking networks form also part of the network (Götzl/Gros, 2009).

Figure 9: Structure of the German cooperative financial network



Even though based on the same principles, all of the 1.099 cooperative banks with their 17 million members that existed per 31 December 2012, there were several sub-groups.

Most of the cooperative banks are either "Raiffeisenbanken" in rural or "Volksbanken" banks in urban environments covering individual regions all over



Germany. Today, every individual can become customer and member as a consequence of the amendment of the Cooperative Act in 1974.

There are twelve *Sparda-Banken* that were set up starting in 1896 by civil servants of the federal train company (accessed at [www.sparda.de](http://www.sparda.de) in June 2013). The Sparda-Banken with their branches cover the entire country and belong to the bigger entities with average total assets of EUR 5,1 billion per December 2012 (BVR, 2013a, and own calculation).

There are fifteen *PSD-Banken* that were set up starting in 1872 by civil servants of the federal postal company (accessed at [www.psd-bank.de](http://www.psd-bank.de) in June 2013). The PSD-Banken, which mainly operate as direct banks, cover the entire country and belong to the smaller sized entities with average total assets of EUR 1,6 billion per December 2012 (BVR, 2013a, and own calculations). Customers are mainly private individuals.

In addition, there are several profession related institutions, i.e. cooperative banks for churches, physicians and pharmacists. Regarding the latter group, the related cooperative bank, the *Deutsche Apotheker- und Ärztebank eG*, is the biggest cooperative bank with total assets of EUR 38 billion per December 2012 (BVR, 2013a). The ten church related cooperative banks have average total assets of EUR 2,6 billion (BVR, 2013a and own calculation). With regard to completeness it has to be mentioned that there is one additional bank with a special status, i.e. *Münchener Hypothekbank eG*. This bank is a cooperative bank with total assets of EUR 36,6 billion per December 2012 (accessed in June 2013 at [www.muenchenerhyp.de](http://www.muenchenerhyp.de)). It is not included in the regular cooperative bank count due to their ownership structure (equity is provided by Bavarian government, the central institutions and members) as well as their business model being focuses mainly on mortgage banking with direct access to the capital market in the form of covered bond issuance programmes. Due to their size, *Deutsche Apotheker- und Ärztebank eG* and *Münchener Hypothekbank eG*, together with the two central banks described below, are the only cooperative banking institutions being subject to the enhanced regulatory supervision as imposed by the ECB (Handelsblatt, 23 October 2013).

Looking further at the composition of primary banks, there is one significant exception to the overall structure in the form of *BBBank eG*. *BBBank eG* was originally founded in 1921 as a bank for civil servants nationwide, however, opened up to private customers in the 1950s. As the only cooperative bank in Germany conducting business with private customers, *BBBank eG* defines its market as overall Germany consisting of private individuals only (data accessed via [www.bbbank.de](http://www.bbbank.de)). With 105 branches, assets of ap. EUR 8 billion and ap. 400.000 members it belongs to the biggest individual savings banks in Germany and Europe. Due to the non-compliance to the regional principle and the focus on a cost leadership strategy, *BBBank eG* is regarded as a persona non grata in the cooperative banking sector and under permanent supervision (Wertel, 2011).

On the other hand, there are the *central bank groups*, which provide a wide array of services to their primary institutions. They act as clearing institutions, provide access to national and international financial markets, provide asset liability management support and offer centralized back-office functions. In addition, they compete with the private sector banks in the investment and commercial banking arenas. *DZ Bank* group is central bank to ap. 900 primary institutions all over Germany and primarily engages in the business fields Corporate Finance, Fixed Income and Sales & Brokerage (accessed at [www.dz-bank.de](http://www.dz-bank.de) in June 2013). *WGZ Bank* group is central bank to ap. 200 primary institutions in the federal state of Northrhine-Westfalia with a rather national regional focus. Both central bank groups are parent companies and consolidate the most significant specialized institutions within the cooperative network. These are *DG Hyp* and *WL Bank*, being mortgage banks and full subsidiaries of *DZ Bank* and *WGZ bank*, not incorporated as a “eG” and providing services to corporate customers only.

In addition, there are jointly held entities and *specialised service provider*, being *Bausparkasse Schwäbisch Hall* as Germany's biggest building society, *R+V Versicherung* as one of Germany's biggest insurance company and *VR Leasing* as leasing specialist, all offering services via separate offices but predominantly also via the primary institutions. Primary institutions are also the primary sales channel for

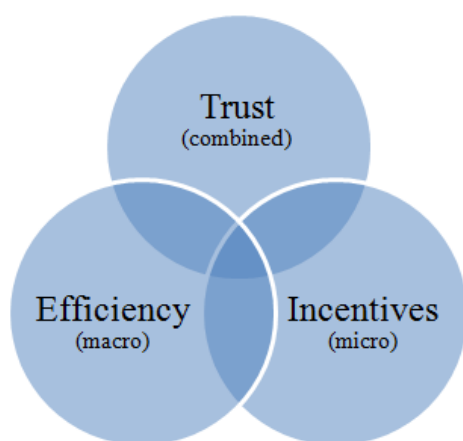
mutual funds of the cooperative network owned asset management company *Union Investment*. Other specialised service providers focus mainly on IT issues. It is this author's opinion that an increased presence of network internal consulting companies, which is lacking as of today, would certainly enhance strategic opportunities among primary banks.

The cooperative audit networks provide services as staff departments (Martin, 1994). According to section 54 Cooperative Act, each cooperative bank is compulsory member of one of the six regional audit networks in addition to the two networks for PSD- and Sparda-Banken. Geschwandtner (2005) highlighted the fact that, especially due to size, many cooperative banks lack the necessary professional qualification making it necessary to impose almost permanent review activities resulting in above average cost for the primary banks. This author, based on his experience with the cooperative banking sector, concurs and confirms this statement.

### 3.2.3 Sustainable Competitive Advantage

From the analyses outlined before, competitive advantage can be derived at, which can be distinguished on three levels in relation to the blocks derived at before:

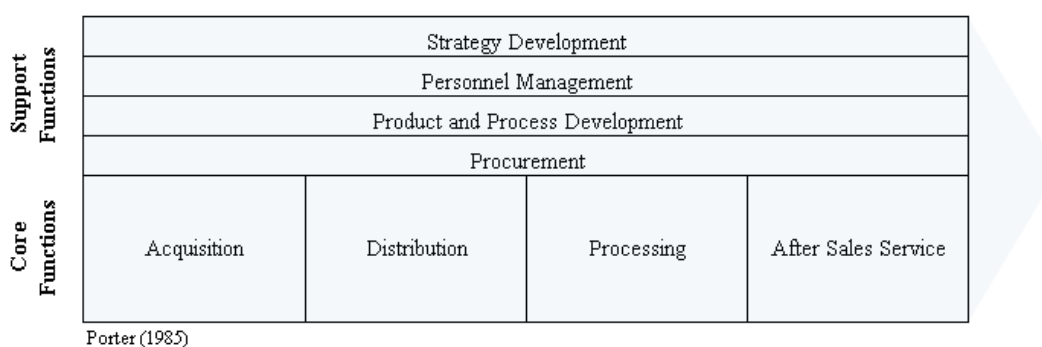
Figure 10: Sustainable Competitive Advantages of cooperative banks



### *Efficiency via division of labour (macrostructure)*

Cooperative banks are part of a company network, i.e. the BVR. Next to the individual cooperative banks, other network companies work together in order to offer a complete range of financial products, i.e. banking and investment products, savings, mutual funds, corporate advisory, IT, etc. This cooperation provides for a special form of the value chain with the individual banks at the end providing access to products developed by network partners. While the aim is to offer the complete product range, i.e. economies of scope, it is also envisaged to achieve economies of scale via the joint handling of certain back office tasks by network specialists. From an academic perspective and applying value chain theory by Porter (1985), the overall aim of the network in terms of operations is for primary banks to focus on core functions while network partners focus on support functions.

**Figure 11: Cooperative financial network value chain (macrostructure)**



### *Incentives and risk management (microstructure)*

As a reason for the economic existence, it is the obligation and privilege of the cooperative primary bank to use and utilize local or regional knowledge about the market and customer preferences and conduct business with relevant market participants being local businesses and private individuals. Achieved by this structure is a degree of transparency regarding risks involved, i.e. via the focus on one limited region only risks can be evaluated and judged by local staff. This can and has materialized in stable financial performance giving low or no valuation effects in connection with loan losses (due to local market expertise and involvement) and

financial instruments (due to the focus on regional economy and plain non-complex instruments). This can also be concluded to be in compliance with Knorr Cetina/Bruegger (2005) who stated that knowledge is the productive force of markets (applied to the region or regional social network). With regard to financial intermediation outlined in section 3.1.1, cooperative banks act as pure intermediaries with detailed knowledge about who capital providers and users are and direct knowledge about what projects are financed. Asymmetric information between customers and bank as outlined before is limited. Core functions as outlined in section 3.2.2 are achieved more easily when transaction partner know each other personally, thus, leading to incentives for pursuing the cooperative banking model.

#### *Trust (combined)*

It can be taken from surveys that customers in the wake of crises shift their focus towards different characteristics or values as far as banking services are concerned. Values in this regard, which become more important, are safety, reliability and stability. In other words, *trust*. Trust in this regard is usually achieved via the ability to personally evaluate and judge the doing of other actors. Actors must be able to make experiences on a personal level, in particular to overcome the issue of information asymmetry, while getting access to all financial services required. The cooperative business model is based on long-term performance and mutual support (e.g. via the protection scheme as outlined in section 3.2.5.1) that serves as a lamppost in the banking sector. Backed up by the performance during the recent financial crisis, this has been and is regarded the major competitive advantage.

#### **3.2.4 Statistics**

Per 31 December 2012, there were 1.099<sup>15</sup> cooperative banks with the smallest bank posting total assets of EUR 14 million (BVR, 2013a). As can be seen from the tables below, the average size of cooperative banks is relatively small. The tenth-largest cooperative bank has total assets of EUR 6,1 billion only.

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<sup>15</sup> excluded from the count are BAG Hamm and TeamBank; accessed at [www.bvr.de](http://www.bvr.de)

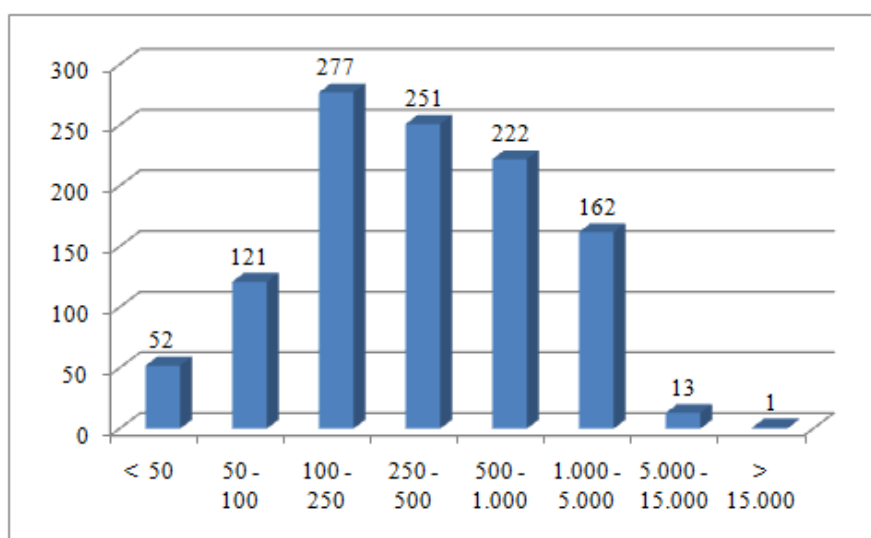
**Table 1: German cooperative banks ranking December 2012**

		Total Assets in EUR billion
1	Deutsche Apotheker- und Ärztebank eG	38,0
2	Sparda-Bank Baden-Württemberg eG	12,8
3	Berliner Volksbank eG	10,0
4	Sparda-Bank Südwest eG	9,4
5	Frankfurter Volksbank eG	8,2
6	Sparda-Bank West eG	8,1
7	EBBank eG	7,7
8	Bank für Sozialwirtschaft AG	7,3
9	Volksbank Mittelhessen eG	6,4
10	Sparda-Bank München eG	6,1
...		
25	Bank 1 Saar eG	3,7
...		
50	Hamburger Volksbank eG	2,3
...		
100	Volksbank Raiffeisenbank Oberbayern Südost eG	1,5
...		
200	Volksbank Achern eG	0,9
...		
500	VR Bank Schlüchtern-Birstein eG	0,4
...		
800	Raiffeisenbank Taufkirchen-Oberneukirchen eG	0,2
...		
1.099	Raiffeisenbank eG, Struvenhütten	0,01

Source: Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, 2013a, ; aggregated by the author

The high granularity of the cooperative banking assets can also be confirmed when looking further at the distribution of assets in bands. As can be taken from the table below based on aggregated data per December 2012 as published by the BVR, there are 923 of 1.099 institutions with total assets below EUR 1 billion, hereof 450 institutions (41%) with total assets below EUR 250 million.

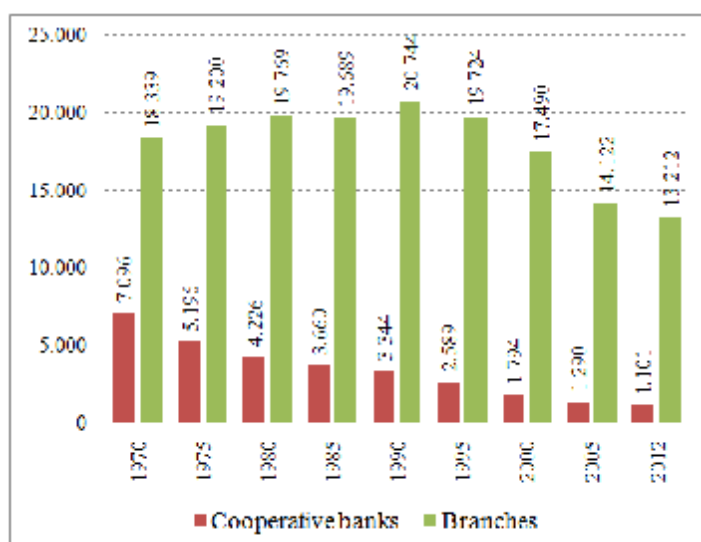
**Figure 12: German cooperative banks asset distribution December 2012**



Source: BVR (2013a); aggregated by the author

Based upon additional data by the BVR (2013a; own calculation) per December 2012, all primary banks combined had total assets of EUR 750 billion, leaving the average primary bank with about EUR 680 million. Adjusting for primary banks with professional focus (e.g. Deutsche Apotheker- und Ärztebank) leaves total average assets of about EUR 590 million. Looking further at the development of the number of cooperative banks, it is interesting to see a consolidation has taken place reducing the number from 7.096 in 1970 to 1.101 in 2012 due to the merger of predominantly small-sized banks. However, while the number of banks went down by more than 50% between 1970 and 1990, the number of branches increased before going down beginning in 2000. It is concluded that this trend is the result of the strategy to expand presence at the cost of quality before realizing that is more efficient to reduce branches and improve service and cost instead.

Figure 13: German cooperative banks: development of banks and branches



Source: BVR (2013a)

### 3.2.5 The meaning of member promotion and value

Every local cooperative bank is set up in the legal form of a "*eingetragene Genossenschaft*", ("eG"), i.e. incorporated cooperative, which is governed by respective cooperative law (Cooperative Act or "GenG"). Its purpose according to section 1 is to promote business ("Förderauftrag"), social and cultural activities of their members by virtue of cooperation (Lang/Weidmüller, 2006). It also allows for

the cooperation of independent companies in order to bundle general activities such as marketing, administration, etc. Every customer can become a member who, similar to a shareholder of a private bank, is entitled to a dividend. The Cooperative Act established basic legal grounds regarding this ownership. For example, it states that shares are non-transferrable (section 76), can only be returned after a notice period as deemed appropriate by the individual cooperative (section 65) and require owners to put in extra funding in case of liquidity issues (section 22a). Members are eligible to participate in the cooperative's annual profit (section 19) depending on the number of shares they hold. While not legally defined and varying from cooperative to cooperative bank, individuals (private/commercial) can hold a maximum of 10 to 20 shares, with values between EUR 50 and EUR 500 (Wirtschaftswoche, 4 March 2008). For example, with Sparda Bank Hessen<sup>16</sup> customers can only acquire one single share of EUR 52. With Berliner Volksbank<sup>17</sup> or Frankfurter Volksbank<sup>18</sup>, among Germany's biggest retail cooperative banks, there is no official limit of shares being EUR 52 each. In these cases the number of shares typically depends on the strength and extent of the business relationship.

### 3.2.5.1 Cooperative values

The concept of cooperative values has been the focus of several empirical studies and investigations. With regard to Germany and in the sense of looking at the cooperative systems in general with only limited reference to cooperative banks, Blome-Drees (2012a, 2012b) discussed their definition and occurrence. The most important values ought to present the basic principles of operations.

Figure 14: Cooperative values



<sup>16</sup> see [www.sparda-hessen.de](http://www.sparda-hessen.de); accessed in September 2012

<sup>17</sup> see [www.berliner-volksbank.de](http://www.berliner-volksbank.de); accessed in September 2012

<sup>18</sup> see [www.frankfurter-volksbank.de](http://www.frankfurter-volksbank.de); accessed in September 2012



Self-help means that a group of entities share a common problem and join forces to solve this problem. The original problem was limited access to financial means. It can be argued that today cooperative banks are not required to get access. There are several banks and other financial institutions providing every product required. Also, in the course of the update of the Cooperative Act in 1973, also non-members were allowed to do business with the banks. Blome-Dreese (1992) explained this step with the need to increase profitability due to the low scale of member-business.

Self-administration means that members as owners ought to manage and control the bank themselves. Also through the amendment of the Cooperative Act in 1973 this principle was undermined by restricting the influence of members on the bank management via the focus on the memorandum and the possibility to hire board members from other banking institutions who are no members and have no cooperative banking background.

Self-accountability means that members are jointly liable for all of the bank's obligations. While originally this meant being liable with all private wealth, this obligation is limited today up to 200% of the individual member's capital ("Haftsummenzuschlag" as described at [www.bundesbank.de](http://www.bundesbank.de)). The obligation is, however, only theoretical. The cooperative network has incorporated a guarantee system to safeguard affiliated institutions, being the *Protection Scheme* ("Sicherheitseinrichtung"), which guarantees all customer deposits at 100% and works based on a contractual guarantee basis. Since foundation in 1934, no customer of a cooperative bank has ever occurred a loss and no cooperative bank has ever had to file for insolvency (web site content at [www.bvr.de](http://www.bvr.de)). Similar protection schemes exist for the other banking groups in Germany as outlined in chapter 5.

### **3.2.5.2 Legal interpretation**

As illustrated before, the main purpose and guiding principle of the cooperative is to promote its members (*Förderauftrag*) as prescribed by law (Cooperative Act), hence combining a legal obligation with an undefined purpose since the *Förderauftrag* is not further defined (Lang/Weidmüller, 2006). This makes sense since members'

needs vary over time. However, due to the lack of definition, further analysis and interpretation needs to be conducted to set the background for further performance management activities.

Section 1 para 1 Cooperative Act sets the rule to promote members and their needs, i.e. it does not comprise non-members (primary purpose). After the amendment in 1973, section 8 para 1 no. 5 Cooperative Act was adjusted in a sense, that business was possible with non-members as an exception to the rule (secondary purpose). However, non-members were not eligible to receive promotion.

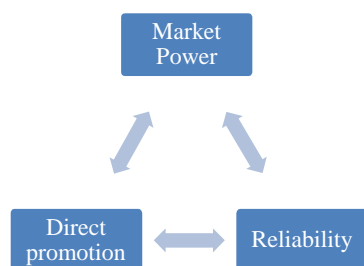
The legal interpretation only describes the purpose of the cooperative but not the type of business. According to section 6 no 2 Cooperative Act, the type of business can be defined individually. It must be aimed at promoting member value, however, it is not prescribed that this must be successful. In the course of the amendment in 2006, it was also included that cooperatives have to promote social and cultural needs of members. Promotion must occur via a joint business operation, i.e. a legal entity. Lang/Weidmüller (2006) stated that a cooperative can be managed with the intention to make profits. With regard to the member business, profits must, however, be regarded as means to the end, e.g. to maintain long-term economic survival in order to further conduct promotions. Again, this only applies to the member *business*, i.e. managing the business with the intention to make profits in the *non-member business* is not prohibited. Since the majority of customers are not members, legal constraints with regard to an enhanced performance management approach are rather limited.

### **3.2.5.3 Economic interpretation**

As illustrated in section 3.2, cooperative banks were originally set up to provide access to capital. Given the current competitive situation with almost all banks offering the same product range, this lack has been overcome. Also, Hanrath/Weber (2009) concluded that all banks in the German market show a comparable market behaviour with cooperative banks not distinguishing anymore between members and non-members.

Several studies and research have been conducted to provide for economic drivers of the member promotion. Reviewing the studies conducted, the following clusters can be distinguished:

Figure 15: Drivers of member promotion



With regard to market power, Wagner (1980) and Hahn (1986) highlighted the theory of presence, i.e. just by being present the cooperative bank fulfils its duty to promote members. This is by representing a *countervailing power* that prevents competitors from becoming too powerful leading to an oligopoly at cost of the members. Giving the structure of the German banking market, characterized by a large number of institutions with different business models that are in competition with each other, this author does not regard presence alone to be a sufficient reason for the economic existence.

With regard to direct promotion, Grosskopf (1990) suggest that *special conditions*, *kick-backs* or *dividends* can be granted to the members. *Special conditions* comprise either higher deposit rates or lower loan rates. Due to German tax regulation, this approach is not applicable since taxable income would be reduced, hence cooperative income and wealth reduced, while customers would be subject for tax evasion due to benefiting from hidden profits. Due to this, special conditions to members cannot be offered. *Kick backs* are also stated not to be applicable due to the same tax reasons and difficulties regarding the calculation. Dividends are part of every cooperative banks business. However, the level of dividends depends only on the number of member shares and not on the volume of the customer's business, which does not provide for the economic existence. From discussions and interviews with cooperative bank managers in 2013, this researcher concluded that cooperative banks are increasingly innovative in this context. A member bonus system has become

popular. In addition to their dividend per member share, members are eligible to receive bonus points for deposits, loans, saving plans and regular money inflows, hence increasing annual rate of return on their share up to 12%<sup>19</sup>. The conclusion by other authors regarding the non-applicability of economic reason due to the exclusion of business volume can, therefore, not entirely be confirmed. Due to the limited or mixed consideration of business volume in connection with the member share as basis with low nominal total impact at the end in comparison with total potential business volume it is still difficult to qualify this approach as a reason for the economic existence (see example in section 3.3.3.2).

With regard to reliability, Schröder (1997) highlighted that bank services are precarious since immaterial, complex and require a great deal of personal information. Customers want to rely on banks. This trust shall, in exchange, lead to lower cost for information, negotiations and control, hence reducing transaction cost (see section 3.1). Trust can be achieved by promoting a special identity, which is closely connected with promoting values such as honesty, ethics, quality, etc. After the outbreak of the subprime and financial crisis, cooperative banks experienced a run on their business since customers increasingly demanded honesty and safety (Handelsblatt, 30 November 2010). Consumer studies regularly confirm cooperative banks to be the fairest banks for retail customers (e.g. Focus Money, 3 April 2013). The BVR has launched a major marketing campaign just focussing on their recognition of values and initiatives to promote these (see [www.werte-schaffen-werte.de](http://www.werte-schaffen-werte.de)). At the same time, surveys among retail customers of the big private banks confirm that large numbers are unsatisfied with their bank relationship (e.g. Bain & Company (2012) stated 40%). In total, reliability appears to be applicable with reference to the economic interpretation. In general, competitors could pursue a similar strategy since strategy based on values is not bound to legal forms. Giving their strategic positioning and market approach this author concludes that sufficient differentiation has been achieved over the past four years.

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<sup>19</sup> internet research confirmed a uniform approach among all cooperative banks identified. Examples: [http://www.r-volksbank.de/wir\\_fuer\\_sie/vr-mitglieder\\_bonus.html#](http://www.r-volksbank.de/wir_fuer_sie/vr-mitglieder_bonus.html#)  
[http://www.vr-bank-bayreuth.de/Meine\\_Bank\\_neu/8/2.html](http://www.vr-bank-bayreuth.de/Meine_Bank_neu/8/2.html)  
<http://www.voba-mg.de/mitgliedschaft/VR-MitgliederBonus.html#>

#### 3.2.5.4 Principal-Agent problem

Based on the previous findings it can be concluded that the issues of member orientation, member promotion and economic orientation are all connected with regard to strategic positioning of the cooperative bank. Member orientation and member promotion in practice are not being followed rigorously, neither is the orientation towards a better economic position by means of higher profits. This raises the question, what the basis for the strategic alignment could be otherwise. Decisions of individual primary banks are made by the board. But what is the motivation of the board? To explain this, reference is made to the *principal-agent problem*. Eisenhardt (1989b) stated that two problems can occur in agency relations. The first one is connected with different goals of principal (members) and agent (manager) or high monitoring costs for the principal. The second one is connected with different risk preferences.

First of all, it cannot be stated that there is no identity between owners and managers since managers are always members of the primary bank. As mentioned before, the status of individual ownership is very limited due to the one-head-one-vote principle. Due to this lack of possible influence as a member/owner, it can be assumed that the manager retrieves his orientation from being the executive officer of the bank, hence giving reason for the principal-agent problem. The information asymmetry is also given and enhanced by the special requirement imposed by section 33 Banking Act, which requires bank managers to meet a number of specific quality criteria that other people and members do not possess otherwise. It can be argued that a bank manager does act in his own interests rather than in his members'.

When considering the most important rationale for management action, *compensation*, there is an interesting fact in reference to cooperative banks. Bank managers are always eligible to the highest salary grade of the cooperative banking union contract. This salary is multiplied with a variable factor depending on the size of the individual primary bank. The compensation package is reviewed annually by the responsible audit network (Pfaffenberger, 2007). As a result, it can be concluded that the compensation package depends on total assets.

As analysed in chapter 4, the development of total assets of cooperative banks has lacked behind that of other banking groups. As is also demonstrated, while asset growth has been moderate, so have profits. There is no evidence that asset growth has been achieved without ensuring necessary asset quality, i.e. loan write-offs have been low, pointing to selected growth. Pfaffenberger (2007) also considered this problem and concluded that many mergers might have occurred due to the desire to achieve higher assets, hence increasing compensation base. However, when reviewing and analysing the rationale behind individual mergers, it can be concluded that the rationale behind this approach is to cut costs and achieve synergies. Also, the high number of small institutions does not confirm the fact that there are management decisions done based on the aim to achieve size for the sake of individual managers. No evidence has been gathered by the cooperative audit networks who review bank operations on an annual basis that point to misconduct of managers in this regard. In summary, even though theoretically grounded, there is no empirical evidence that a principal-agent problem has caused deficiencies in cooperative bank management. Having outlined this, this author believes that the statements made before are intriguing and call for empirical evidence that can be, in fact, provided in a way that is not part of the regular audit framework. An empirical analysis can be made based on desktop research that comprises statistics and data as part of a longitudinal study. By collecting data regarding financial statements, e.g. via the online resource "*Bundesanzeiger*" and linking these data to the names of managers involved in mergers as outlined in their published short statements or websites, conclusions can be drawn if managers show substantial changes in their employment status, e.g. retirement shortly after a merger.

### **3.3 Performance Management: Framework of Cooperative banks**

The previous section has explained the cooperative banking sector and highlighted the development over the past 40 years that has been characterized by an increasing deviation of the original ideal type of a cooperative bank towards a more market oriented structure. Going forward and setting the framework for future strategic initiatives it is essential to consider if this trend is a necessary transformation of the

cooperative value that needs to occur in the current competitive environment or if this is a self-destructing approach.

For the purpose of this work and as outlined before, it is assumed that there is a need for the transformation of the cooperative concept. A competing concept is the concept of shareholder value, being the exact opposite at first sight. Conducting an analysis, three questions are to be answered:

- a) Who contributes towards performance and who has to be considered in the decision making process?
- b) What is to be measured?
- c) Based on a) and b), what are the perspectives?

### **3.3.1 Performance contributors**

The system oriented bank view states that multiple individuals and groups are linked with the banks and that they can influence or take part in the decision making process. These parties formulate individual goals in form of envisaged states, which the banks are supposed to achieve for them (Hamel, 1994). Certain goals can act as maxims with regard to the achievement of the company purpose and be used as a reference for the achievement of the required performance.

Goals for the company become goals of the company and thus part of the goal system, when stakeholders can enforce their objectives regarding the future state of the company. The definition of requirements for banks is, therefore, based on the design of the company's goal system. Of central importance is the differentiation between *goal monism* and *goal pluralism*. Goal monism has its source in the classic national economy, in which the homo oeconomicus strives for profit maximisation as difference between expenses and income. "The idea that a business has only one objective – to maximize profits – has been the majority view of business for the better part of our history. This is the view that business managers exist only to serve the interest of the stockholders" (Steiner, 1975). Central element of goal pluralism is the incorporation of multiple parties' goals. The overall goal is to achieve an optimal

benefit for all stakeholders, which all follow their own interest. Those individual goals and interests can be conform or competing, leading to the need to come up with a multidimensional goal system, which balances all aspects and achieve compromise (Pümpin, 1989).

### **3.3.1.1 Shareholder concept**

The monistic goal concept is linked with Rappaport's (1998) concept of shareholder value, which prescribes the sole orientation on the owners' financial interest, resulting in efforts to maximise the company's equity value. Other stakeholders' interests only have instrumental character and are only regarded if supportive for the achievement of profit maximisation. While the neoclassic view of the shareholder value concept raised several criticisms due to its unrealistic premises of complete markets and symmetric information distribution (Speckbacher, 1997), other views support the shareholder value concept. Examples include the property-rights-theory (Grossman/Hart, 1986), transaction cost theory (Bischoff/Bohnet, 2000) or principal-agent theory (Fama, 1980; Fama/Jensen, 1983).

Even though there is a theoretical ground for the existence of the shareholder value concept, the economic development of the past decade favours a deviation of that goal system. The need to deliver constant and increasing streams of dividends to shareholders and maintain profitability levels as required by market participants, amounting up to 25% (Oeser, 2009), has led to the accumulation of excessive risks to provide for relevant income, which is widely regarded as the main cause of the financial crisis beginning 2007 resulting in massive drawbacks for society as a (as formerly regarded) instrumental stakeholder.

### **3.3.1.2 Stakeholder view**

Due to the narrow focus of the shareholder view concept and its limitations, the stakeholder view concept was promoted, mainly through the work of Freeman (1984), who referred to research conducted by the Stanford University in the 1960s, describing stakeholders as "those groups without whose support the organisation would cease to exist". In a *narrow* sense, Freeman described stakeholders as "any



identifiable group or individual on which the organisation is dependent for its continued survival” (Freeman/Reed, 1983). In this context, stakeholders can be summarised as being employees, customers, suppliers and capital provider. In a *wider* sense, Freeman (1984) described stakeholders as “any group or individual who can affect or is affected by the achievement of the organisations objectives”. In this context, stakeholders also include competitors, community and unions.

What has been identified as a shortcoming within academic literature is the consideration of regulatory institutions as an increasingly dominant stakeholder. In this context, regulatory institutions are not to be considered bodies such as Bank for International Settlements, but national financial supervisory bodies such as the Financial Supervisory Authority (FSA)<sup>20</sup> in the UK or the BaFin in Germany. Also, the European Banking Authority (EBA)<sup>21</sup>, acting as a hub and spoke network of EU and national bodies, is to be included in this context. Even though the level of regulators’ influence within individual countries can vary, it has become very clear that measures taken by national bodies will affect the achievement of company objectives, i.e. there will be a significant impact on financial results and much higher minimum requirements with regard to the operation of the bank business, with non-compliance also leading to the closure of the institution.

Irrespective of the stakeholder view’s rationale to balance all interests, a reasonable concept requires a thorough identification and distinction of relevant stakeholders. Literature in this context contains several approaches and aspects. However, the two main attributes can be identified as *power* and *legitimacy* (Ulrich, 1999). The *power view* distinguishes the extent to which individual parties can positively or negatively impact bank operations. The *legitimacy view* refers to the extent to which individual parties can assert a claim towards the company.

It is this identification and distinguishing process leading to an elevated degree of subjectivity that has attracted most criticism in literature (refer to Eberhardt (1998) for good summary). Criticism also includes the measurement and evaluation of

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<sup>20</sup> see [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>21</sup> see [www.eba.europa.eu](http://www.eba.europa.eu)

stakeholder interests as well as the possibility that these interests are not always known and, therefore, are not fulfilled or only by coincidence. Furthermore, due to the consideration of all stakeholders' interests, there is a high possibility of not sufficiently pursuing the economic success of the company as being the pre-requisite for providing benefits to all stakeholders.

Based upon the previous discussion about the shareholder and stakeholder concept, the next step is to narrow the elements of performance measurement with a focus on the purpose of this investigation. The first step is the identification of the relevant stakeholders representing the perspectives of performance evaluation. According to the before mentioned attributes of power and legitimacy, there are many stakeholders, however, no uniform view.

Most consensus exists regarding equity provider, debt provider, management, employees, suppliers, customers and society. For the purpose of this paper, the stakeholders are narrowed down to equity providers/owners, customers, employees and society. *Management*, in accordance with Freeman (1984) who does not see management as stakeholder in a narrow sense, is not included because of its intermediary position to balance all stakeholders' interests as well as the multiple stakeholder positions it incorporates, i.e. running the bank, being employee, being owner, etc. *Debt providers* are not specifically regarded because of the overlapping with customers, who provide deposits to the bank, and the similar financial objective compared with equity providers/owners. *Suppliers* are not regarded because of their traditional inferior meaning to the value creation process, being 50%-80% compared to e.g. 25% within the automotive industry (Disselbeck, 2007). Marjanovic (2006), with a focus on the German public savings banks sector, identified as stakeholders employees, management, customers, the governing local authority and competitors.

*Regulators* were widely not regarded as stakeholders or were specifically excluded when analysing stakeholders highlighting their low level of consideration in the past. It can be observed that upon the financial crisis and the awareness for an enhanced level of regulation, attention and consideration has improved. In detail, however, this perception is divided. Enhanced perception is applied by large banks that are more

on the radar due to their risk position and, hence, have to endure higher regulatory pressure. Among smaller banks, the old view still prevails, which can be attributed to the attitude or business model: low risk => low regulatory attention.

Despite differences of the two approaches outlined, certain common denominators and similarities can be derived. Rappaport (1998) stated that shareholder wealth can only be increased, if this is not conducted at the expense of other stakeholders. Their interests have to be considered to ensure co-operation. Furthermore, literature also regards the maximisation of shareholder wealth as a key element of stakeholder management, since only in this way sufficient funds are generated to make the consideration of more stakeholders' interest possible. A similar conclusion can be derived by referring to Adam Smith's "Wealth of Nations" (1776). According to him, an "invisible hand" will, in the long run, ensures actions beneficial to all parties, even though actions in the short run focus on the generation of shareholder wealth only. Authors refer to this development as a *synthesis* between the shareholder and stakeholder concept (e.g. Eberhardt, 1998)

With regard to cooperative banks in particular, relevant stakeholders are typically members, customers, employees, board, network partners and the public.

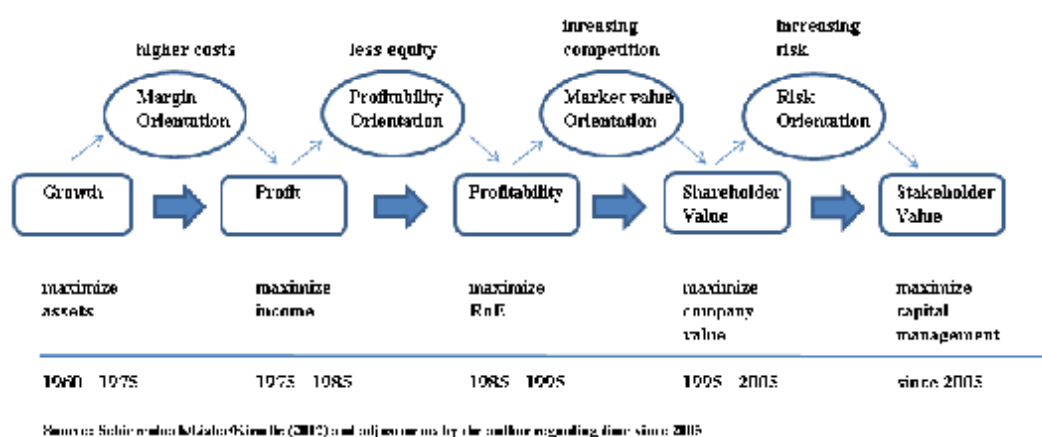
### **3.3.2 Performance measurement**

#### **3.3.2.1 What is it about?**

The definition of "performance" depends on the relevant matter and user, because of which the management of performance is viewed from different angles (e.g. with focus on finance, controlling, organization, human resources, etc.). Hoffmann (2002) defined performance as "the valued contribution towards the achievement of the goals of an organization", which can be provided by individuals or groups within that organisation as well as by external parties. Accordingly, performance combines two constituent aspects: the achievement of a goal as a direct consequence of actions and the outline of goals and requirements as value reference.

Analysing performance management in financial institutions in the past, it can be concluded that there have been several paradigms as demonstrated by Schierenbeck et al. (2008). Up until the 1980s, performance was predominantly measured in terms of volume and growth targets. While still regarded important, performance management had to be adjusted due to the growing competitive situation with importance shifting towards profitability.

Figure 16: Development of performance management concepts



Up until the financial crisis, which originated in 2006/2007, performance in financial institutions was almost solely regarded as profitability. Karr (2005), with a focus on financial institutions, stated that banks were increasingly using Return on Equity (“RoE”) as the ultimate performance scorecard. This approach is based on Rappaport’s (1986) concept of creating shareholder value, which is pursued by virtually all private banks with utmost attention. According to this, shareholder value represents the market value of the equity, i.e. the company value, and corporate doings focus predominantly on the increase of the latter. Due to the increasing internationalization and especially the role of the banks in the financial crisis it is necessary to reconsider this focus on shareholders and apply a multiple stakeholder view when considering future direction. Hereby, performance measurement is a directional process by which the new strategic direction is translated into key performance indicators such as time, satisfaction, quality, ethics, legal compliance, cost and income. This author, therefore, argues for the enhancement of the shareholder value towards a stakeholder value.

While the usage of RoE in today's performance management is undisputed, there is headroom with regard to its methods.

Companies usually apply Value Based Management as introduced by consulting company McKinsey in the 1980s, which serves as a framework for shareholder value maximisation (Hostettler, 2000). Shareholder value, on the one hand, can serve a way of management philosophy and, on the other hand, also be interpreted as a financial measure whereby it refers to the net present value of future investors' income, i.e. the discounted cash flows (DCF) with the application of relevant capital market models such as Capital Asset Pricing Model (CAPM) to determine discount factors. In an efficient market, this value represents the market value of equity. Next to the DCF approach to derive shareholder value, there are other methods, e.g. the discounted Economic Value Added (EVA) approach, developed by Stern Stewart & Co. in 1989 as well as methods to manage the actual increase in shareholder value within a predetermined time period, e.g. Cash Value Added (CVA), developed by Boston Consulting Group, Market Value Added (MVA), being the difference between the current market value of a company and the capital contributed by investors, or Total Shareholder Return (TSR), being the combination between share price appreciation and dividends paid to shareholders (Dressler, 2004).

### **3.3.2.2 What can (cooperative) banks do?**

The original concepts with regard to shareholder value did not aim at banks, hence, do not incorporate banks specific characteristics. Main difference is the fact that financing is not there to support operations but rather is operation itself.

With regard to valuation of banks, economic literature broadly distinguishes two different approaches being DCF and EVA (Schierenbeck/Lister, 2002).

DCF for banks is strongly related to theory concluded by Copeland et al. (1993). Grounded in the calculation is the Free Cash Flow (FCF), which is calculated as net income after tax adjusted for non-cash transactions to derive at the Operative Cash Flow (OCF) adjusted for cash transactions in connections with bank assets to derive at the FCF. The problem with this approach is that estimates have to be incorporated

to provide for medium-term projections resulting in a higher degree of uncertainty and complexity with regard to data gathering. Börner/Lowis (1997) further distinguished this approach by concentrating on value driver in order to reduce uncertainty. Their model focuses on cash flows and applies actual margins from operations.

EVA is more related to actual financial account data and calculated as Net Operating Profit After Tax (NOPAT) less Capital multiplied with Cost of Capital (WACC). Positive values mean that company value has increased.

Focussing on cooperative banks, a number of conditions need to be fulfilled and factors considered:

- Cooperative banks have a widely uniform IT infrastructure. These systems need to include the relevant data needed and must be amendable to include relevant calculation without requiring further add-ons.
- It must be economically grounded as well as "presentable" to stakeholders. Not only do the managers have to understand the mechanism. Due to their influence, other stakeholders, e.g. supervisory board, need to be able to comprehend it, i.e. the higher the level of complexity, the more support is lost.

Given these factors, a tendency can be derived at towards EVA. Banks and especially German banks are not cash flow oriented and, hence, would not opt for a system that would not fit with their (low risk) business model.

### **3.3.3 Performance perspectives**

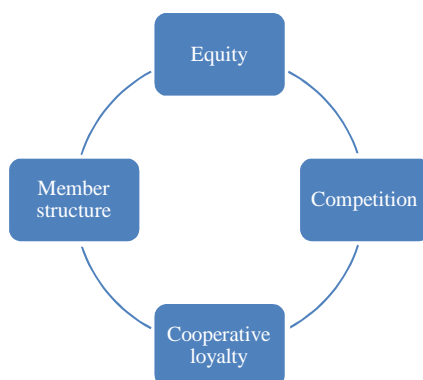
#### **3.3.3.1 Scope of inclusion**

Generally speaking, each cooperative bank that does not feel the need to change could be excluded from the findings and conclusions to follow in this paper. Many

primary banks have already undergone a transformation process<sup>22</sup> or simply do not want to change. The need to change and transform will be identified and derived as part of a financial analysis. How the awareness of the current situation and the willingness to change the modus operandi is existent among banks will be identified in the course of this work. For the purpose of this work it is assumed that each primary bank will have problems achieving its targets and, hence, faces the option to either cease operations or change.

In order to get a better understanding of the forces, it is important to review the most important drivers first. In the light of the current economic situation and his experience, this author applied four distinguishing characteristics:

Figure 17: Drivers of business operations



Primary banks differ in terms of their equity needs. Due to the implementation of Basel III, this is considered the most important issue, especially since members have to provide capital and a market for trading member shares does not exist. Member structure does have an influence since it is assumed that many institutions, especially in rural areas, do want to benefit from direct promotions and also want to be part of the decision making process. Also, primary banks are subject to different levels of competition. While in rural areas, competition comes mainly from savings banks (Sparkassen), it is private banks and near-banks in urban areas that have achieved significant growth in market share (Steria Mummert, 12 February 2013). The fourth

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<sup>22</sup> it can be argued that the decrease in cooperative banks numbers has caused a transformation process already

characteristic is a derivative of this researcher's work experience, cooperative loyalty, i.e. his experience with clients that changed their legal corporation status from an "eG" to "AG" (equivalent of "plc"), i.e. they legally stopped being subject to the Cooperative Act, hence, to cooperative values. Theurl (2002) argued that due to low equity, cooperative banks are expected to significantly change their corporation status.

Even though universally important, primary banks with low equity, a high percentage of dividend-oriented members, high competitive pressure and low cooperative loyalty are expected to have the highest potential for transformation.

### **3.3.3.2 Cooperative compliant shareholder value**

Cooperative economists, among these Theurl (2002) and Tschöpel (2011, 2013), have argued that a member value strategy could be the solution to the increasing competitive pressure on primary banks. This strategy comprises the focus on members and the strategic initiatives to attract potential customers with membership and associated benefits, i.e. direct promotion (real support), indirect promotion (dividends) and sustainable company going-concern (through deposit protection schemes). Their model focuses on promoting member value with income and cost considerations being secondary, i.e. a derivative of more intense business with members. Shareholder value and cooperative value are not regarded to be exclusive in this context. On the contrary, in their model shareholder value principles in a rather pure form are applied to members in order to achieve differentiation to non-members and achieve a USP.

This author concurs with the applicability of this approach in a theoretical model. Being a practitioner and with this research to be of practicable relevance, however, this researcher does not believe that a member value strategy can be feasible in the real world, at least not in that intensity and that the operationalization of a member value strategy as prime strategic directive among primary banks would be a mistake. The rationale behind this is based on the financial development of primary banks over the past 20 years. Böhnke (2012), former CEO of WGZ Bank and looking at the



status quo five years ago, described the cooperative banking network as old-fashioned and boring. Upon the subprime crisis, cooperative banks enjoyed a new kind of attractiveness. No cooperative banks required government aid. While this development is still to be confirmed and analysed in the context of the German banking market as a whole (see chapter 4), the most important question is: If the cooperative mission and value are considered, fostered and promoted as a USP, is it worthwhile doing this or is there evidence for the promotion of a different system in the German banking market? An in-depth analysis of the German banking market as carried out in chapter 4 will provide an answer to this question from an economic perspective.

As outlined in section 3.2.5, direct promotion of members is not practicable, hence, negating a member value strategy. Also the member bonus system as a practicable instrument to directly promote members outside the scope or regular business operations is not considered a significant instrument. This is illustrated by a simple example:

If a customer holds a maximum of ten shares at EUR 50 each, dividends of 4% would lead to income of EUR 20. Even at a maximum return of 12%, income would increase to only EUR 60. While this in fact a high relative ROI, the absolute benefit or marginal benefit of EUR 40 is outweighed very easily by only small variations in conditions. This benefit is more than made up with competitors offering current accounts for free or better rates. On a deposit or loan of EUR 10.000, it only takes a difference of 0,4% to make up the difference. Since cooperative banks are not competing on price terms, their rates are usually slightly worse. If a member value strategy is not deemed to be successful, what then? Answers can be derived by looking at strategy in terms of *potential* with regard to *income* and *costs*. As opposed to the member value strategy, this author believes that better performance will result in better member value instead of the other way around. The aim, hence, should be to enhance income and lower cost in order to maintain or improve RoE allowing cooperative banks to continue following the cooperative principles. Pleister (2001), former president of the BVR, once stated:

*"The most significant difference between a cooperative banks and other banking institutions is the overriding adherence to principles. Cooperative banks and all other members of the cooperative network are subject to their statute and, therefore, have to care about the well-being of their members. This principle applies to members as well as non-members. It prevents the sole orientation on financial measures. Economic success is, therefore, always linked to the interest of the basis."*

Deriving at a cooperative compliant shareholder value is, can and should only be achieved via the optimization of internal processes, being bank or network internal.

Looking at *income* potential, the cooperative banking sector per December 2012 had 30 million customers, while only 17,3 million members<sup>23</sup>. No data has been published as to how many of the 17,3 million members only have a member share due to the good ROI with no further business volume. Also, as Böhnke (2012) stated, there is no evidence as to how many of the 30 million customers are actually "active" customers, i.e. customers that carry out transactions on a regular basis. It is this customer interface that needs to be optimized. On the other hand and even more important, optimizing *cost* structures will be the key to achieving a sustainable shareholder or stakeholder value. While internal processes need to be optimized, it is crucial to approach this issue from a network perspective , i.e. outsourcing and cooperation models are to be analyzed.

### **3.3.3.3 Follow up on bank calculation (quantitative)**

As outlined in section 3.1.3, maturity transformation is a matter of concern, especially for regulators due to the interest rate risk involved. Numbers for 2013 indicate that interest income of the cooperative banking sector has in fact increased and stabilized, even though the overall interest level decreased. Preliminary findings in section 3.1.3 indicate that maturity transformation, i.e. treasury contribution, is pushed. In order to further quantify preliminary findings, discussions have been held with one network representative (NR1) who stated:

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<sup>23</sup> see [www.bvr.de](http://www.bvr.de); accessed in July 2013

*"It is true. Many cooperative banks in our state did not make a profit in the customer business. This is a wanted and desired situation since this represents the cooperative values and also the basis of our success".*

The analysis conducted in this context showed that cooperative banks can indeed maintain a sustainable business model when no profits in customer business is achieved, which is mainly achieved via maturity transformation. Adjusting operating before valuation of 1,02% for the treasury contribution of 0,94% results in operating income of 0,08% only. Further adjusting for loan valuations leaves an extremely low operating income of 0,02% only. This confirms preliminary findings that sales contribution has decreased heavily in importance. It also needs to be considered that loan valuation was extremely low, i.e. in regular times, e.g. in 2009 with 0,27%, loan valuations would totally eat up profits.

**Table 2: P&L with all numbers in % of average total assets in 2010**

	Overall	Customer business	Treasury business
<b>Net interest income</b>	2,30		
<b>Sales contribution from customers</b>	1,36	1,36	
<b>Treasury contribution</b>	0,94		0,94
Commission income	0,69	0,69	
Gross income	2,99	2,05	
Administrative expenses	-1,97	-1,97	
Gross net income	1,02	0,08	
Other income/expenses	0,00	0,00	
Operating income before valuation	1,02	0,08	
Valuation effects Loans	-0,06	-0,06	
Valuation effects Securities	-0,04		-0,04
Operating income after valuation	0,92	0,02	0,90

In connection with section 3.2.3, it is worthwhile investigating how this approach concurs with member value. Since it has been concluded that cooperative banks do not follow shareholder value principles, it can also be concluded that cooperative banks only have to achieve the minimum profit required to provide for a sufficient return of member capital plus a certain minimum profit to ensure commercial going concern and maintain market share in line with economic growth. One interviewee stated:

*"Assuming that the economy grows by about 1,5% p.a. plus inflation between 2,0% and 2,5%, there is a calculated profit requirement after dividend of 3,5% to 4,0%. Equity accounts for 6,8% of total assets, hereof 1,3% member capital that is usually returned with 5% p.a. If we achieve a RoE of 6,5%, this would result in profits after dividend and tax of ap. 3,9% being just sufficient".*

Historical data provided by the interviewee pointed to average return of ap. 4,0% coming from the investment of equity, being not sufficient to cover the required RoE of 6,5%. As was discussed further with the interviewee, a few banks opted to leverage investment, i.e. refinancing facilities referenced to 3-M Euribor lead to returns of up to 7,0% after deducting refinancing. Asked about the additional interest rate risks, it was stated:

*"According to our calculation, also investing twice the amount of equity, i.e. equity and external funding, would not lead a breach of risk limits. In addition, we can also adjust our deposit rates in order to further react to changes."*

Following up on the preliminary conclusions of section 3.1.3, it is concluded that customer business has in fact turned non-profitable and is heavily subsidized by maturity transformation. This author concludes that the current situation is in fact in compliance with cooperative principles and a model that could be maintained in absence of future economic and regulatory pressures. As opposed to the interview partner, this author, however, regards the current situation, which can be described as "we are happy as we are", as a highly alarming signal posing significant threat to future operating profits with high pressure on introducing measures to manage expected future impacts, coming especially from Basel III and the overall monetary policy.

### 3.4 Summary and Conclusion

*"Tradition is not to preserve the ashes but to pass on the flame."  
(Benjamin Franklin)*

It was this researcher's aim to conclude whether the cooperative banking strategy and shareholder value concept are two contradicting approaches. The aim was based on the assumption that cooperative banks are subject to cooperative law and, hence, have to comply with cooperative principles and values, leaving very little room to apply shareholder values, i.e. profit.

In summary it can be concluded that cooperative banks have distanced themselves from the cooperative principles over the years, which is also a result of the socio-economic evolution of people putting more premium on communication, information, individuality and self-definition. Members, especially after the amendment of the Cooperative Act in 1973, are mainly considered as customers only, hence, further reducing the difference between cooperative banks and non-cooperative banks. Still, the focus on being pure financial intermediaries in commercial banking has prevailed and, which can be assumed, will prevail. While this basically negates the existence of cooperative banks in its originally envisaged form, the sector has enjoyed a revival starting 2007 as a result of the economic uncertainty in connection with the subprime and financial crisis. Evidence points to the fact that this revival is, however, not the result of an increased consideration for cooperative values but rather the use of the conservative cooperative banking sector as a safe haven for money.

Based on the analysis of microstructures and macrostructures, sustainable competitive advantages could be identified being, above all, trust, efficiency and enhanced risk management.

The competitive environment imposes pressure on the cooperative banking sector to transform the way it does business. While cooperative loyalty and member structure are internal factors that can be managed, other drivers such as competition and equity

requirements are imposed from the outside. And while it can be assumed that there is an impact of these drivers on performance management, it is still not clear to what extent. What has been identified as a need to maintain and improve performance is to rethink intangible assets, resources and activities that represent the competitive advantage of the cooperative sector. Giving the mechanism of the cooperative financial network, it is structural capital that needs to be focused on by primary banks (see chapter 6).

To achieve transformation, the shareholder and stakeholder concept was analysed and it was concluded that shareholder value and cooperative value orientation do not exclude themselves. While cooperative economists argue to primarily follow a member value strategy, i.e. the promotion of membership and member value, this researcher does not deem it practical and suggests to focus on internal processes to exploit and benefit from potential and synergies. Adjusting the shareholder value concept that asks for maximizing profits, the most suitable approach to achieve a cooperative compliant shareholder value would be to consider several measures with regard to income and costs, supplemented with a optimized Treasury strategy<sup>24</sup> as speciality of banking institutions. Given its straight-forward nature, it is recommended to apply the EVA concept with regard to measure progress on a strategic level. In this regard, the consideration of EVA within a BSC framework is to be tested. The further analysis of factors, measures, drivers and means of operationalization form the design and content of the following chapters.

It was also the aim to preliminarily evaluate the relevance and impact of the advanced Basel III requirements on cooperative banks. In reference to bank theory, the cooperative banking model is deemed to be characterized as risk-adverse. It is concluded that advanced requirements are not applicable. However, the obvious risk is maturity transformation that is heavily pursued by cooperative banks. While this conclusion was initially of *qualitative* nature, a more *quantitative* analysis was conducted. Based on empirical evidence provided, it was concluded that cooperative banks can refrain from customer profits, as long as maturity transformation is

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<sup>24</sup> The Treasury department is responsible for a bank's funding, capital and liquidity, hence, combining income and costs.

possible, which even complies with cooperative principles. However, the assumptions made need to be seen in the context of time and prospects. It is assumed and expected that Basel III will reduce the opportunities for maturity transformation. Also the room for adjusting conditions has significantly been reduced as of the end of 2013 due to the subsequent reduction in the overall interest level. Evidence, hence, point to the requirement that adjusting bank calculation alone will not be sufficient to further maintain the business model.

## 4. The German Banking Sector

Chapter 4 entails an analysis of the German banking sector by highlighting its speciality, i.e. the Three Pillar System. As part of a comparative analysis it provides answers to the questions regarding the economic stance of the cooperative banking sector compared to other banking groups and markets. Hence, the following analyses are conducted:

- Section 4.1 highlights previous and most relevant academic contributions to the topic of bank market analysis in order to get an overview on what has been conducted previously by other researchers including describing their relevant focus. Hereby, the focus is on *profitability, competition and efficiency*.
- Section 4.2 analyses the German banking market and the position of the cooperative banking sector in particular with the aim to confirm economic reasons for the existence of cooperative banks and to identify the most significant performance drivers as possible targets for further measures. This is done by applying key performance indicators relevant to the banking industry and applicable to all banks of the three pillars comprising the German market being private banks, public banks and cooperative banks.
- Section 4.3 elevates findings from previous sections to a European level, i.e. via cross-country performance indicators the aim is to challenge the common perception of the German banking industry being inefficient and overbanked.



#### 4.1 Applicable theory: Competition and concentration

The German banking sector is usually referred to as consisting of “Three Pillars”, i.e. cooperative banks and public savings banks as stakeholder-oriented banks and commercial banks as shareholder-oriented banks. The distinction is made by the structure of ownership, business model or orientation and regional orientation as outlined by Krahen/Schmidt (2004).

Figure 18: Three pillars of the German banking system



Researchers who have looked at the subject from a German banking sector perspective only include Hempell (2002) conducting the most advanced statistical analysis in terms of competition and profitability, Brunner et al. (2004), Tiwari/Buse (2006) and more recently by the IMF (2011). It can be observed that the bulk of research, i.e. the focus on Germany alone, was conducted up until the early 2000s. It can be assumed that the reason behind this development was the relatively static state of the sector being regarded as old-fashioned, conservative and not subject to a lot of change. Tiwari/Buse (2006) identified challenges especially in the form of "pressure to consolidate" (due to the high number of institutions), "increased competition from foreign banks" (due to the increased number of foreign banks), "relatively low profitability" (due to weak income-to-assets ratios), "high productivity and customer satisfaction" (as result of cheap service), "growing role of direct banks and other institutions" (especially due to the massive success of ING Diba as first mover), and "growing competition to win retail customers" (as result of economic downturn in 2001/2002).

Given the composition of the German banking markets, the two initial perspectives applied to analyse the current situation have been identified to be *ownership structure* and *competition*. While theoretical models point to performance or profitability advantages of privately owned banks due to a higher degree of capital market discipline, empirical studies show inconclusive results. Short (1979), Bourke (1989) and Iannotta et al. (2007), while focussing on large banks in various countries, found a positive correlation between private ownership and profitability. Analysing all European banks, Molyneux/Forbes (1995) found a positive correlation, while Goddard et al. (2004) found a negative correlation. More recently, Ferri et al. (2010), focussing on 300 European banks, stated that "there is no evidence of a significant lower profitability either for any co-operative or savings bank class" and that "cooperative and savings banks do somewhat better in terms of cost efficiency and loan losses".<sup>25</sup>

Academic researchers who have looked at the subject from a European perspective with a focus on *competition* are numerous. The most comprehensive ones have been identified to be Jakob A. Bikker<sup>26</sup>, Philip Molyneux<sup>27</sup>, and Asil Demirgüç-Kunt<sup>28</sup>.

There are several approaches to measuring competition and profitability, usually being very statistical. Bikker/Bos (2008) provided one of the most comprehensive reviews on models in use. In connection with other authors, the following can be made:

Panzar/Rosse (1987), developing their own model, applied the so-called *H-statistic* being the sum of elasticities of the reduced form revenue function with regard to input prices. With regard to European banking, Bikker/Haaf (2002), Beck et al. (2003),

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<sup>25</sup> most studies between 2009 and 2013 have been found to refer to transition and developing countries and areas such as China, India, Middle East, etc.

<sup>26</sup>Senior Researcher at De Nederlandsche Bank and professor at Utrecht University. Research focuses on bank performance. In 2008, Bikker/Bos published one of the most respected works regarding the frameworks for the analysis of profitability, competition and efficiency.

<sup>27</sup>Professor of Banking and Finance at Bangor University, Wales. Research focuses on the structure and efficiency of banking markets. In 2011, he published one of the most important works in recent bank economics.

<sup>28</sup>Director of Research in the World Bank. Research focuses inter alia on determinants of financial development, bank concentration and competition, bank supervision and banking crises.

Demirguc-Kunt/Detragniache (2005), Demirguc-Kunt/Huizinga (2010), Demirguc-Kunt/Martinez Peria (2010), Liu et al. (2010) and Bikker et al. (2012) conducted respective analysis.

Bresnahan (1982), Bikker (2003) and Uchida/Tsutsui (2005) look at bank behaviour on aggregate levels in order to determine the *conjectural variation* parameter via the simultaneous estimation of the market demand and supply curves. Berger et al. (1993) define *X-efficiency* as the economic efficiency of any single firm minus scale and scope efficiency affects. Bikker (2004) and Bikker/Boos (2005), also in regard to the European banking sector, conducted several analyses. Bikker/van Leuvensteijn (2007) referred to the *Price Cost Margin (PCM)*, which, in reference to the Lerner index, implies that profits are the result of a lack in competition. The *Structure Conduct Performance (SCP)* model assumes that market structure influences bank behaviour that in turn affects bank performance, i.e. in markets with higher concentration banks are more likely to show collusive behaviour and their oligopoly rents increase performance. Bikker/Bos (2005) questioned this approach due to multicollinearity problems. Van Leuvensteijn et al. (2007) applied the *Boone indicator model*, which is based on the relationship between efficiency as measured by marginal cost and performance as measured by profits when analysing competition in the loan market of the EURO area.

All models stated above are considered rather abstract. With regard to the most commonly used model used for the analysis of banking markets, Panzar/Rosse, (Liu, 2010), while analysing competition for the European banking sector, concluded that "competition measures tend to provide inconsistent results and the measures are statistically unrelated. This raises doubts about the generality of the findings of previous empirical studies". Also because of the highly theoretical nature of the models and findings, other measures have found more practical attention, being especially (a) share of the five largest banks (*CR5*) and (b) the *Herfindahl Index (HI)* index. The HI is calculated as the sum of squares of the market shares of each firm competing in the market (Hayden et al., 2006). While CR5 is easy to calculate and to comprehend, it does not consider the remaining banks in the market in contrast to HI.

Both ratios described are used by Deutsche Bundesbank and ECB as testing for competition and also considered for further conclusions as outlined in section 4.2.3.2 and 4.3.4.

## 4.2 Organisation of the German Banking Market

In order to capture the peculiarities of the German market, Kakes/Sturm (2002) applied three criteria to establish a structured analysis approach. For this work and given the known structure, this author deems the combination of criterion two, being ownership structure, and criterion three, being organisational structure, as more appropriate.

First, looking at the **scope of activities**, a distinction between *universal* and *specialised* banks is applied. Since there is no legal restriction regarding the choice of business model or business fields, most German banks engage in all segments and markets, resulting in a predominantly universal banking system with only a relatively small number of institutions being specialised.

Second, looking at **ownership structure** and **organisation structure**, a distinction between *private* and *public* banks is applied. Public banks comprise savings banks (Sparkassen) and their respective central banks (Landesbanken), organised in one corporate family. Private banks are managed and owned by private individuals, i.e. without public restrictions, and include publicly traded banks. It is generally concluded that cooperative banks and their respective central banks are also considered private giving the lack of public influence. In this context, Schmidt (2011), due to their diversity and regional orientation, referred to savings banks and cooperative banks as stakeholder-oriented banks (STV) in comparison to private banks referred to shareholder-oriented banks (SHV).

It is these groups that form the German three-pillar system which has been subject of several studies and referred to as one of the reasons for the low profitability in German banking. However, recent crises have motivated researchers and practitioners to re-examine this assertion. The Economist in a recent article (10

November 2012), referring to Germany's "bittiest banking system", described it as "old-fashioned but in favour" due to the fact that savings and cooperative banks have not been materially affected by the crises. However, the foundation for the three-pillar system was set in the 19<sup>th</sup> century with the intention to provide for a greater good, especially in poorer parts. While savings banks were created by authorities in order to fulfil their fiduciary duties, cooperative banks were created by local business men as means for self-help.

Relevant data regarding the German banking sector and its groups are aggregated by basically two sides. First, there is the umbrella organization of the savings banks group and the cooperative group. There is no prescribed standard on how these organizations aggregate data, hence they can only be analysed on a stand-one basis and not intra-group. Also, there is different data quality observed over years.

Second, there is *Deutsche Bundesbank*. Within their framework of banking statistics, Deutsche Bundesbank "collects information on the assets and liabilities of all monetary financial institutions (MFIs) in Germany on a monthly basis" (Deutsche Bundesbank, 2013, 2006, 2000). The structure of the statistics also mirrors the three-pillar system.

When analysing and comparing data, it is important to point out that there is one aspect that is often overlooked by academic researchers being differences between local GAAP and international accounting standards (IFRS). Taking effect in 2010, the German Commercial Code was adjusted in the way that banks had to account for derivatives transactions that were previously accounted for off-balance<sup>29</sup> (ifb, 2010). Numbers by Deutsche Bundesbank are based on German regulatory obligations that are based on local GAAP that, however, only have to be published when banks are capital markets-oriented and, hence, need to prepare group consolidated accounts on IFRS basis. In consequence this step lead to a harmonization of business volumes according to German GAAP and IFRS in 2012. Most databases, being predominantly BankScope as the most comprehensive one for international bank data analysis, are

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<sup>29</sup> The "Bilanzrechtsmodernisierungsgesetz "BilMoG" was decided upon by the German Government on 3 April 2009 and introduced in 2010.

based on published data. With regard to Germany, this effect is very significant. Taking, for example, Deutsche Bank, numbers according to German GAAP (prior to harmonization) had been significantly lower due to the non-consideration of derivatives transactions.

**Table 3: Structural data of the German banking sector 2013**

	Number of banks			Number of branches			Number of employees		
	1999	2005	2013	1999	2005	2013	1999	2005	2013
All categories	2.993	2.229	1.844	41.243	41.394	34.531	732.100	672.500	630.350
Private banks	315	357	296	6.867	14.044	10.143	219.750	190.700	170.700
Big banks	4	5	4	3.114	11.446	7.610	n/a	n/a	n/a
Regional banks	223	224	178	3.681	2.526	2.444	n/a	n/a	n/a
Landesbanken	13	12	9	655	580	434	40.800	40.200	33.400
Savings banks	578	477	417	16.892	13.950	12.323	282.150	260.800	244.000
Cooperative central inst.	4	2	2	24	11	11	7.400	4.950	5.250
Credit cooperatives	2.035	1.338	1.081	15.793	12.722	11.541	170.950	162.550	160.100
Mortgage banks	32	25	17	216	56	50	n/a	n/a	n/a

Source: adopted of Deutsche Bundesbank (2014, 2006, 2000) in conjunction with statistical supplements (annually)

As can be taken from the table above, calling the German banking sector "fragmented" is appropriate giving the high number of still 1.844 banks, even though down from 2.993 in 1999, stemming mostly from cooperative banks and savings banks. Both bank groups show a steady trend of reducing branches, even though still considerably high. In terms of employee numbers, the savings banks sector is by far the biggest employer, followed by private banks and then cooperative banks.

## 4.2.1 Shareholder-oriented banks

### 4.2.1.1 Structure

Looking further at shareholder-oriented or commercial banks, three different sub-groups are distinguished, being large-sized banks, regional banks and subsidiaries of foreign banks (the latter is not further described due to lacking legal set-up). While comprising 16% (296) of all banks in terms of numbers, commercial banks account for 36% of total assets, being very low, also for a bank-based banking system and especially compared to market-based banking systems as analysed by Uzunkaya (2012). In comparison, also after consolidation, the US banking sector comprises 6.532 commercial banks at the end of 2010 plus 1.128 savings institutions (Wheelock, 2011).

First established in the middle of the 19<sup>th</sup> century, the goal of the first joint-stock banks was to satisfy the growing financing needs of mass-production industrial countries. Today, they still act as house banks to Germany's large industrial corporations that are in need for financial services to finance overseas business operations (Krahn/Elzas, 2004).

In reference to the three subgroups outlined above, the first group refers to *big banks* that include Deutsche Bank, Commerzbank, UniCreditbank (formerly Hypo- und Vereinsbank) and Deutsche Postbank (since 2004). Over the past decade, there have been efforts to consolidate the sector and build new global banks. In 2000, Deutsche Bank, being the national champion and only true German global player in the banking sector, tried to take-over Dresdner Bank in 2000, which was ultimately rejected by Dresdner Bank management (Handelsblatt, 16 March 2001). Dresdner Bank was subsequently taken over by international German insurance group Allianz for a total of EUR 31 billion (Handelsblatt, 16 July 2001). In 2008, Allianz sold Dresdner to Commerzbank for a total of EUR 10 billion while holding on to several core activities (Handelsblatt, 1 September 2008). In 2010, Deutsche Bank took over Postbank with its 14 million customers in order to expand its retail operations and reduce its reliance on financial markets for refinancing needs (Handelsblatt, 23 November 2010). In 2005, Hypo- und Vereinsbank was taken over by Italian UniCredit for a total of EUR 16 billion (Handelsblatt, 13 October 2013). Average total assets per institutions have significantly increased from EUR 212 billion in 1999 to EUR 429 billion in 2013 (own calculation).

While this development is clearly driven by the expansion of business operations by the major players, it is important to point out to the harmonization effect of accounting standards as outlined before (derivatives accounting). Analysing the data in detail with reference to information published by Deutsche Bundesbank (Deutsche Bundesbank, 2013/2012), the effects can be quantified with EUR 0,9 trillion in 2011 and 0,4 trillion in 2012.

The second group of private commercial banks refer to regional and other credit banks. While their number decreased from 223 in 1999 to 178 in 2013, their share of total assets increased from 7% to 11% in the same period, posting total assets of EUR 817 billion. Assets per institution are considerably lower compared to large banks. The review of banks included in this group points to the majority of banks being part of larger industrial and other banking groups. Prominent examples include bank subsidiaries of car manufactures (e.g. BMW, Mercedes Benz, Volkswagen) and various international banking institutions (e.g. UBS, Goldman Sachs, Morgan Stanley, J.P. Morgan). In addition, there are various private banks, including old and traditional banks (e.g. Berenberg Bank, Sal. Oppenheim and B. Metzler seel.) and retail banks (e.g. ING DIBA, quirin bank). In terms of clients and products, a clear distinction and focus is evident. All banks either concentrate on private clients *or* on commercial clients, not *and*. Also, the range of products offered is typically specialized and tailored to the core clients.

All groups are organized within the *Bunderverband deutscher Banken* or "BdB" (Association of German Banks)<sup>30</sup>. It considers itself as “the voice of the private banks” and serves as point of contact for its members (ap. 210 banks) and the general public. On an international level, it is organized within the European Banking Federation (EBF), the European Banking Industry Committee (EBIC) and International Banking Federation (IBF).

Because the combined domestic asset share of the four biggest private banks was only 24%, the German banking system is often called fragmented. However, it can be argued that the savings bank group and the cooperative group might each be treated as a single large entity, bringing the market share of the biggest banks very close to the European average of 55% in 2007 (Stiele, 2008).

#### **4.2.1.2 Business performance**

While a comprehensive analysis of all banking segment is done in section 4.2.3, i.e. with aggregated stand-alone data, this section focuses on the main players among

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<sup>30</sup> see [www.bankenverband.de](http://www.bankenverband.de) for additional information



private banks and financial data published by these groups. As opposed to the data in section 4.2.3, a comparison of total assets as shown in the financial accounts of the banking groups such as Deutsche Bank and Commerzbank cannot be reconciled with the data of the Deutsche Bundesbank. The financial group accounts consider the consolidation of several non-banking domestic and overseas institutions that do not hold banking licenses and are not considered in Bundesbank publications. Sections 325 – 328 of the *Handelsgesetzbuch* (German Commercial Code), however, do not require the publication of single entity accounts when group accounts are published instead (*Handelsgesetzbuch*).

As outlined above, the most important German private banks are Deutsche Bank and Commerzbank. Individual financial statements based on German GAAP are not available due to a lack in publishing obligations. In order to further analyse their role, their financials based on IFRS as published are outlined hereafter.

**Table 4: Comparison of Deutsche Bank and Commerzbank**

Selected Balance Sheet Items (€bn)	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
	Deutsche Bank					Commerzbank				
Loans	269	258	408	413	397	347	469	438	384	365
Derivatives	1.224	596	658	860	768	11	6	5	5	6
Trading assets	247	235	271	241	246	119	219	168	156	144
Deposits	396	344	534	602	577	299	405	400	364	376
Derivatives	1182	577	647	839	753	21	11	9	11	12
Trading liabilities	68	64	69	64	55	96	193	152	138	116
Equity	32	37	49	53	54	20	27	28	25	27
Balance sheet total	2.202	1.501	1.906	2.164	2.012	625	844	754	662	636
<b>Selected Income Statement Items (€bn)</b>										
Net interest income	12,5	12,5	15,6	17,4	15,9	4,7	7,2	7,1	6,7	5,5
Net commission income	9,7	8,9	10,7	11,5	11,5	2,8	3,7	3,6	3,5	3,2
Net gains on financial assets/liabilities	-10,0	7,1	3,4	3,1	5,6	-1,1	0,1	2,1	-1,6	1,1
Allowance for losses on loans	1,1	2,6	1,3	1,8	1,7	1,9	4,2	2,5	1,4	1,7
Administrative expense	18,9	19,7	22,8	25,8	28,5	5,0	9,0	8,8	8,0	7,0
<i>Personnel expense</i>	<i>9,6</i>	<i>11,3</i>	<i>12,7</i>	<i>13,1</i>	<i>13,5</i>	<i>2,5</i>	<i>4,7</i>	<i>4,4</i>	<i>4,2</i>	<i>4,0</i>
<i>Operating expense</i>	<i>9,3</i>	<i>8,4</i>	<i>10,1</i>	<i>12,7</i>	<i>15,0</i>	<i>2,5</i>	<i>4,3</i>	<i>4,4</i>	<i>3,8</i>	<i>3,0</i>
Net income before taxes	-5,7	5,2	4,0	5,4	0,8	-0,4	-4,7	1,4	0,5	0,9
Net income after taxes	-3,9	5,0	2,3	4,3	0,3	0,0	-4,6	1,5	0,7	0,1
<b>Other</b>										
Employees	80.456	77.053	102.062	100.996	98.219	43.169	62.671	59.101	58.160	53.601
thereof in Germany	27.942	27.321	49.266	47.323	46.308	36.767	46.478	45.301	44.474	42.857
Branches	1.950	1.964	3.083	3.078	2.984	n/a	n/a	n/a	n/a	1.530
thereof in Germany	961	961	2.087	2.039	1.944	1.201	1.537	1.535	1.477	1.200
Tier 1 ratio (%)	10,1	12,6	12,3	12,9	15,1	10,1	10,5	3,9	9,1	11,2
Total capital ratio (%)	12,2	13,9	14,1	14,5	17,1	13,9	14,8	15,3	15,5	17,8
RoE (%)	-16,5	15,3	9,5	10,2	1,3	0,0	-15,6	4,7	2,2	0
CIR (%)	134,3	72,0	81,6	78,2	92,6	77,1	82,2	69,3	80,8	71
Long-term rating (Fitch)	AA-	AA-	AA-	A+	A+	A	A+	A+	A+	A+
Long-term rating (S&P)	A+	A+	A+	A+	A+	A	A+	A	A	A

Source: Deutsche Bank 2013, Commerzbank 2013

In 2012, total assets of Deutsche Bank comprise loans of 20% only, which is considerable up from 2008 with 12%, however still very low compared to other retail banks and also Commerzbank with 57%. While the balance sheet is dominated by derivative transactions, highlighting its status of an investment bank, loans increased significantly through the take-over of Deutsche Postbank in 2010, as did deposits that always, also with sufficient headroom, covered loans granted. In contrast to Commerzbank's takeover of Dresdner Bank, the take-over of Postbank was strategically induced, i.e. the rationale was to increase its activities regarding private clients in order to diversify earnings and lower dependence from investment banking and money market (Handelsblatt, 23 November 2010). Postbank at the time had 14 million customers and a well-established branch network. The take-over of Dresdner Bank by Commerzbank was driven by prospects with regard to cost savings and synergies, while the business model was basically the same, i.e. focus on commercial clients. Due to Dresdner Bank's asset structure, which included a high level of toxic papers, large-scale write-offs became necessary, eventually forcing Commerzbank to shrink operations (Handelsblatt, 23 February 2012) and ask for Government aid.

In 2011, Deutsche Bank was the biggest bank in Europe with total assets of EUR 2.164 billion. Looking at the 20 biggest banks in Europe, Commerzbank with EUR 662 billion ranked 17<sup>th</sup>. The table below highlights the status of Deutsche Bank for Germany and the European market that is otherwise dominated by other European banks, especially from the UK and France.

Table 5: Europe's leading banks by total assets and net profit 2011

#	Bank	Country	Total assets in €bn	Conc. ratio	#	Bank	Country	Net income in €bn
1	Deutsche Bank	Germany	2.164	9.5%	1	HSBC Holdings	UK	12.971
2	HSBC Holdings	UK	1.973	10.1%	2	BNP Paribas	France	6.050
3	BNP Paribas	France	1.960	9.6%	3	ING Group	Netherlands	5.766
4	Crédit Agricole Group	France	1.880	8.6%	4	Santander Group	Spain	5.351
5	Royal Bank of Scotland	UK	1.872	11.3%	5	Deutsche Bank	Germany	4.300
6	Barclays PLC	UK	1.877	11.0%	6	Barclays	UK	3.600
7	ING Group	Netherlands	1.279	9.6%	7	UBS	Switzerland	3.510
8	Santander Group	Spain	1.252	10.74%	8	BBVA	Spain	3.004
9	Société Générale	France	1.181	9.0%	9	Groupo BPCE	France	2.647
10	UBS	Switzerland	1.166	14.1%	10	Nordea	Sweden	2.634
11	Lloyds Banking Group	UK	1.160	10.8%	11	Rabobank Group	Netherlands	2.627
12	Groupo BPCE	France	1.138	9.1%	12	Société Générale	France	2.385
13	UniCredit Group	Italy	927	8.4%	13	Credit Suisse Group	Switzerland	1.604
14	Credit Suisse Group	Switzerland	861	10.7%	14	Crédit Agricole	France	0.812
15	Rabobank Group	Netherlands	782	12.7%	15	Commerzbank	Germany	0.698
16	Nordea	Sweden	716	9.2%				
17	Commerzbank	Germany	662	9.9%				
18	Intesa Sanpaolo	Italy	639	10.1%				
19	Standard Chartered	UK	599	11.8%				
20	BBVA	Spain	598	9.2%				

Source: own research via company websites based on The Statist

Looking further at the development of German banks it becomes clear that it is elements of the Regional Banks sub-group that shows most dynamic. Conducting own research of financial accounts of the most promotional active retail banks show that it is ING Diba (assets increased by 10% to EUR 120 billion in 2012), DKB Deutsche Kreditbank (assets increased by 10% to EUR 67 billion in 2012) and Targobank (assets increased by 10% to EUR 12 billion in 2012) that show highest assets growth, while all other retail banks only show low single digit growth rates or even negative. The common feature of the three banks is that they mainly act as direct banks with an advanced internet presence and infrastructure.

#### 4.2.2 Stakeholder-oriented banks

In the following, public banks and cooperative banks are further explored based on their umbrella group publications. Regarding structure and business model, the savings banks sector is explored in more detail. While chapter 3 focussed on a general analysis of the cooperative banking sector, this chapter focuses more on the analysis from an economic perspective.

#### 4.2.2.1 Structure

Looking further at public banks, two different sub-groups are distinguished, being the individual *Sparkassen* (savings banks) and *Landesbanken* (central banks). While comprising 23% (432) of all banks in terms of numbers, the group comprises 28% of total assets in 2012. While this is down 6% compared to 1999, this percentage highlights the importance of the public sector in German banking. While many other European countries also maintain a public savings banks network, their status, with the exception of Spain with their 45 *caja de ahorros* in 2009 (Financial Times Deutschland, 20 July 2010), has been characterized by a high level of liberalization with significantly decreasing market shares (e.g. Italy with 17% or France with 16%) that is not comparable to the German situation (DSGV, 2005).

Public savings banks are in principal owned by a state or municipality and are governed by the savings bank laws of the respective German states that especially prevents the case of insolvency. The laws oblige the savings banks to serve the public interest of their region by fostering individual savings and the “thriftiness” of the general population and by satisfying the credit demand of their local communities (Hackethal, 2004). Savings banks should thereby focus on the needs of employees, small and medium-sized enterprises (“Mittelstand”) and certain public authorities. The law also stipulates that profit maximization is not the only or even not the primary business objective, although they have to conduct their business according to sound economic principles. They even need profits urgently to self-finance and increase their equity in accordance with a growing lending business since the municipalities as owners are rarely in a position to inject the necessary additional equity. Also due to this trend, a number of savings banks founded their own organisation (Association of German Independent Public Savings Banks). Of the 423 institutions in 2012, there are six which are not bound to municipalities and do not adhere to the regional principle<sup>31</sup>.

The savings bank laws also do not permit savings banks to hold shares in enterprises outside the savings bank group, trade money market, equity of foreign exchange

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<sup>31</sup>see [www.verband-freier-sparkassen.de](http://www.verband-freier-sparkassen.de)

instruments on their own account or take part in an underwriting consortium. Moreover, to avoid competition between local savings banks, each institution is prohibited from operating outside its local area, the so called “*Regional Principle*”. In rural areas they typically compete with cooperative banks and in metropolitan areas also with branches of private commercial banks. From an economic point of view different to understand in this context is the separation of savings banks by the type municipality, which can be a city (Stadtsparkasse) or county (Kreissparkasse). Part of the before mentioned consolidation was the creation of situations in which two savings banks compete with each other within the same region. Prominent example is Cologne (Köln), which is host to Germany’s two biggest savings banks being *Kreissparkasse Köln*<sup>32</sup> and *Sparkasse KölnBonn*<sup>33</sup>.

One important feature of the savings banks group (maybe the most important one with regard to the current banking crisis) is the “*Joint Liability Scheme*”, i.e. the guarantee system of the group. The purpose of the guarantee fund is to safeguard affiliated institutions themselves, and in particular to safeguard their liquidity and solvency. This ensures that each institution can continue to meet its financial obligations. Because of this reliability, no customer of a member institution has ever lost a deposit and no member institution has ever defaulted on its financial obligations, let alone become insolvent<sup>34</sup>.

Two additional characteristics with regard to Sparkassen and Landesbanken caused major concern among non-public banks as well as EU policy makers, being *Anstaltslast* (maintenance obligation) and *Gewährträgerhaftung* (deficiency guarantee). Both characteristics ensured that the owners of the public banks were liable for all bank debts and to ensure that all payment obligations were met (Deutsches Institut für Wirtschaftsforschung, 2004). In consequence to these guarantees, public banks were entitled to the same credit rating as Germany sovereign rating, which enabled them to refinance investments on very favourable conditions. On 18 July 2001, the European Commission agreed to abolish

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<sup>32</sup> see [www.ksk-koeln.de](http://www.ksk-koeln.de)

<sup>33</sup> see [www.sparkasse-koelnbonn.de](http://www.sparkasse-koelnbonn.de)

<sup>34</sup> information accessed under [www.dsgv.de](http://www.dsgv.de)

*Gewährträgerhaftung* and curtail *Anstaltslast* since regarded unjust subsidies and not in compliance with European competition law. Since the end of the transitional period until 18 July 2005, savings banks are required to act like private banks. Public or state support is still possible, however, subject to special approval (Ipsen, 2004).

This structure or pillar is the most significant in German banking market and, looking at importance, is unique compared to other European countries. German savings are inter alia organized in umbrella organisations such as the *Deutscher Sparkassen and Giroverband* (in the following: "DSGV")<sup>35</sup> on a national level and the *European Savings Banks Groups* ("ESBG")<sup>36</sup> on a European level and the *World Savings Banks Institute* ("WSBI")<sup>37</sup> on an International Level. The number of savings banks has significantly decreased to 423 institutions in 2012, being down 30% compared to 1996, as a direct result of consolidation, i.e. the merger of smaller institutions, which are typically regional neighbours.

The Group comprises all types of bank services, while the main responsibility for conducting business lies with the savings banks on a regional level. In summary, the Group consists of

- Savings banks
- Landesbanken
- Deka Bank, being the group-internal asset manager with ap. EUR 165 billion assets under management
- Landesbausparkassen (building societies)
- Public insurance companies
- Deutsche Leasing group (market leader in Germany) plus other leasing companies
- Other financial services provider (e.g. factoring, private equity, real estate, IT, ect.)

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<sup>35</sup> see [www.dsgv.de](http://www.dsgv.de)

<sup>36</sup> see [www.esbg.eu](http://www.esbg.eu)

<sup>37</sup> see [www.wsbi.org](http://www.wsbi.org)

In terms of structure and services offered it is very similar to the cooperative banking network. The difference is the high level of clusters. Per December 2012, there were 9 Landesbanken and 10 regional building societies. Even though the owners and representatives of the savings bank group state the high degree of efficiency, it is, without conducting further research, obvious that synergies could be achieved by consolidating individual group clusters. Especially since the Subprime crisis in 2007, numerous bank representatives and also politicians have considered mergers of Landesbanken. In 2010, the German Ministry of Finance proposed a major consolidation effort to merge 4 Landesbanken all over Germany plus Deka Bank to one large entity. Due to resistance from several prime ministers of the federal states concerned, merger efforts were put to a hold. Other merger attempts on regional level, i.e. Landesbanken in two major southern states (BayernLB and LBBW), were also cancelled due to regional government resistance (Wirtschaftswoche, 27 September 2010). The latest consolidation attempt was the merger between Landesbank Berlin (LBB) and Deka Bank in 2012, which was also abandoned due to economic reasons. Subsequently, Deka Bank only took over several business activities (Wirtschaftswoche, 17 July 2013).

Their business model is focused on private customers and small and medium-sized companies (*Mittelstand*), typically indicating relatively stable results. With reference to data for 2009 – 2012 published by the DSGV, this assumption is backed up. Net income as well as expenses are very stable in the period with savings banks and central banks comprising a share of 2/1. Regarding balance sheet items, the share is ap. 1/1 with a clear focus of savings banks towards non-banks. Also, while savings banks are able to refinance their loans (EUR 786 billion) with deposits (EUR 951 billion) only, Landesbanken show a significant gap of EUR 128 billion, which have to finance with money market instruments.

The table below also highlights the profitability problem of the savings banks group being the Landesbanken. Landesbanken are usually owned by one of the 16 federal states in Germany and regional savings organizations. Founded with the purpose to support regional medium and large-scale projects and provide services to regional

savings banks, these banks soon were managed as commercial banks in order to improve their long-lasting low level of profit. A study by the Deutsches Institut für Wirtschaftsforschung (2009) confirmed that, in the period 1998 – 2007, Landesbanken had the lowest RoE of all German banking groups, being 5,8%, compared to the overall average of 8,2% and savings banks, being the best, with 11%. Also, to improve regional budgets, decision makers of the federal states were imposing profitability expectations of around 15% forcing Landesbanken to engage in international businesses as well as complex financial products (Handelsblatt, 2005). As one of numerous studies in recent years, Noack/Schrooten (2009) pointed out, the management of the Landesbanken was characterized by numerous failed investment and business decisions as well as weak governance by supervisory committees, which ultimately led to significant losses and capital support measures by the federal states and the government to avoid insolvencies.

With regard to cooperative banks, reference is made to section 3.3.2.

#### **4.2.2.2 Business performance**

Data for both banking groups are aggregated and published annually by their respective umbrella organisations, i.e. DSGV and BVR.

##### *Public banks*

Data for the savings banks finance group is fractionally accumulated by the DSGV on an annual basis and aggregates the financial statements of all savings banks, Landesbanken and building societies. It is stated that the aggregated numbers are based on German GAAP and do not take into account consolidation effects.



**Table 6: Financial Structure of German public savings banks group (in €bn)**

	2009	2010	2011	2012	2009	2010	2011	2012
<b>Selected Balance Sheet Items</b>	Group				Savings Banks			
Loans	1.817	1.759	1.662	1.625	-	752	781	786
<i>Loans to banks</i>	616	545	461	409	-	92	104	90
<i>Loans to non-banks</i>	1.201	1.214	1.201	1.216	643	660	677	696
Deposits	1.810	1.764	1.675	1.670	-	928	941	951
<i>Liabilities to banks</i>	650	599	534	492	-	188	182	172
<i>Liabilities to non-banks</i>	1.160	1.165	1.141	1.178	752	740	759	779
Equity	126	122	123	140	56	58	63	77
Balance sheet total	2.563	2.456	2.326	2.308	1.073	1.084	1.098	1.106
<b>Selected Income Statement Items</b>								
Net interest income	35,0	35,3	34,9	33,3	22,6	23,5	23,8	23,2
Net commission income	7,0	7,2	6,8	7	5,9	6,1	6,2	6,3
Administrative expense	26,9	26,1	25,3	26,1	19,1	18,6	18,7	19,0
<i>Staff Cost</i>	n/a	15,2	14,7	15,4	11,9	11,5	11,5	11,9
<i>Operating expense</i>	n/a	10,9	10,6	10,7	7,2	7,1	7,2	7,1
Net income before taxes	-0,3	5,7	5,7	5,5	4,7	4,5	4,7	4,7
Net income after taxes	-2,9	3,1	2,2	2,1	2,5	2,0	2,0	2,0
<i>hereof savings banks</i>	2,5	2,0	2,0	2,0	n/a	n/a	n/a	n/a
<i>hereof Landesbanken</i>	-5,5	1,0	0,1	0,0	n/a	n/a	n/a	n/a
<i>hereof building societies</i>	0,1	0,1	0,1	0,1	n/a	n/a	n/a	n/a
<b>Other</b>								
Employees	n/a	348.500	345.600	355.000	249.000	248.000	246.000	245.000
Tier 1 ratio	n/a	9,9	10,5	12,5	n/a	n/a	n/a	n/a
Total capital ratio	n/a	15,1	15,8	15,9	n/a	n/a	n/a	n/a
RoE	-0,2	4,7	6,3	7,5	8,5	11,5	10,5	10,7
CIR	n/a	61,6	60,8	64,8	67,2	63,0	62,2	64,5
Long-term rating (Fitch)	-	A+	A+	A+	n/a	n/a	n/a	n/a
Long-term rating (Moody's)	Aa2	Aa2	Aa2	Aa2	n/a	n/a	n/a	n/a

Source: DSGV Financial Report 2012, 2011 and 2010

As can be seen from the table above, the most important performance driver is savings banks with Landesbanken contributing only small or, as in 2009, negative effects. Not included in the numbers above, however stated in footnotes of the DSGV Financial Report is the reclassification of reserves according to section 340f Commercial Code to reserves according to section 340g Commercial Code in the amount of EUR 9,0 billion in order to be ready and comply with equity requirements due to Basel III (also refer to section 6.1.1).

### *Cooperative banks*

Data for the cooperative financial network is published by the BVR on an annual basis. As opposed to the DSGV publications, BVR accounts are prepared in accordance with IFRS accounting and voluntarily aggregated to the consolidated

financial statements considering all entities of the network. They, however, do not mean to provide the degree of certainty expected from audited consolidated accounts.

**Table 7: Financial Structure of German cooperative banks group (in €bn)**

Selected Balance Sheet Items (€bn)	2009	2010	2011	2012	2009	2010	2011
	Network				primary banks		
Loans	600	623	652	674	470	480	503
<i>Loans to banks</i>	40	40	45	42	77	72	78
<i>Loans to non-banks</i>	560	583	607	632	393	408	425
Allowance for losses on loans	-12	-10	-11	-10	n/a	n/a	-7
Deposits	695	730	750	776	585	602	623
<i>Liabilities to banks</i>	107	110	103	111	103	96	99
<i>Liabilities to non-banks</i>	588	620	647	665	482	506	524
Equity	58	62	65	72	54	58	62
Balance sheet total	1.017	1.020	1.058	1.090	681	696	720
<b>Selected Income Statement Items (€bn)</b>							
Net interest income	17,4	19,0	19,4	19,6	14,7	15,9	15,9
Net commission income	4,6	5,0	4,8	4,9	4,0	4,2	4,2
Allowance for losses on loans	-2,2	-0,8	-0,8	-1,0	n/a	n/a	-0,3
Administrative expense	-15,2	-15,5	-15,9	-16,3	n/a	n/a	n/a
<i>Staff cost</i>	-9,2	-9,4	-9,5	-9,7	n/a	n/a	n/a
<i>Operating expense</i>	-6,0	-6,1	-6,4	-6,6	n/a	n/a	n/a
Net income before taxes	6,6	8,1	5,7	9,3	5,3	6,2	6,0
Net income after taxes	4,6	6,1	4,5	6,9	3,9	4,7	4,3
<b>Other</b>							
Employees	186.719	187.296	188.256	190.095	158.300	158.200	158.250
Tier 1 ratio (%)	8,3	8,9	9,1	10,1	10,5	10,7	11,2
Total capital ratio (%)	13,0	13,7	14,0	14,7	14,0	14,7	15,6
RoE* (%)	11,4	13,1	8,8	12,9	9,8	10,7	9,7
CIR (%)	63,2	63,2	71,2	61,2	65,8	65,8	67,8
Long-term rating (Fitch)	A+	A+	A+	A+	n/a	n/a	n/a
Long-term rating (S&P)	A+	A+	AA-	AA-	n/a	n/a	n/a

Source: BVR Consolidated Financial Statements 2012, 2011 and 2010 (IFRS)

\* own calculation using net income before taxes and equity as presented

The focus of performance presentation has been found to be on a group basis. Also, while only presenting limited information of income related aspects regarding the savings banks sub-group in prior years, the consolidated accounts for financial 2012 do not provide any further information on the performance of the cooperative banks sub-group. As with the public bank sector, the cooperative banks are the most important performance driver. However, central institutions are not performing as bad as the Landesbanken have.

As part of the follow up to the statistics part in part, the most recent publication by the BVR (2014) was the preliminary aggregation of performance for the financial year 2013 and of the entire network. The following summary can be made (primary banks only):

**Table 8: Cooperative network 2013 - 2012 financial development**

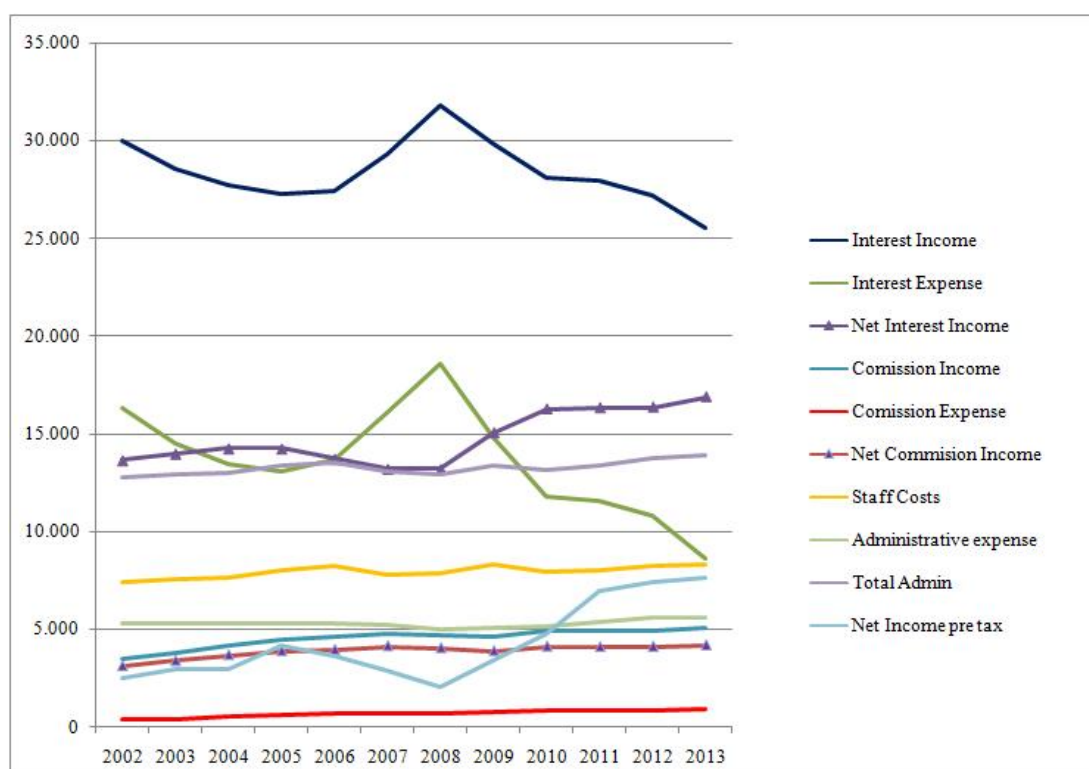
<b>Selected Balance Sheet Items (€bn)</b>	Dec13	Dec12	Dif. EUR	Dif. %
Callable deposits	298,3	268,6	29,7	11,1
Medium-term deposits	60,5	69,4	-8,9	-12,8
Savings deposits	189,0	187,1	1,9	1,0
Savings certificates	13,4	17,2	-3,8	-22,1
<b>Total liabilities non-banks</b>	<b>561,2</b>	<b>542,3</b>	<b>18,9</b>	<b>3,5</b>
Short-term receivables	32,7	33,3	-0,6	-1,8
Medium-term receivables	28,7	27,6	1,1	4,0
Long-term receivables	400,9	382,3	18,6	4,9
<b>Total receivables non-banks</b>	<b>462,3</b>	<b>443,2</b>	<b>19,1</b>	<b>4,3</b>
<b>TOTAL ASSETS</b>	<b>762,9</b>	<b>750,3</b>	<b>12,6</b>	<b>1,7</b>
<b>Selected Income Statement Items (bn)</b>				
Interest income	25,4	27,2	-1,8	-6,6
Interest expense	8,6	10,9	-2,3	-21,1
Net interest income	16,7	16,4	0,3	1,8
Commission income	4,2	4,1	0,1	2,4
Administration expense	13,9	13,8	0,1	0,7
Number of cooperative banks	1.078	1.101	-23	-2,1
Number of branches	13.056	13.211	-155	-1,2
Number of members	17.712.774	17.348.742	364.032	2,1

As can be taken from the table above, financial performance of the cooperative banking sector, despite annual warnings by network representatives, has not decreased in 2013. The impact of the overall low interest level has further resulted in a shift from long-term to short deposits and a higher demand for long-term financing. More revealing conclusions can be drawn based on the information recently published by Deutsche Bundesbank (2014b), which was combined with other historical data in order to provide for a comprehensive overview of operational performance of the cooperative banking sector.

**Table 9: Primary bank income performance 2002 - 2013**

Income components in € Million												
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Interest Income	29.958	28.514	27.687	27.297	27.427	29.281	31.770	29.842	28.085	27.929	27.226	25.538
Interest Expense	16.310	14.527	13.438	13.057	13.711	16.062	18.565	14.780	11.821	11.598	10.863	8.659
Net Interest Income	13.648	13.987	14.249	14.240	13.716	13.219	13.205	15.062	16.264	16.331	16.363	16.879
Commission Income	3.491	3.802	4.184	4.499	4.601	4.809	4.720	4.665	4.926	4.937	4.969	5.083
Commission Expense	367	401	499	613	652	671	683	772	812	846	862	901
Net Commission Income	3.124	3.401	3.685	3.886	3.949	4.138	4.037	3.893	4.114	4.091	4.107	4.182
Staff Costs	7.442	7.619	7.677	8.013	8.250	7.807	7.874	8.283	7.940	7.983	8.209	8.304
Administrative expense	5.296	5.286	5.286	5.320	5.286	5.249	5.035	5.097	5.194	5.399	5.559	5.583
Total Admin	12.738	12.905	12.963	13.333	13.536	13.056	12.909	13.380	13.134	13.382	13.768	13.887
Net Income pre tax	2.517	2.923	2.977	4.183	3.614	2.880	2.039	3.404	4.789	6.981	7.411	7.648

Source: Deutsche Bundesbank "Die Ertragslage der deutschen Kreditinstitute", September 2008 and September 2014



In 2013, even though overall interest level was decreasing and deemed to be negative for all banks, net interest income could be increased slightly. Contemplating this development it can be concluded that there are two contributing factors: First, refinancing costs, as expressed in interest expense, decreased more than interest income, hence, increasing interest margin. Secondly, *maturity transformation* has been intensified (see section 3.1.3). While it is not possible to back-up this statement with empirical evidence, it is this researcher's observation as well as statements made by the Deutsche Bundesbank (2014b) confirming this fact. Overall, net income pre tax has reached an all-time high in the bandwidth highlighted.

From the table above, further valuable insights can be drawn. The impact of regulatory initiatives can best be evaluated by referring to *Administrative expense* for implementation costs as well as *Net income pre tax* for the overall impact. Basel II was implemented 2004. As can be drawn from the table provided, no significant change in evaluation indicators could be noticed in 2004 as well as the two years before, that normally carry corresponding costs. *Administrative expenses* could only be observed increasing by a marginal rate. *Net income pre tax* was not observed to decline. Rather, net income could be increased in the following years and was impacted by the financial crisis in 2007/2008. Again, *since net interest income* increased upon this event, it is concluded that maturity transformation has been exploited to a large extent.

Based on the manual sample data of disclosure reports as outlined in section 2.4.2.3, an interesting finding can be concluded regarding the issue of bank size. Aggregating the data of the 362 banks results in the following distribution:

**Table 10: Performance by size in total assets**

# banks	bandwidth	Total Assets in €m	Equity ratio %	RoE in %	Equity in €k	Income in €k	Net Interest margin
56	1 - 100	3.597	8,3	3,8	297.800	11.200	2,9
78	100 - 200	11.187	7,5	4,4	844.418	36.900	2,8
49	200 - 300	11.922	7,4	4,4	887.000	39.000	2,7
45	300 - 400	15.445	7,5	4,7	1.150.800	54.300	2,7
21	400 - 500	9.245	6,9	4,5	641.300	28.600	2,8
24	500 - 600	12.968	7,0	4,3	911.800	39.400	2,6
20	600 - 700	12.914	6,9	4,6	896.600	40.900	2,6
14	700 - 800	10.402	6,7	4,3	701.200	30.400	2,6
10	800 - 900	8.315	6,7	4,8	554.700	26.400	2,8
6	900 - 1000	5.642	8,3	4,3	471.000	20.200	2,6
17	1000 - 1500	19.389	7,4	4,6	1.431.000	66.400	2,5
18	1500 - 2500	31.691	6,2	4,2	1.967.600	83.100	2,2
4	2500 - 7500	23.289	8,4	2,2	1.965.400	42.600	2,2
362		176.006	7,2	4,1	12.720.618	519.400	

As can be taken from the table above, smaller banks cannot be defined as being of lower performance. Equity ratio and RoE prove to be rather stable over the bandwidths, i.e. size is not an indicator for performance. In fact, smaller banks tend to show higher interest rates than larger banks. As a result and from a desktop view,

no empirical confirmation can be made that cooperative banks should strive for a concentration strategy in order to benefit from economies of scale.

On a sector basis, the strategic profile can be summarized based on a SWOT analysis as follows:

**Table 11: SWOT analysis of German cooperative banking sector**

<p><b>Strengths:</b></p> <p>Dense branch network and close access to private clients and SMEs</p> <p>Sound financial conditions, basically without exposure to market risk, resulting in stable financial performance over the past decades.</p> <p>Strong brand name and awareness</p> <p>High market share and well-educated workforce</p>	<p><b>Weaknesses:</b></p> <p>Limited in market orientation due to regional principle</p> <p>Still considered old-fashioned</p> <p>High costs due to centralized structure with no single product approach (e.g. no common online bank)</p>
<p><b>Opportunities:</b></p> <p>Increasing demand for financial products with lower risk profile and stable, even though lower, returns</p> <p>Cross selling potential through inclusion in Cooperative Finance network</p> <p>Synergy potential through mergers on regional level and leaner production</p>	<p><b>Threats:</b></p> <p>Competition from online banks (e.g. ING Diba) and other financial service companies (e.g. AWD) working with sales representatives</p> <p>Strategic repositioning of large German private banks (Deutsche Bank / Commerzbank) increasingly concentrating on SMEs and private individuals</p> <p>Obligation to support central banks in times of economic downturn</p> <p>Low interest level</p> <p>Expensive distribution/sales (branch network)</p>

### 4.2.3 Intra-group analysis and comparisons

#### 4.2.3.1 Structure

Bank theory foundations as outlined in section 3.1 refers to the role and status of financial intermediaries and bank definition. In summary and based on the previous analysis of the German banking sector, the following summary can be drawn (RAG classification):

Table 12: German banking sector and foundations of bank theory

		investment intermediary	commercial banking
Private banks			
Deutsche Bank			
Commerzbank			
other private banks			
Public banks			
Savings banks			
Landesbanken			
Cooperative banks			
Primary banks			
Central banks			

Source: own classification

*Financial intermediation* is predominantly based on and refers to individuals that want to invest surplus funds. With reference to bank operations, this means being in contact with private individuals, taking on loans and converting them into other companies to finance growth. These characteristics apply to large-sized private banks as well as the regionally operating savings and cooperative banks that foster branches to assist individuals in their investment decisions. Also, the central banks of the savings and cooperative banking groups carry out intermediation while substituting private individuals (as capital providers) with member banks. Other private banks also can be categorized, however, not in all cases as a result of very specialized business models (e.g. banks of industrial organizations being financed with capital or money market as well as parent funding).

With regard to the economic definition outlined before, i.e. the relevance of commercial banks and investments bank, *private banks* in Germany are typically *commercial banks*. There is no binding definition of an *investment bank*. The ECB usually refers to an investment bank when “the share of commission and trading income was higher than the share of net interest and other income in most periods” (ECB, 2010a)<sup>38</sup>. According to this definition, Deutsche Bank can still be regarded as an investment bank, even though net interest income has dominated the past two years as a consequence of the strategic repositioning after the financial crisis away

<sup>38</sup> The ECB publishes reports on Financial Stability and Supervision that can be accessed under [www.ecb.europa.eu](http://www.ecb.europa.eu); in undetermined intervals; latest *Banking structures report* was published in November 2013

from investment banking towards commercial banking. Given their balance sheet structure, a predominant focus on investment banking is visible that also lead to the high degree of volatility of earnings as a consequence of the dependence of money and capital markets. In consequence, Deutsche Bank refers to itself as a universal bank that combines “the complexity of investment banking with simpler commercial-banking services for individuals and companies” (The Economist, 18 August 2012). Commerzbank still has a high level of investment banking activities, however, and in contrast to Deutsche Bank, wants to cease these activities and focus itself towards private and commercial clients only. Still, Deutsche Bank, in contrast to Commerzbank, has the necessary resources to carry out this repositioning and expansion in the sector, putting Commerzbank’s business model at a high risk.

The savings banks and cooperative bank groups are similar in their definition and characterized by the clear separation of duties between member banks and their respective central banks. Member banks conduct commercial banking *only* as required by statute, while their central banks have engaged into investment banking activities, however, being on a low level with the intention of risk diversification and income enhancement.

With reference to the before mentioned distinction between stakeholder-oriented banks and shareholder-oriented banks, the following summary can be drawn:

**Table 13: Stakeholder ranking of German bank groups**

	Stakeholder ranking by priority		
	Private banks	Savings banks	Cooperative banks
Owners	1	3	1
Customers	2	2	2
Employees	3	4	4
Society	4	1	3

Source: own classification based on business model and policies

#### 4.2.3.2 Business performance

Data on business performance, which is available in a comparable and uniform way, is best analysed via the aggregation by the *Deutsche Bundesbank*. Supplemental data, which is not further commented by the *Deutsche Bundesbank*, aggregates financial



data of all German institutions with a bank licence as required by the Banking Act. Commentaries are done by this author via *descriptive statistics*:

**Table 14: Most important income positions of German banks 2013**

<b>in % of operating income</b>	all categories	Big banks	Regional banks	Landes-banken	Savings banks	Cooperat. centrals	Credit cooperatives	Mortgage banks
Net interest income	71,9	60,7	66,8	78,5	80,0	68,1	78,5	104,2
Net commission income	23,9	33,8	26,0	6,9	21,6	16,9	19,5	3,3
Net trading income	4,9	12,1	1,5	12,5	0,1	16,0	0,0	0,1
Net other income	-0,7	-6,6	5,7	2,1	-1,6	-1,0	2,0	-7,6
<b>Operating Income</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>
Administration	-69,1	-78,3	-64,8	-61,8	-67,1	-52,3	-64,6	-75,4
Staff cost	-35,9	-35,3	-28,5	-30,0	-41,8	-27,1	-38,6	-29,9
Other admin	-33,2	-43,0	-36,2	-31,9	-25,4	-25,1	-26,0	-45,4
Net valuation of assets	-5,4	-3,0	-5,3	-31,1	0,3	-15,2	1,5	-23,1
Net other extraordinary	-7,6	-7,5	-17,2	-11,6	-3,5	-7,9	-1,3	5,1
Net Income before tax	17,9	11,2	12,7	-4,5	29,7	24,6	35,6	6,7
Tax	-6,0	-3,3	-3,5	-4,4	-9,2	-5,7	-9,1	-5,0
Net Income after tax	11,9	7,9	9,2	-8,9	20,5	19,0	26,5	1,7

Source: adopted of Deutsche Bundesbank (2014b) in conjunction with statistical supplements (annually)

Looking at German banks in 2013, the notion that there are *performance* advantages of privately owned banks cannot be sustained. As expected in relation with their business models, the share of net interest income of cooperative banks (79%) and savings banks (79%) is clearly higher than the respective share of big or regional banks (61% or 67%). Also, it is obvious that trading income plays practically no role at cooperative banks and savings banks, while it accounted for 12% at big banks. Further analysing use of operating income, cooperative banks and savings banks do show higher staff cost levels compared to big and regional banks, while other administration costs (e.g. IT infrastructure) were significantly lower compared with private banks. In total, administration costs of shareholder-oriented banks were just slightly higher than of their stakeholder-oriented partners. The most striking finding is that the percentage of net income of operating income is the highest among cooperative banks with 27%, followed by savings banks with 21%, while large banks only show 8%. In total, stakeholder-oriented banks show better ratios than their shareholder-oriented counterparts.

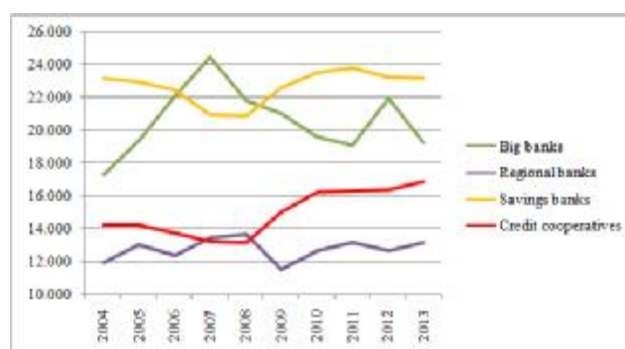
Given the static view of financial 2013, a further time series analysis is conducted in order to confirm whether the finding above holds true covering the period 2004 - 2013. This is done by looking at the core performance indicators in absolute terms being *Net Interest Income*, *Operating Income* and *Net Income*, and in relative terms being *Cost-Income-Ratio* and *Return-on-Equity*.

**Table 15: Net Interest Income of German banks 2004 - 2013**

Net Interest Income in €m										
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	84.998	88.211	89.124	91.577	90.636	91.472	92.136	91.342	92.243	86.365
Big banks	17.340	19.419	22.111	24.454	21.828	21.060	19.584	19.121	21.944	19.235
Regional banks	11967	13.050	12.362	13.466	13.660	11.519	12.664	13.160	12.685	13.162
Landesbanken	9886	10.019	10.030	10.877	12.161	11.354	10.325	10.548	8.702	8.383
Savings banks	23.192	22.926	22.449	20.949	20.861	22.570	23.506	23.791	23.278	23.142
Cooperative central inst.	948	1.037	1.009	1.265	1.590	1.175	1.259	1.242	1.403	1.479
Credit cooperatives	14.249	14.230	13.716	13.219	13.205	15.062	16.264	16.331	16.363	16.879
Mortgage banks	3.847	3.933	3.774	3.737	3.213	3.760	3.505	2.616	2.413	1.828

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements (annually)

Stakeholder-oriented banks show an almost parallel development characterized by decreasing net interest income up until 2007 with increasing tendency since 2007, while shareholder-oriented banks show an opposite development. It



is assumed by the author that this is the result of the Subprime crisis, that lead to increased interest-bearing assets among cooperative and savings banks. However, while the increase mainly took place between 2008 and 2010, interest income has been stagnating with cooperative banks and slightly decreasing with savings banks. Giving the development of the overall interest level, it is assumed by this author that this is the effect of the decreasing interest margin threatening the most significant income driver of stakeholder-oriented banks.

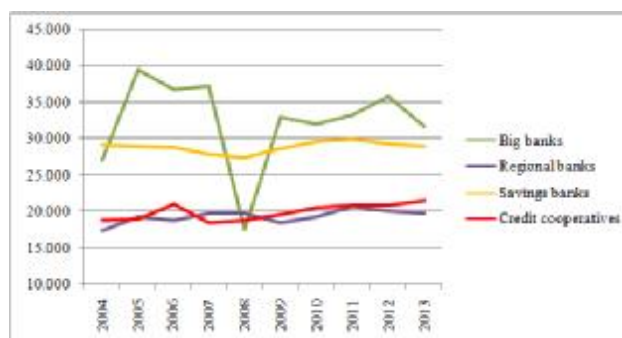
Looking further at income mix and performance indicator, operating income is another major indicator of performance. For the purpose of this work, it is calculated as Net Interest Income plus Net Commission Income plus Net Trading Income plus Other Income, i.e. before valuation effects and administration costs.

**Table 16: Operating Income of German banks 2004 - 2013**

Operating Income in €m	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	115.689	129.290	130.681	125.621	107.191	126.298	125.928	125.317	128.999	120.037
Big banks	27.144	39.424	36.863	37.208	17.620	33.025	31.976	33.231	35.892	31.668
Regional banks	17.416	19.250	18.773	19.831	19.822	18.525	19.338	20.727	20.097	19.706
Landesbanken	12.447	12.045	14.272	11.872	13.476	13.943	12.227	11.164	10.572	10.682
Savings banks	29.119	29.026	28.898	27.872	27.438	28.705	29.707	29.887	29.318	28.935
Cooperative central inst.	1.698	1.808	1.761	1.122	1.048	2.437	2.080	1.763	2.601	2.171
Credit cooperatives	18.878	19.058	21.039	18.531	18.889	19.581	20.614	20.930	20.923	21.491
Mortgage banks	3.986	4.137	4.129	4.387	3.702	3.913	3.782	1.925	2.653	1.754

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements; Net Interest + Net comission + Trading income + Other income

Shareholder-oriented banks show very strong operating income that, normalized for the Subprime effects in 2007/2008, is superior to that of other banking groups. The reason behind this is mainly the large share of trading income



coming from investment banking activities. As with interest income, stakeholder-oriented banks show a very stable development with cooperative banks being lower, due to asset volume, with savings banks showing a decreasing tendency.

**Table 17: Net Income (before tax) of German banks 2004 - 2013**

Net Income in €m	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	10.372	33.242	27.597	20.531	-25.014	-3.487	17.785	30.481	30.195	21.512
Big banks	-2.067	14.867	7.520	15.290	-17.833	-6.691	2.039	-94	5.138	3551
Regional banks	1.646	2.958	2.500	3.237	1.301	22	1.071	2.015	2.714	2.497
Landesbanken	472	3.030	6.014	788	-6.051	-5.913	-929	72	2.296	-479
Savings banks	4.400	4.927	4.421	3.759	2.161	4.710	6.586	16.760	9.483	8.598
Cooperative central inst.	220	406	382	-375	-416	696	614	1.210	607	535
Credit cooperatives	2.977	4.156	3.614	2.880	2.039	3.404	4.789	6.977	7.420	7.648
Mortgage banks	566	160	568	375	-2.913	-1.419	-86	-307	97	117

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements (annually)

Net Income is derived by Operating Income less Administration Costs and Valuation effects from financial instruments (bonds, loans, etc.). Shareholder-oriented banks



showed a performance advantage up to the Subprime crises with relevant effects taking place in 2008 and 2009. Since then, consolidated net income has not been able to keep up with that of cooperative banks and savings banks showing a stable, even increasing development since the Subprime crisis.<sup>39</sup>. The table above highlights the high degree of volatility included in the commercial bank groups that is basically solely related to big banks that hit a record high in income in 2007 with EUR 15,3 billion, i.e. just before the outbreak of the subprime crisis, before hitting a record low in 2008 with EUR -17,8 billion in 2008, followed by another loss of EUR -6,7 billion in 2009. This volatility mainly stems from valuation effects in connection with financial instruments that cooperative banks and savings banks predominantly do not chose to invest in

In order to further analyse the market environment and competitive situation, it is important to understand the elements of profitability and key performance indicators that are relevant to the banking industry. The most common of these performance ratios in relative terms are Return on Assets (RoA) and Return on Equity (RoE), usually referred to as *profitability ratios*. A typical approach in providing a profitability analysis is to relate such ratio measures to other ratios through a Dupont analysis as outlined by Saunders/Cornett (2003).

RoA is simply the net income in the year divided by total assets. Regarding the numerator, net income before tax is usually used due to different tax rates between countries. Regarding the denominator, usually the average value over the year instead of year-end book value of assets is used.

$$RoA = \frac{NetIncome\ (before\ tax)}{Average\_Total\_Assets}$$

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<sup>39</sup> In 2011, savings banks reclassified certain reserves in the amount of EUR 8,6 bn included in the net income income, which have to be normalized in an economic view.

As financial institutions' business model moved away from pure intermediation, the traditional financial measure that has become perhaps the most important, is RoE. Often the term book equity is used on purpose to distinguish this traditional accounting measure from risk-adjusted measures. It is also used by analysts to evaluate whether a bank has created or destroyed value

$$RoE = \frac{NetIncome\ (before\ tax)}{Book\ Equity}$$

Next to profitability ratios, referring to profit components mainly, differences in the expense burden can make a significant difference in its profitability and explain why different banks or banking sectors have performances superior or inferior to others. To analyse operating performance, *efficiency ratios* are typically used, being Cost-Income Ratio (CIR) and Cost Asset Ratio (CAR). Both ratios are useful, but CAR (also called cost margin) is less manipulated and better reflects a bank's core efficiency even though not as commonly used in public and professional coverage. CIR as well as CAR include all non-interest expenses or administrative costs. It does not include valuation effects since these are considered to be related to loan decisions made in prior periods and no indicator for the current performance of the bank. Lower levels of CIR indicate better operating efficiency.

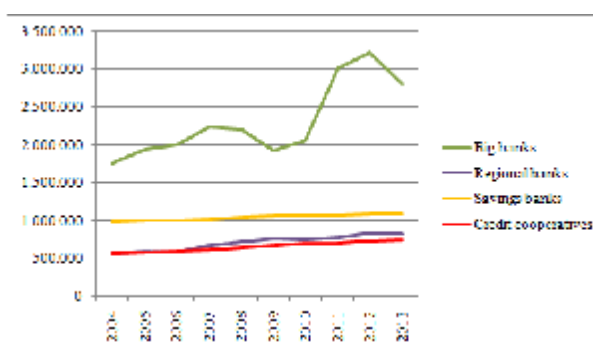
$$CIR = \frac{Administrative\ Costs}{Total\ Income}$$

**Table 18: Average total assets of German banks 2004 - 2013**

Average total assets in €m	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	7.183.653	7.524.722	7.718.988	8.158.884	8.327.069	8.022.116	8.105.203	8.968.671	9.341.874	8.551.574
Big banks	1.764.080	1.939.373	1.995.918	2.240.698	2.212.741	1.931.021	2.061.016	3.010.173	3.217.291	2.798.461
Regional banks	573.493	602.538	586.058	671.668	722.740	766.860	751.218	778.662	840.168	822.706
Landesbanken	1.519.005	1.581.453	1.651.972	1.668.143	1.695.465	1.587.259	1.512.276	1.504.774	1.371.385	1.229.051
Savings banks	985.944	995.377	1.007.033	1.019.129	1.042.947	1.060.725	1.070.231	1.078.852	1.096.261	1.098.581
Cooperative central inst.	194.244	219.881	233.847	254.397	273.650	263.438	262.437	275.900	294.430	282.833
Credit cooperatives	567.674	578.641	595.576	614.428	641.771	676.780	697.694	711.046	739.066	750.899
Mortgage banks	875.035	879.136	878.310	859.798	821.083	803.949	793.476	645.145	565.008	482.524

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements (annually)

As outlined before, big banks are by far the biggest sub-group in terms of assets, especially due to Deutsche Bank. The steep increase in 2011 and, to a lesser extent in 2012, is due to the newly introduced requirement to account



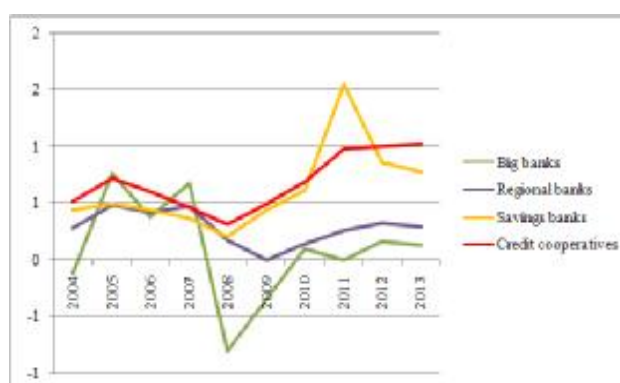
for derivatives transactions, having an effect of ap. EUR 0,8 trillion in 2011 alone (see section 4.2). Besides big banks, regional banks showed the biggest % increase of 47% between 2004 and 2012, with cooperative banks at a high 32% and savings banks a low 11%. Both groups, however, show a constant and stable growth as opposed to the other banking groups.

**Table 19: Return-on-Assets of German banks 2004 - 2013**

RoA in %	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	0,14	0,44	0,36	0,25	-0,30	-0,04	0,22	0,34	0,32	0,25
Big banks	-0,12	0,77	0,38	0,68	-0,81	-0,35	0,10	0,00	0,16	0,13
Regional banks	0,29	0,49	0,43	0,48	0,18	0,00	0,14	0,26	0,32	0,30
Landesbanken	0,03	0,19	0,36	0,05	-0,36	-0,37	-0,06	0,00	0,17	-0,04
Savings banks	0,45	0,49	0,44	0,37	0,21	0,44	0,62	1,55	0,87	0,78
Cooperative central inst.	0,11	0,18	0,16	-0,15	-0,15	0,26	0,23	0,44	0,21	0,12
Credit cooperatives	0,52	0,72	0,61	0,47	0,32	0,50	0,69	0,98	1,00	1,02
Mortgage banks	0,06	0,02	0,06	0,04	-0,35	-0,18	-0,01	-0,05	0,02	0,02

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements / own calculation (annually)

As can be taken from the tables, stakeholder-oriented banks clearly show better profitability as measured in asset utilisation than their shareholder-oriented counterparts. Also, when normalizing savings banks for one-off effects in 2011, it becomes



apparent that cooperative banks are profitability leaders in terms of RoA when adjusted for one-off and special effects.

**Table 20: Return-on-Equity of German banks 2004 - 2013**

RoE (before tax) in %	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	4,2	13,0	9,4	6,6	-7,7	-0,8	5,2	8,4	7,8	5,3
Big banks	-4,0	31,7	14,0	26,0	-25,3	-9,1	2,9	-0,1	6,7	4,6
Regional banks	5,7	8,6	7,0	8,5	3,8	0,1	2,8	4,8	6,1	5,3
Landesbanken	1,1	6,4	11,4	1,5	-11,1	-8,2	-1,5	0,1	3,9	-0,8
Savings banks	9,7	10,5	8,9	7,2	4,0	8,5	11,4	27,4	13,0	10,6
Cooperative central inst.	2,9	5,3	4,5	-4,0	-4,4	7,2	5,8	10,3	4,9	4,1
Credit cooperatives	10,3	13,8	11,0	8,1	5,5	9,0	12,1	16,4	15,7	14,8
Mortgage banks	3,3	0,9	2,8	1,9	-15,5	-8,3	-0,5	-1,7	0,6	0,7

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements (annually)

RoE with stakeholder-oriented banks has been stable with an upward trend since the Subprime crisis and, since then, has also been considerable higher than that of shareholder-oriented banks. Again, normalizing for one-off effects in



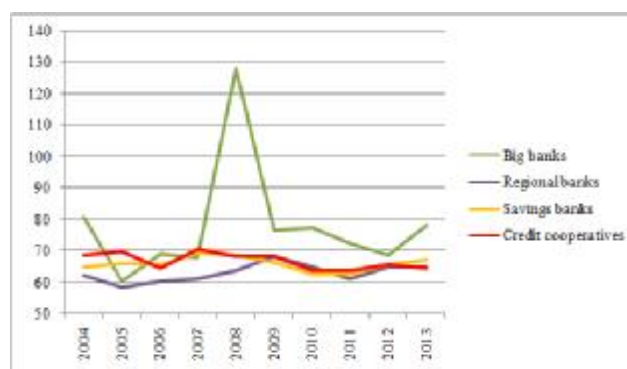
2011 would result in cooperative banks being the best performing sub-group over the past five years. In the years 2005 - 2007, performance of shareholder banks was considerably better being a function of higher net income.

**Table 21: Cost-Income-Ratio of German banks 2004 - 2013**

CIR in % of operating income	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	65,5	61,0	62,3	64,9	73,4	65,1	63,7	63,9	64,2	69,1
Big banks	80,8	60,5	69,0	68,1	128,2	76,8	77,4	72,5	68,8	78,3
Regional banks	62,2	58,4	60,3	61,2	63,8	68,2	64,8	61,0	65,0	64,8
Landesbanken	53,5	59,3	53,6	61,1	54,6	21,1	54,7	59,8	59,6	61,8
Savings banks	64,9	66,0	65,8	69,5	68,8	66,6	62,8	62,7	65,7	67,1
Cooperative central inst.	59,2	53,9	62,2	89,1	93,1	43,9	47,6	57,7	42,3	52,3
Credit cooperatives	68,7	70,0	64,4	70,5	68,3	68,3	63,7	63,9	65,8	64,6
Mortgage banks	35,0	35,2	38,9	36,0	37,6	36,6	36,3	73,7	51,7	75,4
Special purpose banks	35,4	35,2	35,3	38,2	37,3	33,0	31,8	36,0	47,1	89,0

Source: adopted of Deutsche Bundesbank (2014b, 2010, 2007) in conjunction with statistical supplements (annually)

CIR of cooperative banks has been relatively stable, yet high, in a corridor between 60% and 70%. The same applied to savings banks with both sub-groups



performing better than big banks. Given the relative stable development of operating income of cooperative and savings banks, negative trends are mainly the result of higher administration expenses. Shareholder-oriented banks showed a pike in 2008 due to massive valuation effects in regard to toxic assets.

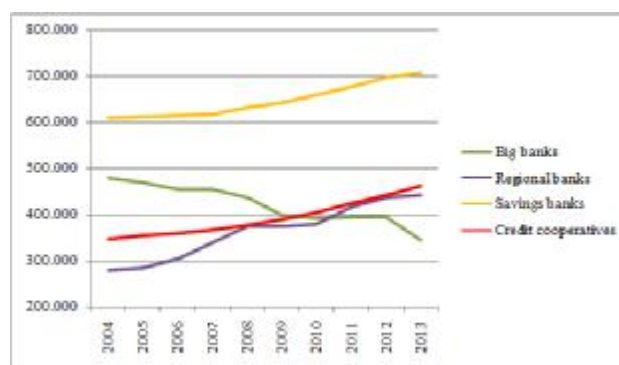
When comparing the performance of individual banking groups, representatives also tend to apply balance sheet related indicators next to income statement related ones. Especially cooperative banks as well as savings banks usually refer to parameters in terms of loans and deposits representing the predominant positions. For comparison, the respective numbers in connection with domestic customers are outlined hereafter.

**Table 22: Loans to non-banks 2004 - 2013**

Loans to non-banks in €m	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	3.005.935	3.020.110	3.050.739	3.140.365	3.227.428	3.161.182	3.231.604	3.230.249	3.227.516	3.097.401
Big banks	478.613	468.819	453.897	455.798	437.046	400.034	392.310	393.964	395.826	345.210
Regional banks	279.415	285.266	305.596	339.011	373.400	375.581	379.133	416.013	436.232	441.649
Landesbanken	421.699	436.325	468.610	515.848	549.890	531.542	528.266	523.649	493.864	444.369
Savings banks	608.992	611.715	614.879	616.988	631.041	642.370	660.135	676.936	695.940	708.263
Cooperative central inst.	28.871	30.005	26.853	35.718	38.526	36.247	31.032	32.702	36.265	33.070
Credit cooperatives	347.504	353.768	359.869	366.620	376.398	389.460	405.281	423.619	442.309	461.633
Mortgage banks	490.990	471.701	442.777	409.792	391.722	366.065	400.313	311.094	273.684	235.753

Source: adopted of Deutsche Bundesbank - Statistical supplements 2005 - 2014 (monthly publication)

As demonstrated, especially big banks restrain from providing loans to non-banks (-28%) confirming their focus on the international business as well as other investment banking activities that are not part of these positions.



Cooperative banks as well as savings banks show a constant growth, also evident during the subprime and financial crisis. In the time horizon under review, cooperative banks increased their loans by 33% compared to savings banks with 16%. Regional could improve the most with an increase of 58%.

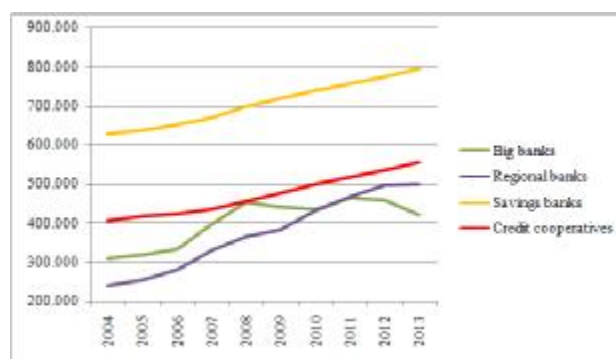


**Table 23: Deposits from domestic non-banks 2004 - 2013**

Deposits from domestic non-banks in €m										
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All categories	2.199.995	2.276.612	2.394.579	2.579.129	2.781.358	2.829.745	2.935.180	3.045.454	3.090.178	3.048.699
Big banks	310.545	319.125	333.727	396.839	452.690	441.544	436.964	463.356	459.257	421.569
Regional banks	241.549	255.392	282.240	329.642	366.549	383.509	432.459	467.421	495.973	499.800
Landesbanken	231.816	249.569	266.421	295.124	342.185	354.317	336.139	336.702	306.739	267.226
Savings banks	629.262	637.188	650.732	668.188	697.364	717.927	739.138	756.314	775.307	795.316
Cooperative central inst.	25.479	26.110	31.866	30.023	37.617	29.151	27.779	32.795	30.328	29.743
Credit cooperatives	407.756	417.517	423.537	436.079	455.474	476.715	500.362	517.461	535.611	554.805
Mortgage banks	147.759	157.808	173.491	184.609	184.107	182.604	198.765	183.951	174.826	153.985

Source: adopted of Deutsche Bundesbank - Statistical supplements 2005 - 2014 (monthly publication)

Deposits show a similar development. Cooperative banks could increase their volume by 36% with savings banks by 26%. Big banks could increase volumes by 36%. This is an interesting fact that not only concerns statements

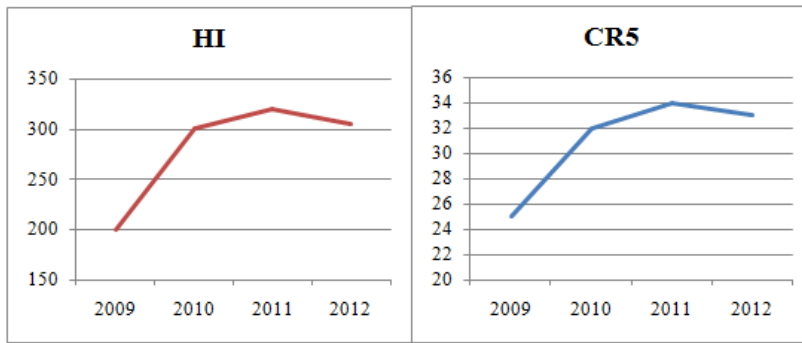


by big banks that these want to increase deposits to depend less on other banks for refinancing. It also indicates that regarding their intermediation role, deposits received do not get passed on to domestic non-banks. As with loans, regional banks could increase their volumes the most with an impressive growth of 107%.

Even though confirmed positive, the development clearly indicates that regional banks do have a higher dynamic in terms of growth indicators.

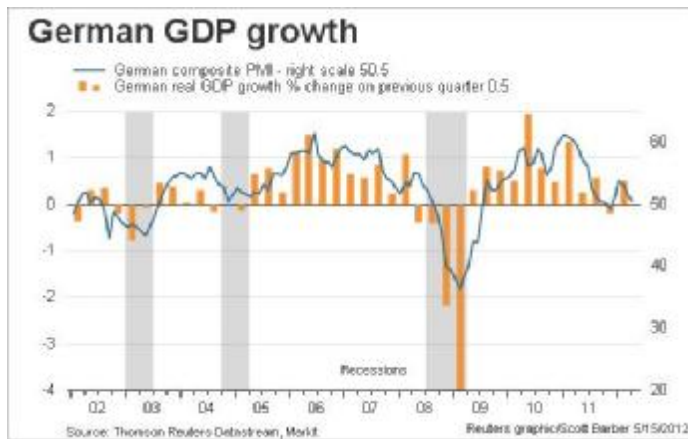
Even though considered to be a major factor in analysing the German banking market, competition ratios have not found to be a significant indicator that is considered widely. Also, due to the change in accounting obligations in 2010, making comparisons to the time before do not lead to meaningful results since data regarding derivative volumes before 2010 are not available.

Figure 19: Concentration ratios of German banks 2010 - 2012



Preliminary conclusions indicate that there are performance differences between stakeholder-oriented banks and shareholder-oriented banks in a way that the latter is far more volatile with the former being more stable and resilient to crises. It can, hence, be confirmed that ownership structure does have an influence on performance. Going further into categories for development, the findings indicate that a more determining factor of performance is also the *macro-economic development*, being the overall economy with recession and crises. The following picture describes the German GDP growth between 2002 and 2012.

Figure 20: German GDP growth



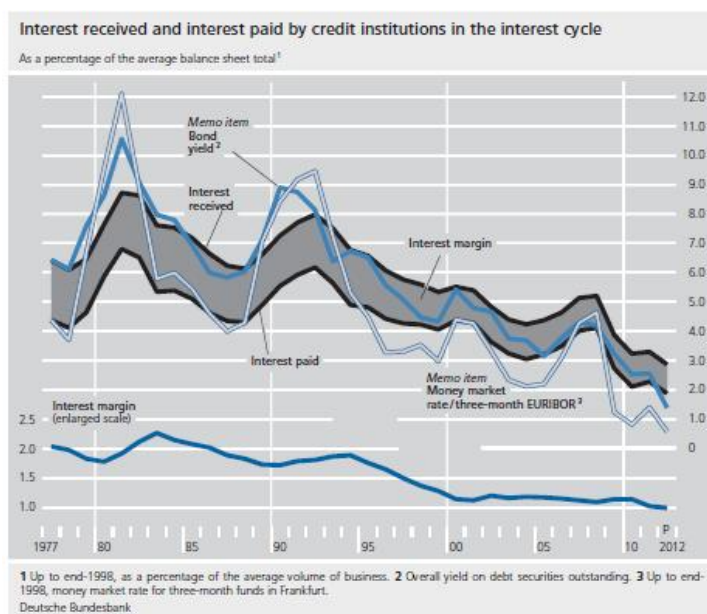
The years between 2002 and 2004 were characterized by economic downturn with the upturn beginning in 2005. According to economic theory, times of *economic downturn*, characterized by less consumption, investment and production activity, lead to a decrease in demand for bank services, hence lower margins and profits. Additionally, the value of collateral, securities and other assets typically decreases,

while the risk of customer default increases, forcing banks to increase risk reserves, which leads to even lower profits and consequently a lower degree of stability due to limited opportunities to build up equity buffers. In turn, times of *economic upturn* are usually linked with higher profitability and lower risk among banks. Empirical studies regarding the link between economic growth and profitability point to a positive correlation in majority, e.g. Ford/Olson (1978), Bikker/Hu (2002) or Athanasoglou et al. (2005). This author concludes that the statement predominantly applies to shareholder-oriented banks only (in the German banking sector). Also, looking the other way around, Hakenes et al. (2009) showed that the cooperative banks had a positive effect on growth, hence, stabilizing and contributing to GDP through their focus in SME financing.

Next to economic variables, theory and studies have also discussed the impact of monetary variables such as *interest rate*. Higher interest rates promote the creation of savings, while demoting other investment opportunities and, hence, economic growth. Also, there is increased risk that borrowers will not be able to service their debt on agreed terms. Regarding the individual institution, the impact of interest rate changes depends on its capability to manage maturity transformation, i.e. interest rate management and how long term lending is refinanced. Empirical studies point to a positive correlation between level of interest and profitability in majority, e.g. Short (1979), Bourke (1989), Molyneux/Thornton (1992), Demirgüç-Kunt/Huizinga (1998). Flannery (1981), Demirgüç-Kunt/Huizinga (2000) and Bikker/Hu (2002) find no significant correlation. This author concludes that the impact is generally not specific to certain ownership structures but rather determined by the revenue mix. Regarding the German banking sector, stakeholder-oriented banks are far more exposed to net interest income (see above), hence, subject to interest rate risks.

Most recently on 7 November 2013, the ECB reduced the ECB rate by another 0,25% to 0,25% (Handelsblatt, 7 November 2013) being the lowest in the post-war period. As can be taken from data by the Deutsche Bundesbank, the interest margin has slowly narrowed to just about 1% with a negative outlook.

**Figure 21: Development of interest margin**



### 4.3 Germany within the European banking sector: A comparison

The German banking sector is widely considered to sustain several weaknesses such as “low profitability (including when adjusted to risk) and susceptibility to excessive political influence” (IMF, 2011). In context of the changes to the regulatory framework as outlined in chapter 5, following the financial crisis as main driver, and consequences to the cooperative banking sector as focus of this work, the functioning of the sector must be addressed with a focus on the quantification of the most important bank performance elements.

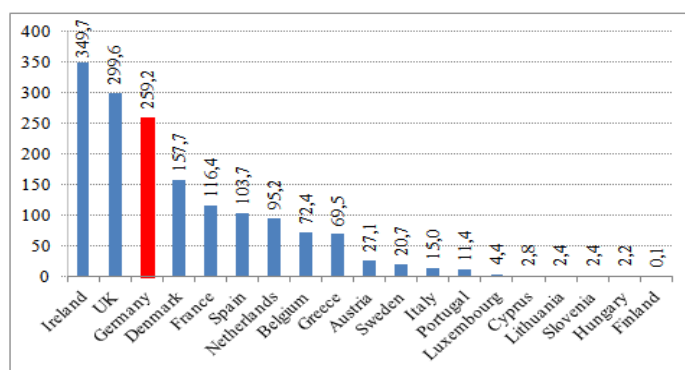
#### 4.3.1 Impact of the Financial Crisis

In order to get a better understanding of the banking market in Germany and also the EU, it is important to conduct an analysis of how the financial crisis, starting in 2007, has had an impact.

According to the IMF, a total of EUR 4.5 trillion (36,7% of EU GDP) was approved in aid (capital injections and guarantees) to the financial sector in the period between 2008 and 2011 (IMF, 2013). In a report by the Directorate-General (DG) for Competition from October 2011, covering the period September 2008 until 2010, it

is highlighted that Germany, despite being regarded as having an old-fashioned and low-volatile banking market, was affected among the most with capital of EUR 259,2 billion, behind only after Ireland with EUR 349,7 billion and the UK with EUR 299,6 billion (European Commission, 2011).

Figure 22: Government aid to financial institutions 2008 to 2010

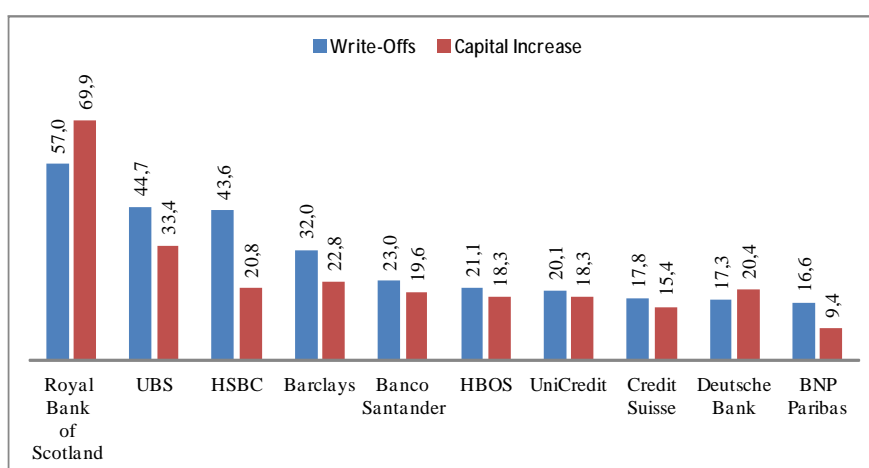


Note: countries not listed did not engage in support measures  
Source: European Commission Staff Working Paper, October 2011

The report did not describe individual rescue packages for or measures of financial institutions, however highlights that Royal Bank of Scotland did receive the largest amount of support. Based on numerous reports and articles in relevant commercial publications (especially Hans Böckler Stiftung, 2009), an analysis of the impact on income and capital structure on the most important banks has been conducted by this author has been conducted with reference to banks in the EU as well as in Germany.

From a European perspective, Royal Bank of Scotland suffered the most with write-offs of EUR 57 billion and capital measures of EUR 70 billion, mainly by the UK Government, which in turn manages and holds a stake of 82% through UK Financial Investments Limited (Handelsblatt, 2 August 2012). Other banks concerned were also mainly from the UK and Switzerland, however, without Governments taking over significant equity stakes or providing other direct financial support, i.e. capital increases were financed by private and commercial entities.

Figure 23: Cost of EU banks as consequence of financial crisis 2008 – 2011



Note: Capital increase also includes government support  
Source: own research based on company reports

In Germany, financial aid on a Government level is managed through the *Sonderfonds Finanzmarktstabilisierung* “SoFFin” (Special Financial Market Stabilization Funds), governed by the *Finanzmarktstabilisierungsanstalt* “FMSA” (Financial Markets Stabilization Institution), which was set up on 17 October 2008 as part of a EUR 500 billion rescue plan, hereof EUR 400 billion for guarantees, EUR 80 billion in cash for recapitalization and EUR 20 billion in loans for exceptional issues (Handelsblatt, 13 December 2013). Since set up until 30 June 2012, government aid by the SoFFin hit its peak in 1<sup>st</sup> half 2010 with capital support reaching EUR 29 billion and guarantees reaching EUR 149 billion.

Table 24: Costs of the Special Financial Market Stabilization Funds “SoFFin”

	31.12.2008	30.06.2009	31.12.2009	30.06.2010	31.12.2010	30.06.2011	31.12.2011	30.06.2012	31.12.2013
<b>Capital Support</b>									
Aareal Bank	0,0	0,5	0,5	0,5	0,4	0,3	0,3	0,3	0,3
Commerzbank	8,2	18,2	18,2	18,2	18,2	6,7	6,7	6,7	5,1
Hypo Real Estate	0,0	3,1	6,3	7,7	7,7	7,7	9,8	9,8	9,8
WestLB	0,0	0,0	0,7	3,0	3,0	3,0	3,0	3,0	2,0
	8,2	21,8	25,7	29,4	29,3	17,7	19,8	19,8	17,2
<b>Guarantees</b>									
Hypo Real Estate	16,9	52,0	95,0	102,0	15,0	0,0	0,0	0,0	0,0
HSH Nordbank	7,0	17,0	17,0	14,0	9,0	6,0	6,0	3,0	0,0
IKB	0,0	5,0	7,0	10,0	9,7	8,6	7,3	4,3	0,0
SdB	0,0	6,7	6,7	6,7	5,4	5,4	4,4	2,2	0,0
BayernLB	0,0	5,0	5,0	5,0	4,7	2,8	2,8	0,0	0,0
Commerzbank	0,0	5,0	5,0	5,0	5,0	5,0	5,0	0,0	0,0
Aareal Bank	0,0	2,0	2,0	4,0	4,0	2,0	1,2	0,0	0,0
DüsselHyp	0,0	2,5	2,5	1,3	2,4	2,4	1,5	1,5	0,0
CorealCredit	0,0	0,1	0,5	0,5	0,4	0,0	0,0	0,0	0,0
	23,9	95,3	140,7	148,5	55,6	32,2	28,2	11,0	0,0

As can be taken from the table above, government aid was necessary and granted to private banks, being Aareal Bank (mortgage bank), Commerzbank, Hypo Real Estate (mortgage bank), DüsselHyp, IKB (semi-public mortgage bank) and CorealCredit (mortgage bank). The latter two were taken over by private equity funds with support by the SoFFin (Handelsblatt, 10 September 2012). The remaining were public savings banks, i.e. *Landesbanken* being WestLB, HSH Nordbank and BayernLB. Realized losses as occurred by the SoFFin up to September 2012 amounted to EUR 23 billion due to write-offs and higher refinancing costs of the supported banks (Handelsblatt, 7 December 2012).

Being mostly neglected, there is also financial aid on the level of individual federal states, which support their *Landesbanken* (see section 4.3.2). WestLB received a guarantee from the state of North-Rhine-Westphalia of EUR 5 billion. HSH Nordbank, being one of the world's biggest ship financer and suffering from the continuous decline of the industry, received from the federal states of Hamburg and Schleswig-Holstein capital support of EUR 3 billion and guarantees of EUR 10 billion. BayernLB received EUR 10 billion capital support of the federal state of Bavaria and an additional EUR 5 billion in guarantees. Additionally, LBBW received EUR 5 billion in capital and EUR 12,7 billion in guarantees from the federal state of Baden-Wurttemberg. With the exception of HSH Nordbank, all *Landesbanken* were affected by heavy investments in structured investments. As the only public savings bank in Germany, Sparkasse KölnBonn, Germany's second biggest *Sparkasse*, received a total of EUR 650 million from their owners, being the cities of Cologne and Bonn (European Commission, 2011). Realized losses cannot be determined yet since support measures were granted on a long-term basis mostly.

From the information above and with reference to the focus of this work, it can be observed that the cooperative banking sector has not had to ask for Government or federal state aid. However, DZ Bank due to losses of EUR 1,47 billion pre-tax in 2008, had to increase its capital by EUR 0,9 billion in 2009, being financed by its member cooperatives, which prevented the call for state aid and prepare the bank for the merger with WGZ Bank, being the second cooperative central bank and much

better capitalized at the time and not requiring financial aid from the state or member cooperatives (Handelsblatt, 10 February 2009). In 2013, DZ Bank announced another capital increase of EUR 1,4 billion due to preparation for future regulations (Handelsblatt, 29 May 2013)

One consequence from the financial crisis was the creation of “bad banks”, which are set up to centralize and separate loss-making and risky assets from low-risk assets. In Germany, a legal framework was set up in 2008 via the *Finanzmarktstabilisierungsfondsgesetz* (Financial Markets Stability Act) to allow for the creation of special entities. The only two cases of state-owned bad banks have been the set-up of *Erste Abwicklungsanstalt* and *FMS Wertmanagement* as bad banks for WestLB and Hypo Real Estate (Bolder/Wargers, 2012). It is important to know that these two entities are no banks as regulated by the German Banking Act and, therefore, are limited in their scope of activities. The first bad bank in Germany, however, was *Bankaktiengesellschaft (BAG)*. The bank emerged from the former cooperative bank Spadaka eG that got into financial difficulties in 1985 and was reorganized in 1987 to become the bad bank for the cooperative bank network and subsidiary of the BVR (Wittler, 2006).

From a European perspective, the creation of real bad banks in Germany is unique. Other countries have similar support programmes, e.g. the United Kingdom with the *Asset Protection Scheme*, set up in 2009 and insuring “toxic assets”, from which especially Royal Bank of Scotland participated, however, planned to exit from. The difference of this insurance solution is, that assets stayed in the financial accounts, however protected for a premium, leaving considerable more freedom in dealing with them. In Ireland, the *National Asset Management Agency (NAMA)* was set up in 2009 to purchase bad assets, mainly from the five biggest Irish banks. In total, NAMA purchased assets with a book value of EUR 77 billion at a discount (“haircut”) of 30% in exchange for bonds (Handelsblatt, 8 February 2011).



### 4.3.2 Structural indicators

Relevant data for analysing banking markets on a regional or international level (*sector size*) are usually collected by regional central banks, e.g. ECB. Within their framework of monetary statistics, ECB consolidates balance sheets of the monetary financial institutions (MFIs) <sup>40</sup> on a monthly and aggregate, yet comprehensive, basis. This data was also applied for the following descriptive statistics that were downloaded by the respective data warehouse in May 2013. Further international organisations, e.g. OECD, IMF, World Bank, BIS, also provide statistical data, however, on a more aggregate level and with a focus on more macro-economic indicators. While, with reference to the latter, information on the banking sector is limited <sup>41</sup>, data available can be used to establish relevant comparisons.

Germany's economy ranks first in the EU with a GDP of EUR 2,6 trillion per December 2011 posting considerable headroom to second-place France with EUR 2,0 trillion and third-place UK with EUR 1,8 trillion.

Table 25: German banking market in a European comparison

	# MFI				total assets in m€						GDP		Population			
	1 Jan 09	%	1 Jan 12	%	1 Jan 09	%	per MFI	1 Jan 12	%	per MFI	in m€	% 100 m€	1 Jan 12	%	per cap	
<b>Euro area</b>																
BE	153	2	122	2	713.996	5	4.667	1.200.783	4	9.812	369.836	4	32	11,0	2	11,1
DE	3.280	33	1.956	28	5.306.131	36	1.618	8.393.336	25	4.291	2.592.600	28	75	81,8	25	23,0
FR	-	-	37	0	-	-	-	19.020	0	511	15.951	0	28	1,3	0	25,5
GR	102	1	79	1	152.608	1	1.526	476.911	1	6.027	208.552	2	38	11,6	2	5,8
IT	96	1	590	8	241.952	2	2.420	1.113.506	4	2.226	156.438	2	37	4,1	1	14,1
ES	608	6	415	6	967.187	7	1.591	3.621.173	11	8.729	1.063.355	11	39	47,2	14	8,8
FR	1.938	19	1.247	18	3.548.806	24	1.831	8.398.744	25	7.322	1.996.583	21	57	65,5	19	15,1
IT	944	9	785	10	1.603.984	11	1.698	4.089.607	12	1.181	1.579.659	17	50	60,4	18	15,0
CY	-	-	143	2	-	-	-	151.634	0	801	17.979	0	79	0,9	0	15,8
LIT	676	7	351	5	578.023	4	855	1.099.338	3	1.954	42.023	0	130	0,5	0	1105,0
MT	-	-	33	0	-	-	-	51.347	0	1.526	6.544	0	30	0,4	0	32,5
NL	668	7	297	4	951.386	6	1.424	2.426.733	7	3.171	601.973	6	49	16,7	5	17,8
AT	910	9	783	10	461.136	3	567	1.010.102	3	1.350	300.713	3	26	8,4	3	63,2
PT	228	2	159	2	220.094	1	962	575.510	2	3.639	171.040	2	92	10,6	2	12,0
SI	-	-	29	0	-	-	-	52.423	0	1.878	36.172	0	86	2,0	1	14,5
SK	-	-	44	1	-	-	-	58.023	0	1.319	69.108	1	61	5,4	2	8,1
FI	324	4	358	5	110.292	1	312	644.328	2	1.820	182.568	2	18	5,4	2	66,3
	9.957	100	7.531	100	14.857.602	100	1.492	13.540.548	100	4.454	9.418.475	100	80	131,5	100	32,7
<b>EU area</b>																
Other	393	4	1.619	21	0	-	-	3.078.195	24	1.867	1.471.579	15	11	10,0	5	15,6
UK	556	5	407	5	4.075.478	27	7.330	9.731.516	73	23.919	1.750.396	18	22	62,0	2	5,6
	951	100	2.026	100	4.075.478	100	4.282	12.809.711	100	6.229	3.224.975	100	64	168,0	5	22,2
Total	10.908		9.557		18.933.080		1.784	16.150.059		4.851	12.643.450		76	199,5	5	10,2

Source: European Central Bank, OECD, Eurostat, own calculations

<sup>40</sup> MFI comprise central banks, credit institutions, money market funds and other financial institutions

<sup>41</sup> See [www.oecd.org](http://www.oecd.org) („The database on Bank Profitability is frozen and the annual updates of this database are suspended due to lack of resources“)

For decades, Germany has been criticised for its high number of banks and branches leading to weak competition and low efficiency. “Overbanked” was the usual associating term (Wübke, 2006; Weiß/Herr, 2007; Financial Times, 1 September 2008 and 17 February 2013), rejected by only a few individuals (e.g. Pleister, 2005). Looking at the table above, Germany with 1.956 MFI indeed accounts for 26% of all 7.531 MFI in the Euro area. Representatives of the savings and cooperative banking groups oppose this statement by pointing out to the relation with economic power and population. As seen in the table above, showing the ratio of *MFI per million people*, the value of 23,9 puts Germany slightly above the Euro area-average of 22,7 as well as the total EU-average of 19,2. Compared to other major European economies, Germany also lacks behind with France showing 18,1, Italy showing 13,0, Spain showing 8,8 and UK showing 6,6. The unusual high values for Luxembourg, Ireland, Malta and Cyprus point to the local attractiveness of these countries due to tax and liability reasons.

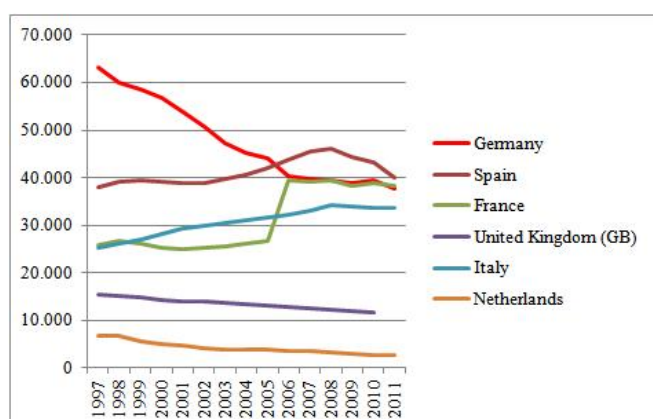
More important is the development of MFI and their relation to total assets. Consolidation in the German banking sector, mainly occurring in the savings and cooperative banking sector, lead to a decrease by 40% to 1.956 MFI between 1999 and 2012. With total assets increased by 58% to EUR 8,4 trillion, the average assets per MFI increased and improved from EUR 1.618 million to EUR 4.291 million. While this development indicates progress of the consolidation efforts, it should be noted, however, that the current state is still only Euro area-average and lacks behind values and especially dynamic of other countries such as France, Spain, Netherlands and UK.

With reference to the GDP, it is important to point out to the risk for individual economies. From the table above it becomes apparent that especially small Western-European countries with a population below 5 million have considerable total bank assets compared to their GDPs. Cyprus and Malta show total assets to GDP factors of 7,3x and 7,7x, Ireland of 8,4x. Luxembourg with a factor of 25,6x especially highlights the importance of the banking sector to the national economy, including a very significant concentration risk. In comparison, Germany shows a factor of 3,3x,

the United Kingdom of 5,6x. This is comparatively low, however, with reference to the United Kingdom and their concentration index as outlined below, it still posts a significant risk to the national economies when the international financial markets. Schoenmaker/Werkhoven (2012) derive at similar results while analysing the appropriate size of banking systems, also pointing out the risk of Switzerland, where there are only two major banks, UBS with total assets of EUR 1.158 billion and Credit Suisse with EUR 854 billion compared to GDP of EUR 464 billion.

As shown in the table below, the number of branches (*branch density*) in Germany has been unusually high. Standing at 37.853 per year-end 2011 and being just below Spain with 40.103 and France with 38.323 it has been reduced by 40% since 1997 indicating a great deal of overcapacity, especially when compared to other countries such as the UK and Netherlands which appear to be underbranched.

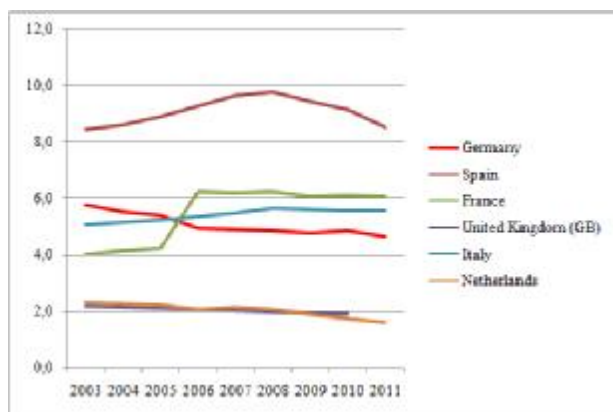
Figure 24: Bank branches in a European comparison



Again, these numbers have to be put into perspective, especially when looking at previous development. Up until 2005, Deutsche Postbank was accounted for with all individual branches of their postal service segment, i.e. bank services were provided in kiosks with no bank employees. It was the focus on the maintenance of a proper branch network, that has brought the number of Postbank branches down from 10.645 in 2003 to 1.100 in 2011 (Postbank website). The most appropriate way to look at branch networks is by comparing population and employees. The number of branches per 10.000 residents in 2011 was 4,6, being well above UK (1,9 in 2010)

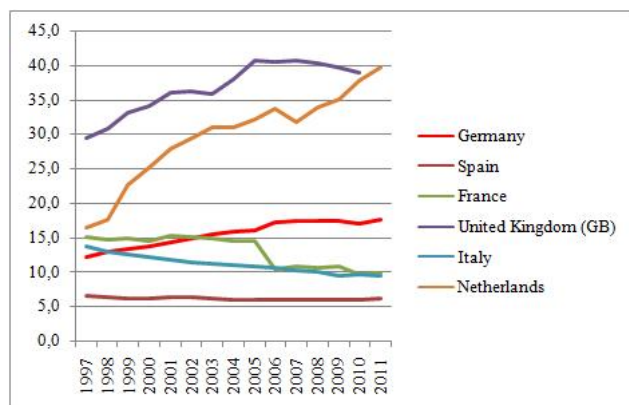
and Netherlands with 1,6, however, well below Italy, France and especially Spain with 8,5.

Figure 25: Bank branches per 10.000 residents



Similar results are derived looked at the ratio of employees per branch. Germany with 17,5 employees per branch is, again, well below the UK and Netherlands, however, well above Italy, France and Spain.

Figure 26: Bank branches and employees per branch



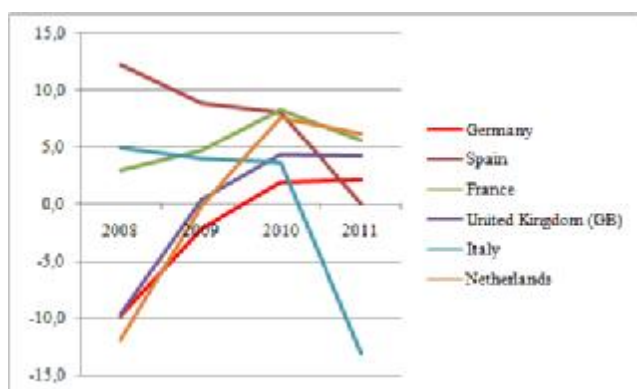
Overall, the numbers indicate that Germany still has a very high number of branches, however, has achieved considerable improvement over the past decade leading to better ratios compared to other major European economies and providing for easy access to banking services. The most appropriate look to evaluate branch economics would be to look at domestic business only, i.e. compare number of branches to the amount of domestic business indicators, i.e. income statement related (e.g. interest

income) and non-banking related loans and deposits. An analysis of the Deutscher Sparkassen- und Giroverband (2005) pointed to the fact that the average German branch handled EUR 154 million in customer volumes per year, compared with EUR 318 million in the UK. Given twice the number of employees per branch, productivity of both countries is more or less even.

Economic constraints and especially the proposed Basel III reform have put pressure on financial institutions to improve their income situation (*profitability*). Applicable are the same performance indicators as for the German banking sector, i.e. RoA, RoE as well as CIR.

Referring to available ECB data for the period 2008-2011, total banks in Germany, as well as the UK and Netherlands, had to take a big hit in profitability in 2008 with -9,8% as a result from the then existing subprime crisis. In the aftermath, profitability rose steadily to 2,2% in 2011, being, however, rather low compared to other European countries.

Figure 27: RoE in European Banking

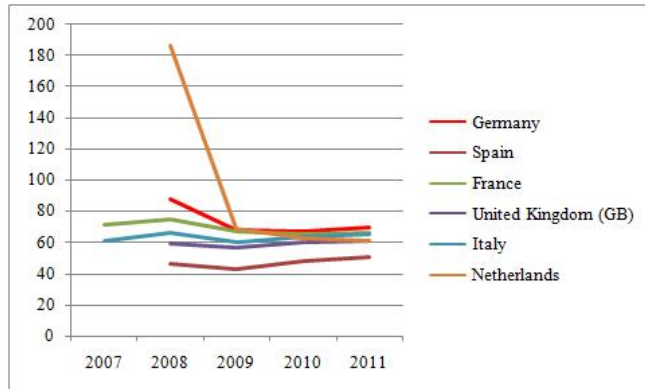


The low profitability level is even more of concern, when putting into relation with cost of equity. Several studies and researchers have estimated cost of equity for the German banking sector using different methods. Hackethal/Schmidt (2005) calculated a value of 10%, Maccario et al (2002) calculated 7,0% for 1993-2001 and King (2009) calculated 11,4% for 1993-2001 and 9,0% for 2002-2009. Overall, the development indicates the erosion of economic value of the past 20 years, while

other European countries with higher RoEs and lower cost of capital performed significantly better.

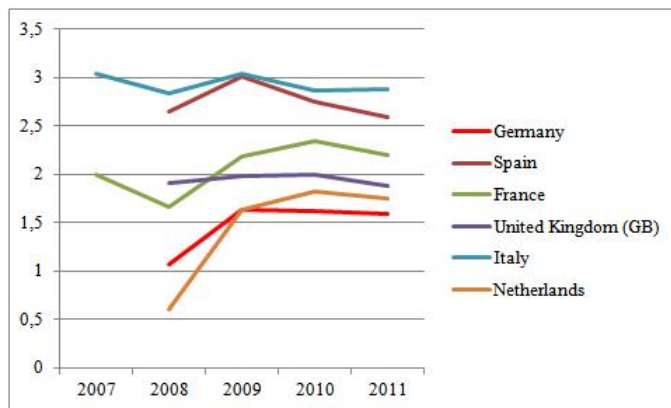
Regarding CIR, Germany leads major European countries with a ratio of 70%, almost 10 percentage points above the UK with 61% and even further above Spain with 51%.

Figure 28: Cost-Income-Ratio (CIR) in a European comparison



Statistics suggest that the reason for Germany's bad CIR is not the cost side, but rather the income side. Operating Income to Total Assets are consistently low, being the lowest in 2011 with 1,58% and well below other major European countries.

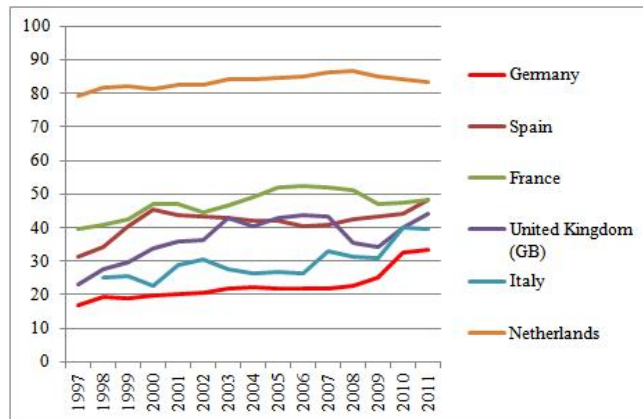
Figure 29: Income Asset Ratio



With regard to *competition*, also after the accounting adjustments as described in section 4.2.3.2, Germany is considered very low concentrated with a CR5 that increased from 17% in 1997 to 25% in 2009 and subsequently to 34% in 2011. After

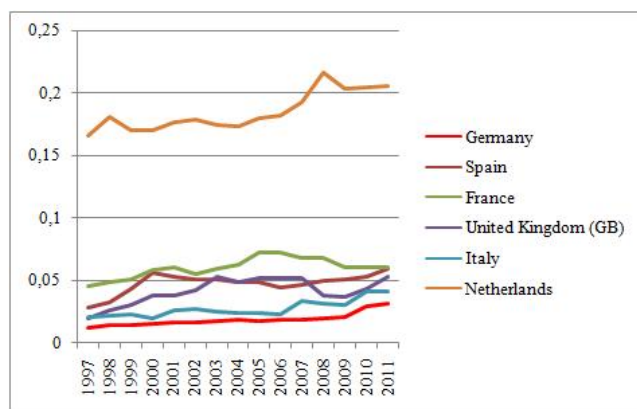
Luxembourg with 31% it has the second lowest concentration ratio within the European Union with significant concentration evident in Netherlands. Here, the OECD (2007) noted that 90% of the retail business was accounted for by the three big banks ING (40%), Rabobank (cooperative bank; 30%) and ABN AMRO (20%).

Figure 30: CR5 ratio in European comparison



Applying HHI, very similar results are derived with Germany at 0,03 being least concentrated and Netherlands being most with 0,21.

Figure 31: HHI in European comparison



Both ratios do not take into account the special Three-Pillar system within the German banking market. Savings and cooperative banks are limited to their individual regions leading to no competition on a regional perspective but only between savings, cooperative and private banks on a regional level. The European Commission (2006) noted that “whereas in countries such as Belgium or the

Netherlands regional and national market structure do not seem to differ dramatically, this is clearly the case in Germany which shows a high degree of regional concentration despite a totally fragmented national market”.

It is important to note that these measures, even though usually used due to their easy calculation and otherwise limited available data, serve as indicators only. Due to the high degree of regional concentration delineating the market is a problem, i.e. the structural measure on a national basis assumes a national competitive arena, whereas local markets still play a key role in many segments. Being more relevant, local market structures are usually not considered sufficiently.

### **4.3.3 Cooperative banking specific observations**

The ECB data warehouse does not provide relevant filter to cluster monetary institutions by banking groups. Researchers, hence, turn to other data sources when conducting relevant analyses (e.g. BankScope).

Research in general on the cooperative banking sector (and model) has been identified to be rather underdeveloped. According to well-received articles by Iannotta et al. (2007) and Hesse/Cihak (2007), while looking at European banks, the authors concluded that cooperative banks have lower profitability, yet better cost efficiency. A renaissance of the cooperative banking sector and related research occurred after the financial crisis in 2007/2008. Practically all research pointed to the fact that cooperative banks performed better during the crisis (Groeneveld/de Vries, (2009); Birchall/Ketilson (2009); Ayadi et al. (2010), Groeneveld (2011); Birchall (2013)). Also, large consulting companies such as McKinsey (2012a) and Deloitte (2012) found cooperative models to be beneficial for today's economic world. Oliver Whyman (2014) state that they "are convinced that the co-operative model as a distinctive model of banks can be a driving force to a more sustainable society and economy". The most comprehensive collection of academic studies was recently conducted by publishers Mooij/Boonstra (2012) analysing the differences of cooperative banks in various countries and arguing that cooperative banks are



essential for the functioning of banking systems due to their ability to weather crises well.

In the most recent study, Groeneveld (2013), having been identified as the most active researcher in the analysis of the European co-operative banking sector, investigated 15 European cooperative banking groups (via company reports) by testing ten hypotheses. With regard to various performance indicators investigated in this research, he derived similar conclusions when projected to the German market (see also Summary below), e.g. the rejection of cooperative banks having lower RoE and RoA than other banks, CIR being similar to that of other banking groups, and dense branch networks. Also, Bley (2012), focussing on the German cooperative market and looking at the development of loan and deposit volumes between 1999 and 2011, identified that cooperative banks could increase their volumes even though the overall economic indicators decreased, resulting in the conclusion that this sector has a sustainable market niche and crisis proven business model.

#### **4.4 Summary and Conclusion**

It was this researcher's aim to analyse the German banking market in terms of structure and performance to identify differences and conclusions in terms on how banking markets can be designed and what the role, status and economic relevance of cooperative banks is within. The aim was based on the assumption that due to the Three-Pillar structure of the German banking market, diversity is achieved leading to a corresponding diversification of risk. The aim was also to find empirical proof for the economic viability of the cooperative banking sector. In addition, it was aimed to bring preliminary conclusion into a European context.

Evidence provided illustrated that, in Germany, the cooperative banking sector has had, in fact, a better economic development than generally assumed and can keep up with private commercial banks on an aggregate basis. Main competitors are not considered to be the global players like Deutsche Bank or Commerzbank, but rather savings banks and established direct banks with easy and cheap accessibility and a focus on retail-operations. To what extent maturity transformation has contributed to

this fact could not be analysed empirically due to a lack of published and accessible data. However, it is concluded by this author by previous findings that the good performance has been achieved by increasing interest rate risk, hence, increasing the risk of a more negative impact coming from Basel III.

No evidence could be gathered confirming the often stated notion that cooperative banks show lower efficiency. Efficiency indicators such as RoE, RoA, etc. show similar results over all banking groups. Especially when applying a 10-year horizon, average values indicate better performance than in other segments. Especially due to the very stable development over the past four years, evidence has been gathered to confirm the economic viability of cooperative banks.

Additionally, research indicates the main driver is not the actual inherent or internal strength of the cooperative sector but external forces that have made customers being critical towards shareholder-oriented banks. It is argued that, when the overall economy recovers, private banks will again outperform stakeholder-oriented banks in terms of profitability. This requires cooperative banks to implement measures on the short-term in order to maintain performance and market share. This researcher, based on his research activities in connection with professional judgement, concluded that cooperative banks do discuss this issue, however, on a very high level and without agreeing on actual measures to follow up on confirming the practical use of this project.

Research also indicates that performance on a network level has been able to be kept stable despite on-going forces on performance. Also, research does not provide for the superiority of larger banks in terms of assets by applying standard performance indicators such as return on equity. In fact, smaller banks do manage to achieve higher interest rate margins than larger banks.

In an ex-ante view, two issues have been identified to be most relevant. *First*, cooperative banks have been acknowledged to be more resilient to bank crises. It is, therefore, argued that this sector positively adds to diversity and should be considered appropriately. Especially with regard to the proposed Basel III changes,

being mostly the result of shareholder-oriented banks' business practices in the past, it has to be analysed what the impact is and if these are appropriate and justifiable for the sector. Evidence that Basel II, implemented in 2004, led to decreased financial performance, could not be provided. It is this author's conclusion that Basel III and other regulatory initiatives will have a different impact. Up until now, impacts could be balanced by maturity transformation that has been identified to be a major performance contributor by this author as well as other institutions. The new Basel III will accord will limit the headroom in terms of pursuing maturity transformation, i.e. while administrative expenses are deemed to increase by a higher rate, net interest income is deemed to decrease upon implementation or shortly hereafter. Hence, the need to introduce measures for performance improvement is considered to be confirmed.

*Second*, while the business model is not deemed to be adjusted, income and costs streams, which have been slightly decreasing, have to be reconsidered looking forward. The impact of the overall ECB interest level on interest income as the most important income driver has to be re-evaluated. At the same time, customer management needs rethinking. Sales measures for existing customers need to be discussed, especially from internet and mobile perspectives, while discussing measures to re-gain customers previously lost to direct banks. Further to be analysed is especially the cost structure and size related conditions. Savings banks, being the most direct competitor, show average assets of EUR 2,5 billion per bank, while cooperative banks only show EUR 0,7 billion, pointing to a significant cost potential. In the same cost context, operational excellence must also be enhanced.

From a European perspective, evidence provided confirmed that the overall performance of the German banking sector is characterized by low profitability. However, based on the analysis it was concluded that there is potential to improve performance, mainly achieved in terms of costs through scale economies when using savings banks as a benchmark. It could clearly be demonstrated that consolidation has occurred with the number of banks and branches heavily decreasing. It is further concluded that due to the expected regulation impact, consolidation will accelerate.

## Theme Two: Regulatory Framework

*“One of the great mistakes is to judge policies and programs by their intentions rather than their results.”*

(Milton Friedman)

Theme Two considers the regulatory framework from two perspectives. In a first step and from a *qualitative* perspective, it outlines the theoretical background of regulation and context, the concept of capital within banks and then continues to outline the new Basel III accord as major change driver as well as other significant change drivers (e.g. banking union). The central question that is being addressed in this context is: "Does the new regulatory framework make sense to the cooperative banking sector?" In a second step and from a *quantitative* perspective, the findings are applied to the cooperative banking sector. In particular, it is envisaged to find out feasible and required strategies on how to improve performance and profitability.

## 5. Development of regulatory initiatives

Chapter 5 entails a critical re-evaluation of the regulatory framework with a predominant focus on Basel III. In particular, it is envisaged to conclude whether the new regulatory framework is justified, i.e. from a cooperative bank perspective it is analysed whether and how the new framework matches with the existing business model. Hence, the following topics are discussed and evaluated:

- Section 5.1 identifies and highlights the reason for imposing regulatory initiatives, hence, providing reasoning, grounds and an overview of the intention and requirements to comply with. It also describes the shadow banking issue as part of this development.
- Section 5.2 first provides for a description of technical standards to comply with in regard of the Basel Accord. It then goes on by analysing the weaknesses of previous standards that resulted in the set up of Basel III.
- Section 5.3 provides for a thick description of Basel III rules and regulations in particular including an overview of the calculated and expected quantitative impact.
- Section 5.4 looks beyond Basel III in terms of regulatory initiatives and identifies as well as analyses other challenges faced by the German banking sector in particular.
- Section 5.5 narrows previous findings down to the cooperative banking sector and investigates application of the Basel III and other standards to it. This is important in order to investigate and understand whether application is justifiable at all. In this context, an alternative concept for the application of regulatory standards as drawn upon by this author is outlined and discussed.

## 5.1 Applicable theory: Bank regulation

### 5.1.1 Why it is necessary

*“A properly functioning banking and financial services system is indispensable for the performance potential of a country's economy. An efficient banking supervision system is therefore essential for the whole economy.”*

The statement by the BaFin<sup>42</sup> refers to the economic theory that self-regulation of the financial market has failed making intervention by regulatory organizations necessary in order to prevent negative consequences for the financial system and financial institutions within.

In academic literature, there is no consensus on the overall aim of financial market regulation. Greenbaum/Thakor (1995) identified five areas making regulation necessary, being (1) safeguarding competition, (2) financial stability, (3) customer protection, (4) credit allocation, and (5) capital transaction control. In a comprehensive study on financial regulation, Michler/Smeets (2011) in reference to the recent financial crisis summarized that information asymmetry as discussed by Diamond (1984) leads to Moral Hazard and Adverse Selection, which ultimately results in *market failure* and, if not regulated properly, to bank runs.

The overall aims of bank regulations, in this context, are referred to be (a) system stability and (b) customer protection. Especially the latter has found academic attention by researchers such as Dewatripont/Tirole (1994) who derived at the *Representation Hypothesis* and the necessity to implement regulation in order to overcome the problems of information asymmetry, prevent market failure and increase economic welfare.

The implementation of Basel III is one measure to deal with the latest market failure that needs to be taken into account together with other reform measures that have been discussed. While taking into account the requirements of Basel III, these

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<sup>42</sup> published online at [www.bafin.de/EN/Supervision](http://www.bafin.de/EN/Supervision)

measures go further beyond by suggesting an adjustment of the organizational structure of overall business operations (see section 5.5 for analysis).

**Table 26: Regulatory reform measures in addition to Basel III**

<b>Reform measure</b>	<b>Assumption</b>	<b>Regulatory measure</b>
EU: Liikanen-Report (October 2012)	Excessive interconnectivity between banks	Separation of proprietary trading/high risk
UK: Vickers-Report (September 2011)	Excessive risk taking and speculation	Higer equity and leverage requirements than Basel III; Ring fencing
USA: Volcker-Rule (July 2010)	Excessive risk taking and speculation	Protect core capital by prohibiting proprietary trading

Own aggregation

### 5.1.2 Capital structure management

In general and especially by bank executives, tighter capital requirements of the Basel accords are associated with higher cost of equity (Sachverständigenrat der Wirtschaft, 2011). Classic theory on finance and capital structure, as prominently discussed and modelled via the *Modigliani-Miller theorem*, points out that in the absence of certain circumstance (e.g. taxes, bankruptcy costs, agency costs, and asymmetric information) and providing there is an efficient market, the company value is not affected by the choice of financing (“*capital structure irrelevance principle*”). Based on this theory, an increase in equity would not result in an increase of cost of capital. This is described via the determining factors of differences in return between equity and debt: the operational risk and the risk of higher bank indebtedness as outlined by Hartmann-Wendels et al. (2010). While the first is independent of capital structure, bankruptcy risk is reduced with higher equity. Also, higher equity leads to lower risk premiums and lower cost of debt. In an aggregation, increase in equity will not lead to higher cost of equity since the average cost of capital remains constant (Sachverständigenrat der Wirtschaft, 2011).

The arguments of economists, however, do not sufficiently take into account the situation on the capital markets, which differently influence returns for equity and debt. Information asymmetry exists, e.g. certain capital measures (such as issue of

shares) can be misinterpreted as a negative signal, leading to higher cost of equity. Tax incentives have an impact on average cost of capital, i.e. since cost of debt are tax deductible, while dividends are not, average cost increase with higher equity shares. Another factor to consider is the still prevailing concept of state guarantees and deposit insurance schemes, i.e. in case of distress or bankruptcy, debt providers are protected, leading to higher average cost of capital due to higher cost of equity (Hartmann-Wendels et al., 2010). Additionally, average cost of capital can be lowered via their speciality in terms of refinancing with deposits. Since the usual rate for deposits is lower than the market rate, profits or margins are created and value added, i.e. higher deposits will reduce average cost of capital.

In summary, the capital irrelevance principle does not prevail, especially in reference to the special characteristics of the banking industry. The Basel accords will imminently lead to higher cost of capital since almost all and especially large-sized banks are in need for additional equity. Since there is currently not sufficient capital available to cover additional requirements at current prices, equity provider will ask for increased returns. With reference to Basel III it is essential to further look at the quantitative impact of the new requirements.

### **5.1.3 Companies concerned and the issue of shadow banks**

The general rule is that all institutions, which require a licence by the respective domestic regulatory authority, are subject to the entire regulatory framework. In Germany, this applies to all institutions owning a bank licence in accordance with section 1 Banking Act, i.e. credit institutions and financial service companies. In consequence, these institutions need to retain sufficient own funds and a functioning business organisation.

Besides the regulated banking landscape, a parallel financial sector offering bank-like services has developed at significant speed, i.e. the *shadow banking system*. While discussing the design of the new Basel III framework, G20 leaders during their summit in Seoul in November 2010 pointed out to the fact that there are gaps with regard to the non-regulated financial entities and urged, under the management



of the Financial Stability Board (FSB), to improve oversight of this sector (Financial Stability Board, 2012).

Up until now, there is no binding and official definition of shadow banks. The FSB in their first initiatives to approach the issue in a structured way defined the shadow banking system as “the system of credit intermediation that involves entities and activities outside the regular banking system“ (Financial Stability Board, 2011a/2011b). Adrian/Ashcraft (2012), while evaluating the US American financial sector, emphasize that “although shadow banks conduct credit and maturity transformation similar to that of traditional banks, they do so without the direct and explicit public sources of liquidity and tail risk insurance available through the Federal Reserve’s discount window and the Federal Deposit Insurance Corporation”. Entities referred to as shadow banking institutions include hedge funds, money market funds and structured investment vehicles (SIV). Following this definition, a large share of operations by banks and credit institutions are conducted in the shadow banking sector, making regulation a comprehensive challenge.

Also due to volume and importance, the bulk of overviews regarding the shadow banking system is from US American academics. Authors include Pozsar (2008), Adrian/Shin 2009), Pozsar/Singh (2011), and Pozsar et al. (2012) who regularly comment on the development and risks of the sector. The most detailed description of actual entities included in the shadow banking sector to date was conducted by Pozsar et al. (2013), which identified three sub-groups of institutions, being (a) Government-Sponsored Enterprises (GSE), which especially include the mortgage companies Fannie Mae and Freddie Mac that were taken over by the US Government in 2008 and required financial aid of USD 190 billion as a consequence of the subprime crisis, (b) “internal” shadow banking sub-system, being subsidiaries and other SPEs of commercial and investment banks as a result of horizontal integration and (c) “external” shadow banking system, being similar to internal shadow banking, however the result of vertical integration measures.

The size of the shadow banking sector is regularly analysed and measured by the FSB. In their Global Shadow Banking Monitoring Report 2012 (Financial Stability Board, 2012), the FSB described the increase of the sector to a volume of USD 67 trillion in 2011, being the equivalent of 111% of the aggregated GDP of all countries analysed and significantly up from the 2002 volume of USD 26 trillion as well as the pre-crisis volume in 2007 of USD 62 trillion. The largest sector was the USA with USD 23 trillion, followed by the Euro area with USD 22 trillion and the UK with USD 9 trillion.

In Germany, the role of shadow banks (OFIs) is not that significant since banks are the most important intermediaries compared to money and capital market oriented countries such as the USA. However, it was the use of SIVs that caused the near collapse of IKB, HRE and several *Landesbanken*, i.e. excessive investments in toxic papers via special entities. The Deutsche Bundesbank (2012b) also described the German shadow banking system as comparatively small with a volume of EUR 1,3 trillion that predominantly are allocated to open-end mutual funds with assets under management of EUR 1,2 trillion.

The shadow banking systems usually is referred to as one of the drivers behind the financial crisis as a result of investments in riskier ventures in order to achieve above average returns (see Nersisyan/Wray (2010), Balz (2011) and Poschmann (2012) for a good overview). In order to limit the influence of the growing shadow banking sector, the FSB on 18 November 2012 issued a consultative document paper with recommendations to reduce the associated systemic risk and avoid spill-over effects (Financial Stability Board, 18 November 2012). In the same paper, the FSB points out to the fact that the intermediation of shadow banks “appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity”. The scope of regulation for shadow banks is still subject to discussion as the date of this work. In a follow up to this project, the Global Shadow Banking Monitoring Report 2013 (Financial Stability Board, 2013) still did not show any conclusions on how to deal with the issue, while the volume increased further to USD 71 trillion.

However, first recommendations were published towards the end of 2013 (Financial Stability Board, 29 August 2013).

Even though shadow banking is regarded a negative issue in public, the trend moves towards a more practical view. Recently, Buch (2014) and the President of Deutsche Bundesbank (Handelsblatt, 18 July 2013) stated that intermediaries also fulfil important roles for the overall economies due to the decreasing willingness of banks to provide sufficient funds. It is also stated, that due to the small size of this sector in Germany, the biggest risk is the interaction with international actors within the shadow banking system.

With regard to the focus of this project, shadow banking and shadow banks are not regarded to play a material role. Due to the scope of business operations, cooperative banks do not and cannot engage in shadow business activities. Still, via their asset management company *Union Investment*, there is indirect involvement with the sector. However, the cooperative banking sector and primary banks in particular are not seen in any direct connection.

## **5.2 Historical development**

The Basel Committee on Banking Supervision (BCBS), founded in 1974, has played a great role in standardizing bank regulations across jurisdictions. The BCBS consists of various representatives from central banks and regulatory authorities. The objectives of the committee have evolved over the last years. Among many other tasks, the committee accounts for defining the roles of regulators and supervisory practice in cross-jurisdictional situations, i.e. ensuring that international banks and financial institutions do not escape comprehensive supervision and creating fair and decent competitive financial market environments by imposing uniform capital requirements (BCBS, 2004).

The financial crisis, which started in 2007 as a subprime crisis and is still present in form of a sovereign debt crisis today, represents a decisive turning point for the financial industry. Due to its systemic impact, i.e. the interdependencies of financial

institutions and correlations between financial markets and national states, its coverage even affected the global economy and permanently changed the lives of numerous people until the present day. Accordingly, policy makers have been called to action in order to take appropriate measures to calm the financial markets, institutional players and provide for an anchor of stability. As a result, a vast number of policy changes and initiatives have been introduced on the global scale aiming at the restoration of financial stability as well as the recovery of trust in the financial system. With regard to supervisory structure and practice, fundamental changes have been forwarded since 2007 in order to respond to both the “systemic impact ”and the “global repercussions” of the financial crisis. Amongst others, the Basel III framework represents an essential part of the new ‘post-crisis’ regulatory culture respectively regime. By combining a microprudential approach (i.e. focus on single financial institutions, e.g. by introducing certain quantitative minimum capital requirements and financial indicators) with a macroprudential approach (i.e. focus on the financial system in general, e.g. by mitigating systemic risk), Basel III symbolizes the core of modifications that target credit institutions respectively banks and may serve as an instrument fostering the stability of the financial system as well as the resilience of individual financial institutions.

### **5.2.1 Development, rationale and description**

The financial regulatory environment is mainly influenced by the BCBS that plays a vital role in standardizing banking regulation across jurisdictions. In 1988, the Basel Committee developed the ‘International Convergence of Capital Measurement and Capital Standards’ (Basel I) as the first international risk-based capital standards for banks (Smith, 2005). The main goal of this accord was to set up a flexible regulatory system concerning banks’ capital requirements. Basel I dealt with credit risk in a simple manner, while market risk was not neglected and operational risk was not dealt with at all being one of the main weaknesses of this accord. As a consequence, the BCBS issued a new framework in 2004 that included substantially more capital adequacy requirements. This so-called “International Convergence of Capital Measurement and Capital Standards: A Revised Framework,” is also known as ‘Basel II’ (Smith, 2005).

## 5.2.2 The three pillars

Due to criticism against Basel I, adjustments became necessary. However, the basic logic of Basel I was retained with regard to Basel II (Doherty, 2008). The Basel II accord appears to be more risk sensitive and differentiated than Basel I. This differentiation resembles a necessity because banks perform crucial functions within the financial system and are thus subject to the risk of failure from a number of sources. These inherent risks demand public policy intervention to protect the banking system from its realization. Therefore, Basel II aimed at improving existing rules by a closer alignment of regulatory capital requirements to the aforementioned risks which internationally active banks face in today's financial markets (Doherty, 2008)

The Basel II framework describes a more substantial and accurate measure and the minimum regulatory standards for financial institutions' capital adequacies.

The minimum capital requirements are covered in pillar 1 while pillar 2 focuses on the supervisory review of capital adequacy; market discipline is addressed in pillar 3.

The second and third pillars were new and complement the first pillar that already existed in Basel I. The sum of the three pillars intends to achieve a level of capital that is respective of a bank's overall risk profile.

### *Pillar 1- Minimum Capital Requirements*

The first pillar covers the minimal capital requirements for credit, market and operational risk. First of all, *credit risk* implies the possibility for a bank to lose money if debtors are not able to fulfil their obligations. To evaluate this risk, the internal ratings-based approach (IRBA) can be used to allocate capital charges to credit risks. The IRBA is one of the most innovative aspects of Basel II. It enables banks to choose between the "foundation" and the "advanced" approach, depending on their ability to comply with the demanding sets of supervisory standards (Hall, 2004). The IRBA is based on banks' internal risk assessments and thus, the feasibility for more risk sensitive capital requirements is substantial. However, the

approach does not allow banks to determine the entirety of the essential elements needed to calculate their own capital requirements autonomously. Also, the IRBA is thoroughly monitored by the supervisory authorities (BCBS, 2003).

Secondly, *market risk* covers a possible value decrease of an investment due to specific market conditions. The measurement of the market risk is possible via the internal value at risk (VaR) model, which is a measure of losses resulting from normal market movements (BCBS, 2003).

Finally, *operational risk* comprises the risk of a possible loss respectively default as the result of failed internal (control) systems, processes or human mistakes. There are different methods to evaluate operational risk. The first method is *the basic indicator*, which measures the bank's average annual gross income over the previous three years and multiplies this average by the factor 0.15 to determine the capital requirement. The second method is the standardized approach, which establishes fixed risk weights to each supervisory category and uses external credit assessments to enhance the risk sensitivity. The third method is the advanced measurement approach to gauge the operational risk that is systematic and presumably based on events that can be quantified with objective statistics (BCBS, 2003).

#### *Pillar 2 - Supervisory review process*

The second pillar is a supervisory review process of capital adequacy to evaluate whether the financial institutions possess sufficient capital to meet their obligations and cover their risks, based on guiding principles that point to the need for banks to assess their capital adequacy relative to their overall risk. These risks include, for instance, the reputational risk, legal risk and liquidity risk which are called residual risks in the accord.

The guiding principles of the supervisory review entail that the banks are equipped with adequate processes for the assessment of their overall capital adequacy. The capital assessment can be reviewed by the supervisory and regulatory authorities who are able to intervene if necessary. Both supervisors and regulators expect banks to

operate above the minimum capital requirements, hence, they will step in on the chance that a bank falls below this limit (BCBS, 2003).

The inclusion of the supervisory review element in Basel II provides benefits by emphasizing the need for strong risk assessment capabilities on the institutional side as well as by strengthening the demand for ratings of capital adequacy and risks on the supervisory side.

### *Pillar 3 – Market discipline*

The purpose of pillar 3 is to complement the minimum capital requirements of pillar 1 and the supervisory review process of pillar 1. Pillar 3 focuses on market discipline and forces banks to disclose their risks in order to influence the public market positively. It is responsible for the amount of publicly available information to promote the public reporting and disclosure of banks and to supplement reviews by the national regulatory authorities. Therefore, pillar 3 may procure significant benefits for the financial system by supporting banks and supervisors to manage risk consciously and improve stability and resilience on a micro- and macroeconomic level (BCBS, 2003).

### **5.2.3 Capital Requirements**

Basel II recommends two methods for the management and measurement of banking risks: The *standardized approach* and the *IRBA* (see pillar 1 above). The *standardized approach* is the extended version of Basel I where the standard rate of capital requirement was fixed at 8% percent irrespective of existing ratings, while the Basel II standardized approach assesses this amount by taking the ratings into account. Under the IRBA, banks are allowed to use their own internal estimates to determine the solvency of their debtors to evaluate the respective credit risk. This approach offers the banks the opportunity to choose a suitable method for the assessment of remaining risks within the supervisory criterion. Financial institutions are supposed to provide all information available concerning the risk that one of their counterparties (e.g. individuals, banks, sovereign governments or various

corporations, etc.) will default as well as the percentage of the amount which is already assumed as doubtful and that would be difficult to get back. The rating of the customers into different groups depending on their individual risk profile is the core idea of this method. Additionally, it also aims at performing an assessment of the necessary capital requirements depending on the collected information.

#### **5.2.4 Liquidity Requirements**

Liquidity is a bank's ability to fund increases of assets and meet obligations as they are due without incurring losses. An effective liquidity risk management helps to guarantee the bank's ability to meet cash flow obligations, which are uncertain because of possible external events. Liquidity risk management plays an essential role in financial management because a liquidity shortfall at a single institution may provoke system-wide repercussions (BCBS, 2008). Despite the fact that liquidity and leverage are, as far as risk management is concerned, more important than capital, the Basel II accord does not cover liquidity management (Moosa, 2010). The BCBS published the "Sound Practices for Managing Liquidity in Banking Organizations" in 2000 (BCBS, 2000). This paper includes 14 principles with respect to the assessment of liquidity management in financial institutions. Still, liquidity management has not been considered in the Basel II accord.

#### **5.2.5 Lessons from the financial crisis: Weaknesses revealed**

The Basel II accord is considered as a major casualty of the global financial crisis, as the weaknesses of the accord have been exposed during that time (Moosa, 2010). Its capital based regulations were supposed to protect banks from insolvency, but the financial crisis revealed no relation between capital ratios and the occurrence of losses. It was found that capital based regulation pushed banks in Switzerland to raise their capital levels but not to reduce risk exposure (Rime, 2001). Additionally, the capital based regulations led to a higher systematic market risk exposure of US banks, which limited their interest rate (Allen/Jagtiani, 1997). The large losses that hit the financial institutions during the crisis question the usefulness of VaR as the foundation of risk management. The VaR estimates the worst possible outcome by



using data from the past three to four years. This practice results in a higher number of positive predictions the longer the things are fine. But normally one would expect the risk of a blow-up to increase with the time distance to the last recession. Losses resulting from catastrophic events like the earthquake in Japan are overlooked due to its dependence on statistical measures that deal in the same way with upside and downside risks. As shown in section 5.3.1.3, liquidity and leverage are not taken into account although the lack of liquidity risk management represents a strong impact factor for the financial crisis.

Another major flaw that has been uncovered by the crisis was the fact that Basel II is mainly dealing with deposit banks despite the fact that a main contributor to the financial crisis displays the wrong risk management at investment banks. These findings lead to the conclusion that Basel II does not provide the right kind of regulations to safeguard the financial system from a severe tailspin.

As shown in the last chapter the financial crisis revealed how inaccurate banks' internal models are. Beyond that, the profound and lasting consequences of the crisis depict the inadequacy of the Basel II framework on the one hand and capital-based regulation in general. Certain requirements of the Basel II accord are insufficient. The three part structure of Basel II can create inverted incentives. One example for such an inverted incentive is the fact that the capital requirements for low-quality and risky instruments are significantly lower under the standardized approach than under the IRBA. As a result, banks that are using the standardized approach have an incentive to specialize on risky credits, which leads to a downstream elevation concerning the overall risks of the banking system (Kupiec, 2001). On the other hand, the regulations do not take into account that risk also creates value, i.e. the avoidance of systematic risk will possibly induce a financial system that is even more unstable. Basically, there are some major design flaws in the first two pillars that make the achievement of the capital requirements of first pillar doubtful (Kaufman, 2003). The second pillar is designed to allow supervisors to declare capital charges above the minimum requirements by the first pillar. This implies the inadequacy of the first pillar. Hence it is not clear how supervisors and regulatory authorities are

supposed to determine the required capital over and above the pillar one minimum (Kaufman, 2005).

Basel II does not address all the regulatory issues that figure into the lessons learned from the current market events. The challenges in the markets go beyond the constraints of the Basel II framework. The advances in knowledge that could be acquired through the experiences with financial institutions that collapsed in the aftermath of 2007 reveals that liquidity and leverage, which are overlooked by Basel II, matter at least equally respectively even more than capital. Especially the financial crisis brought forth severe deficiencies concerning banks' capital endowments. Furthermore inadequate liquidity resources became apparent. A main contributor to the financial crisis was the wrong risk management at investment banks and the extreme leverage of hedge funds. Unfortunately, these institutions are not covered sufficiently in the Basel II accord. Therefore, the new regulatory standard needs to strengthen the capital requirements of financial institutions and to entail new regulatory requirements on bank liquidity and leverage.

### **5.3 Introduction of Basel III**

#### **5.3.1 Elements of the new Basel III reform package**

In the light of the financial crisis, severe deficiencies concerning banks' capital endowments and adequate liquidity resources became apparent. As a result, Basel III brings two weighty prudential ratios into focus: capital and liquidity (Carmassi/Micossi, 2012). Against the background of the target floor mentioned above, on the one hand, the Basel III reform package aims at improving the capital equipment of financial institutions on both accounts: Its qualitative as well as its quantitative aspects. On the other hand, Basel III is targeted on enhancing the institutions' liquidity provisions by introducing two new liquidity standards as well as a debt ratio (Leverage Ratio).

### 5.3.1.1 Capital enhancement

Without doubt, the fundamental nucleus of the Basel III framework concerns the redefinition of the regulatory equity capital. Ex-post crisis findings show that banks lacked sufficient equity capital ratios during the time before. Furthermore, they did not have adequate equity capital instruments of a high-quality manner at hand. Retrospectively, even an intense increase in the use of hybrid capital components can be observed in the pre-crisis years. Unfortunately, these capital instruments implied certain weaknesses which were manifested in a merely limited ability of loss compensation and durability of disposition as well as explicit rights of termination and shortcomings in terms of prudentially validating the asset side on the balance sheet. It is a question of utmost complexity to answer what amount of “capital is adequate -regardless of regulatory minimums - to ensure that capital levels are aligned with an institution’s overall risk profile” (Zamil, 2010).

By reworking the capital requirements, the BCBS faced two severe challenges. Firstly, it had to deal with the trade-off between elevated systemic stability on the one hand and the endangerment of the real economy’s recovery as well as banks’ lending capabilities on the other hand; and secondly, the BCBS needed to consider a solution for the so-called ‘regulatory paradox’, namely ‘What is the use of increased capital requirements if this capital cannot be utilized for risk or loss compensation in times of crisis due to the fact that a shortfall in the minimum capital requirements already entails the imposition of sanctions?’ (Friedrich-Ebert-Stiftung, 2011). The regulatory paradox has been encountered by fixing a gradual timeframe regarding an implementation plan that comes into effect in January 2013<sup>43</sup> and earmarks the final realization not until 2019. Thereby, banks are granted ample time to accommodate to the new Basel III guidelines and to transform their business processes and structures accordingly. In order to ease the former one of these target conflicts, the BCBS introduced two novel capital buffers that will be explained in the following paragraph.

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<sup>43</sup> Subsequently to this research, Basel III is subject to be go live on 1 January 2014

Additionally, the capital ratio is supplemented by a concept entailing two capital buffers that are added to the minimum capital requirements: The *capital conservation buffer (CCB)* and the *countercyclical capital buffer (CCCB)* are free to be melted off under certain circumstances. The CCB resembles a fixed buffer of microprudential nature which is “designed to cushion capital in phases of stress” (Carmassi/Micossi, 2012). Moreover, it leads to an increase in minimum CET1 to a total of 7% (4.5% CET1 plus 2.5% CCB) of RWA. Hence, it eases the regulatory paradox by providing a cushion that can be spend either partly or completely during running business operations without endangering the minimum CET1 quota that may ultimately provoke supervisory sanctions. However, banks which make use of their CCB are subject to certain restrictions concerning profit distribution and discretionary payments.

### **5.3.1.2 Liquidity stabilization**

Exaggerated maturity transformations and illiquidity are considered as two fundamental causes of the financial crisis (Carmassi/Micossi, 2012), hence, making enhanced supervision necessary. The strengthening of the Basel liquidity framework involves the initial introduction of two globally harmonized minimum liquidity ratios:

- Liquidity Coverage Ratio (LCR)- short-term
- Net Stable Funding Ratio (NSFR) - long-term

The LCR focuses on improving a bank’s short term liquidity assurance while enhancing its resilience to cope with potential stress situations (e.g. liquidity collapses, institute-specific and systemic shocks, significant downratings, etc.) (KPMG, 2011a). According to the LCR guidelines, banks will be required to retain a time buffer of 30 days to cope with stressful impacts and implement effective measures. It has to be reported to the national supervisory authority on a monthly basis. Basically, the LCR matches the amount of high-quality liquid assets with the expected net liquidity outflow within a 30-days stress test scenario that is based on certain idiosyncratic assumptions of market-wide validity (Liermann, 2012).

The high-quality liquid assets applied in the LCR are categorized into two levels according to their degree of accounting liquidity. While level 1 assets like cash, central bank deposits and sovereign bonds without any risk deduction may be credited against by 100%, level 2 assets (e.g. sovereign bond with a 20% risk deduction, corporate bonds and covered bonds with a minimum rating of AA) may be applied by only 85% due to a 15% value deduction factor.

The following three implications are worth noting: First of all, a positive effect of the LCR's introduction may imply the reduced risk of a potential occurrence of a bank run, hence, it increases the stability of the financial sector. In contrast, the compliance of the LCR may induce negative consequences on the profitability of a bank. This is due to the fact that banks have to hold available considerably more assets which are highly liquid but rarely profitable. Finally, assets may be disproportionately weighted by national regulators resulting in unequal market conditions on a global scale. The outcome of this may evoke distortions of competition for certain banks that will be discriminated due to their regulator's weightings.

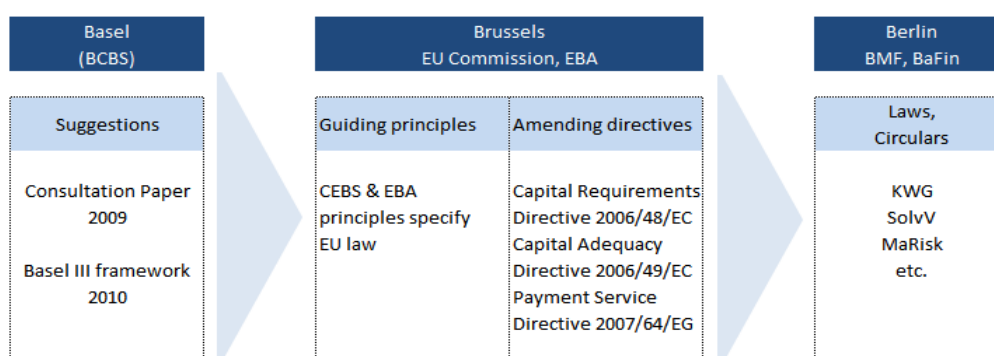
The novel long-term liquidity ratio known as *NSFR* serves as a measure for the evaluation of structural liquidity risk. By balancing the maturity's structure within the balance sheet, it aims at antagonizing the excessive mismatch of maturities between the lending and the refinancing business, which became apparent during the financial crisis. As a result, the NSFR provides for an acceptable minimum amount of strong refinancing based on stable funding and weighted assets over the time frame of one year. Also, the sum of stable funding available has to surpass the (liquidity proximal) weighted long-term assets and therefore accommodates the risk of cumulating net outflows beyond the liquidity buffer in the medium term. It is based on the so-called *golden bank rule*, which goes back to Otto Hübner, the founder of the first Prussian mortgage bank (Hübner, 1853). The rule implies that the maturities of a bank's granted loans and the deposits used to refinance these loans should match each other. While the metric's numerator's elements, i.e. the liabilities used for stable funding, are categorized in terms of their stability, the denominator's

items, i.e. long term assets, are classified according to their accounting liquidity. The exact weightings of the NSFR elements are still to be determined, hence, a transition period is intended until the final implementation of the NSFR on January 1st, 2018.

### 5.3.1.3 Timeline

On a European level, Basel III will be implemented via the Capital Requirements Directive IV (CRD IV) as well as the Capital Requirements Regulation IV (CRR IV) that was issued by the European Commission (EC). This innovative legislative package replaces the present Capital Requirements Directives 2006/48/EG and 2006/49/EG “and constitutes another major step towards creating a sounder and safer financial system” (KPMG, 2011c). While the CRD IV “governs the access to deposit-taking activities”, the CRR IV “establishes the prudential requirements institutions need to respect” (European Commission, 2012). According to the European Community Law, regulations constitute final regulatory action. Unlike directives which need to be implemented into the individual national law of each European member state, regulations lack this necessity respectively option of translation into national law. Although the CRD IV is based on the BCBS’s Basel III framework, it goes beyond the initial proposal by comprising amendments that are targeted on the EC’s core concern: The further alignment respectively harmonization of European financial supervisory practice (KPMG, 2011c).

Figure 32: Basel III and its way into German law



The Basel III implementation timeline schedules a gradual introduction starting on 1 January 2013 (planned). The deadline for the final implementation deadline has been set for 31 December 2019. This arrangement with a transition period of six years is supposed to enable banks to adapt to the upcoming changes and standards. The following table provides an overview of the different deadlines and periods of transitions of the various Basel III instruments:

**Table 27: Basel III implementation timeline**

Phases		2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%
	Minimum Total Capital		8.0%					8.0%
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%
	Net stable funding ratio						Introduce minimum standard	

### 5.3.2 Evidence from selected impact studies

With reference to the proposed changes to capital and the derived theoretical impact on capital cost numerous studies have been published by academic and practical research objects that deal with the micro- as well as macro-economic impact of the new regulation. *Micro-economic* studies focus on the analysis of capital requirements and the impact of new capital rules on profitability of banks. *Macro-economic* studies focus on the analysis of the net effect of new capital rules by comparing cost and benefit of new regulation.

### 5.3.2.1 Micro-economic studies

Studies conducted in this context can be distinguished into two groups: (a) studies conducted by supervisory authorities (BCBS/EBA) and (b) studies by private organizations (e.g. consulting companies, banks), which also point to courses of action to better fulfil requirements. Since the studies by private organizations usually focus on international banking entities, smaller banks or banking groups, such as the cooperative banking sector, are not covered.

#### *Supervisory authorities*

The most rigorous analysis of implication of Basel III (QIS or *Quantitative Impact Study*) is analysed via the *monitoring exercise* as conducted by the BCBS on an international level and by domestic central banks (i.e. Deutsche Bundesbank on German level) on a semi-annually basis, which distinguished between Group 1 banks (banks with Tier 1 capital in excess of EUR 3 billion and international operations) and Group 2 banks (all other banks).

According to the results based on data as of 30 June 2012, published for 210 international banks by the Bank for International Settlements (2013), “the average CET1 of 101 Group 1 banks was 8,5%, as compared with the Basel III minimum requirement of 4,5%. In order for all Group 1 banks to reach the 4,5% minimum, an increase of EUR 3,7 billion in CET1 would be required”. More importantly, in order to reach the CET1 ratio of 7,0%, i.e. including the capital conservation buffer, another EUR 208,2 billion are required<sup>44</sup>. Regarding 109 Group 2 banks, average CET1 ratio was 9,0% with EUR 4,8 billion needed for all banks and additional EUR 16,0 billion needed to reach the CET1 target of 7,0%<sup>45</sup>.

According to the results based on data as of 30 June 2012, published for 33 German banks by the Deutsche Bundesbank (2013), the average CET1 of 8 Group 1 banks was 5,7%, of 25 Group 2 banks 8,5%. In order for all Group 1 banks to reach the

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<sup>44</sup> As point of reference: Total aggregate of profit after tax for all Group 1 banks in the financial year 2012 was EUR 379,6 bn.

<sup>45</sup> As point of reference: Total aggregate of profit after tax for all Group 2 banks in the financial year 2012 was EUR 22,9 bn.



4,5% minimum, an increase of EUR 3,6 billion in CET1 would be required. To reach 7%, EUR 32,4 billion are required. Group 2 banks only require EUR 0,4 billion to reach the 4,5% minimum and EUR 1,3 billion to reach the CET1 ratio of 7,0%.

Following up on this topic, the results as of 30 June 2013 were accessed in May 2014 (Deutsche Bundesbank, 2014). Also due to an increase in the sample up to 48 banks, results do point towards a positive development. The 8 Group 1 banks showed an average CET1 of 8,3%, hence, achieving the threshold of 7,0%. The 40 Group 2 banks showed an average CET1 of 12,8%. Considering all add-ons, Group 1 banks were deemed to require EUR 4,7 billion in additional equity, Group 2 banks EUR 1,2 billion.

### *Private organizations*

The most comprehensive studies by private organizations are conducted by Boston Consulting Group (“BCG”) and McKinsey. The studies focus on the requirement of a CET1 of 7%. Also, they assume an imminent implementation and do not consider the transitions periods.

BCG (2011), while looking at 145 large banks worldwide, calculated the need to improve equity to be EUR 345 billion, which equals a reduction of Risk Weighted Assets of ap. EUR 5 trillion. BCG (2010), while looking at 84 banks, calculated a capital gap of EUR 275 billion for European banks. McKinsey (2010) pointed out that the European banking sector would need ap. EUR 1,1 trillion of additional Tier 1 capital, the US banking sector ap. USD 870 billion. McKinsey (2011) calculated additional CET1 of USD 660 billion for European banks and USD 820 billion for US banks.

Compared to the studies by supervisory authorities, these have a more limited and changing sample size and are only conducted on an irregular basis. A direct comparison is, therefore, not possible without analysing individual countries in detail, which is not within the scope of this work.

### 5.3.2.2 Macro-economic studies

Macro-economic studies focus on analysing the net effect of the new regulatory capital measures by comparing economic benefit and cost in reference to GDP situation and development. Economic cost related to the expected increase in interest rates offered by banks as a result of the expected growth of cost of capital, which are expected to have a negative impact on demand and spending behaviour of private and commercial entities. Going forward, this can have a negative impact on economic welfare since input parameter for respective measurement models are expected to be negatively affected (Berg/Uzik, 2011). Barrel et al. (2009) describe economic benefit as (a) reduction of expected losses during bank crises, (b) increase in system stability and (c) reduction of volatility of economic cycles.

Most studies are conducted on a cross-country basis and calculate the increase of interest spreads to be paid by customers per 1% increase in capital (e.g. Barrel et al. (2009), Slovik/Cournede (2011), Roger/Vlcek (2011), Santos/Elliott (2012)). A separate task force (Macroeconomic Assessment Group) has also been set up by the FSB and BCBS to assess the macro-economic impact of new regulation (Bank for International Settlements, 2010). However, these studies do not sufficiently take into account the German economic structure which is dominated by the “*Mittelstand*”<sup>46</sup>. As stated in section 3.2, the *Mittelstand* is core client of cooperative banks (and savings banks) due to their regional presence and focus. German leader Deutsche Bank also recently announced to strategically push their efforts to finance *Mittelstand* clients (Handelsblatt, 12 March 2013).

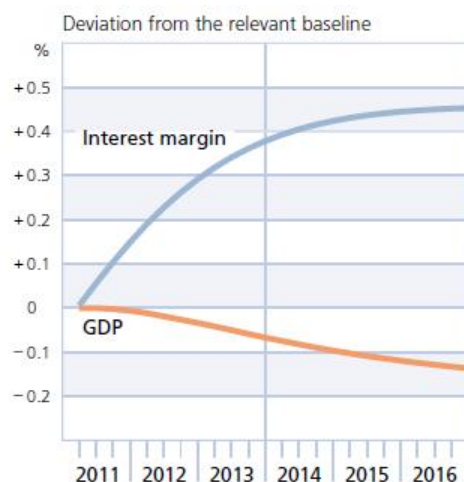
Berg/Uzig (2011) in their study on the impact for the German *Mittelstand*, sponsored by the umbrella organization *Bundesverband mittelständische Wirtschaft*, assumed that the most likely reaction of banks in order to comply with new regulatory requirements will be to reduce lending by 2,47% and increase interest spreads by 54

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<sup>46</sup>Though unofficial, this term typically refers to small and medium sized according to German standards (max. 500 employees and max. EUR 50 m turnover) or to European standards (max. 250 employees and max EUR 50 m turnover). In a recent study of the German Federal Ministry of Economics and Technology (2013) it is stated that “more than 99% of all German firms belong to the German *Mittelstand*”, which also “contributes almost 52% of total economic output” and “around 39% of the overall turnover of German companies”.

bp. Their conclusion was about in line with the results of the impact study of Deutsche Bundesbank (2011a) that saw an increase of interest spreads of 50 bp resulting in a decrease of projected GDP by a max. of 0,1% p.a. or cum 0,4% up to 2016.

Figure 33: Simulated adjustment paths for the interest margin and GDP

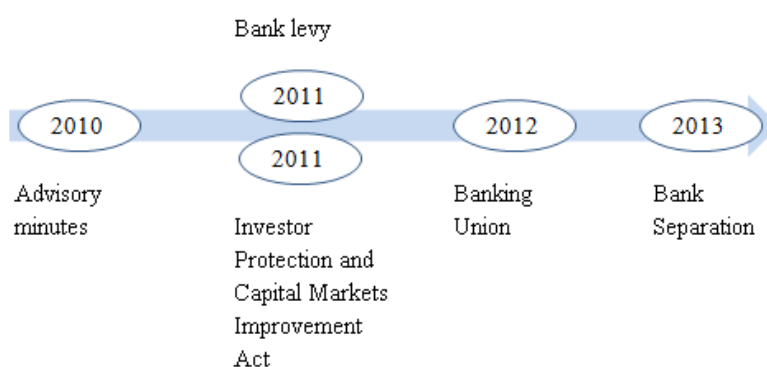


A recent study by Santos/Ellitoo (2012) only foresees increase of interest spreads of 17 bp in Europe. An on-going study by the Bundesverband deutscher Banken (2014) highlighted the negative impact on external financing and the unjustified requirements for banks giving out loans to Mittelstand customers. In an interview, the Vice President of the Deutsche Bundesbank (2012) outlined that she does not agree with the statement, that increasing interest rates and lower credit supply to Mittelstand customers (as a consequence of reductions in RWA to lower equity requirements) are certain and that data upon implementation of Basel III is required before thinking about adjusting the current framework. Without providing further any backup for her statement, it can be assumed that she was aware of the high level of speculation in this regard. As is demonstrated in chapter 4, the impact of Basel II did not lead to a material burden of financial performance. Hence, there was no empirical evidence for projecting a substantial negative impact arising from Basel III.

## 5.4 Additional regulatory challenges

While Basel III has received the most attention in literature due to its international orientation, the focus, for this research has been widened in order to identify other regulatory forces. The development of regulatory obligations has been observed by this author as part of his professional work. Formal compliance has been audited, however, without considering the economic impact.

Figure 34: Regulatory initiatives



### 5.4.1 Advisory minutes and Investor and Function Improvement Act

Implemented in 2010, section 34 Securities Trading Act requires every bank that conducts advisory services for customers to prepare a detailed memorandum about the aim of the advisory, length of the talk and financial situation of the customer. In 2011, with the implementation of the Investor Protection and Capital Markets Improvement Act, obligations were further enhanced requiring banks to inform customers on at least two pages about costs and risk of products discussed, hence, enabling customers to conduct comprehensive comparisons with other banks (Clifford Chance, 2011).

All interview partners, when discussing the operational aspects of this obligation, stated the same experience. Representative, an interviewee (CEO2) stated:

*"The protocol was introduced as a consequence from the subprime crises. Large banks sold products that were not suitable for many customers, nor were they understood. We cooperative banks have never been subject of mal-*

*advisory since we do not sell complex products. Still, we need to comply and have made bad experiences. Customers do not understand why they have to stay until the protocol has been finally drafted by the advisor with no option to send it via mail. People dislike this documentation and rather opt to avoid advisory while deciding themselves".*

While it is highlighted that income is impacted due to lower turnover and transactions by customers fearing bureaucracy, it is also a matter of cost.

*"For us a small bank, customer protection requirements represent a high cost burden. Protocols need to be drafted, discussed with the client, analysed and documented. This requires a lot of expensive advisor time that he cannot use otherwise for other advisory contacts. Overall, we estimate administration expense having increased by ap. 10%".*

#### **5.4.2 Bank levy**

Via the introduction of the Restructuring Fund Act (RStruktFG) in July 2011, all banks according to section 1 Banking Act are subject to new bank levy with the intention to set up a fund of up to EUR 70 billion to deal with further bank restructuring measures on a national basis. Providing further calculation details, the Restructuring Fund Directive (RStruktFV) incorporates a scale as outlined in section 1 that is grounded in total liabilities volume:

- over EUR 300 m to EUR 10 bn; value multiplied with 0,0002
- over EUR 10 bn to EUR 100 bn; value multiplied with 0,0003
- over EUR 100 bn to EUR 200 bn; value multiplied with 0,0004
- over EUR 200 bn to EUR 300 bn; value multiplied with 0,0005
- over EUR 300 bn; value multiplied with 0,0006

In reference to section 3.2.2, 587 of 1.100 cooperative banks per December 2012 would be concerned when looking at total assets. Small banks are not concerned, hence, not leading to additional cost burden.

This author believes that the theory behind the set up is certainly applicable. However, the introduction of the levy over all three pillars of the German banking sector is deemed not to match causality. The German Ministry of Finance<sup>47</sup> in reference to "Fairness" states in reference to the bank levy:

*"During the global financial crisis, the public sector was forced to step in and provide billions of Euros to stabilise banks or wind them up in an orderly manner. At the same time, many financial market participants made a great deal of money over long periods of time by pursuing reckless business practices. That is grossly unfair..... Under the new **bank levy**, all banks that reach a certain size must contribute to a fund that will be used in the event of bank restructuring before the state is allowed to intervene. In this way, the financial sector is being systematically involved in the costs of financial crises for the first time. The bank levy will also significantly increase the stability of the banking sector".*

Even though the case study banks do not reach the threshold of EUR 300 million, this matter has been discussed from the perspective of applicability. An interviewee (CEO2) stated:

*"Regulators in their explanation totally failed and misinterpreted the situation of the German banking sector and cooperative banking sector in particular. Cooperative banks have not contributed to the financial crisis whatsoever. Still, we are put on the same level as Lehman Brothers."*

This author agrees with cooperative banking representatives when causality is applied. Empirical evidence provided before pointed to the supporting role of cooperative banks during the financial crisis. Furthermore, the one-size-fits-all approach, even though balanced via the introduction of thresholds, is not supported by reason since risk and mal-behaviour is not grounded in size but rather business model and products sold.

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<sup>47</sup>[www.bundesfinanzministerium.de/Web/EN/Topics/Financial\\_markets/FinancialMarketRegulation/Fairness/fairness.html](http://www.bundesfinanzministerium.de/Web/EN/Topics/Financial_markets/FinancialMarketRegulation/Fairness/fairness.html)

### 5.4.3 Banking Union

The idea of a European banking union was first brought up by the President of the European Council, Herman Van Rompuy (Van Rompuy, 2012). The idea of a banking union can be summarized in the elements *supervision, resolution and deposit insurance*.

First, there is the introduction of a *single mechanism* for the banking *supervision*. Article 127 (6) represents the legal ground to transfer special tasks in connection with the supervision of banks to the ECB. From the perspective of cooperative banks it was important whether this new supervisory mechanism would lead to cooperative banks also being supervised by the ECB which would cause more administrative and monetary expenses. This question was left open until autumn 2013.

Based on the votes by the European Parliament on 12 September 2013, the Single Supervising Mechanism (SSM) was created with full assumption of supervisory task after 12 months upon publication in the official Journal of the EU, i.e. autumn 2014 (ECB, 12 September 2013). Under the new supervisory system, the ECB will supervise "significant" credit institutions. In this regard, "significant" is defined as applicable when one of the following five criteria is met:

- total assets > EUR 30 billion
- total assets > EUR 5 billion AND 20% of relevant GDP
- bank belongs to the top 3 banks in its country
- banks has significant activities abroad
- bank receives ESM support

According to these criteria, all *primary banks* are excluded from the new SSM. On 23 October 2013, the ECB published the final list of banks that will be subject to the new supervisory regime and that have to undergo the Comprehensive Assessment in advance (ECB, 23 October 2013). In total, 124 banks are included, hereof 24 in Germany. Among these are the two cooperative central institutions, DZ Bank and

WGZ Bank, as well as the two major cooperative banks Deutsche Apotheker und Ärztebank eG and Münchener Hypothekenbank eG due to their asset size<sup>48</sup>.

With regard to *resolution* and *deposit insurance*, the same progress has not been made. Both elements ask for the introduction of a single European support system for banks in distress which can broadly be divided into two segments. On the one hand, there is the Single Resolution Mechanism (SRM) that includes the two major components, being the Bank Recovery and Resolution Directive (BRRD) and Deposit Guarantee Scheme Directive (DGSD). Both components mean that ALL European banks are to be included in the support system. The BRRD was voted for in favour by the finance ministers of the EU Member States in June 2013 (Council of the European Union, 27 June 2013). While, with regard to the BRRD, primary banks are not required to prepare detailed resolution plans due to their low systemic relevance, they are concerned regarding the implementation of a European resolution fund. With regard to the DGSD it is envisaged to harmonize individual deposit protection schemes within the eurozone. What this means is that there should be joint liability of all individual banks in case a bank goes into distress. Representatives of the German cooperative network refused this approach by highlighting their own system (BVR, 18 September 2013). Also in connection with resolution, the European Stability Mechanism (ESM), a supranational organisation based in Luxembourg, was founded on 8 October 2012. Being capitalized with EUR 500 billion as brought up by the eurozone member states, it allows the ESM to directly support banks in distress, however, under strict conditions (Handelsblatt, 4 December 2013).

In summary, policy makers plan to shift support for banks from the tax payer to banks. The ESM should therefore be regarded as an interim solution only that will cease to exist once resolution instruments are fully operational. Judging the instruments this author agrees with the general approach of policy makers by trying to contain risks and losses within the banking market. However, this author deems the "one size fits all" approach with regard to resolution and deposit insurance and with regard to the German cooperative sector as being highly inappropriate due to

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<sup>48</sup> see section 3.2.2 regarding their status in the German cooperative network



two reasons. First, German cooperative banks did not engage in any business activities that lead to the financial crisis. On the contrary, German cooperative banks helped to level-out the impact. Secondly, regulatory measures are not risk-oriented. The system as proposed would result in low-risk primary banks in Germany having to support high-risk business activities, e.g. in Spain or France. In other (and extreme) words, deposits of local German cooperative banks' savings customers would have to cover e.g. speculation losses made by bonus-oriented traders of non-German investment banks. While the details of these aspects of the Banking Union have not been finalized yet, it is assumed that German cooperative banks will have to take part in the resolution programmes in some way, hence, making legal measures necessary. It is up to the power of German policy makers to limit these obligations as far as possible.

#### **5.4.4 Legal separation of investment/commercial banks**

As outlined in section 3.1, banking activities can be broadly separated into investment and commercial banking activities. Supporters of universal banks traditionally refer to diversification benefits with the possibility to offer full-service to clients. However, recently influential bank executives and policy makers have brought up the issue of separation, e.g. former Citigroup CEO Sandy Weill (Forbes, 25 July 2012) or the Governor of the Bank of England saying he saw "real merit in pursuing the separation of this utility-type banking from investment banking" (The Economist 18 August 2012).

In this context and in connection with the Liikanen report (Liikanen et al., 2012), German parliament on 15 May 2013 decided to push forward with a national law<sup>49</sup> being the first mover among EU countries (Handelsblatt, 16 May 2013). While not following all recommendations by Liikanen, it does incorporate the basic idea of prohibiting customer deposits to be used for refinancing of own risky transactions. The new regulation, for which the existing Banking Act (KWG) will be amended,

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<sup>49</sup> "Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen"; no proper or official English translation available yet

will apply to all institutions breaching tolerances defined as follows (as per year-end balance sheet volume classified as "for trading" or "held for sale"):

- Trading activities represent more than 20% of total assets (relative value) and total assets during the last three balance sheet dates was at least EUR 90 billion
- Trading activities represent more than EUR 100 billion (absolute value)

All the tolerances refer to own transactions, i.e. exclude trading activities on behalf of customers. With regard to the German cooperative banking sector, primary banks will not be concerned by this legislation, neither will be the larger institutions Deutsche Apotheker- und Ärztebank eG und Münchener Hypothekenbank eG, being under ECB supervision soon. Due to their size, central institution WGZ Bank will also not be concerned. The only bank from the cooperative sector could be central institution DZ bank, however, detailed analysis have to be carried out based on internal information.

With regard to the aspect of separation of activities, this author does not concur with the current approach of policy makers in Germany and the EU. The universal banking business model has proved to be resilient with universal banks being the best performers during the financial crisis. This author argues that by shifting the risk from one legal entity to another one, the risk situation or volume will not change, hence, no contribution towards stability is seen. The containment of existing risks within a bank or financial group will predominantly depend on accounting regulation, i.e. on rules on how intra-group transactions will be handled. This author argues that even though large banks breaching tolerances will have to separate activities, causing significant expenses leading ultimately not just to lower profits but also to higher costs for customers. Additionally, large banks have necessary resources to find solutions for levelling-out risk separation current policies, hence, not resulting in the envisaged risk limitation.

This author also argues for an alternative approach which was recently discussed by Demirguc-Kunt/Huizinga (2011) with regard to the size of banks. According to their findings, banks' profitability, as expressed in RoA, decreases with size. Furthermore

they doubt "the need to have systematically large banks". The bigger banks are, the more risk they present for stability. Due to this, instead of forcing changes to the operational model, it should be considered to introduce size limits in connection with domestic economic power.

## **5.5 Situation of Cooperative banks**

### **5.5.1 Current regulatory framework**

While the overall supervision of banks, especially in Germany, is strong, it is not only this researcher's opinion that the supervision of cooperative banks is even more intense due to the obligatory audit requirements by their respective audit networks (see section 3.2.2). However, the leading German think tank, the Deutsches Institut für Wirtschaftsforschung (2009), has pointed out that the control intensity of cooperative banks by federal authorities is contrary to their systemic relevance. The overriding aim of the new regulatory framework is to make financial systems more resilient to crises. Successful regulation on a European level, therefore, needs to consider and enhance elements that have a stabilizing impact.

However, it is the combination of the coherent model of cooperative banks as outlined in section 3.2 backed up by empirical evidence in chapter 4, both acting as benchmark, that makes Basel III a poor match to the cooperative banking sector. As outlined, performance has been stable, which most certainly is due to the overall organizational set-up providing competitive advantages as outlined before. This organizational set-up provided sufficient headroom to well-endure the most recent stresstest.

Cooperative banks as well as all small and medium sized banks, in the first place, are subject to regulations that were made to reduce systemic risks. Authorities, hence, follow the *matryoshka principle*, i.e. a framework is designed for large systemic banks and then imposed on smaller banks. This requires time and staff intensive processes in order to deal with these. Small and medium sized banks are hit the most due to size and scale-effects.

This raises the question, whether there should be different regulatory frameworks that depend on variables such as total assets, risk and business model. In order to derive a solid conclusion, it has to be analysed, if there are actually arguments for retaining the proposed framework from the perspective of the entire cooperative banking sector. Subsequently, it is contemplated how an alternative approach with regard to the applicability of regulatory amendments could look like.

### **5.5.2 Reasons for keeping**

If options and exemptions are possible with regard to the application of equity and liquidity regulations, it cannot be assumed that all cooperative banks would opt for one way only due to their different sizes. The entire cooperative banking network would have to provide several *technical solutions* for options available, causing massive costs that would have to be carried by all cooperative banks.

Different regulatory approaches would also dilute the envisaged *Level Playing Field*. For example, introducing asset thresholds in connections with regulation applicability is, in theory, possible. On the one hand, policy makers argue in favour of the proposed framework that in order to avoid regulatory arbitrage, no differences in connection with Basel III applicability are made. On the other hand, several studies point to the fact, that Basel III will enforce *regulatory arbitrage* (Blundell-Wignall/Atkinson, 2010; Ojo, 2011). The Financial Times Lexicon (accessed online on 22 November 2013) defines regulatory arbitrage as a situation "where firms take advantage of loopholes in regulatory systems to avoid certain types of regulation. This can be achieved by conducting business, creating products and services in certain locations that are outside the purview of regulators".

With regard to the banking sector this refers to the possibility to migrate business off-balance or off-shore. Looking at asset size only is not regarded a suitable option. Banks with smaller total assets can have elevated risk positions, hence, require stabilizing measures, while cooperative banks with higher assets have a lower risk profile. Also, distinguishing by business model alone is not deemed feasible. While it

can be argued that different banking models require different regulatory framework, it is more than doubtful that this could be translated into applicable law.

Also to be considered are *reputational issues*. While cooperative banks have performed well during the crisis, the exemption of the new regulatory framework could lead to the public perception that cooperative banks are not able to comply with. While it is not expected to be a lasting effect, there would, nevertheless, be image problems.

### **5.5.3 Concept for an alternative approach**

As was outlined and analysed in chapter 4, cooperative banks in Germany helped stabilizing the financial system in Germany during the stress-test that occurred subsequently to the subprime crisis 2008. Due to their highly granular structure, simple business model and organisation within a financial network they promoted a "small is beautiful" approach rather than "too big to fail". From a systemic perspective, the current regulatory framework with the "one size fits all" approach, hence, does not make sense for cooperative banks. Among others, CEO-3 stated:

*"It cannot be that institutional groups and business models, which even increased loan supply during the financial crisis, are punished the most".*

Especially the development towards a banking union represents a danger for the stability of the German cooperative systems. It can be observed that most of the current discussions among EU policy makers aims a collectivization of risk and does not sufficiently address the issue of risk prevention.

While it is assumed that the current direction of regulation cannot be changed, individual concepts could be amended. Researching the approach of other countries, an interesting and comprehensive approach has been identified in reference to Switzerland that scaled capital requirements based on quantitative criteria (FINMA, 2010). The criteria support the consideration of bank size, business model and risk profile. In detail, criteria comprise total assets, assets under management, deposits and equity. By classifying banks into 4 categories, a comprehensive distinction is

achieved. This approach, in general, follows the general debate regarding the classification of banks as *systemic* and *non-systemic*. Weder di Mauro (2010) described systemic risk as “the extent of propagation of an initial shock (failure of one institution) through the financial system and it tends to be highly non-linear on the downside”. To deal with systemic risk, by means of introducing a systemic risk levy in connection with a tax base and tax rate, she suggests a scoring system around the criteria size, interconnectedness and complexity. Pflock (2014) further elaborates on this scoring approach by introducing more categories, i.e. he adds level of international activities and substitutability, while defining the application of only one factor, such as size, as questionable. Laeven et al. (2014) also call for a regulatory system that is based on systemic risk considerations.

This author fully concurs with the described focus on high risk banks. However, regarding the estimation of risk and narrowing it down to the German banking sector he has a slightly different view. The problem is the estimation of risk and reliance on the subsequently calculated numbers. Leaven et al. (2014) state that larger banks, as measured by size, create more systemic and individual risk. Hence, this author concludes that risk may not be an alternative option to lower "size" risk. In other words, he does not deem it appropriate that banks that are big in size but low in risk could benefit from lowered regulation standards. Even under severe market conditions, large size banks with a focus on traditional banking do require additional capital as highlighted by the subprime/financial crisis. Therefore, this author suggests an approach that comprises size as well as risk, however, applied in a different way. A two-step structure with two variables is suggested comprising

- a) bank size (total assets as expressed in Euro) and
- b) risk assets (share of assets that inherits elevated risk; examples include securitization assets, trading assets, volume of NPL and intensive monitoring assets). Consideration should be via a threshold assumed to be ap. 5%.

Banks would first be classified in terms of total Euro numbers with no opportunity to mitigate the relevant risk category downwards. On the contrary, risk category could move up if risk assets exceed the threshold, i.e. that risk is disproportionately higher

than size risk. This approach is inspired by the mechanism of the SSM as outlined in section 5.4.3. As outlined, the consideration as being "significant" was not based on risk but on asset size and significance for the local financial market.

In total, four categories are suggested that represent level of regulatory requirements, which is to be further detailed. As guidance and also in respect to, for example, FINMA requirements, category 1 should comprise higher requirements than current Basel III standards with category 2 being equal and others being lower.

Criteria	Bandwidth	Category	Bandwidth	Category
Total Assets: Risk assets:	> EUR 500 bn n/a	1 (substantial)	n/a	n/a
Total Assets: Risk assets:	EUR 100 bn - EUR 500 bn < 5%	2 (high)	EUR 100 bn - EUR 500 bn > 5%	1 (substantial)
Total Assets: Risk assets:	EUR 10 bn - EUR 100 bn < 5%	3 (medium)	EUR 10 bn - EUR 100 bn > 5%	2 (high)
Total Assets: Risk assets:	< EUR 10 bn < 5%	4 (low)	< EUR 10 bn > 5%	3 (medium)

The following categorization and bank clustering would occur:

- Category 1 would comprise Deutsche Bank and Commerzbank only, which is assumed to be grounded in their size and systemic risk.
- Category 2 would comprise most of the Landesbanken and both cooperative central institutions.
- Category 3 would comprise medium size banks with a national orientation
- Category 4 would comprise almost all cooperative banks and the majority of savings banks as well as other smaller commercial banks (ap. 2.000), which have a regional orientation and conservative business model.

In this theoretical model, overwhelming bulk of cooperative banks would be officially excluded from adherence to elevated regulatory obligations, hence, saving costs for additional resources in order to comply with additional requirements.

What the model also does is the provision of incentives to keep or improve the relevant risk category. Banks near the threshold will have an interest to keep regulatory burdens and, hence, costs down. In this way, risk granularity and distribution is expected.

## **5.6 Summary and conclusion**

It was this researcher's aim to provide for a comprehensive review of the Basel III accord and the applicability to the cooperative banking sector. The aim was based on the assumption that cooperative banks, from a risk-based perspective, do not require additional regulation due to its business model.

From the analysis conducted, it could be concluded that the intention of Basel III is correct and necessary to provide for further financial stability. It is concluded that banks do need an elevated framework in order to minimize the risk of further downturns of the overall economy. However, the proposed framework is deemed disproportional since it penalises small institutions. This calls for an increased intervention by relevant lobby representatives as well as policy makers. From relevant discussions as well as specialised media coverage it can be concluded that the BVR is trying everything possible to get as many exemptions as possible from the proposed measures. While discussions are still on-going, progress has been made regarding the consideration of certain elements within relevant calculations. However, it is deemed unlikely that there will be further benefits confirming the need to undertake additional measures.

Having analysed the Basel III framework, this author concluded and believes that the current regulatory situation has two major weaknesses. First, it is predominantly reactive in contrast to proactive. No evidence has been gathered or conclusion made that measures are undertaken to avoid risk. Regulation has only increased the safety net that kicks in once financial distress occurs. It should be considered to adjust this approach by prohibiting high-risk transactions in the first place. Second, it is not risk-oriented. No evidence could be provided to justify the application of enhanced rules to the cooperative sector. Empirical evidence points to the positive role of



cooperative banks over the past decade, so additional rules would be punishment for good work. This work has identified an alternative approach that incorporates risk indicators. Even though the basis for further discussions only, this approach would automatically exclude low-risk banks, i.e. cooperative banks, from enhanced requirements.

Evidence also pointed to the conclusion that other regulatory requirements besides Basel III are actually considered more negative since these typically lead to a daily increase in operational duties. In other words, while Basel III affects mainly balance sheet positions, i.e. capital and liquidity, which do not pose a significant threat to cooperative banks, other requirements affect mainly income sheet positions, i.e. costs. For cooperative banks, this has been concluded the most pressing issue since this cost potential will accelerate the negative impact trend stemming from the low interest level. It also confirms the need perceived by this author to initiate measures to improve profitability in view of expected regulatory ideas to come.

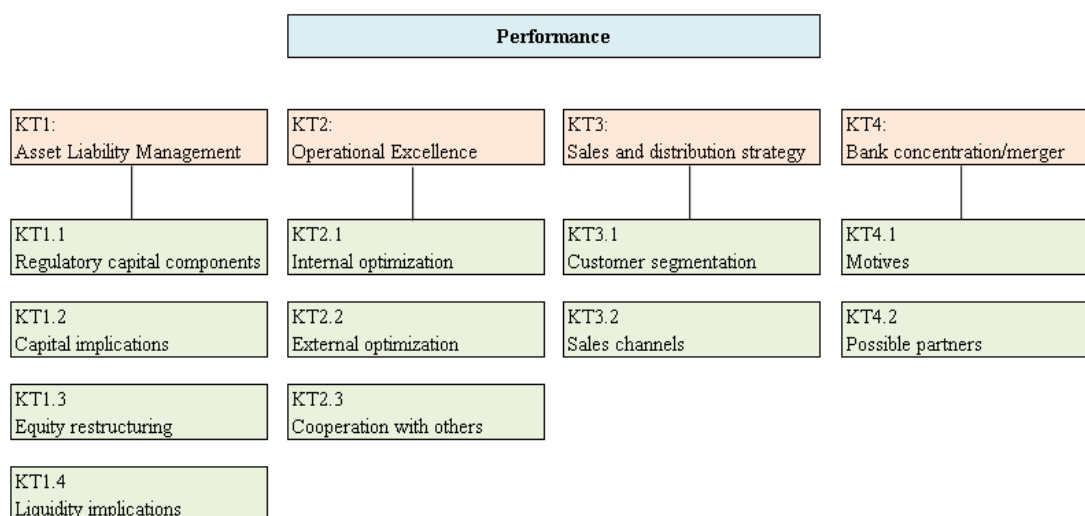
## **6. Managing impact from regulatory and market forces**

Chapter 6 entails the identification and analysis of measures and responsive actions that can be taken by cooperative banks to cope with the expected regulatory and market burdens assuming that the combined force will have an impact on performance thereby filling the gap of previous studies on this topic.

The chapter was approached top-down with results being aggregated on three levels. The first one entails the concept of Performance Improvement (PI) as outlined by Rummler/Brache (1995) stating "PI can be applied to improve the performance of organizations, processes, and individuals" or Stolovitch/Keeps (1999) stating "PI is concerned with measureable performance and how to structure elements within a results-oriented system". Elements considered in this context are performance analysis, cause analysis, intervention selection, design and development, implementation and change management, and evaluation. The second one entails the application of bank operation theory as outlined by Rolfes (2008), i.e. cluster with value creation potential were identified. The third one entails individual measures that are discussed from a theory and literature perspective at the beginning of each section.

During the approach of this topic, many brain storming sessions, informal and official discussions and interviews, and attendances of relevant seminars and meetings were conducted, mostly between 2011 and early 2014 and mostly as part of work and projects due to and in the course of full-time employment. The aim was to identify key topics that are of strategic priority for cooperative banks during the next years and that will or could lead to profitability and efficiency enhancement. This was done taking into account the view and theory regarding tangible and intangible assets as outlined in section 3.2.1.3. The information were first coded and subsequently aggregated in the following categories.

Figure 35: Key topics among cooperative banks



The categories are summarized in terms of two dimensions. The first one deals with tangible assets, being capital and liquidity, in a direct way, i.e. measures are in a direct connection with tangible assets. This concerns KT1 being a focus of this project. The second dimension first deals with intangibles as described in section 3.2.1.3, mainly structural capital issues (KT2, KT3 and KT4), which, however, aim at directly improving tangible assets. From a financial statement perspective, the categories were set up to encompass the most important elements of bank management, being *balance sheet, costs, revenues as well as organizational structure*.

In the following sections, the key topics identified are analysed one by one as aggregated in the four categories.

- Section 6.1 analyses the asset liability management from a cooperative bank perspective. Next to the identification of relevant capital components being concerned of Basel III and a corresponding empirical study of the status quo in terms of capital situation, measures and concepts are analysed. Also, a financial model was set up in order to simulate quantitative capital adherence. In terms of economics, this section refers to *balance sheet management*.

- Section 6.2 analyses opportunities with regard to operational excellence, i.e. possible efficiency enhancement concepts are analysed. The concepts discussed include internal measures as well as measures to be undertaken with external partners. In terms of economics, this section refers to improving *costs*.
- Section 6.3 analyses opportunities with regard to marketing, i.e. linking customers with products and services. An emphasis is placed on customer group analyses as well as internet and social media issues. Also, one of the most important issues, the intense branch network and alternative measures are investigated. In terms of economics, this section refers to improving *revenues*.
- Section 6.4 analyses the on-going debate regarding mergers among banks. Next to an overview of studies already been written on this topic, i.e. the actual performance in quantitative terms, a hands-on approach on the operational issues is outlined. In terms of economics, this section refers to *organizational structure*.

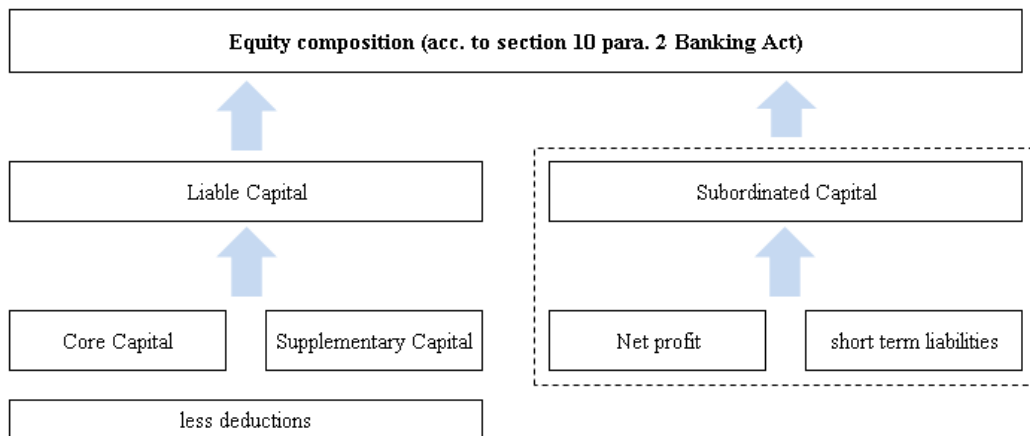
## 6.1 Asset Liability Management (KT1)

The aspect that has received by far the most attention is the future consideration of capital or equity (see before-mentioned impact studies). Due to increased capital requirements, McKinsey (2010) expected a decrease in RoE of ap. 4% for international banks. In a recent study on capital markets and investment banks, BCG (2013) expects RoE levels to go down to 7% to 10% until 2018 coming from currently 15% to 20%. This research was, therefore, conducted with a preliminary focus on equity and the consequences for cooperative banks.

### 6.1.1 Regulatory capital components

Equity and its composition is regulated by section 10 para. 2 Banking Act. According to this, equity consists of liable capital and subordinated capital. Liable capital consists of core capital and supplementary capital less deductions. In the international context, these terms are referred to as Tier 1 (core capital), Tier 2 (supplementary capital) and Tier 3 (subordinated capital).

Figure 36: Capital composition according to German Banking Law



Core capital includes all funds that the banks can make use of, i.e. are not due for repayment. In case of losses, this capital can serve as cover. The components of the supplementary capital incorporate repayments rights of the provider. In consequence, it is of minor quality in terms of loss coverage and subject to numerous limitations in terms of maximum applicability (Bieg, 2009).

Equity in accordance with German Commercial Act (HGB) is defined more narrowly compared to the Banking Act (KWG). In reference to section 266 Commercial Act, equity comprises paid-in capital, reserves and retained profit. In the balance sheet, it is shown as the residual amount of total assets and liabilities. The components represent regulatory tier 1 capital and the basis for all other regulatory capital calculations. Since 2005, listed companies in Germany are required to publish annual accounts in accordance with IAS/IFRS, where equity is also calculated as the before mentioned residual amount (Scharpf/Schaber, 2009). In contrast to German GAAP, IAS/IFRS refers mainly to Anglo-Saxon accounting and, therefore, is subject to higher volatility as a consequence of fair-market valuation that uses market prices for general valuation purposes. It should be noted, that for this work's focus, application of IAS/IFRS standards is of no concern since German cooperative banks are entirely non-listed and apply German GAAP only.

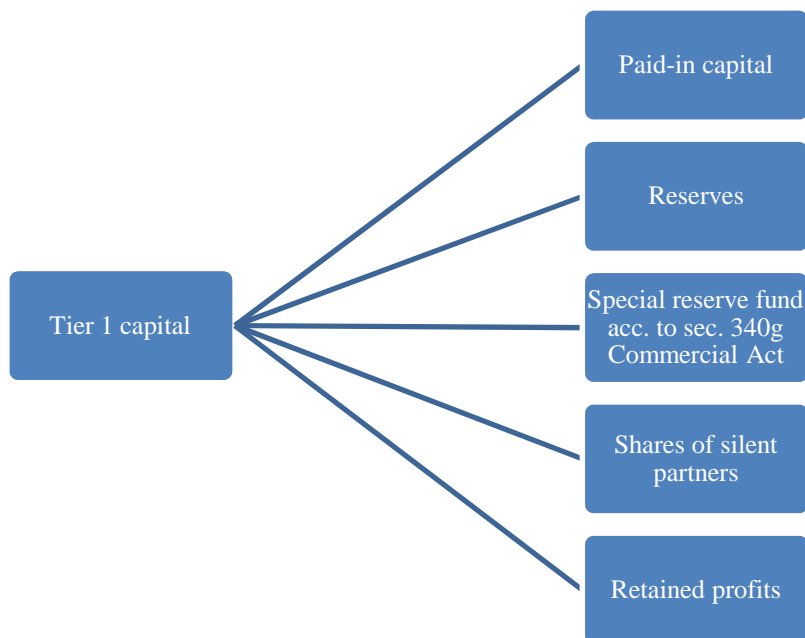
Next to the significance of the previous capital definitions, it should be noted that the capital base banks are using for internal and strategic management decisions, is not compliant with the definition of regulatory or shareholders' equity. This capital is referred to as *economic capital* and is defined as the amount necessary to cover future unexpected losses from banking transactions, i.e. the economic risk (Pfungsten, 2010). Especially in the light of Basel III it is important to make strategic decisions about which economic risks are necessary and how to adjust them in order comply with equity requirements.

Also in perspective of future regulatory requirements, the Deutsche Bundesbank (2011b) pointed out to the need for revision of capital position while highlighting the different treatment of individual balance sheet positions. In particular, certain regulatory equity positions are made up of liabilities in an accounting sense. In order to understand the impact of Basel III and determine future capital allocation, it is therefore necessary to distinguish the different capital components (Luz et al., 2009).

### 6.1.1.1 Tier 1 capital

Core capital as regulated by section 10 para. 2a Banking Act consists of:

Figure 37: Tier 1 capital



Deductions include retained losses, intangible assets (predominantly goodwill), correction amounts according to section 10 para. 3b Banking Act as well as other individually determined positions.

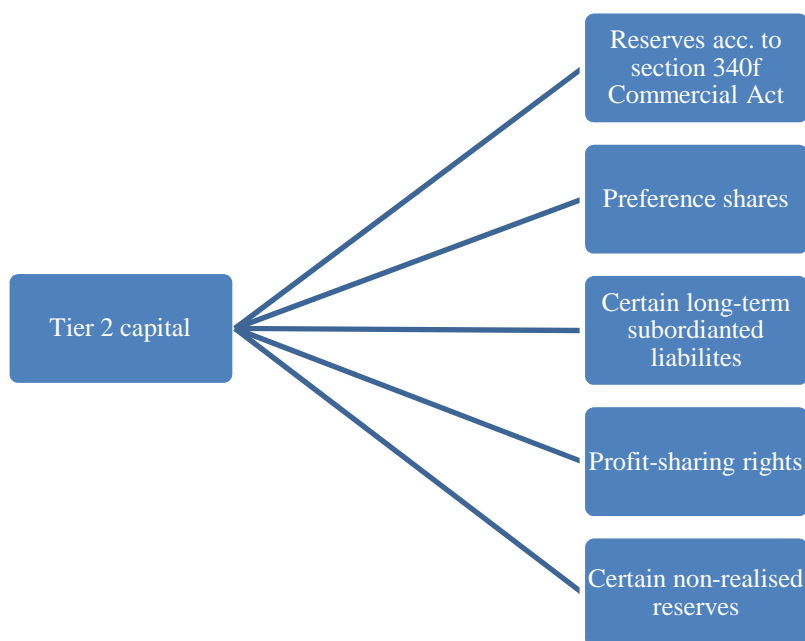
A special feature of German bank accounting is the *fund for general banking risks according to section 340g Commercial Act*. The permits banks and financial institutions to set up a fund or risk reserve that is not tied to a specific asset and does not entail restrictions on limit. Increases or decreases are debited or credited to annual profit and shown in the income statement. Being categorized as tier 1 equity, this reserve is shown on-balance, i.e. the existence and volume of the reserve can be observed as shown on the liabilities side (Scharpf/Schaber, 2009).

Retained profits are only shown to the extent to which it has been decided to attribute them to reserves already (Scharpf/Schaber, 2009).

### 6.1.1.2 Tier 2 capital

Bieg (2009) states that tier 2 capital is of lower quality and is characterized by limited availability and subordination towards first ranking creditors. Tier 2 capital, according to section 10 para. 2, sentence 2 Banking Act, may not exceed tier one capital in terms of volume. According to section 10 para 2b Banking Act it consists of:

Figure 38: Tier 2 capital



Next to the special *reserves according to section 340g Commercial Act*, German commercial law allows banks to create hidden reserves that are directly related to the business operations they conduct. In practice, this means banks, with regard to assets in forms of shares, bonds and receivables, are allowed to show lower values in their balance sheets as required by section 253 para 1 Commercial Act (nominal or book value), i.e. assets net of *340f Commercial Act reserves*. The maximum amount that can be set up is 4% of the total of shares, bonds and receivables as shown in total assets before setting up section 340f Commercial Act reserve (Bieg, 2009).



### 6.1.1.3 Tier 3 capital

Upon implementation of the capital adequacy directive (CAD) via the 6<sup>th</sup> amendment of the Banking Act (KWG) in 1998 banks for the first were required to cover market risks, comprising FX risks, equity risks and interest risks, with equity. Tier 3 capital consisted of net profits (section 10 para. 2c Commercial Act) and short-term subordinated liabilities (section 10 para. 7 Commercial Act).

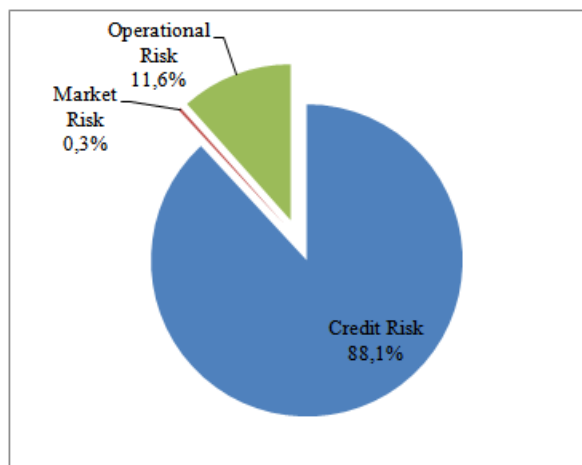
Within the new Basel III framework, tier 3 capital will cease to be regard (BCBS, 2010), i.e. market risks will require tier 1 capital for cover. Pollmann/Schätzle (2012) state that tier 3 capital has little or no relevance for cooperative banks given their extremely low market risk. For this research, tier 3 capital is, hence, not further analysed and considered.

## 6.1.2 Capital implications and challenges

### 6.1.2.1 Composition of risk position

The Basel accords require banks to back and support risk positions with equity. In particular, risk positions to be backed are credit risks, market risks and operational risks. In order to get insights on the relevance of the Basel III requirements, the risk data of the disclosure reports (see section 2.4.2.3) was aggregated and summarized in the figure below showing the average percentages of risk.

Figure 39: Average composition of risk structure



As can be seen from the table above, *market risks* with a share of 0,3% play only an inferior role<sup>50</sup>. *Operational risks* with 11,6% are by far more important, with *credit risk* at 88,1% being the most significant risk. This finding is congruent with the notion of Becker/Peppmeier (2011) stating that most cooperative banks and savings banks are non-trading institutions.

Despite being the most significant impact for large and internationally active bank, the risk structure outlined above indicates that the impact of Basel III requirements for market risk on cooperative banks is expected to be rather low. A detailed analysis of the impact is neither possible, due to the lack of published data, nor necessary due to the negligible significance. Operational risk will not be adjusted by Basel III and, therefore, is not further investigated.

Reviewing the disclose reports it has also been confirmed that practically all cooperative banks in the sample apply the basis indicator for measuring operational risk as well as standard method for credit risk. With regard to the measurement of credit risks Basel III so far has not indicated changes to the risk weights of certain receivables positions. A network representative (NR1) strongly questions this approach by pointing out to empirical data and the current requirements:

*“Basel III does not solve the problem of unequal treatment. Loans to small and medium sized entities are still subject to higher risk weights than riskier positions, e.g. sovereign receivables to Greece. Small and medium sized entities have not caused the financial crisis, but stabilized the system. Consequently, Basel III needs to take notice of the smaller risk of these loans in terms of capital requirements.”*

Due to the stable and conservative business model, Basel III is not expected to change the risk position of cooperative banks, i.e. the impact is defined by tougher requirements towards the quantity and quality of equity.

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<sup>50</sup> In comparison: Deutsche Bank per 31 December 2012 has market risk share of 16%, operational risk share of 15% and credit risk share of 69%.

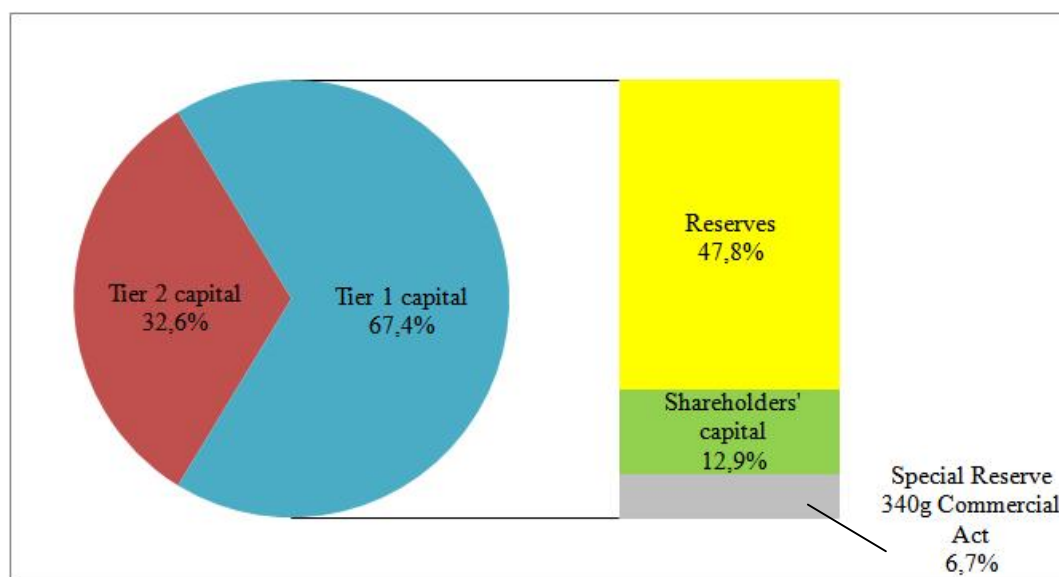
### 6.1.2.2 Capital structure of cooperative banks

*As is situation*

In order to evaluate the impact on capital ratios it is also necessary, next to the analysis of the risk position, to analyse the capital structure of cooperative banks. For this purpose, the cooperative banks in the sample are analysed towards their shareholders' equity and regulatory equity by applying average values.

Information about the capital structure can be taken from the compulsory disclosure reports that describe the regulatory capital position with reference to Tier 1, Tier 2 and Tier 3 capital. For the sample defined in section 2.4.2.3, the following has been calculated.

Figure 40: Average composition of regulatory capital



*Tier 1* capital accounts for 67,4% before deductions. While shareholders' capital, i.e. member shares, only account for 12,9%, the most significant element is reserves with a share of 47,8%. Special reserve according to 340g Commercial Act accounts for 6,7%.

The sample also highlighted that *Tier 2* capital, being of less quality, accounts for slightly over one third of regulatory capital. Practically all disclosure reports do not contain data on the composition of the *Tier 2* capital position. Given the definition of section 6.1.1.2 and descriptive data of the disclosure reports, it can be expected that the bulk of this volume refers to reserves according to section 340f Commercial Act.

As can be taken from the table above, the sample provided no evidence on the existence of *Tier 3* capital, i.e. the disclosure reports pointed to the non-existence. In consequence, it can be confirmed that the abolition of *Tier 3* capital in the context of Basel III will have no impact on cooperative banks.

### *Looking forward I*

Pollmann (2011) while analysing the equity structure of cooperative banks concluded that requirements for equity management will significantly change in the short-term highlighting several material issues. Among a few issues that this author does not deem material<sup>51</sup>, he pointed to the status of member capital and its recognition as tier 1 capital. BCBS (2010) outlined several minimum requirements applicable to be recognized. In particular, it is stated that equity instruments that are callable (except in insolvency), do not qualify as core equity. Member shares are callable, hence, did not qualify. However, BCBS (2010) in their definition of 14 minimum requirements to be fulfilled for recognition stated (page 15, footnote 12) that cooperative banks and their member capital can be recognized when bank supervisory authorities introduce measures that prevent shares being called. Analysing the byelaws for a random sample of 30 cooperative banks in the master sample of 115 banks revealed that all of these have in fact reacted by introducing respective amendments<sup>52</sup>.

Old version	Amended version <sup>53</sup>
"The retiring member has the right to claim and call his member capital."	"The retiring member has the right to claim and call his member capital; <b>necessary for pay-out is the approval of management and supervisory board.</b> "

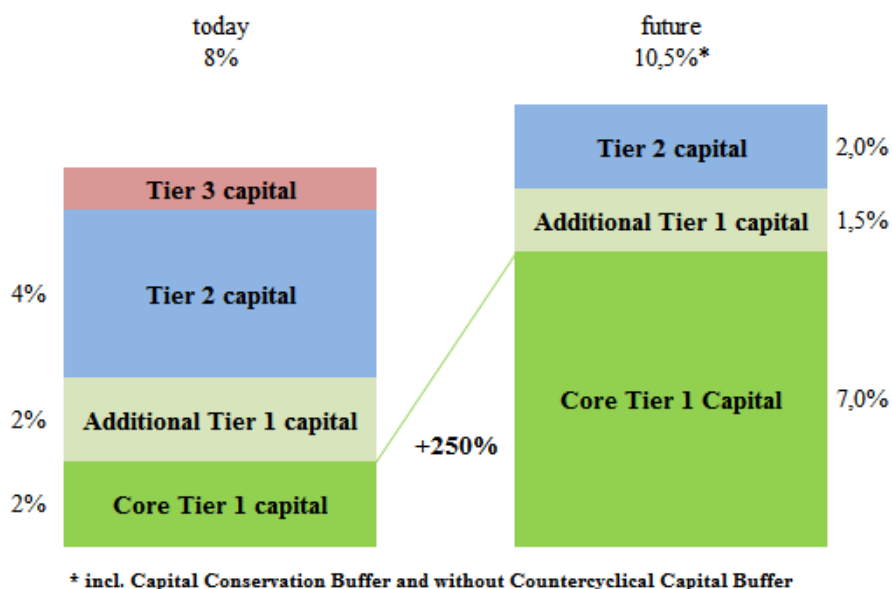
<sup>51</sup> refers especially to the unknown treatment of mezzanine capital, which, however, is not noteworthy

<sup>52</sup> Relevant articles were published online

<sup>53</sup> <http://www.volksbank-plochingen.de/content/dam/f0037-0/Dokumente/Produktinformationen/satzungsaenderung12.pdf>

In order to visualize the impact on the cooperative banking model, the Basel III capital requirements are compared to the still valid Basel II accord.

Figure 41: Capital reconciliation Basel II to Basel III



Based on the manual sample data of disclosure reports, an average Tier 1 ratio of 11,9% has been calculated. Aggregate data of the Bankscope database (all 362 banks) indicates an average Tier 1 ratio of 11,7%, basically confirming the values of the manual sample. However, the Bankscope sample also indicates that 62 banks or 17,7% of the sample do not reach the future requirements of 8,5%.

Important to reconsider is the fact, that today’s as well as the future requirements are considered *minimum* requirements as described by the network representative (NR1).

*“You should never forget that the requirements discussed in the context of Basel III are not what is necessary at the end of the day. Today, Tier 1 capital requirement is 4%. Still, banks strive to exceed requirements in order to present themselves in a good position towards business partners and as a sign of trust. Even though cooperative banks are not capital market oriented, they try to maintain high levels of capital as a result of solid and prudent entrepreneurship. However, the spread between required and voluntary ratios can certainly not be maintained”.*

The statement is backed by empirical data, i.e. the spread between today's requirements of 4% (for Tier 1) and empirical 11,7% (Bankscope sample) indicates a factor of 2,9x overachievement, which certainly cannot be maintained. Giving the economic circumstances, a factor in the range between 1,5x and 1,75x represents a realistic target. Giving the new requirement of 8,5% this results in a benchmark ratio between 12,8% and 14,9%. Applying the median of 13,9% to the Bankscope sample, 288 or 80% of the sample do not meet future requirement as of 31 December 2011.

### *Looking forward II*

This author, based on this review of the *as is situation*, used the work of Pollmann (2011) as a basis for discussion with network representatives in order to discuss other elements of important in of forward looking analysis. In this regard, the following aspects were identified to be of important to cooperative banks going forward:

- Reserves according to section 340f Commercial Act
- Members uncalled liabilities to capital and reserves
- Deduction of participations in central institutions

*Reserves according to section 340f Commercial Act* do not qualify as tier 2 equity anymore since these are not accounted for as equity in accordance with German GAAP and are not published, i.e. hidden on the asset side (BIS, 2010)<sup>54</sup>. The only opportunity to maintain recognition is to restate or reclassify these reserves as *reserves according to section 340g Commercial Act* (see section 6.1.1.1).

Investigating the response of cooperative banks in term of financial statement movements, no significant actions have been noted by analysing the monthly reports published by the Deutsche Bundesbank up until end of 2012. In comparison and in reference to the analysis in section 4.2.2.2, savings banks (Sparkassen) in Germany in 2011 heavily reclassified reserves indicating their low level of equity. Analytics, hence, point to the comfortable equity situation of cooperative banks.

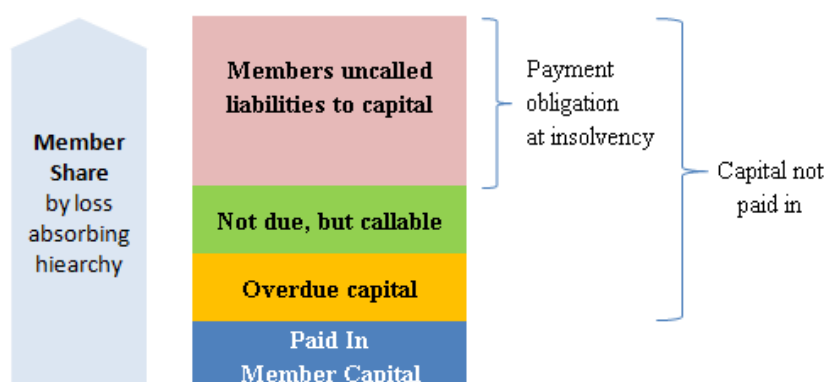
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<sup>54</sup> This type of reserve is special to German accounting and unknown in most other accounting principles. German GAAP focuses on the rights of creditors with headroom for profit adjustments, whereas IFRS focuses on investors and providing a clear picture of financial condition (PwC, 2010).

Even though this author does believe that regulators do not fully appreciate the superiority of hidden reserves as a mean to level out income situation, regulators do have reacted and implemented a *grandfathering* mechanism to account for a provisional treatment. In accordance with section 484 Capital Requirements Regulation all capital components that existed per cut-off date 31 December 2011, will be phased out until 2022, i.e. starting in 2014, 340f Commercial Act reserves will be accounted for at a rate of 80% with regard to tier 2 capital, with the rate being reduced by 10% each year.

While the latest agreement on the 340f Commercial Act reserve has been a compromise from the perspective of cooperative banks, the treatment of *members uncalled liabilities to capital* (Haftsummenzuschlag; see section 3.2.3.1) as described in the Cooperative Act section 119 - 145 has turned out to be negative.

Figure 42: Composition of member share



The speciality of German cooperative banks is that most primary banks have agreed on additional liable capital, i.e. in case of insolvency, members have to pay additional amounts up to a cap of their paid-in member capital. With regard to German regulatory accounting, this payment obligation could be accounted for as tier 2 capital. Due to the lack of the paid-in element, this component will not be considered with regard to Basel III.

The third central aspect to cooperative banks is the treatment of *participations in their central institutions*. According to section 36 Capital Requirements Regulation, several deduction requirements have been originally laid-out that included the obligation for cooperative banks to deduct participations from their liable capital. According to the amended section 49 Capital Requirements Regulation, banks that are part of a institutional protection scheme (IPS) are not required to apply deductions, hence, no reducing capital base.

### 6.1.2.3 Expected development

The network representative (NR1) describes the expected consequences as follows:

*“The new capital requirements will limit the scope of activities, i.e. it will not only reduce the availability of loans to small and medium sized entities, it will also make loans more expensive for those companies.”*

The following straight-forward example is discussed with network representative (NR1) in terms of *loan volumes*:

*“Giving today’s capital requirement of 8%, this implies that EUR 12,5 million of new loans can be granted for EUR 1 million in capital. The future requirements of 10,5% implies, that only EUR 9,52 million in new loans can be granted for EUR 1 million in capital, i.e. the reduction in scope can be summarized to be ap. 24%.”*

In the past, *pricing* frequently was not based on the real risk of a borrower or engagement.

*“In many cases, competitors were able to maintain pricing under deteriorating market conditions, forcing us to compete on a pricing level, which, if not done so, had resulted in a good pricing policy, but without any generation of new business”.*



Financial theory in this context usually refers to a loan pricing formula, which has been subject to numerous studies (e.g. Santos/Elliott, 2012; Slovik/Cournede, 2011). In simpler terms, the calculation of a credit price comprises four to five elements as for example outlined by Pichler/De Silva (2008) Refinancing costs (interbank rate) are calculated using market interest method. The costs for handling the loan (cost premium or standard costs) are based on internal operational cost factors. In this context, the most important elements are standard risk cost (Expected Loss) and the cost of equity (risk premium or Unexpected Loss).

Figure 43: Loan pricing (simplified)

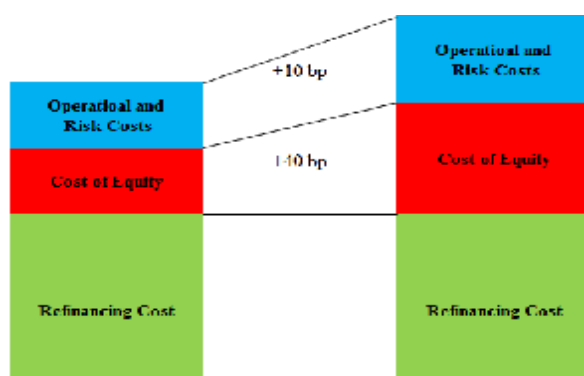
Interbank rate	200 bp	e.g. EURIBOR, based on tenor
Standard risk costs	38 bp	depending on EL
Risk Premium	10 bp	depending on UL (cost of equity)
Cost Premium	52 bp	e.g. for operational handling
Contribution relationship banking	-20 bp	depending on competitive environment
<b>Pricing</b>	<b>280 bp</b>	

Source: Pichler (2008)

It is expected that loan pricing will increase upon the introduction, which the network representative views critical with regard to the financial capacity of SMEs.

*“Loans are by far the most significant source of financing for the German Mittelstand. For the typical Mittelstand loan we expect pricing to increase by about 40 basis points as a consequence of higher equity costs. Due to increased investments in infrastructure and negative consequences for borrowers, we expect another increase of about 10 basis points”.*

Figure 44: Loan pricing increase visualised



In the course of discussing possible solutions and responses on a regulatory level, two approaches have been derived upon, being from a regulatory perspective and from a financial perspective.

*“From a regulatory perspective, looking especially on small and medium sized cooperative banks and assuming that the Basel III mechanism will not change, the only way to provide for fair treatment is to adjust risk weights”.*

In the statement above, the network representative (NR1) makes reference to the *Solvabilitätsverordnung* or "SolvV" (Regulation governing the capital adequacy of institutions and financial holding groups). The Solvency Regulation refers to 15 receivable classes for which risk weights between 0% and 150% are assigned to. The disclosure reports, on one hand, outline capital requirements per receivable class and, on the other hand, the individual risk weights. Within the scope of the research sample the risk positions per risk weights have been aggregated in order to better understand the impact and consequences of the enhanced requirements:

**Table 28: Volume per risk weight**

Risk Weight	Significant receivable class	Sample distribution
0%	Receivables to sovereigns (Germany, EU) Receivables to international organisations	14%
20%	Receivables to certain institutes with remaining maturity < 3 months	7%
35%	Receivables not 100% covered with residential real estate	9%
50%	Receivables of building societies to borrowers Receivables not 100% covered with commercial real estate	4%
75%	Retail Receivables	31%
100%	Investments and participations	28%
	Other (including 150% Risk Weight for Overdue Rec.)	7%

Source: Own calculation

The table above indicates that retail receivables are the most significant risk driver among the sample banks. According to section 25 of the Solvency Regulation, retail receivable include loans to private individuals (excluding residential and commercial property financings) and small and medium sized entities of up to EUR 1,0 million. These receivable are weighted with 75% in accordance with section 34 Solvency Regulation. Amounts in excess of EUR 1,0 million are subject to 100% risk weight.

Giving the fact that the new capital requirements are not up to national Governments to adjust, the focus of potential solutions is in fact on the risk side representing the basis for the new capital requirements.

*“We want to continue to position ourselves as local partners and supporter of the local economy. In order to be capable to accomplish this mission and offer competitive rates, we suggest to lower the risk weight for retail receivables to 50% and increase the threshold to EUR 1,5 million”.*

Based on today's requirement of 8%, the capital rate necessary is 6% (75% risk weight x 8% capital requirements = 6%). Depending on the application of capital buffers, future capital requirements of up to 12% could be balanced by applying the risk weight of 50% resulting in an unchanged ratio of 6% (50% risk weights x 12% capital requirements = 6%). The *Bundesverband deutscher Banken* still rejects this demand by stating that regulation should be unified (Börsenzeitung, 26 January 2012). It also has to be stated that umbrella organisations do not engage into levelling loan conditions for private individuals, i.e. via the passing through of equity requirements, loan pricing for these is expected to become more expensive.

While the above statements refer to the regulatory perspective, where the scope of action by cooperative banks is not applicable or limited to suggestions by umbrella organisations, the other perspective or approach aims at measures available to banks with regard to their financial management decisions, which are discussed in more detail in the next section.

### **6.1.3 Equity restructuring potential**

Based on the findings above, cooperative banks are forced to think about measures to restructure their balance sheet or capital position. As opposed to regulatory discussions, which is based on a more aggregate and abstract level, this analysis aims at operational measures that are available to individual cooperative bank managers. In order to find out and identify options available to bank managers, interviews with

executives have been conducted, being a Partner of a cooperative audit network and the others being managers of cooperative banks.

### 6.1.3.1 Capital management: A simple equation

As described before, capital requirements depend on the volume of assets or Risk Weighted Assets (RWA) that can be summarized as outlined in the equation below:

$$\frac{Equity}{RWA} > \text{Minimum Capital Ratio (e. g. 8\%)}$$

The overall consensus regard the impact of Basel III on the as is situation of banks is that capital ratio as well as RWA are expected to increase, while capital is expected to decrease. Practitioners' literature typically outlines several possible responses to mitigate this impact. A good example and summary that found a lot of attention among practitioners was a study by KPMG (2011b) outlining the following measures:

- "Improving the performance of existing assessment methodologies in internal ratings-based credit risk approach and internal model market risk approach.
- Legal entity reorganization to optimize the impact of capital deductions.
- Active balance sheet management and hedging strategies.
- Redesign of business model and portfolio focus."

Discussed with the interview partners, the following was stated.

*"The study you have as well as most other articles refer to general private banks that individually operate on an universal level. Cooperative banks are special and, due to their focus on products, clients and region, the scope of possible actions is rather limited compared to those private banks".*

Possible measures feasible for cooperative banks were discussed that are related to the equation above and lead either to the *increase in equity* or the *reduction in RWA*.

### 6.1.3.2 Increase/optimize Core Tier 1

An increase in core tier 1 capital can occur via the issue of new member shares, increase of the funds for general banking risks as well as income reserves.

Stolz/Wedow (2011) in a study on the effect of business cycle stated that cooperative banks primarily depend on the optimization of their income reserves since the number of new member shares that can be issues is economically limited due to the achievement of certain profit per share while achieving stable net income.

Regulatory capital, therefore, can only be increased via improving reserves.

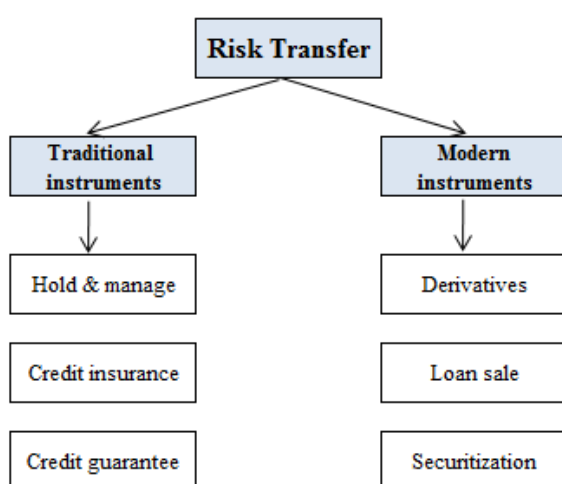
Transfers to the *fund for general banking risks* are first decided by the board of directors of the individual cooperative banks. The amount is quantified based on "sound economic assessment taking into account the specific risks of the bank" as outlined in the German Commercial Code, which means that there is a high degree of subjectivity involved. In terms of calculation, the amount of the transfers is provided by the profit after tax but before dividend payouts. Nevertheless, the decision of the board of directors can be overruled by the members' meeting as defined in the Cooperative Act. The transfer to *income reserves* can occur via an obligation as laid out in the individual statute or via the annual decision of the members' meeting.

*"In order to react to Basel III, it does not matter whether we increase the general banking risk fund or income reserves. The challenge we have is to balance regulatory requirements with members' expectations. The overall plan of the cooperative banking network is to position itself as THE local bank that provides a reasonable dividend return. Even though dividend returns vary from region to region, the level of return of individual banks has been rather stable. Our own research has shown that our members would be willing to and agree to dividend cuts down to a total return of ap. 3%. Given the average return of ap. 5% this leaves sufficient head room. We also do not expect this return claim to go up in the short and medium term due to the current overall interest level that provides for returns on deposits of only ap. 1,5%".*

### 6.1.3.3 Decrease/optimize RWA

Looking at bank specific literature, there are several options available for decreasing RWA levels. There has been no official categorization of existing options. One way to do this is by looking at past and current practice, which can be summarized by clustering into traditional and modern instruments as done by this author for subsequent discussions with cooperative bank managers:

Figure 45: Risk transfer options



Source: own classification

*"From your classification, the only feasible option individual primary banks have got and actually pursue is to hold and manage existing exposures, i.e. they want to deal on their own. All options with reference to other financial instruments lack the necessary local expertise. Loan sales are possible for extraordinary cases only".*

The statement by CEO3 confirms the author's previous assessment and experience from non-performing loan transactions. Local banks do not have the necessary resources to deal with transaction issues they have problems understanding. At the same time, local cooperative banks need to maintain their status as regional partner. Evidence for the statement can be derived from industry reports on the sale of non-performing loans, e.g. PwC with their Newsletter NPL Europe (2012) or the Ernst & Young (2013a) NPL study, which show no transactions by the cooperative banking

sector going back to 2009. Also the cooperative banking sector's own bad bank, BAG Hamm, is regarded as the last possible option only with regard to medium sized exposures that have complex structures and require highly specialized expertise. In 2012, BAG Hamm acquired problem loans in the amount of EUR 145 million, confirming their status as a niche player.<sup>55</sup>

In discussions with the audit Partner, similar conclusions can be drawn based on his experience with regard to the financial years 2011 and 2012.

*"During the past two years we have not noticed a significant movement in assets, i.e. receivables to banks and customers, especially not downwards. However, what we noticed was a slower growth in loans and higher collateral levels, especially in 2012".*

The audit Partner makes reference to the risk weights as described in section 6.1.2.1. The statement is to be analysed from a regulatory perspective. The Solvability Act, section 5, makes reference to credit risk mitigation techniques, which comprise "financial assets" in the form of cash deposits and certain liquid securities and "other instruments" in the form of certain guarantees. Since cooperative banks almost entirely apply the standard approach, these techniques do not apply here. Relevant are primarily first ranking mortgages on real estate. In order to lower capital requirements, banks and especially cooperative banks try allocating as much volume to bandwidths with lower risk weights. The following simplified example was discussed with the audit Partner.

- credit granted in the amount of EUR 50.000 to private individual
- secured by mortgage on residential real estate with a value of EUR 60.000; general lending maximum is 60% hereof, i.e. EUR 36.000.
- The share of EUR 36.000 is allocated to the risk weight 35%, i.e. capital requirements, applying 8%, would be EUR 1.008.

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<sup>55</sup> information accessed via website content ([www.bankaktiengesellschaft.de](http://www.bankaktiengesellschaft.de))

- The remaining share of EUR 14.000 is allocated to the regular risk weight for unsecured exposure, e.g. 75% for retail exposure, which would result in capital requirements of EUR 840. Total capital requirement, therefore, adds up to EUR 1.848.
- In comparison: The same credit granted on an unsecured basis has a capital requirement of  $\text{EUR } 50.000 \times 75\% \times 8\% = \text{EUR } 3.000$  or 62% higher than on a secured basis.

Bank related literature refers to this effect typically as "credit crunch", i.e. more severe conditions to obtain a loan (more collateral; better financial situation and rating) and the reduction of loan availability. The cooperative network BVR, however, stated that with regard to cooperative banks, no credit crunch is expected with loan availability unchanged (BVR, 17 December 2012).

From the interviews conducted it can be taken that options regard the decrease of RWA are rather limited. The best possible action is to enhance the risk position of new loans, where banks can make a fresh start. The adjustment of existing loans is also possible due to the general business principles that allow banks to enforce additional claims for collateral (Nachbesicherungsanspruch) in case of a deterioration of the borrower's financial condition or the collateral situation.

## **6.1.4 Financial model**

### **6.1.4.1 Challenge and approach**

Due to the expected increase in capital requirements, this author concluded that enhanced advisory needs would be the consequence especially for small and medium sized banks that do not have the resources and expertise to set up own models. In this regard, it was decided upon to design a pilot financial model. This decision can be considered as a joint initiative to combine academic work on this research project with practical work of this author, while it is clearly stated that without this research project, the model would not have been designed.



Requirements of the financial model comprised the following issues:

- Compliance with CRDIV/CRR
- Incorporation of plan/budget figures
- Options for scenarios to test sensitivities
- Transfer to other banks and business models
- User-friendly and customizable by accounting staff

Discussions on how to set up the model were first held late 2012. In several brainstorming sessions with bank staff it was agreed to use an Excel model as basis due to acceptance and handling reasons. It was acknowledged that all details of the new reform package were and would not be available until mid of 2013 at least, so flexibility was necessary. Working design was based on consultation papers as published. Due to client structure, the model was solely designed in German. It comprised a time horizon up until 2020.

An essential requirement was the adaptability to other banks and business models. Even though this author has a focus on cooperative banks, potential projects with other banks were expected, so the model needed to take into account extended characteristics in terms of financial statement positions. However, the scope is limited that it is not deemed appropriate for large scale banks and other investment banks, i.e. advanced measurement techniques with regard to market risk (e.g. consideration of derivatives) are not considered.

It also needs to be acknowledged that the primary aim of this model was not to optimize balance sheet structure in order to maximize profits. The aim is to simulate regulatory compliance first in order to identify actions to be taken if necessary. This is based on the notion that the typical clients of this author do represent banks that have a pre-determined business model (e.g. cooperative banks) with less variation to the risk profile and performance expected.

In the designed process, the documents and information as outlined in chapter 5 were the basis and standard for the model. Additional reference was made to the works of other authors in order to enhance quantitative quality of the model. The bulk of literature available refers to balance sheet optimization in a very quantitative way. Literature deemed most helpful and appropriate by this author were Santomero (1984), Alexander (2004), Schmaltz/Pokutta (2011), and Kruger (2011). These authors mainly provide models based on linear programming that lead to the "optimal" balance sheet, i.e. their aim was not to provide a conclusion but rather ideas on how to deal with a number of product categories given the supervisory framework.

#### **6.1.4.2 Model composition**

The model was designed by a logic order and comprised the following sections typical for a real-life project.

- Cover sheet
- Summary of Output SolvV
- Input Data Scenarios
- Input Data Balance Sheet and Calculation "plan"
- Plausibility checks regarding accuracy
- Plan Balance Sheet
- Plan Equity Requirements
- Plan Capital Ratios
- Mapping table for balance sheet items and regulatory reporting items

##### *Summary of Output SolvV*

The summary of output according to the SolvV (see section 6.1.2.3) is the aggregated overview of the balance sheet "plan", distinguished by assets and liabilities, the aggregated overview of existing Tier1 and Tier2 capital, the aggregated overview of

RWA with corresponding equity requirements together with an overview of additional equity needed/equity available.

In this view, the recipient of the model obtained the "hard facts" of the model, i.e. the regulatory result of their economic forecast.

#### *Input Data Scenarios*

This section was designed to allow the application of certain basic variables as well as additional assumptions regarding the development of balance sheet data. In detail, it allowed the user to input

- date of last "as is" balance sheet data
- assumption regarding balance sheet development (it allows for input of already planned data without assumptions, manual input or two other defined scenarios that can be defined (scenario 1 or scenario 2).
- predefined ideas regarding the transfer to reserves (340f/340g/ profit reserves, distribution)
- options regarding the development volume of RWA
- options regarding the development of collateral
- options regarding the development of market risk
- options regarding the development of operational risk
- options regarding the development of 340f Commercial Act reserve

#### *Input Data Balance Sheet and Calculation "plan"*

The model is based on the balance sheet, i.e. income statements are not considered or only via variations in the annual net income. The set up of balance sheet positions needed to be on two levels:

- a) Legal form: Form and naming conventions for banks in Germany are legally binding and outlined in the "Verordnung über die Rechnungslegung der Kreditinstitute und Finanzdienstleistungsinstitute" (RechKredV)<sup>56</sup>. The sum of all balance sheet items equals total assets.

$$TotalAssets_{Bal} = LegalForm_{Bal1} + LegalForm_{Baln}$$

- b) Economic form: Each balance sheet position is made up of products that differ from bank to bank depending on their business model. Economic composition had to entail the opportunity to enter as many individual bank products as possible with individual names. The sum of all economic positions always has to equal the volume of legal form.

$$LegalForm_{Bal1} = EconomicForm_{1_{Bal1}} + EconomicForm_{n_{Bal1}}$$

#### *Plausibility checks regarding accuracy*

In order to identify possible breaks with regard to data input, a number of numerical checks have been incorporated. These checks comprise reconciliation on a total level with regard to assets and liabilities in the scenarios applied. Rationale behind this is to improve data quality and consistency.

#### *Plan Balance Sheet*

This section calculated the balance sheet as put together in the individual scenarios up to financial year 2020 in terms of legal and economic balance sheet positions. It also highlights the development of equity over the time horizon on a detailed position level.

This section also provided a reconciliation of economic balance sheet positions to receivable classes as required by SolvV and as defined in the mapping table. Hence, it provides for the same aggregate numbers, however, based on regulatory classes.

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<sup>56</sup> see [www.gesetze-im-internet.de/rechkredv/](http://www.gesetze-im-internet.de/rechkredv/); financial statement standards for banks and financial institutions

These numbers represent the basis for the calculation of credit risk as described in section 6.1.2.1.

#### *Plan Equity Requirement*

In this section, reconciled numbers are weighted in accordance with regulatory rules. Also, the allocations to regulatory position fields are conducted.

In addition, to derive at the relevant basis, credit risk mitigation measures are considered. In this context, relevant collateral is outlined and deducted from the volumes to derive at the net basis amount.

This amount is multiplied with the relevant equity ratio required, e.g. 8%.

#### *Plan Capital Ratio*

The first section of this calculation describes the individual Tier1 and Tier2 capital components during the time horizon.

From the capital deducted are risk volumes, especially credit risk volume as outlined before. Deducted are also volumes for market and operational risk. Since this models assumes a stable, non-complex business model, no advanced calculation and simulation was conducted. Reference is made to the Scenario section.

The section concludes with an analysis of CCCB and CCB, i.e. their development in the context of the overall capital development.

#### *Mapping table for balance sheet items and regulatory reporting items*

The mapping table is the definition or convention for the link between economic balance sheet positions and the 15 receivable classes as per the SolvV. This rationale is to exactly simulate the required reporting numbers with the plan values.

#### **6.1.4.3 Preliminary conclusion**

The model as it is was tested in one real-life project. In the progress, individual items were adjusted to resemble the individual risk situation and strategy of the bank. The bank was no cooperative bank, however, has a comparable business model and is deemed appropriate by this author for testing purposes.

Based on the application of the model, evidence has been gathered to proof validity of the model. Evidence was, after all, gathered via the acceptance of the client bank regarding the applicability of the model, usage and incorporation into its management system. The manager stated:

*"The model allowed us to gain assurance regarding regulatory compliance as provided by statutory auditors. The benefit is also that it helped us to simulate ideas we have. We have a conservative business model and do not intend to alter it. However, the model provided us with impulses on how to direct our model in order to gain certain economic benefits by adjusting certain asset group.."*

While this author strongly believes in the validity of this model, reference is made to further improvements and potentials. As mentioned before, it is based on balance sheet items. In order to provide for a more risk-reward oriented approach, the model should be enhanced by incorporating income statement related numbers. In detail, the model can be further developed by incorporating cash flow-related numbers in order to provide for conclusions not only on regulatory compliance but also on bank steering and strategy decisions.

#### **6.1.5 Liquidity implications and challenges**

Up until the cut-off date of this research it has been observed that liquidity issues in connection with Basel III have not received the same attention as capital issues, especially in connection with cooperative banks. This development can be explained with the initial introduction of liquidity related standards and the lack of experience as well as the lack of information to be published in connection with liquidity. In

contrast to capital issues, which can be taken straight-forward from individual positions in the financial statements or other supporting documents, liquidity is mainly a matter of internal classification as well as individual counterparty and maturity parameters, which are not published. In addition, the progress on liquidity issues, i.e. the consideration of individual factors, has not been fully drafted, especially with regard to cooperative banks with respective network issues, hence, negating the applicability of enhanced analyses.

In January/February 2013, interviews with responsible persons of one cooperative bank (CEO2) took place in order to analyse the impact and simulate possible options. The discussion took place rather late, since liquidity was not regarded to be challenging.

#### **6.1.5.1 Liquidity Coverage Ratio**

In preparation for the discussion, a preliminary Excel tool was designed. The Excel tool was designed to be a draft for the enhancement of the financial model presented in section 6.1.4. However, since liquidity was no focus of this work, only the first designs were drafted in order to identify the most important issues to look out for.

As outlined before, relevant input data is not publicly available, hence no results could be calculated beforehand. The Excel tool incorporated all relevant requirements with regard to liquidity compliance as outlined by the BIS per 31 December 2012. Even though LCR is to be introduced in 2015 with minimum requirements starting at 60% gradually increasing by 10% until 2019, the standard basis is that full compliance is expected right away, i.e. in 2014.

Provided to this author were internal steering documents for year-end 2012, i.e. risk reports and ytd balance sheet and income statement. Based on these, it was calculated that LCR at the time was 96,2% (*as is*), i.e. minimum requirements are not met yet. Most influential factor were deposits by institutional customers, accounting for EUR 7,2 million in outflows.

**Table 29: LCR calculation**

Payments outflows from uncovered deposits	EUR m	factor in %	EUR m
Deposits > 30 days maturity, thereof	21,2	0,0%	0,0
refunding transferred loans	13,9		0,0
savings certificates and time deposits	7,3		0,0
Unsecured deposit 1: deposits < 30 days maturity, thereof	14,6		
demand deposits private clients/SME < 1 m Euro	9,9	5,0%	0,5
savings deposits, call deposits, time deposits private clients/SME	4,7	10,0%	0,5
Corporate and commercial clients (> 1 m), thereof			
uncovered demand deposits for corporate purposes	4,9	5,0%	0,2
savings deposits, call deposits and time deposits	10,1	75,0%	7,6
institutional investors, states, public authorities			
and German Central Bank, uncovered demand deposits			
for corporate purposes	0,0	5,0%	0,0
uncovered deposits for other purposes of			
institutional investors	0,0	100,0%	0,0
German Central Bank	0,0	75,0%	0,0
covered deposits, collateralised with bonds			
Class 1	6,0	0,0%	0,0
Class 2	0,0	15,0%	0,0
other bonds, central bank	0,0	20,0%	0,0
officers of credit lines:			
reciprocal credit lines private clients/SME	1,5	5,0%	0,1
credit lines commercial clients, states,			
central banks	0,5	10,0%	0,1
credit lines financial sector	0,0	100,0%	0,0
public credit commitments/guarantees	0,0	0,0%	0,0
minimum reserve	1,0	100,0%	1,0
<b>Total payment outflows</b>	<b>138,0</b>		<b>13,5</b>
<b>Liquid assets (unmortgaged)</b>			
Class 1: cash/central bank deposits	1,7	100,0%	1,7
Class 1: government bonds	5,1	100,0%	6,7
Class 2: covered bonds and government bonds	12,9		
(credit standard approach, 100,0% AA- and better)			
max. 2/3 of class 1		85,0%	5,2
uncovered bank bonds and other bonds	5,0	0,0%	0,0
<b>Total liquid assets</b>	<b>24,7</b>		
<b>Total liquid assets creditable</b>			<b>13,0</b>
<b>Payments inflows</b>			
from liquidity lines in favor of the bank	0,0	0,0%	0,0
deposits at central banks of the organisation	0,2	0,0%	0,0
and other banks maturity < 30 days			
Inflows mature credits private clients/SME	0,3	50,0%	0,3
Inflows mature credits commercial clients	0,3	50,0%	0,2
Inflows credits financial institutions	0,0	100,0%	0,0
<b>Total payments inflows</b>	<b>0,5</b>		<b>0,4</b>
<b>Balance net of outflows</b>			<b>13,0</b>
<b>Liquidity coverage ratio (LCR)</b>			<b>96,2</b>



Based on these findings several options were discussed in order to analyse sensitivity to LCR. While these options refer to possible actions by the cooperative bank analysed, the impact of the options also serve as the analysis of other cooperative banks with corresponding balance sheet ratios. Options or parameters originally discussed were (in reference to *as is*):

- Option A) Increase government bonds by EUR 10 million to EUR 16 million via transfer of EUR 5 million in each covered bonds and bank bonds.
- Option B) Increase governments by EUR 5 million to EUR 11 million and loans by EUR 20 million (private by EUR 16 million; commercial by EUR 4 million) via transfer of bank receivables of EUR 11 million and transfer of EUR 9 million in covered bonds and EUR 5 million in bank bonds.
- Option C) as Option B) with additional increase in loans by EUR 9 million in new business volume financed by EUR 9 million in bank deposits.

Table 30: LCR options

	A	B	C
<b>ASSETS</b>	<b>€m</b>	<b>€m</b>	<b>€m</b>
<b>I. Liquidity buffer:</b>			
Cash/Central bank credit	1,7	1,7	1,7
Government bonds (standard approach 0%)	6,1	16,1	11,1
Covered bonds and government bonds (standard approach 10/20% AA- and better)	12,9	7,9	3,9
Uncovered bank bonds and other bonds	5,0	0,0	0,0
Debits credit institutions	11,0	11,0	0,0
Deposits at central banks maturity < 30 days	0,2	0,2	0,2
<b>II. Credits</b>			
Credits private clients and SME	45,0	45,0	61,0
Credits commercial clients	13,1	13,1	17,1
<b>III. Other assets</b>			
Participations	2,3	2,3	2,3
Fixed assets	1,4	1,3	1,3
Miscellaneous	1,3	1,4	1,4
<b>Total</b>	<b>100,0</b>	<b>100,0</b>	<b>109,0</b>
<b>LIABILITIES</b>	<b>€m</b>	<b>€m</b>	<b>€m</b>
<b>I. Uncovered deposits:</b>			
<b>A. Deposits &gt; 30 days maturity, thereof</b>	21,2	21,2	21,2
refunding transmitted loans	13,8	13,8	13,8
savings certificates and time deposits	7,4	7,4	7,4
<b>B. Deposits &lt; 30 days maturity, thereof</b>	69,8	69,8	78,8
1. Private clients SME total investments < 1m Euro			
a. Demand deposit for payments	10,0	10,0	10,0
b. Savings deposits, call deposits, time deposits	44,8	44,8	44,8
2. Corp. and commercial clients total invest. > 1m Euro			
a. Demand deposit for operational purposes	5,0	5,0	5,0
b. Savings deposits, call deposits, time deposits	10,0	10,0	10,0
3. Institutional depositor, state and public authority demand deposit for operational purposes	0,0	0,0	0,0
4. Deposits for other purposes of			
a. Institutional investors and banks	0,0	0,0	9,0
b. German Central Bank	0,0	0,0	0,0
<b>II. Covered deposits, secured with bonds</b>			
Class 1	0,0	0,0	0,0
Class 2	0,0	0,0	0,0
other bonds at central bank	0,0	0,0	0,0
<b>III. Other liabilities</b>			
Accruals	2,1	2,1	2,1
Equity capital	6,9	6,9	6,9
<b>Total</b>	<b>100,0</b>	<b>100,0</b>	<b>109,0</b>
outstanding liquidity line at central bank	2,0	2,0	2,0
Callable credits and outstanding credit lines:			
credits due within 30 days to			
private clients/SME	0,5	0,5	0,5
commercial clients	0,3	0,3	0,3
financial institutions	0,0	0,0	0,0
outstanding credit lines financial sector	0,0	0,0	0,0
irrevocable credit lines private clients/SME	1,5	1,5	1,5
credit lines commercial clients, states, central banks	0,5	0,5	0,5
callable credit approval/guarantees	2,0	2,0	2,0
<b>LCR</b>	<b>96,2</b>	<b>181,3</b>	<b>105,2</b>

Based on the change in parameters stated it is concluded that banks with deposits excesses over loans are not expected to be required to change their balance asset-liability structure significantly. Option A would certainly lead to excess-compliance with LCR with respective consequences for income. Option B is more realistic and points towards the most desirable situation. Option C would result in a worsening of the situation, hence, no alternative for future strategic orientation. Overall, it has been concluded and calculated that a transfer from bank and covered bonds to government bonds in the amount of EUR 0,4 million is the most appropriate way of action, i.e. no significant adjustments are needed, not considering headroom required.

In summary, it has to be stated that management of existing securities in Depot A is the biggest challenge. Loans and deposits cannot be adjusted materially in the short- or medium-term, hence, management of what is *at hand* is most important. This is considered a significant issue since Depot A of cooperative banks primarily consists of corporate, bank and covered bonds (Gschrey, 2011).

One of the most influencing factors is the consideration of bank receivables.

*"We and other cooperative banks typically park liquidity with our central bank".*

This statement by the bank managers refers to the typical network mechanism that encourages primary banks to centralize deposits with DZ Bank or WGZ Bank that coordinate funds to support their member banks. In reference to section 5.4.1.2, these deposits do not account as level 1 or level 2 assets anymore. If not amended, this directive will result in the adjustment of cooperative bank business model that will have a strategic impact not only on central banks but also on primary banks since these are pushed to allocate assets in government bonds or other low risk, hence, low income securities.

At the same time, the new requirements favour refinancing via private customer deposits (as opposed to commercial customers). This will further increase the importance of retail business and competition coming from other banks.

### **6.1.5.2 Net Stable Funding Ratio**

According to this researcher's conclusion upon reviewing relevant information, NSFR has received the lowest attention in the new Basel III framework. Based on the conclusions from interviews and professional work, it can be concluded that the impact of the NSFR on cooperative banks will be significant. As concluded in section 3.1, the business model of cooperative banks is based on a high degree of maturity transformation, i.e. funds or liabilities are generated mainly short-term (up to three months) and used to finance medium and long-term assets (e.g. real estate financing). This is a typical approach since short-term refinancing is cheaper than long-term refinancing due to the risk premiums in connection with uncertainty. While this is economically grounded, it leads to higher liquidity risks or call risks. As outlined by McKinsey (July 2013), this risk was a major factor in the financial or subprime crisis when assets were refinanced via the issue of Commercial Papers with the related market drying up leading to defaults.

The calculation of the NSFR is regarded more straight-forward than LCR with legal compliance to be introduced in 2018. Contrary to LCR, no step-by-step implementation process is planned with full compliance straight way. As with the LCR, reference was made to the preliminary Excel tool to calculate the relevant ratio for the client bank.

**Table 31: NSRF model**

<b>Stable refinance available</b>	<b>EUR m</b>	<b>factor in %</b>	<b>EUR m</b>
Equity	7,0	100,0%	7,0
Other liabilities > 1 year	9,0	100,0%	9,0
Stable deposits from private clients < 1 year	51,0	90,0%	45,9
Other deposits < 1 year	22,0	50,0%	11,0
Other liabilities	11,0	0,0%	0,0
<b>Total</b>	<b>100,0</b>		<b>72,9</b>

<b>Stable refinance required</b>	<b>EUR m</b>	<b>factor in %</b>	<b>EUR m</b>
Cash, Bonds < 1 year	8,0	0,0%	0,0
Securities (risk weight 0%, > 1 year)	1,0	5,0%	0,1
Off-Balance	3,0	5,0%	0,2
Shares, bonds at A- to A-, > 1 year	8,0	20,0%	1,6
Loans to corporates, governments, central banks < 1 year	3,0	50,0%	1,5
Real Estate financing	7,0	65,0%	4,6
Other loans to private customers/SME < 1 year	15,0	85,0%	12,8
Other assets, loans to institutions, financial entities > 1 year	55,0	100,0%	55,0
<b>Total</b>	<b>100,0</b>		<b>75,6</b>

<b>Net Stable Funding Ratio (NSFR)</b>		<b>96,4</b>
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Based on the calculations, compliance is not achieved yet with NSFR currently staying at 96,4%. While it is not possible to empirically transfer this result to the entire cooperative bank sector, it confirms the general conclusions in practical literature (Börsenzeitung, 15 September 2012). Also, in accordance with this author's experience and insights into various other cooperative banks it can be stated that variance in terms of relevant balance sheet positions is low with an estimated bandwidth of ap. 5% per position. Given this expected outcome, the next step is to consider relevant solutions.

First, on a high level, a strategy is necessary to devise a strategy to ensure that funds, which have flown in to cooperative banks in the aftermath of the financial crisis, do not flow out again. It can be and is assumed by this author that the amount of short-term deposits is highly comparable to the one of savings banks (Sparkassen) where it accounts for ap. 80% of deposits.

Second, concrete measures that can and must be carried out are based on two variables individually or combined, being counterparty and maturity with regard to the refinancing or liabilities side given that the asset side structure will not be subject to change:

- substitute short-term deposits from institutional entities with short-term deposits from private customers and SME. With regard to this model bank, this would result in a necessary increase in short-term deposits of EUR 3 million (6%).
- substitute short-term deposits with long-term deposits or instruments, e.g. via the issue of covered bonds. With regard to this model bank, this would result in a necessary increase or issuance of EUR 3 million (30%) in bonds, or alternatively, certificates.

It has to be stated that there are several other options available, also with regard to the asset side. The biggest impact would be achieved via the reduction of loans to commercial and institutional customers. However, these options are not realistic due to the cooperative value to support regional companies being also their members. Also, it has to be considered that other asset instruments (e.g. bonds) are needed with regard to LCR. It is this interdependence that represents the biggest challenge for banks that do not strive to achieve NSFR compliance via liabilities adjustments only.

In a combined ALM view, the identification of the optimal *maturity transformation strategy* will be a core task from 2014 on, hence, elevating the strategic importance of relevant experience and know-how in the form of the *Treasury* function. Based on the expected and required cash-flows from interest bearing products it is necessary to balance income components.

## 6.2 Operational excellence (KT2)

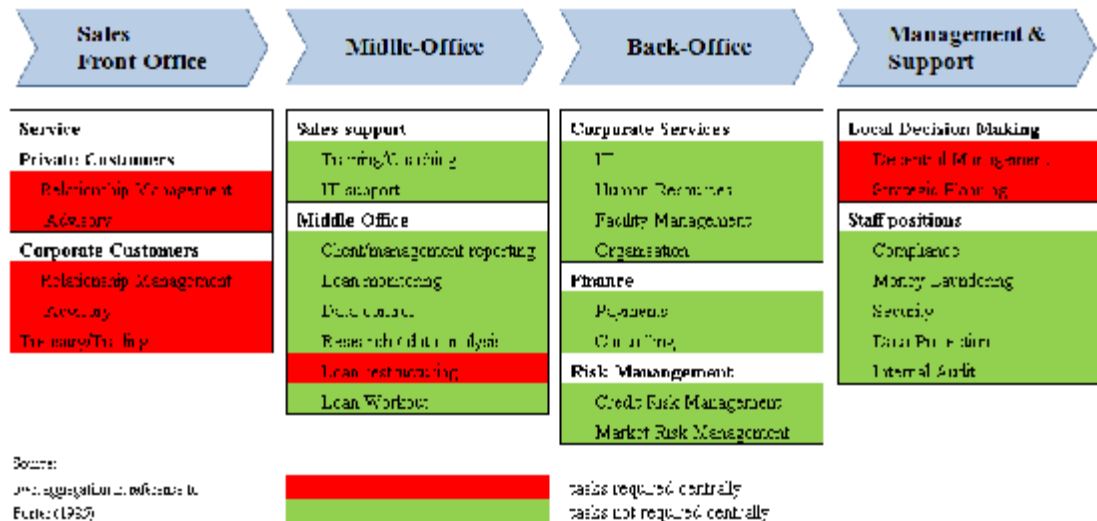
### 6.2.1 Groundwork and introduction

#### 6.2.1.1 Relevant theory

As outlined before, due to the expected stagnation or even reduction of revenues in short and medium term due to the development of lower interest income, it is of strategic importance to optimize the cost structure in order to provide for some headroom with regard to conditions. While other measures, especially with regard to revenue generation, are heavily influenced by external factors, cost reductions depend on internal decisions and the will to push through.

The most appropriate starting point to conduct an analysis has been identified as being value chain analysis as developed by Porter (1985). Adjusting the original value chain with a focus on cooperative bank's private banking model results in the following:

Figure 46: Value chain for private banking business



Lamberti (2004) in reference to the overall banking sector, pointed out that there is already a high degree of optimization and also outsourcing with regard to certain business segments, e.g. securities processing and payments, i.e. predominantly Middle- and Back-Office activities. This author based on experience and observation

agrees that the findings also apply to the cooperative banking sector with network entities handling a good share of these activities. As part of the network, the two entities *VR Kreditwerk* and *VR Kreditservice* have been set up to conduct Back-Office activities with regard to loan services mainly.

The overall aim is to optimize resources within the triangle between processes, organizational structure and personnel management in connection with the decision to optimize internally or externally. In this context, attention must be focused to the tasks that cannot be outsourced, hence, need to be kept centrally. These must be the core competence and responsibility of the primary bank (sales).

In order to achieve operational excellence and productivity improvements, there is a mix of options available that has been analysed mainly from an academic perspective. In reference to relevant literature, the options available can be aggregated in the categories *process optimization* and *process outsourcing*, which are also to be considered linked.

This approach is based on the assumption that the probability of outsourcing being successful is higher when internal optimization has occurred before as identified by Lacity et al. (2004) for British banks. The literature review in this context has revealed that, even though vast for manufacturing industry and large for banking in general, there is very limited existing information on these issues in connection with cooperative banks. Spandau/Theurl (2012) in a survey of 193 primary banks on competition and looking at various individual minor banking activities concluded that cooperative banks do consider productivity measures as important, however, hesitate to conduct real actions.

Further analysing "make-buy models", Poppo/Zenger (1998) conducted empirical studies and concluded that due to the complexity with the respective choice "requiring integration of transaction cost, knowledge-based, and measurement reasoning". Based on these grounded theories, Theurl (2003) categorized outsourcing into external outsourcing and internal outsourcing. External outsourcing occurs when cooperative banks make use of non-network-related servicers that conducts activities

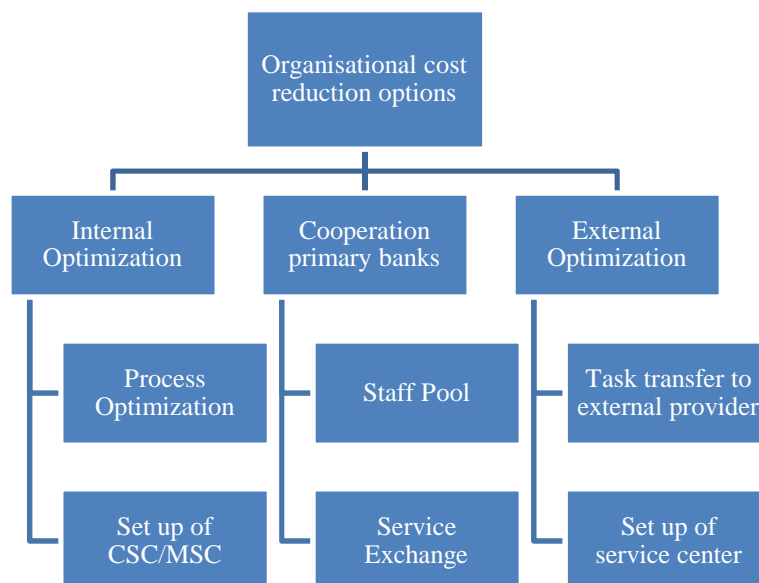


based on his own business and finance strategy. Internal outsourcing occurs when a new entity is set up from inside the cooperative network. Due to the network orientation of the cooperative banks with no envisaged ties in connection with external services, external outsourcing is limited only.

Spandau (2011b) further details internal outsourcing by distinguishing between four types, being (a) internal outsourcing within the bank (set up of internal service centre with high standardisation of processes), (b) internal outsourcing within the network (set up of external service centre externally), (c) internal outsourcing within cooperative organization (joint set up of service centre between several primary banks and other network partners), and (d) internal outsourcing via network partners (set up of service centres by network partners only).

The most notable finding of this author has been that even though the intention to make things better is there, there is a lack of structure in the local process. It is argued that this situation is due to a lack of practical and/or external expertise. In order to achieve optimization, it is, therefore, recommended to decide upon a fixed approach. Based on expert discussions (in reference to BVR's *Leitfaden zur Produktivitätssteigerung*) and practical experience relevant options have been identified, further analysed and coded as presented below:

Figure 47: Strategic options for cost reductions



These options are partly congruent with the options outlined by Spandau (2011a, 2011b). However, while the latter analysis has very narrow academic focus, this analysis goes further by outlining practical issues to consider, hence, supporting primary banks in their decision making process as opposed to just describing answer distributions.

### 6.2.1.2 Optimization analysis

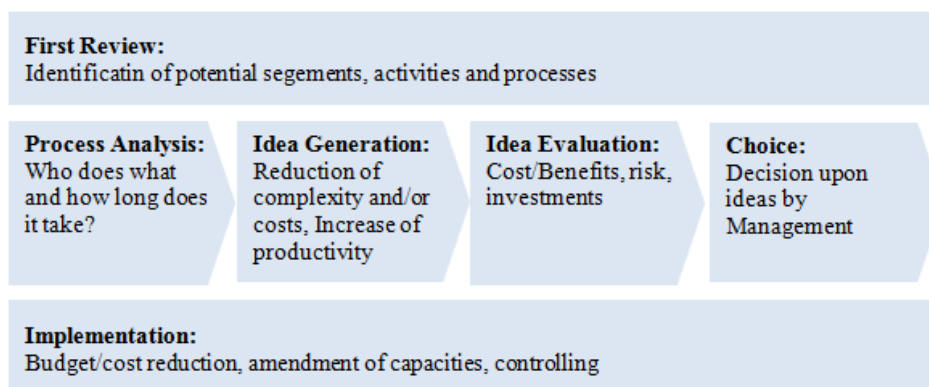
This author, on a regular basis, conducts analyses on behalf of cooperative banks with regard to structure and functioning of the organisation. In this regard, it can also be observed that cooperative banks are interested in doing things better, however, lack guidance. For management discussions, a decision matrix has been developed in cooperation with experts to provide for a first touchdown leading to transparency in terms of benefits of the individual options for the individual bank building also the basis for further in-depths analyses. The decision matrix, comprising a scoring model, consists of several aspects and aims that were defined in reference to BVR recommendations and Leipold (2009) who, in connection with productivity enhancements, aggregated four dimensions, being quality improvements, increasing sales time, generation of cost benefits and improvement of cost transparency.

**Table 32: Decision matrix**

	Internal Optimization		Cooperation			External Optimization		
	Process Optimization	Str. op. of CSC/CEC	Staff Pool	Exchange	coll. Orga Transfer	coll. Orga Transfer	RSC	Bank Transfer
Quality improvement	2							
Cost reduction	2							
Reduce staff short-term	1							
Reduce staff medium-term	2							
Influence and control	1							
Keeping coordination low	1							
Keeping initial investments low	2							
Bank Size								
	1							
	2							
	3							
	4							

The decision matrix outlined is, of course, just a starting point for a more detailed and individual analysis. In practice and upon the first analysis, the next step is to initiate a comprehensive approach with the primary bank to identify cost and process optimization. This researcher applies the following model which has proved to be of practical assistance when conducting project work.

Figure 48: Process optimization approach



The aim of this approach is to achieve *organizational fitness*. Even though fitness is achieved, it will vanish if not actively pursued on a regular basis. The biggest challenge identified is overcoming the philosophy of "This is how we have always done it". Small and medium sized cooperative banks act in a rather static environment, i.e. their own micro-cosmos. The *first step*, hence, is to achieve transparency about the status quo. In this regard, a straight-forward scoring model has proven to be mostly accepted to identify optimization potential. In this connection, BVR tools such as *VR Control*© for cost center accounting or *Metris*© for personnel management are used as data supply and for further calculations. This author concluded that there is still a lot optimization potential with regard to sales and Front-Office activities. Optimization and operational excellence is only achieved when sales time is maximised and when sales staff have the opportunity to concentrate on their key competence of "selling" and do not need to focus on administrative matters such as setting up appointments, handling forms, handling customer data, etc. Sales staff requires a mobile and comprehensive data set that can be used to discuss contract details and personal circumstances with customers.

With regard to Back Office, additional potential is still seen with regard to the set-up of accounts and the storage of data. Bank managers in general referred to these fields as not having been considered in the past. Hence, there still are loops, double handlings and breaks. The *second step* is to bring inhouse-knowledge together with help of advisors to generate ideas and decide upon what needs to be done. Implementation as a third step is crucial since here staff is trained and prepared for

doing things differently. Regular staff of small and medium-sized cooperative banks are no first movers, i.e. they need a map of what the change is all about, i.e. expected outcome and their contribution with detailed instructions. Only if a different approach is set out in writing, it can be used as a benchmark and for further measurement purposes.

## 6.2.2 Internal optimization

### 6.2.2.1 Process optimization

The most practical approach to distinguish processes is by balance sheet side, i.e. asset side and liabilities side. With regard to primary banks, this author concluded that the focus should be on not more than five reference products and related processes. Correspondingly, priority measures have been aggregated based on practical experience that are used for discussions. Being second level categories only and meant to be discussed with reference to all sub-products and sub-processes, overlaps and general suggestions are given that are, however, important to consequently point to the aim of the task.

Figure 49: Product / Measures matrix

	Asset Side	Liabilities Side
Products / Processes	Personal loan Personal overdraft facilities Mortgage loan Commercial loan Commercial overdraft facilities	Savings account Home loan and savings contract Private current account Payments "Depot B"
Measures to be discussed	Consequent use of all IT systems available by BVR/DGRV Standardisation of processes for all sub-products Introduction of quality management Standardisation of rating methods Standardisation of competence responsibilities Standardisation of collateral processes (exclude for small loans) Reduction of complexity Increase online-ratio Reduction of data control Simplify legal forms (e.g. savings book) Simplify documentation	

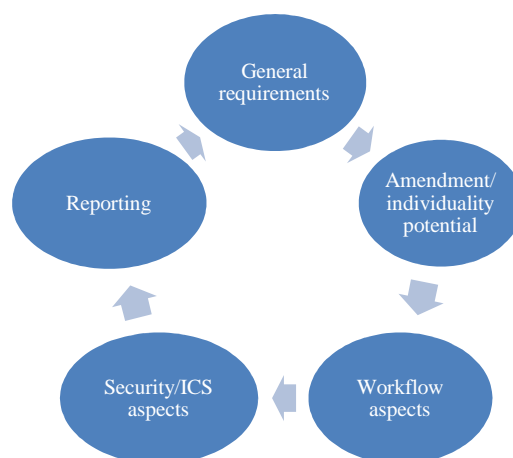
When discussing new ways to define processes, several steering instruments need to be considered. KPIs for ranking purposes should be used and the processes visualized (e.g. flow diagram). Reporting structures need to be implemented as well as a formal process for idea management and incentives. Above all, a coherent ratio analysis tool needs to be implemented to track progress, e.g. *VR-Kennzahlen-Analyse-Tool*©.

#### 6.2.2.2 Set up of CSC/MSK

Market-Service-Centre (MSC) and Customer-Service-Centre (CSC) are usually referred to as internal service centre (Spandau/Theurl, 2012). MSC refers to a back-office unit within the bank that provides support for the front-office prior to and after sales time. CSC as central organisation unit is the single point of contact (SPOC) for all customers. Both centres are considered to be "out of sight" of the customer.

Since the set up of internal service centres means changing the current organisational infrastructure, a more formal planning process is required. As with process optimization, a thorough analysis phase is required at first. After, a conception phase is required to define operational as well as strategic goals. In connection with defining the new process and organisational landscape, it is essential to agree on *IT* and *personnel* capacities. IT capacities are typically analysed in terms of the following dimensions:

Figure 50: Analysing IT capacities



The cooperative banking network's IT companies FIDUCIA and GAD do offer relevant IT tools, i.e. *agree*© and *bank21*© to manage most of the relevant tasks. With regard to personnel capacities is to be defined, which expertise is required for the new positions to be set up with formal description of the positions (inbound and outbound communication on operational level, higher expertise required for heads). With regard to the cooperative values it is important to communicate that personnel will not be laid off, hence, no job cuts, with reductions to be achieved over time due to natural fluctuation.

In summary, it is concluded that the set up of internal service centres requires a significant amount of change and, as a prerequisite, need a certain scale in order to make it economically viable. Even though no detailed analysis is available, it can be stated that this measure on an individual basis is only to be regarded by banks with total assets of at least EUR 500 million if done alone.

### **6.2.3 Cooperation with neighbouring banks**

Based on the benefits of internal centralisation another method for optimization has been identified, being cooperation with other primary banks with regard to staff pooling and the joint use of expert staff. These models comprise the exchange of services between the cooperation partners. Especially with regard to smaller banks synergies can be achieved since excess capacities have a larger impact on them (e.g. regulation requires the maintenance of Money Laundering Officers for every bank, however, without requiring a staff full-time equivalent).

When several banks set up a *staff pool*, different projects will take place worked on by a certain number of staff (e.g. student interns, part-time mothers, newly qualified bank employees, etc.) in the primary banks taking part. The most important issue to consider is that all primary banks agree upon a common process when capacity bottlenecks occur. That includes the definition of roles and responsibilities, time of notice and IT-requirements. The benefit in this context is that people who do not

have a regular staff contract, can be included in the pool, hence, helping them to reposition themselves.<sup>57</sup>

While the staff pool is more general, the *exchange of service* is considered more specific and in reference to specific tasks. In this context, two or more banks can appoint specialists for certain tasks, e.g. legal issues, real estate valuation, human resources, accounting issues, etc. Participating primary banks would stay independent and agree to join forces in fields requiring expert knowledge.

## **6.2.4 External optimization**

### **6.2.4.1 Task transfer to external provider**

This measure refers to the transfer of tasks, activities and positions to an external company with regulation based on Service Level Agreements (SLA), leading to the reduction of staff. External providers in this context refer to companies that are either not part of the cooperative financial network or part of the network as specialists, i.e. no other primary banks are included. Next to economic considerations, there are additional regulatory requirements to comply with, i.e. section 25 Banking Act as well as section AT 8 Minimum Requirements for Risk Management require detailed organisation documentation. Research in this context has been conducted by Bausch/Behrends (2013) who also provides legal advice and benchmark contracts. It is pointed out that most of external outsourcing occurs with regard to payments and data processing. Other tasks, e.g. money laundering and market conformity checks, do find medium attention only, with Call Centres, Facility Management, IT and Data Security only at low attention.

Network representatives and specialists have stated that outsourcing has been discussed for many years, however, with only little progress being made (Handelsblatt, 5 May 2009). In the most recent study on outsourcing of cooperative banks, Aulinger/Hahne (2012) conducted a survey on 377 cooperative banks and

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<sup>57</sup> further aspects refer to the legal approval of this approach in accordance with the Arbeitnehmerüberlassungsgesetz (AÜG). Due to the temporary nature of this approach, it is not deemed to require additional regulatory approval.

confirmed that keeping processes in-house is by far the most dominant choice. It was also stated that there is currently no notable focus on core competences and other measures to optimize the value chain. Observations by this author as well as conclusions from interviews confirm this status. However, a dynamic development is notable. The willingness and readiness of cooperative has increased as a result of increased regulatory obligations. This refers especially to tasks that are not directly related to the bank operations and sales, i.e. to internal audit, legal services and IT. The on-going complexity of external regulation leads to enhanced requirements that local staff can hardly handle. Audit and legal companies can bridge this gap by providing specialist knowledge. With regard to bank operations, acceptance by primary banks will be difficult. As CEO1 stated:

*"Compliance with cooperative values is not achieved, when as many functions as possible are outsourced leaving the primary solely as a sales unit for network products".*

This author, however, believes that outsourcing of selected tasks is an economic necessity and also sees no problem with cooperative values. In fact and outlined in chapter 3, the cooperative value is defined as many people working together to achieve a certain goal. Outsourcing does match with this principle. Hence, there is also no issue in terms of challenging cooperative values.

#### **6.2.4.2 Set up of service centre**

Starting point for evaluating the practicability of outsourcing is an analysis of related project issues. In discussions with cooperative bank managers and other managers it has been identified that the most important con is giving up control, hence, increased dependence. Small and medium sized cooperative banks, regardless of their size, consider themselves as universal banks and, therefore, want to maintain all value chain elements as far as possible. Consequently, they also do not have experience from past transactions that they could build upon. Another issue to consider is the reputation of cooperative banks. As part of their community and regional orientation they put a premium on being a social employer. Outsourcing would lead to a



reduction of staff, either by laying off or transferring to the new entity. From a pure finance perspective, transaction costs as outlined by Williamson (1985) are to be considered. Given that there are no uniform standards with infrastructure to be set up on the green field, expected initial investments are expected to be high and considerable for primary banks in the short-term. One solution and recommendation to overcome these obstacles is to set up Regional Services Centres (RSC), in which certain tasks of member banks are bundled. Plans in this context have been discussed especially among the cooperative central institutions (e.g. DZ Bank, June 2013), however, have not been realised in total. The first pilot project was the creation of *Regional ServiceCenter VR-Banken Rhein-Main eG*, (Golembiewski/Pröber, 2010). According to their information (Regional ServiceCenter VR-Banken Rhein-Main eG, November 2013) they provide eight business segments, mainly Middle- and Back-Office activities, that currently 22 cooperative banks make use of. According to their own statements, they can achieve cost savings of up to 40% in a benchmark comparison. Since this is the exception, it is important to analyse the process of setting up a RSC in order to identify problems and challenges. In order to provide for structure, the analysis is approached from a strategic management process perspective, consisting of auditing, planning, implementing and operation.

*Auditing* deals with the questions: How do I find partner banks with similar thoughts? Where are these located? Who would be prepared to support in planning, implementing and operation? Given the regional orientation of cooperative banks, answers can be found in regional conferences and other regional associations.

When partners have been identified, the project needs advanced *planning*. At this stage, projects among partnering cooperative banks often fail. It has been observed, that cooperation fails not due to technical reasons, but rather emotional ones. Individual managers often have different ideas on how the project should look like, they have different ideas on how fast to realise the project, they realize late how much input is needed, they simply do not have the cultural maturity to deal with the issue, they lack the initial economic risk or they simply do not want to comply with a new rule set.

Even when primary bank managers have managed to agree on a project, challenges still do occur with regard to *implementation* when the intention is communicated to other stakeholders. Members of the supervisory board, often regional representatives or farmers with influence, often want to avoid being approached by other stakeholders and explain why there is a change that usually implies staff re-organisations. Also, customers directly might become suspicious since "their" cooperative bank changes due to reasons that cannot be easily comprehended.

Given, the project is still a go and the centre set up, challenges still prevail with regard to communication and management quality while *operating* the new RSC. Starting with the implementation phase, there must be a comprehensive change management where all stakeholders are included. Based on all observation, evidence points towards the necessity of a strong leadership. People at cooperative banks below management level have been identified to lack initiative, however, reactive to proposed change when communicated appropriately.

It is assumed that even though diversity is high among all cooperative banks, differences within individual federal states or regions will not be as high. The RSC would at least partly overcome the problem of dependence since staff and know-how would remain in the region and not transferred to a nationwide oriented servicer. In this context, it must be considered, however, that cost savings will not be as high with the RSC than with nationwide servicers due to scale effects.

While this author confirms that he has not had any practical experience with RSC, there are discussions being held with several banks regarding the design of a new target operation model (TOM), i.e. an auditing phase is currently on-going. In order to provide for structure and input for this research, the following preliminary checklist has been prepared. The checklist comprises several levels of information details and comprises information as well as documents that need to be gathered, analysed and processed.

**Table 33: RSC checklist**

A. Operating Model	A1	Vision and mission
	A2	Product and Service Portfolio
	A3	Process Model
	A4	IT
B. Legal and Organisational Structure	B1	Legal Form
	B2	Participation Model
	B3	Management
C. Sales and Marketing	C1	Pricing Model
	C2	Sales Concept
D. Organisation	D1	Location
	D2	Organisational Structure
	D3	Personnel
E. Transformation	E1	Project Management
	E2	Business Plan/Case
	E3	Network Support
	E4	Change Management/Communication

With regard to the overall cooperative banking model and giving the current economic and regulatory pressures, it is currently being discussed which core competences need to remain with the primary bank and which non-core competences can be transferred.

### **6.3 Sales and distribution strategies (KT3)**

#### **6.3.1 Trends and developments**

As many studies on retail banking point out, one of the most important factor deciding about future income streams is a balanced sales mix (e.g. Deloitte, 2013; Oliver Wyman, 2013). A customer satisfaction survey by marketing agency J.D. Power (2013) states: "Successful banks are not pushing customers out of the branch, but rather providing tools that make it easier to conduct their banking business when and where it is convenient for them. Customers are quickly adopting mobile banking, making it a critical service channel for banks, not just a 'nice to have' option." This situation requires every primary bank to reconsider the established branch sales channel by adding internet and mobile banking tools. However, the internet as potential only finds slow acknowledgement among the cooperative banking sector.

Former CEO of WGZ Bank, Werner Böhnke (2012), stated recently: "The cooperative banking network is not visibly present among the internet platforms, which is not considered a deficit by many bank managers. However, this is where the world has changed. Furthermore, web presence of the primary banks is highly heterogenic, not just in terms of their layout and styles, but in terms of their usability and quality of information provided".

A recent survey (Statista, 2012) found out that during the past 10 years the share of internet users in Germany has increased from 37% to 75%. In this context, age distribution has become surprisingly even, i.e. next to young people also people above the age of 60 years have become common users. Driver behind this development is the expectation to obtain good products, prices and conditions and compare them. This is also confirmed by a study by Deutsche Bank (2010) stating that 60% of all new contracts were compared prior to signing pointing to the *ROPO effect* (Research online, Purchase offline). The same study also highlights that there are 26 million Germans using online tool for their banking activities with products being sold online having increased by 60% since 2004. In a follow-up study by Deutsche Bank (2012), it was analysed that by 2030 nearly 44 million Germans will be using online tools.

It can be acknowledged that despite the changed customer behaviour, customer needs have been constant as expressed in spending money, saving and investing money and transferring money. The information and research intensity is determined by the customer itself due to the abundance of information available online. Important for banks in this context, next to identifying customer needs, is the fulfilment of customer expectations. In reference to a recent study by Bartmann et al. (2011), these are: financial success, being liquid, safety and individual advisory in terms of reliability and comfort.

### **6.3.2 Analysis of the current internet strategy**

As outlined above, the current internet strategy among primary banks can be regarded as highly granular. As part of this research, a thorough review of the

internet presence of the sample banks (see section 2.5.1) has been conducted confirming the statements by Böhnke (2012). It confirms also the statement by Martin (2011), pointing to the fact there are 1.138 individual cooperative direct banks locally available. On the one hand, it can be stated that all the banks actually had an internet presence. Bank size was not identified to be a factor for quality, i.e. many smaller banks in terms of total assets had surprisingly well developed internet presences. The overall strategy of being a strong partner for the region with the aim to provide bank information and services online does not seem to be applicable to explain this effect. However, the decentralized structure and business model allows for this effect. This effect is also congruent with this author's experience and observations during his practical work as an auditor and advisor, i.e. the rarely occurrence of innovative decision makers on the operational, i.e. not managerial, level. These employees do not just want to finish their daily work but think further and try to find better solutions. A study by Meyer (2011) refers to these employees as *proactive innovators*, who, however, have been identified to have problems with their superiors not being as innovative and not open to do things differently representing 80% of companies investigated.

Having a strong brand image has been identified to support a successful internet strategy. The study by Deutsche Bank (2010) highlighted that 73% of finance related search terms in relevant engines were directly connected with a brand name, e.g. Deutsche Bank or Volksbank indicating their orientation. This is deemed to support cooperative banks in the achievement of their strategy given the infrastructure is provided.

### **6.3.3 Challenges**

Even though not directly related to cooperative banks, a study by consulting company Bain & Company (2012) among 3.000 customers of larger banks in Germany found out that 40% of customers are not satisfied with their bank and lost trust due to a lack in personal advisory and bad service. Cooperative banks, however, can use the findings of this study to amend their strategy. Summarizing the findings from the customer satisfaction studies it can be derived that, in order to enhance trust

and satisfaction, banks need to have a differentiated and communicated customer value, innovative sales models with improved customer service quality as well as segment-oriented sales and product strategies. All these factors relate directly to the interface with customers, hence sales channels. Based on Porter's (1985) value chain analysis and practical application to the banking industry (Ernst & Young, 2013b) it is concluded that sales is the main differentiating characteristic among retail banks. Hence, the better the management of the customer interface, the better the bank's success.

### **6.3.3.1 Customer segmentation**

Bartman et al. (2011) in regard to retail banking state that different customer groups have different needs. Segmentation strategies that are based on gender or wealth alone do not sufficiently address current expectations. Lesson can be learned from food retailing. According to a recent study (Lebensmittel Praxis, 11 February 2011), customers choose discounters and premium supermarkets combined, either for daily use or special occasions. The same principles appear to be applicable to retail banking. Customers pick different partners for particular banking needs, e.g. a free current account from one established bank in addition to securities services from another. Hence, it must be the aim to deliver specific products and services to defined customer groups.

It is acknowledged by this author that the concept of customer segmentation is not new. Literature and research available on the issue of customer segments in retail banking has been identified to be vast. Most of the literature (and most relevant one) stems from consulting and advisory companies offering services in this regard with the support of IT based tools. Examples include Deloitte (2011), Ernst & Young (2010), PwC (2011), McKinsey (2012d) and Bain & Company (2012). In summary, all studies state that customer identification must be based on an income hierarchy, i.e. the most profitable customers shall receive the highest attention. One opportunity deemed important by this author is the development of strategies for less developed customer segments. Observing the development of banking institutions, especially in urban areas with high shares of migrants, it is noted that there are foreign banks that

offer tailored products for people with overseas ties. Examples include Chaabi Bank, Sekerbank or Ziraat Bank, setting up businesses in larger cities. These banks do predominantly attract certain customer nationalities. This represents an untapped potential, especially for smaller cooperative banks that can position themselves as niche provider.

It is argued by this author that the advanced techniques used by large consulting companies should not be considered as the holy grail of customer centricity. Most of the small and medium sized cooperative banks, being the centre of this research, do not have the necessary customer volume to allow for advanced methods, hence, advanced methods have not been prevailed. In addition, these banks do know their market and customers. However, they do not align internal process based on their expertise. This researcher, in the course of his professional work, concluded that most cooperative banks do business like 20 years ago. Since this cannot be disregarded it needs to be understood that, while it is essential in introduce segmentation, the approach must be straight forward and easy to comprehend. It is suggested that segments must be limited to a maximum of four in order to avoid complexity. Essential in this context is to overcome the issues that have been highlighted by several interview partners of this researcher:

- Cooperative bank staff does know their customers, i.e. they do have a strong insight into the customer situation. However, the level of insight decreases with the size of the bank, i.e. small banks do have a close tie, whereas bigger banks cannot maintain this close tie. Also, there is a common lack of initiative regarding on what criteria are segments are to be built around.
- Present IT systems do not enable enhanced segmentation or multi-channel-service.
- Bank staff does not have sufficient support to deal with new customer segments or data.

### 6.3.3.2 Development of sales channels

With regard to banks and cooperative banks in particular, sales channels can be distinguished between *branch* and *internet* only. A recent study (Eurogroup Consulting, 14 October 2013) on 1.250 banking clients found out that, by 2020, 48% of customers will use stationary branches exclusively for banking services, while 41% of customers opt for online services exclusively. The number of ROPO customers is expected to decrease from 30% to 10%. Mihm/Jacobs (2013) and Müller et al. (2013) derive at similar results. All studies point out that due to the increased complexity of financial products and need to provide for wealth solutions, the share of people asking for advisory services will increase. This applies especially to retirement benefit products, loans and securities. Online customers will focus on simple products, e.g. current accounts or savings contracts.

As outlined in section 4.3.2, the number of branches has decreases substantially over the past 10 years. The recent studies outlined above, in this author's opinion, do not consider this industry trend sufficiently. Even though the share of customers expected to use stationary branches, the number of branches MUST decrease, simply because of reducing costs to make up for income reductions.

*Physical* sales, in a future scenario, must, therefore, be approached from two levels to achieve branch network optimization. *One*, stationary branches must be consolidated. Upon focussing on less branches, the idea of the branch must be reconsidered. As outlined by PriceWaterhouseCoopers (2012b), banking must be considered by customers as an *experience*. This implies that branches need to be modernized and incorporate some sort of event character, e.g. a coffee bar. An interesting concept, which is also practically feasible for cooperative banks in Germany, has been introduced by US Umpqua Bank in 2010 (The Financial Brand, 18 January 2010) with their "*Neighborhood Store*". With low construction and running costs, these branches are designed to "provide people with an engaging space to browse local merchandise, shop online, enjoy a cup of coffee and learn about community events and resources - in addition to banking". In reference to consumer electronics or clothing manufacturers, there should be flag-ship branches that represent all brand



associations, being either the head office or another anchor (redesigned) branch. The branch network itself must be reconsidered from a location perspective. Physical branches in locations that are not profitable should be considered to be relocated or closed.

*Two*, enhanced considerations should be given to mobile sales forces. It is this author's observation with no empirical data available that there is only limited sales staff of cooperative banks that conducts business outside the regular branch network. With an increasing share of cooperative bank customers being over the age of 50 years and the cooperative mission to be locally available, this issue is expected to be particularly important in the future. Bank staff must be individually mobile, while visiting customers at their home as well as collectively mobile by bringing setting up mobile branches for customers groups, e.g. sending bank buses to provide service to several villages on certain days instead of maintaining costly stationary branches. While cooperative banks have not been identified to consider this approach, savings banks have been found to do so, e.g. Sparkasse Kiel (Kieler Nachrichten, 6 February 2013) and Kreissparkasse Köln (Remscheider General-Anzeiger, 4 September 2013).

Parallel to physical sales, *internet and social media* sales must be urgently pushed, i.e. an advanced internet strategy needs to be integrated into the overall strategy of each cooperative banks. While, as mentioned before, all cooperative banks do have an internet presence, there is no uniform design and generally low information on products and, especially, conditions and prices. Asking CEO2 for a reason behind this observation, it was stated:

*"We are a branch based bank. We do not publish all information online because we want to bring the people in the bank to make the advisory service more attractive".*

This author deems this approach as old-fashioned or outdated and insufficient giving today's need for being informed, e.g. via internet or social media. As outlined before, people want to be informed prior to going to the bank. Evaluating a feasible internet and social media strategy for cooperative banks, it must be clearly distinguished what

is possible and realistic. Being a national network of cooperative banks, the overall internet strategy needs to be defined, designed and implemented by the network. This refers especially to social media tools. Primary banks do not have the expertise and resources to deal with this aspect. As a network, the BVR has to react, with utmost priority, to introduce relevant banking tools that can be "personalized" down to each primary bank. According to a recent review (Wirtschaftswoche, 18 November 2013), the number of non-banks is expecting to radically expand over the next three years due to technical innovation that can be used by customers on the move. These innovations take into account the changed communication and banking behaviour of customers increasingly using Facebook or Twitter, hence, creating and using customer segments. What primary banks can and must do is to (a) extend their online information portfolio and (b) make use of internet services to get in touch with customers. With enhanced information on products, conditions, prices, personalized benefit and profitability calculation that can be linked with the automated creation of forms and linked to the primary bank advisor's calendar, customers will be in a comfortable situation when discussing details with advisors. Also, since customers do use branches less frequently, online video chats, e.g. via Skype, can be used to personally get in touch.

#### **6.3.4 Practical recommendations**

Sales and distribution, next to operational excellence, is regarded the most important strategic initiative in the short and medium term. During his employment, this author held several discussions with cooperative management staff dealing with this issue. Especially over the year 2013 a list with key points has been assembled that is discussed with management in order to provide for focus and initiate small-scale inhouse projects. This is grounded on this researcher's view that the present operational design of most cooperative banks is inadequate for current challenges.

- Enhance customer centricity by optimizing operating model
- Simplify products and enhance transparency
- Bring staff culture in line with new operating model
- Enhance customer insights and improve analytics
- Enhance messaging and branding

Experience indicates to introduce segments based on four principles that capture most criteria: *Convenience, Service Quality, Value* and *Safety*. Different customer groups typically have different preferences. While younger customers tend more towards convenience, more affluent and mature customers tend towards safety and service quality. In order to achieve profit improvements, it is required to introduce *soft prioritization*. As outlined before, cooperative banks are not run like a high-street private bank. Cooperative banks are for all people and they cannot take the risk of becoming unpopular. However, an enhanced focus on affluent customers with more investments into training and skills is deemed crucial.

## **6.4 Concentration and mergers (KT4)**

### **6.4.1 Relevant theory: A wrap up**

While asset and liability management refers predominantly to profitability, mergers, in this research, are considered a means to achieve efficiency. The review of existing literature in this context has resulted in the identification of several performance studies. Eekhoff (2004) in his survey among 86 merged cooperative banks figured that 72% of respective cooperative managers and 49% of staff regarded the merger as a success, however, pointed to the notion that higher ratios would have been possible with better merger management. Theurl (2004), looking at 86 banks, investigated mergers between 1995 and 2002, highlighted obstacles on an operational level and provided insights on how people involved evaluate the process. Koetter (2005), looking at 1.417 cooperative and savings banks mergers, concluded that mergers will result in economic enhancements when there is a merger of equals. In this regard, 50% of mergers were defined as successful, while efficiently compared to non-merged banks differed only slightly by ap. 1%.

Pfaffenberger (2007) in his survey among 29 merged primary banks concluded that a merger is to be regarded as ultima ratio given the problems with combining different corporate cultures. A merger should be considered, however, after having excluded other cooperation models. Auerbach (2009) in his analysis of 1.456 mergers among cooperative banks concluded that, in the long term, merged banks performed slightly worse in terms of costs and profit than their non-merged peers. Spandau (2010), from an academic perspective and looking primarily at motivational theories and differences in performance indicators, concluded that a proper value chain analysis needs to be conducted prior to every merger and that alternatives, such as regional platforms, should be considered.

All of these studies do not incorporate the impact of Basel III. This author argues that mergers, despite their mixed success in the past, need to be considered in order to improve efficiency and make up for expected profitability shortfalls.

In summary, research and studies indicate an improvement in efficiency in the medium-term. This can be explained by size effects, i.e. since merged banks are usually small-sized, merger integration occurs faster with synergies achieved faster and better. In the same context, Auerbach (2009) identified even larger effects at savings banks, which could even outperform cooperative banks in terms of merger success as measured in profitability.

#### **6.4.2 Merger motives**

From an economic perspective, the main drivers behind mergers are usually the realization of efficiency and scale effects, which are usually referred to as *synergies*. Ansoff (1987) describes synergy as an effect in which "the combined return on investment of firm is higher than the return which would result if each division (or strategic business unit) operated without taking advantage of sharing and complementarity".

From the perspectives of cooperative banks in particular, drivers behind mergers can be aggregated in four categories. The categorization is based on Pfaffenberg (2007) and amended by this author.

- First, there is value maximising motives, e.g. economies of scale, economies of scope and cost reductions. While profit maximization is not envisaged, it still is regarded essential as to maintaining competitiveness. Next to cost reductions, it is also possible to achieve additional income stemming from bigger size since larger customers can be approached with additional products and services.
- Second, there are non-value maximising motives, e.g. personal, monetary or status related reasons of bank management.
- Third, there is the willingness to avoid insolvency ("distressed merger"), being the main driver behind previous mergers (Elsas, 2004).
- Fourth, there is the need to comply with Basel III or CRD IV. In this regard, Uwe Fröhlich, President of the BVR (Handelsblatt, 9 July 2013) stated that he expects the number of mergers to increase to about 40 by year-end 2013 compared to 20 by year-end 2012.

### **6.4.3 Identification of possible partners**

Spill (2007) concluded that the right partner is the most important factor for merger success. With regard to cooperative bank, there are two system inherent factors that need to be considered: First, there is the regional principle that limits potential partners to neighbouring cooperative banks. Second, due to being part of the cooperative financial network, it is legally not possible to merge with other banks than cooperative banks.

In addition to the inherent factors, it is important to point to personal reasons among decision makers involved, i.e. bank managers. Pfaffenberger (2007) argued that many bank managers lack necessary diligence due to personal preferences. On the other

hand, it is this author's experience that a number of mergers do not take place due to personal differences among managers involved.

#### **6.4.4 Conclusions and Challenges**

This author has conducted several interviews with bank managers and other executives during the course of his professional work in the financial years 2011-2013. Discussions were held on a semi-annual basis with five cooperative banks with total assets of up to EUR 300 million and stable economic condition. The particular issue of merger and other cooperation was addressed in a formal way why analysing the economic condition as part of the quarterly reviews. This approach helped to identify if the mindset changed over time. With regard to the banks analysed and observed, it has been concluded, that the merger process is still not a priority on the agenda, hence, confirming previous findings. Independence is the most decisive factor. In order to further verify this preliminary conclusion, additional research has been conducted by analysing a sample of eight mergers that have occurred in 2013. The BVR does not publish on-going information regarding number of mergers, hence, data was gathered via other sources, i.e. websites of regional networks and individual cooperative bank websites<sup>58</sup>. Given that there were 20 mergers in total 2012, coverage is expected to be sufficient. While it was not envisaged to conduct enhanced quantitative analyses of the economic situation, the major aim and focus was to identify benchmarks, features, trends and parallels. With one cooperative bank manager, an unstructured interview was held during a seminar on bank strategic management organized by Duisburg University on 18 September 2013<sup>59</sup>.

The analysis of the eight banks indicated that there were no urging economic reasons, i.e. all banks have not been making losses, hence, ruling out the option of economic necessity. Yet, with all banks it could be observed that income stagnated despite asset growth between 3%-5%. It could also be observed that, with the exception of one bank with total assets of EUR 180 million, all other banks posted total assets >EUR 400 million. There is an indication that banks with higher asset

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<sup>58</sup> see [www.rwgV.de](http://www.rwgV.de) being the largest cooperative network, which included three mergers.

<sup>59</sup> see [www.ecfs.de](http://www.ecfs.de) "Banken-Symposium 2013"

volumes show higher readiness and willingness towards mergers than smaller ones. From the merger announcements and feedback from the interview partner it can be concluded that these banks have indeed reacted to the on-going pressure:

*"With the merger, two healthy institutions came together. We aim to achieve scale effects, increase competitiveness and, hence, secure the long-term economic existence of the two entities involved. What we also deem important is that no employee will be laid off in the process. On the contrary, we will offer better development opportunity due to higher volume and a wider operational radius".*

From the findings and own experience, the following recommendations can be drawn:

#### *Objective review: Due Diligence*

In order to achieve an efficient merger process, merger preparation needs to be allocated sufficient time for the analysis of processes, cultures and the "strategic fit", i.e. there needs to be a sufficient Due Diligence that represents the basis for synergy identification. It has to be considered that even though there is a common value understanding among cooperative banks, processes and cultures differ significantly. As one bank representative pointed out:

*"People always see cooperative banks as one bank. Mainly due to our network strategy, the same logo, etc. What people do not see is that we are more than 1.000 different banks. We want to be different and independent. That is part of our local market approach. And if we do things differently here than in neighbouring banks than this is because we think we address things in a more appropriate way."*

Next to the strategic fit, a proper analysis also includes a thorough review of financial accounts. A merger must contribute, at least on paper and in advance, to improvements in terms of efficiency or profitability (McDonagh Bengtsson, 1992).

From a practical point of view, this raises the question how this objective review can be carried out. In this author's opinion, there are three options available. First, the regional audit networks can provide advisory services. However, representatives of regional audit networks are determined by the managers of the primary banks, this leaves doubts regarding independence. Secondly, the BRV as a national network can provide advisory service assuming there is more independence. It should be considered to set up a tool kit that can be used by primary banks to evaluate options. Thirdly, external advisors and accountants can provide advisory. Compared to the first two options, this is deemed the most favourable option since not only objectivity is the highest, but also there would be specialized advisory expertise with regard to merger management and integration. Köppel et al. (2011) also point to the fact that external advisors provide for more acceptance among bank managers involved and also lead to better knowledge transfer with regard to necessary post-merger processes. In this context, Theurl (2004) pointed out that 56% of bank mergers analysed were conducted without the support of external advisors.

#### *Customer base analysis*

Ex-post investigations of mergers have often revealed that the new customer base is less than the combined old ones (Pfaffenberger, 2007). Customers, especially commercial ones, want to diversify their bank relationship, hence, increasing independence, what could lead to the outflow of profitable business. On the other hand, banks themselves want to reduce certain business activities due to new concentration risks.

From a practical perspective, this implies to carry out analyses on two levels. First, there must be an analysis of existing customers in order to find out who is profitable and, hence, needs to be addressed to remain customer of the merged bank. In a recent study by consulting company Roland Berger (Oppenberger, 13 November 2013) it was pointed out that most banks do not sufficiently exploit tools for data mining and customer relationship management, hence, lack the necessary data quality to support sales initiatives. The second level refers to winning back customers, which, according to this author's findings and experience, has not found the necessary



attention among banks yet. As outlined in chapter 4, near-banks and other direct banks are increasingly becoming popular making numerous customers leave existing bank relationships in the past. A merger offers a unique opportunity to increase the knowledge on customers lost and prepare for a comprehensive effort on presenting the former bank as something bigger, better and more suitable. Studies with regard to marketing in this field figured out that efforts regarding winning back customers have been a taboo among banks, yet, find more attention (Schüller, 2007; Greve, 2010). Given the intense competition, this issue has been discussed by this author with several bank managers. One finding that has been gathered is that there have been in fact no further initiatives once a customer has left the bank, hence, previous findings can be confirmed. In the search for excellence, this issue needs to be approached thoroughly when having in mind the *regional principle* outlined before. The number of customers in each region is rather stable or decreasing, i.e. the regional orientation is limited. In other words, cooperative banks must make the best of their market. In early 2014, therefore, a small scale project was discussed with bank managers in order to approach this topic that comprised the following steps:

- Identification of lost customers
- Installation of an early warning system
- Reasons for leaving the bank
- Customer segmentation (in reference to section 6.3.3)
- Development of Come Back products
- Fast timing and personal talks
- Control and Prevention

In the follow up to this small scale project in May 2014, it was concluded that field study banks have addressed this issue thoroughly and dealt with every step, i.e. the taboo could be broken by dealing with the issue in an open way. While it is still too early to present quantitative findings, it can be confirmed that several customers, especially affluent ones, have signalled interest in coming back to the bank especially due to the possibility of personal service.

## *Incentive*

The previous studies outline above highlight that most mergers have occurred among cooperative banks with economic problems, referred to as distressed mergers.

Cooperative banks that are in good economic shape have vastly not been observed to enter in mergers. Updated findings by this researcher point to a different development which is also assumed to be the result of an overall economic improvement with better risk results. The biggest challenge will be to convince the economically stronger cooperative banks to take on partners that are weaker while not disappointing existing members in terms of risk and profitability.

From a practical perspective, this author has not identified options for a comprehensive operational approach. There is, of course, institutional support of the cooperative protection scheme, which, depending on compliance with certain covenants, can provide guarantees and capital (Hartmann-Wendels, 2011). While this helps balancing out increased risk levels, it does not balance future profit levels and income for members. Combining two corporate values alone with pro rata ownership of former members will not lead to sufficient incentives. Sound profits of bigger banks will be diluted with weaker profits or even losses, leaving former members worse off. The only practical alternative is to clearly and rigorously approach the problem issues of the (supposedly) weaker and smaller bank. This author argues for strict cost cutting measures within the weaker bank, which need to be communicated by a strong merger manager, preferably the manager of the stronger bank. This might include the closure of branches and consecutive lay-off of staff. It must become obvious that the merger is inevitable and requires *good medicine, which usually tastes bitter* (Chinese idiom). It is acknowledged that this might not fully comply with cooperative values. However, due to expected development unpopular measures need to be considered and taken in order to provide for the sustained existence of the overall cooperative banking system.

The current economic climate fosters an improved merger climate. This research has identified several banks and factors that do show that mergers can be carried out before economic situation turns negative. Even though not empirically analysed as

part of this research, it can be assumed that, due to the regulatory impact and latest economic development, these mergers will be successful in sense of, at least, not posting a worse economic development than on a stand-alone basis.

## **6.5 Summary and conclusion**

It was this researcher's aim to identify the impact of the new regulatory framework Basel III on cooperative banks. The aim was based on the assumption that cooperative banks will struggle with the new requirements. In addition, it was aimed to identify responsive actions in terms of operations and strategy.

Having waited until 2014 for respective empirical data in reference to the financial performance in 2013, 2012 and 2011 (see chapter 4), evidence could be provided on an aggregated level indicating that there were no major adjustments on a sector level, i.e. with reference to the most significant item of dispute, the section 340f Commercial Act reserve, no material movement was identified. This is opposed to the savings bank sector that reclassified EUR 9 billion in section 340f Commercial Act reserves to section 340g Commercial Act reserve, indicating the lower tier 1 capital level of savings banks. The overall conclusion is that cooperative banks are already well capitalized and, with reference to the new capital requirements, are in no need to conduct major equity restructuring. This is the positive consequence since it has been identified that equity restructuring potential is low given the static business model and required compliance with cooperative principles such as being regionally available and being "partner" without pure profit orientation.

A major aim was also to bring in more quantitative methods in the regulatory adherence process. A model was designed and envisaged to be proofed in practice as a tool suitable for regulatory compliance. Evidence gathered in the course of designing the model confirmed that once the formal regulatory requirements are laid out, simulation of future performance can be achieved straight forward. Also, giving the incorporation of scenarios it is possible to test sensitivities to provide for vital impulses regarding the direction of future business activities, i.e. the optimization of asset composition.

It has been identified that *formal* fulfilment of the Basel III standards will not require cooperative banks to conduct major adjustment. Basel III will, nevertheless, pose a challenge for cooperative banks in terms of *technical* fulfilment. Banks and cooperative banks need to implement new technical infrastructure and know-how that will require financial resources. A recent study by KPMG (2013) calculated the implementation costs to be EUR 9 billion between 2013 and 2015, which need to be covered by cooperative banks as well. In connection with the most influential factor, being the low and decreasing interest level, further measures are required to maintain performance.

With regard to the identification of potential responsive actions, preliminary evidence points to a hierarchy of required measures discussed. Evidence suggests that the internal mindset and orientation of primary banks is still characterized by independence, i.e. collaboration with other (network) partners occurs only as long as there is no influence on local decision-making. Hence, in the short-term, internal optimization is the only realistic option applicable to all cooperative banks. Possible measures for cooperative banks in terms of sales and distribution have been identified, yet, evidence suggests that banks do not have a coherent approach to go new ways. It can be observed that this lack of willingness increases the more rural cooperative banks are. Evidence for an enhanced awareness towards external optimization and concentration or mergers could not be found, hence, confirming the internal orientation. The most important conclusion from the findings is the need to create urgency to change by focussing of issues and trends (market and regulatory forces) that will be identified and analysed in chapter 7.

As final consideration it can be stated that there is need for strategic and operational measures in order to maintain sustainable performance. The driver behind this pressure is, however, not considered to be Basel III, but rather the overall competitive situation and network imminent cost structures. Even though slow progress is being made towards performance improvement, it could be observed that local bank managers are open for ideas. Numerous ideas, concepts and approaches have been discussed with local management. While some of the ideas are

progressing, this researcher considered the details to be too preliminary and confidential to be included. It has been concluded that local staff usually does not know how to deal with given challenges. Evidence suggests a stricter and more comprehensive local management process with not only performance management, but also better performance measurement. The overall management process is, of course, known to this researcher with the limitation that he is not involved in the actual process. It is, therefore, required to deeper analyse the strategic management process in cooperative banks to further the mechanism. This needs to be paired with tools that can be implemented in regard to short-term measures in order to provide for fast improvements. Relevant analyses and conclusions are presented in chapter 7 and chapter 8.

In connection with the organisation of the cooperative financial network as analysed in chapter 5, it has also been concluded that there is need for a central consulting unit within the network. During the course of this research, this researcher concluded that most strategic input came from individual seminars at relevant off-site locations. Deemed highly beneficial in terms of quality, there is the clear lack of bringing this human expertise to the primary bank in the field. Giving the number of primary banks and volume of initiatives to undertake, the need for bringing in external expertise has been concluded.

Reflecting the issue of tangible and intangible assets as outlined in section 3.2.2.4, most potential to improve performance indeed can be derived from intangible assets. It is the interaction between intangibles being first and tangibles being second that have been found to benefit the value creation process the most. As a matter of fact, the optimization of intangibles is the considered the only option to improve value creation since tangible assets, being capital and funds, are subject to higher limitations due to Basel III.

## **Theme Three: Strategy**

*"If you don't know where you are going, you will end up somewhere else."*

(David Campbell)

Theme Three investigates and further analyses the strategic management process within the cooperative banking sector by means of a survey and specially designed questionnaire in order to further elaborate on previous findings and provide for further transparency in this still relatively unknown field. In a second step, the findings are applied within the scope of a field or longitudinal study. In particular, it is envisaged to transfer findings with regard to the testing of the BSC as a tool for strategy change in order to enhance short- and medium-term performance.

## 7. Strategic Management Process in Cooperative Banks

Chapter 7 is an in-depth analysis of the strategy process of cooperative banks in Germany. It aims to analyse the *Status Quo* by means of a questionnaire and survey in order to identify potential reform needs, possible options and interconnections, which are aggregated in a tailor-made Balanced Scorecard for a cooperative bank. Hence, the following topics are discussed and evaluated:

- Section 7.1 describes the strategy management process and combines strategy with regulatory requirements in this context. Based on this, the strategy management approach as conducted and induced by the cooperative network is described and analysed in order to understand the division of tasks envisaged.
- Section 7.2 describes the approach undertaken to conduct the survey, i.e. it outlines the design as well as reception of the questionnaire among cooperative banks.
- Section 7.3 highlights the results from the survey as aggregated in the sections analysis, choice and implementation. This is followed by the identification of **potentials**, i.e. opportunities open to cooperative banks to improve the strategy process.

## 7.1 Applicable theory: Strategic Management

### 7.1.1 Relevant components

The recent crises have shown that banks had invested too little time in the strategic management process and, therefore, were at risk of not understanding the changing environment completely. Especially in the light of Basel III, leading to lower revenues and higher costs, high attention is necessary to achieve sustainable income. In addition, banks have been found to lack necessary controlling instruments in order to provide for a solid basis when decisions are to be made, resulting in a situation where banks make wrong decisions, make decisions too late or make no decisions at all. One finding from this researcher was that this finding still holds in today's banking world, especially when cooperative banks are concerned that lack necessary resources and considers strategic and controlling instruments as luxury. CEO-2 stated:

*"In principle, cooperative banks have many advantages like being near and present in the market and the opportunity to achieve scale effects via the transfer of standard products to network entities. However, those opportunities are not used sufficient. Also, there is a lack of management concepts and market potentials are not exploited".*

As outlined in the analysis of the German banking sector in chapter 4, there is a high number of banks and cooperative banks in particular with a level of income being low and lower than of other European financial sectors. Besides, authors over time have attributed the neglected strategy process as one driver behind this development (e.g. Neumann, 2003; Deloitte, 2009). The focus was on operational issue, i.e. to put it simply, the handling of transactions of the daily business that occurred basically without specific acquisition efforts. Even though this handling comprised most of the resources, the actual doing is usually regarded to be inefficient. Authors have compared the operational development of banks and industrial companies and concluded that banks lack way behind their industrial counterparts (e.g. Deloitte, 2009). Often it is not known which individual costs contribute to overall product



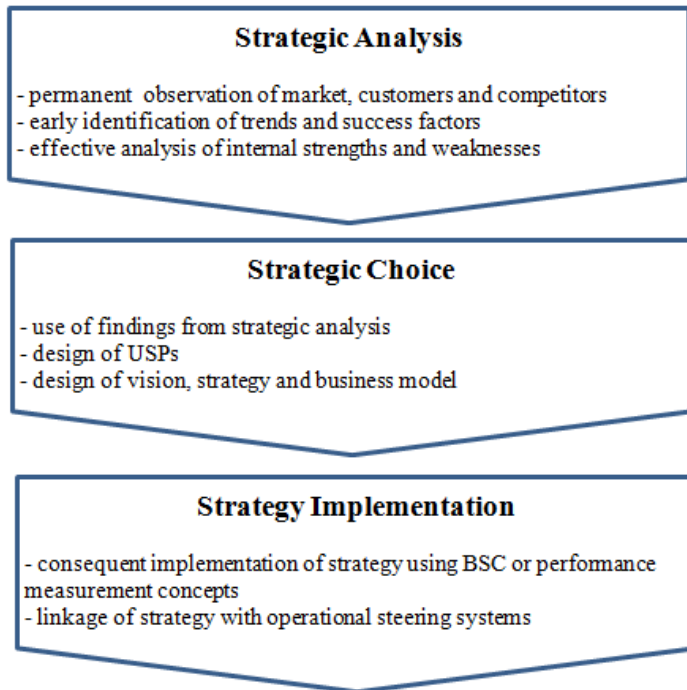
costs making it virtually impossible to provide for an effective decision making basis.

Bringing the approach into a management context, reference is made to the work of Porter (1996). Cooperative banks' approach is to look at their operations that have been implemented a long time ago and try to make them better giving their regional focus. Studies also showed that *operational excellence* is regarded the most decisive factor in setting competitive strategies (Horvath & Partner, 2011). Strategy theory, however, has been further developed. Porter (1996) stated: "While operational effectiveness is about achieving excellence in individual activities or functions, strategy is about combining activities". While stating that operational excellence is necessary, Porter (1996) states that it is not a strategy and not sufficient to sustain a competitive advantage. Necessary is a winning strategy that sets a company apart from its competitors.

Chapter 4 highlighted the good income situation of several banking groups in Germany that have a similar banking model as cooperative banks and drivers for this development. The before mentioned study by Horvath & Partner (2011) also pointed out to the fact that these companies, among others, have incorporated a thorough strategy process that enables them to react quickly. It is, therefore, essential for cooperative banks not only to further push operational excellence, but rather implement a concept to achieve *strategic excellence*.

The aim of this Project is to analyse this process, benchmark it and summarize it in a concept that assists cooperative bank managers in designing future direction. It is grounded on the strategic management process as, for example discussed by Johnson/Scholes (1993), who refer to it as consisting of three elements, being *strategic analysis*, in which "the people in charge seek to understand the strategic position of the organisation", *strategic choice*, which is to do "with the formulation of possible courses of action, their evaluation and the choice between them", and *strategy implementation*, which "is concerned with planning how the choice of strategy can be put into effect and managing the changes required".

Figure 51: Strategic management process



Source: Johnson/Scholes (1993) and adjusted by the author

### 7.1.2 Strategic management and regulatory requirements

Next to management theory, that emphasises the need for a structured approach, regulatory bodies also require banks to come set up necessary steps. The Minimum Requirements for Risk Management by the BaFin<sup>60</sup> demand the following as outlined in section AT 4.2 Strategies:

"The management board has to define a business strategy and a consistent risk strategy. ... The management board has to review the strategies at least once per year and adjust them as appropriate. ....The content of the risk strategy as well as any amendments thereto, together with the business strategy where appropriate, have to be communicated in a suitable manner within the institution".

According to this researcher's experience as an auditor of small and medium-sized banks, there is a considerable lack in compliance with the regulator requirement as

<sup>60</sup> Legal requirement retrieved online under [www.bafin.de](http://www.bafin.de)

stated above. This is confirmed by published summaries by the BaFin, which state that "strategic plans are documented in several papers that show no common direction", ".....there are no sufficient instruments to control strategic targets as agreed upon" or ".....it is not clear, which products are deemed relevant to achieve financial targets agreed upon" (BaFin, 2010).

### **7.1.3 Strategic approach in the cooperative network**

Due to the changing environment, the need to adjust the business strategy has been acknowledged by cooperative banks as well as the BVR. In 1999, the BVR initiated a study on the strategy of the network that was finally documented in report "Bündelung der Kräfte" in 2001 (BVR, 2001) and approved by the majority of individual cooperative banks. The overall aim was to "to better exploit the market potential of the network, to improve cost structures in order to secure and enhance performance and to create a commonly agreed and efficient risk management"<sup>61</sup>. The entire concept is based on the vision to provide universal banking services to all members and customers. Even though more than ten years old, the report laid out the long-term vision and direction the cooperative sector has to evolve towards, which is still frequently referred to by cooperative network executives (Fröhlich, 2009). The milestones can be summarized as follows:

#### *Strategy of the cooperative banking sector*

The cooperative bank sector in total shall maintain its decentralized structure with legally and economically independent primary banks. However, for a better strategic alignment and a better division of labour in the network it is necessary that primary banks abandon some of their decision making competences. These are delegated to a centralized entity. By doing so it is intended to further develop the cooperative financial network into a strategic network. The centralized entity equipped with control competencies as well as sanctioning competencies is usually referred to as *focal organization*, which is also responsible for maintaining the reputation of the network (Kring, 2002).

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<sup>61</sup> translated from German by the author, since no English version available

### *Strategy of primary banks*

The individual cooperative banks shall position themselves as local or regional financial service providers that offer products to all private and commercial customers. This approach can be referred to Porter's (1996) niche strategy with the focus on a regionally limited market. Cooperative banks shall maintain their status as universal banks by providing products and services as part of a multi-channel distribution. The production depth is to be reassessed from an efficiency perspective with activities regarding product development, back office and administration to be transferred to centralized entities of the network as far as possible. Also, primary banks have to achieve a certain minimum size or business volume in order to fully meet their market responsibility.

### *Strategy of the central banks, network companies and processing hubs*

Central banks, next to providing central bank services, shall directly engage in the market, thereby limiting the scope of activities by primary banks. To achieve this, new communication and information channels are to be implemented. The same shall apply to network companies, i.e. the direct engagement into the market without primary banks as intermediaries. Processing hubs shall intensify their work with the primary banks in order to better align their services to the needs and identify synergies.

Giving different markets, customer groups and member structures, the direction of the BVR needs to be regarded with care. Also, even though the suggestions make sense from an economic perspective, it is up to primary banks' will and ability to enforce these. The financial years up to 2007 did not put enough pressure on primary banks to fully comply with the suggestions. However, the changes in the banking industry over the past five years and Basel III have reignited the need for action. This background gave reason to re-examine the strategic management process of cooperative banks in Germany.

The key question, which arise from the approach outlined above, is to what extent this poses problems and barriers to the strategic formulation and implementation among primary banks in terms of scale and scope. This discussion can be aggregated on three levels.

First, there is the Cooperative Act and cooperative values. As outlined, due to regional principle cooperative banks are limited in terms of action radius. Every strategy needs to be compliant with cooperative values and BVR requirements setting out the strategic cornerstones of the network. It also needs to be ensured that all services and products are backed up by support from network partners, e.g. in terms of IT or staff training, even though no formal sign-off process is in place.

Second and giving the limitation of the first level, local cooperative banks are flexible in terms of to what degree they engage in businesses. Strategy setters are expected to engage in prudent activities that provide for a stable and low-risk performance. In this course, local or regional specialties are to be considered. In connection with the first level this also means that in case local or regional circumstances do not provide for sufficient volume or income, certain initiatives by the network do not need to be followed.

Third, cooperative banks, as every bank in Germany, is required to comply with the Minimum Requirements for Risk Management (MaRisk) as imposed by the BaFin<sup>62</sup>. Section AT 4.2 MaRisk defines requirements that every banks needs to comply with in terms of strategies (see Appendix 10.4 for a translation). This also comprises the legal responsibility of the bank's management board to set up the strategy process in order to derive at a business strategy and risk strategy. Legal compliance is audited annually by statutory network auditors.

It is the above mentioned third level that kind of counteracts with cooperative principles. It solely focuses responsibilities to the management board, which means that cooperation with other cooperative banks is not possible. Due to the subsidiarity principle and attitude by local bank managers, this is also not envisaged by them.

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<sup>62</sup> [http://www.bafin.de/SharedDocs/Downloads/EN/Rundschreiben/dl\\_rs\\_1210\\_ba\\_marisk.html](http://www.bafin.de/SharedDocs/Downloads/EN/Rundschreiben/dl_rs_1210_ba_marisk.html)

## 7.2 Structure of the survey

Upon describing the theoretical background of this research project, it is described how the survey was developed the way it is and how the return rate turned out. The original questionnaire is attached as Appendix 10.3.

### 7.2.1 Survey design

The structure of the survey basically follows the strategic management process as outlined below, i.e. there are three phases being analysis, choice and implementation. Individual questions partly followed issues raised by Kring (2002). In terms of weighting of the individual elements, the focus was set on analysis and implementation. The rationale behind this is that strategic choice is predominantly dictated by the overall cooperative banking model. In contrast, the strategic analysis and implementation is characterized by numerous individual factors and surroundings that need to be identified individually.

The questions regarding strategic *analysis* have been discussed with CEO-1. Assistance and support was provided to cluster the questions, i.e. during a brainstorming session the most important and relevant codes were fixed with subsequent questions designed by the author. This approach was deemed to provide the best cover of the most pressing trends and to ensure that the overall research aim is met. The same logic applies to *choice* and *implementation*. Both elements refer to individual actions of primary banks. Due to this, questions and issues have been discussed with CEO-2 and CEO-3.

The questions regarding strategic *analysis* aim to identify the degree to which primary banks have adapted a structured approach to information collection, the usage intensity, the use of trends as discussed by the BVR and their assessment of internal capabilities. By combining the findings with questions regarding the use of the data collected, the aim of this research is to derive at conclusions on the way cooperative bank set their strategic direction by way of make a strategic *choice*. The definition of USPs is deemed a vital step.

Next to setting appropriate strategic direction, the challenge for bank managers is to put the direction into practice. A common feature of failed strategies was the fact that problems and issues during the implementation had been underestimated in the concept phase (see chapter 6). The aim of this research is to provide depth in how strategies are usually communicated within the primary bank, which structures are used for it and which performance indicators are used for measuring progress.

In order to provide a better ground for comparison, bank statistic data and data regarding their competitive situation and economic environment were asked.

### **7.2.2 Return rate**

Achieving a sufficient sample, this author followed a two-step approach making use of the privileged situation of being in professional full-time employment.

*First*, return rate was accelerated by applying data collection method that his professional employer supports (*direct contact*). Working together with a small number of Universities in Germany with specialised departments for Auditing and Taxation, this author regularly participates in survey and case studies that are handed out and explained by University representatives in between internal seminars lasting about 30 minutes. Between June 2012 and June 2013, this author used four workshops organized by his employer to hand out the questionnaire to the participants.

*Second*, the questionnaire was sent to the 115 banks described in section 2.4.2.3, i.e. to their respective managers and executives (*postal contact*). Given that the 115 banks comprised total assets between EUR 200 million and EUR 500 million, two of the 115 banks were filtered out since already covered via direct contact. Thus, from the 113 questionnaires finally sent out, a total of 47 were sent back, representing a high response rate of 41,6%.

Excluding participants from the savings bank and private bank sector as well as double-counts, the following return can be summarized:

Total assets in €m	Response (direct)*	Response (postal)	Total response	Total banks**	Response in %
<50	4	-	4	52	7,7
50 - 100	19	-	19	121	15,7
100 - 250	15	29	44	277	15,9
250 - 500	3	18	21	251	8,4
Total	41	47	88	701	12,6

\*excluding participants from savings banks and private banks as well double-counts

\*\*see section 3.2.2 for data per December 2012

Overall, cooperative banks with smaller asset size are more represented and show higher participation. The majority of participating banks are from rural regions (89%). In total, the sample distribution represents a good match with the total distribution of the cooperative sector. The relative response rate of 12,6% or absolute response of 88 with regard to the focus banks, i.e. cooperative banks with assets up to EUR 500 million, is deemed sufficient by this author to answer the designed research question. In regard to Cochran's (1977) formula and applying a confidence level of 95% and confidence interval of 10% (regarded as the maximum error acceptable by this author), the calculated minimum sample of 85 is achieved.

### 7.3 Survey Findings

The findings from the survey are presented in the following sections. The scope of the survey did not allow to address all questions equally in this work. The focus was to present questions with the most relevant connection to the research objective. With regard to the question, relative or absolute values are analysed and evaluated. The presentation of findings is based on the following structure:

- a) Motive of the question
- b) Formulation of a hypothesis with related validity to be evaluated with the survey
- c) Presentation of results
- d) Conclusion



### 7.3.1 Strategic analysis in cooperative banks

In this phase, the information basis for future bank direction is to be established. All collected and analysed data shall help to avoid "gut decisions" and make the decision making process more formalized. A broad information basis will also help reduce the risk of making wrong decisions. It is assumed that data collection follows the economic principle, i.e. data is collected as long as the expected benefit exceeds costs of data collection.

Starting point of each strategic consideration are the overriding aims and values of the bank. Academic literature typically distinguished between the following elements (Johnson/Scholes, 1993):

- a) Analysing the environment
- b) Analysing resources and strategic capability
- c) Culture and stakeholder expectations

In the course of the survey it was deemed relevant which elements are considered important, which methods and instruments are used and what the intensity of strategic analysis is.

#### 7.3.1.1 Trends

Question 1 deals with the overall trends that influence cooperative banks' business operations.

<b>Question 1a:</b>	<b>Trends</b>
<b>How do you evaluate the importance of the following macro criteria when deciding upon the future strategic direction of your bank?</b>	

<b>Question 1b:</b>	<b>Trends</b>
<b>Elaborating more on the macro criteria above, which specific elements do you consider most important for your future business? (5 = positive impact; 1 = negative impact)</b>	

#### a) Motive

Question 1 is set up into two parts. The motive of question 1a is to find out the influence of the overall framework and general conditions on the Strategy Setting Process. As outlined in previous sections, the financial sector is undergoing a fast changing processing with changes coming from various drivers. Being a cornerstone of this research, legal/regulatory changes (Basel III) are the major topic among banks these days with regard to their business models. Equally intensive are discussions with regard to the overall economic situation in Germany and the influence on the domestic interest level. Technological challenges stem from the rapid development of IT related banking services that are not only required and expected from customers but also present opportunities in terms of sales. Social changes stem from the perceived trend of people moving towards urban areas, hence influencing especially the business model of *Raiffeisenbanken* being predominantly in rural areas.

Question 1b, building upon the aggregate level of question 1a, aims at elaborating further on specific drivers behind the general conditions in order to pinpoint individual factors of utmost important.

#### b) Hypothesis

Based on the preliminary thoughts it is expected that cooperative banks place a premium on the importance and influence of the general conditions while analysing the current situation and deciding upon future direction. Furthermore, it is expected that, given the recent level of discussion, Basel III related issues are of utmost importance in the strategy setting process.

#### c) Results

As can be taken from the table below regarding question 1a, cooperative banks mostly deem economic and legal/regulatory changes important.

	5	4	3	2	1
Legal/Regulatory changes (Basel III)	31%	37%	16%	10%	6%
Economic changes	37%	42%	13%	7%	1%
Technological changes	19%	49%	25%	7%	1%
Social changes	10%	39%	40%	9%	1%

Changes with regard to economic issues are important to 79% of cooperative banks, followed by 68% regarding changes regarding legal/regulatory changes.

With regard to question 1b it can be taken that the most important single factor regarding *economic changes* with 53% is the money market policy of the ECB being responsible for the overall interest level. Building upon question 1a this is coherent with expectations. Cooperative banks' business model is focused on interest income, hence, the current low interest level is of utmost concern. Also interesting was the fact that 52% of banks expect the overall economic situation in Germany to have a negative impact on their success indicating their negative outlook despite the currently still beneficial situation. Regarding *legal changes*, a total of 65% expects a negative impact stemming from conduct duties<sup>63</sup>. 62% consider the results from external test services as important, which can be linked to conduct duties. Both aspects confirm that cooperative banks follow the overall strategic direction of the BVR to become quality leader. Surprisingly, both aspects of Basel III, being equity requirements and liquidity requirements are not considered to have a major negative impact on future business. Regarding *technological changes*, mobile applications are considered most important with 70%, indicating that especially payment methods are of crucial importance. Basically equally important with 69% is internet presence demonstrating the importance to provide for a proper interaction platform with increasingly web-oriented customers. Regarding *social factors*, it can be observed that the decreasing population with 51% are the most important negative factor, while only 34% consider the aging population as a negative influence. This is in line with recent observations that smaller retail banks aim specifically at older customers with higher wealth to generate more commission income.

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<sup>63</sup> Conduct duties refer to administrative duties in connection with customer and consumer protection laws as currently promoted by the BaFin ([www.bafin.de](http://www.bafin.de)).

	5	4	3	2	1
Equity requirements	8%	18%	45%	23%	7%
Liquidity requirements	5%	20%	57%	17%	2%
Risk Management (MaRisk)	3%	15%	40%	33%	10%
Conduct duties	2%	8%	26%	43%	22%
External service tests	22%	40%	27%	10%	2%
Economic / GDP development in Germany	3%	20%	25%	40%	12%
Volatility of financial markets	3%	30%	34%	31%	2%
Introductin of further economic stability funds	3%	19%	55%	22%	1%
Money market policy of ECB	7%	14%	25%	48%	5%
Social Media	8%	40%	38%	12%	3%
Cloud services	21%	40%	28%	10%	1%
Mobile applications	27%	44%	18%	8%	4%
Internet presence	21%	48%	28%	2%	1%
Social imbalance	3%	21%	37%	34%	5%
Increasing migration from rural to urban areas	13%	20%	38%	20%	9%
Decreasing population	8%	13%	28%	32%	19%
Aging population	7%	24%	35%	22%	12%
Increasing migration from foreign countries	3%	25%	53%	18%	1%

#### d) Conclusions

The overall finding was that cooperative banks do consider general conditions as a prerequisite when deciding upon future strategic direction. The extent to which analysis instruments are used will be further analysed in Question 2.

The most interesting finding was that Basel III related issues are not considered most important as opposed to conduct duties. Economic factors are the foremost issue on the strategic agenda that need to be analysed in more detail.

#### 7.3.1.2 Strategy

<b>Question 2a:</b>	<b>Strategy</b>
<b>How do you evaluate the importance of the following instruments within you strategic analysis process of external and internal factors?</b>	

<b>Question 2b:</b>	<b>Strategy</b>
<b>How often do you use the following instruments?</b>	

#### a) Motive

A bank is a commercial unit that is in permanent interaction with its environment. In this process, there are several interconnections with several stakeholders, e.g. customers, members, network partner, etc. Bank behaviour is strongly influenced by market structures and competition, i.e. the supply and demand for financial services, as well as the necessity to provide for sufficient resources. In reference to Johnson/Scholes (2003) it is essential to conduct an audit of these influences. In the course of an external *environmental audit* it is necessary to identify interconnections, opportunities and threats relevant to the individual bank. In the course of an internal capability assessment it is necessary to identify existing resources, strengths and weaknesses and compare them to competitors. Both findings are combined to provide ground for the strategic choice. To identify relevant factors, external and internal factors are addressed to investigate audit procedures in place.

#### b) Hypothesis

Given the high importance regarding the availability of specific information, it is expected that a structured approach in gathering specific information enjoys high importance among cooperative banks.

Even though consuming a significant deal of time and cost necessary to conduct these analyses, it is expected that cooperative banks regularly carry out these analyses in a structured way in accordance with the importance attributed.

#### c) Results

As can be taken from the table below, regarding external factors members' expectations play the most significant role with a dominant 90%, followed by customers' expectation with 85%. While member orientation is compulsory due to the cooperative act, the results show an increasing trend towards customer orientation and the need and willingness to include relevant aspects in the strategy process.

Even though results are not as strong as for external factors, internal factors also receive a great deal of attention in the strategy process. Customer structure analysis is deemed most important with 77% followed by staff potential analysis both indicating the people orientation of cooperative banks. Interestingly, present organisational structure comprises a relatively high share of 17% deeming it to be of low importance.

	5	4	3	2	1
Market analysis	39%	43%	15%	3%	0%
Strategic group analysis	32%	39%	21%	7%	1%
Customer expectation analysis	42%	43%	13%	2%	0%
Member expectation analysis	61%	29%	9%	1%	0%
Value chain analysis	23%	44%	29%	2%	2%
Customer structure analysis	24%	53%	15%	7%	1%
Present organisational structure	11%	39%	33%	15%	2%
Staff potential analysis	31%	42%	21%	5%	1%

As can be taken from the table below, some instruments are used never or rarely. While a total of 47%/46% conducts market analysis/strategic group analysis at least quarterly, member and customer expectations are not analysed on a regular basis. Looking at internal factors, the level of analysis is even lower. Organisation structure is analysed only rarely and value chain analysis conducted only every two years or never.

	ongoing	quarterly	anually	2 years	never
Market analysis	28%	19%	34%	11%	8%
Strategic group analysis	39%	7%	31%	13%	10%
Customer expectation analysis	11%	8%	45%	15%	21%
Member expectation analysis	25%	12%	23%	33%	7%
Value chain analysis	23%	6%	23%	36%	12%
Customer structure analysis and surveys	19%	14%	32%	15%	20%
Present organisational structure	4%	4%	21%	69%	2%
Staff potential analysis and surveys	16%	3%	45%	34%	2%

#### d) Conclusion

Question 2 has identified a significant gap between the perceived importance of strategic instruments for the strategy process and the actual initiatives taking place. While low analytics is comprehensible with regard to members, the low level of initiatives with regard to customer expectations is surprising. While not only avoiding to receive valuable feedback and insights into customer behaviour, it also is contrary to the high importance assigned. One reason is deemed to be the high costs associated especially for smaller banks. Here, activities beyond the daily operations are often neglected and deemed unnecessary. Still, the findings indicate the need for a structured strategy process and the development of a coherent and economic approach in order to provide for an appropriate data basis for the strategic choice process.

Elaborating more on the issue of looking into areas to look at in strategic analysis, question 3 goes beyond the state, where the bank looks at self-designed issues and criteria but rather at areas of strategic importance for the entire cooperative sector as predefined by the BVR.

<b>Question 3:</b>	<b>Strategy</b>
<b>The BVR has issued several core topics as part of its "Kompass 2013" initiatives. Which of the following have influenced your strategy?</b>	

#### a) Motive

Being responsible for providing general support to individual primary banks, the BVR, on an irregular basis, outlines core topics of strategic importance to the group that are to be considered by primary banks. These are supposed to provide for early guidance in the increasingly competitive environment. The core topics defined can also be regarded as a substitute for data from strategic analysis not conducted individually, i.e. a "one size fits all" approach.

## b) Hypothesis

A lack of identified factors with regard to external and internal areas analysed can be made up or enhanced by placing high importance on the topics by the BVR.

## c) Results

As can be taken from the table below, most cooperative banks, 85%, take the improvement of a multi-channel distribution seriously. While customer protection is also high on the agenda with 82%, the better degree of product usage is also discussed actively by 72% of banks. Surprisingly, initiatives with regard to green energy are not regarded a strategic priority.

	5	4	3	2	1
Cost efficiency and productivity enhancement	29%	34%	24%	11%	2%
Customer segmentation	33%	36%	21%	9%	1%
Increase of product usage	31%	41%	17%	11%	0%
Risk and reward oriented management of Treasury	19%	25%	34%	13%	9%
Quality improvement in terms of customer protection	38%	44%	13%	4%	1%
Improvement of the cooperative advisory process	14%	38%	41%	3%	4%
Improvement of multi-channel distribution	39%	46%	13%	1%	1%
Offering of products with regard to renewable energies	7%	23%	29%	29%	12%
Financing of measures to improve energy efficiency	6%	17%	31%	33%	13%

## d) Conclusion

The core topics by the BVR cover the most important factors to be considered. This research has identified that many cooperative banks still lack the necessary attention towards key drivers, either identified internally or predefined by the BVR. Even though it is acknowledged that there are regional differences between banks due to the decentralised structure of the network, a joint approach is required to ensure that the network is acknowledged as one entity. Achieving an attention level of at least 75% in all the nine core topics outlined above is regarded an appropriate approach.



### 7.3.1.3 Sales

<b>Question 4:</b>	<b>Sales</b>
<b>What do you consider the most important success factors in sales by profit contribution today and in the future?</b>	

#### a) Motive

Research indicates that interest income contributes about 78% to total income of cooperative banks making it by far the most important source (see section 4.2.3.2). Being aggregate values for the overall cooperative network it is important to understand how bank managers for smaller sized individual primary banks evaluate the situation with regard to their income sources. Giving the pressure from competitors, regulators and the economic and monetary development it is also essential to understand what the banks expect the future development to be.

#### b) Hypothesis

Given the pressures, it is expected that there will be a trend from interest income towards non-interest income.

#### c) Results

Survey results indicate that interest income is and will be by far the most important source of income, however, with importance going down from 96% to 92%. The importance of commissions is expected to increase in future, increasing from 72% to 91%. Importance of payment services is expected to decrease from 76% to 69%. Joint operations with other banks, e.g. savings banks, will become more important going forward with indications now at 12% compared to 5% before. The most significant increase stems from paid advisory services, which increases from 4% to 29%.

<b>today</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Interest	61%	35%	4%	0%	0%
Commission	7%	65%	24%	3%	1%
Payment services	9%	67%	21%	2%	1%
Paid advisory services	0%	4%	7%	58%	31%
Setting up joint operations with other banks	1%	4%	9%	58%	28%

<b>future</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Interest	59%	33%	8%	0%	0%
Commission	28%	63%	9%	0%	0%
Payment services	16%	53%	27%	4%	0%
Paid advisory services	4%	25%	35%	27%	9%
Setting up joint operations with other banks	4%	8%	23%	61%	4%

#### d) Conclusion

Cooperative banks do expect a change in income mix, however, with interest income still being the foremost important factor and cornerstone of the business model. The surprising finding was that cooperative banks apparently expect new fee models for their advisory process. Relevant legislation (*Honoraranlageberatungsgesetz*) has been only recently approved on 10 June 2013 improving consumer rights and enabling banks to charge fees for better advisory services when certified<sup>64</sup>. The success of this trend for cooperative banks is deemed highly uncertain by the author. First, German customers are very price sensitive and are not used to pay for services. Second, this development requires cooperative banks to be perceived as high quality providers in the financial service market. Cooperative banks are commonly associated with providing down-to-earth services that are reliable and low-risk. Also, it requires cooperative bank staff to act less as sales staff and more as advisory or consulting staff requiring a more elaborate set of social skills. Acquiring these skills through support by the BVR and local development initiatives is considered a highly uncertain venture by the author given the current staff level.

<b>Question 5:</b>	<b>Sales</b>
<b>In 2011, the BVR launched the milestone project "webErfolg". Please comment on the following. (5 = highly agree; 1 = do not agree)</b>	

<sup>64</sup> <http://www.bundesregierung.de/Content/DE/Artikel/2013/06/2013-06-10-gruenes-licht-fuer-honorarberatung.html>

#### a) Motive

One of the most importance success factors for future business is the creation of a sales and distribution mix. Next to the branch network, i.e. local and peripheral physical presence, it is important to extend internet initiatives as means of communication and information. The necessity is a direct consequence of the fact that internet usage has increased significantly, i.e. 76,5% of Germans over the age of 14 use it on a regular basis with increasing usage in the higher age groups (Statista, 2012). Banking surveys conducted in this context point to the ROPO effect, i.e. customers conduct research online, however purchase offline (see section 6.3.1). The BVR is discussing this development and has launched several initiatives such as "webErfolg" to communicate the process with its primary banks. One of the cornerstones of this BVR strategy is, however, that a single direct bank, which the big private banks such as Deutsche Bank and Commerzbank operate, is not expected to be created, i.e. it is expected to operate "1.138 direct banks locally" as outlined by Martin (2011).

#### b) Hypothesis

Cooperative banks increasingly work towards the further development of their internet presence to improve their distribution mix.

#### c) Results

The vast majority of banks, i.e. 80%, reject the creation of one single direct bank, hence following the overall strategic direction of the BVR. This corresponds with the more locally oriented initiatives regarding the improvement of internet presence, that 75% deem necessary and the improvement of the branch network that 67% deem necessary. Also, social media initiatives are deemed important by 64%, indicating the importance of other internet channels besides bank specific websites.

Approaching this topic from a different angle, 67% of banks also do not agree with the statement that initiatives are too expensive and do not lead to benefits, indicating

the priority of the topic. However, only 50% indicate that specific measures, e.g. webbank+ for the creation of a virtual branch, are already actively discussed.

	5	4	3	2	1
A single direct bank is to be rejected	34%	46%	9%	11%	0%
Internet presence and services are to be improved	34%	41%	15%	6%	4%
Branch network services are to be improved	32%	35%	17%	9%	7%
Social Media content will be of high importance	43%	21%	19%	15%	2%
Multi-channel distribution is expensive and non-beneficial	9%	11%	13%	43%	24%
webbank+ is already on our strategig agenda	23%	27%	21%	22%	7%

#### d) Conclusion

The findings indicate that online services enjoy a very high priority among cooperative banks. The surprising findings are the high percentage of banks pointing to reorganisation of branch services indicating new ways branches are expected to be operated. In addition, the percentage of banks that are already discussing specific measures is rather low, pointing towards the often perceived impression that local or decentralized banks lack the necessary push to take specific steps.

<b>Question 6:</b>	<b>Sales</b>
<b>Customer loyalty is one of the imperatives of the cooperative network. How do you rate the following statements regardnd brand management and ways to improve it? (5 = highly agree; 1 = do not agree)</b>	

#### a) Motive

Membership is the distinguishing characteristic of cooperative banks and considered a valuable instrument in terms of customer loyalty. Many cooperative banks have begun to implement shift the focus away from a competition oriented strategy towards a member oriented strategy (Jakobs, 2008). The rationale behind this approach points to the fact that once a member, that person stays a customer in the long-term. Per year-end 2012, the cooperative banks in Germany had a total of 17,3 million members and 30 million customers (Fröhlich, 2013). A strategic priority is to increase number of members and customers by offering certain benefits. The overall strategy of the BVR is to concentrate on an emotional level and distinguish from

other profit oriented banks<sup>65</sup>. What needs to be further elaborated on is the degree to which primary banks follow this approach and apply it in their operations.

#### b) Hypothesis

Cooperative banks follow the emotional strategy to attract new members, however, deem additional initiatives in reference to competition as important.

#### c) Results

Practically all cooperative banks, i.e. 96%, indicate that their members place a premium on the member concept of the sector. The emotional factor is also dominant with 73%, indicating that even though members have a high awareness for social values, there is also room for non-social values such as achieving a solid return for their equity stakes only. Regarding differentiation from competition, 48% of banks see a lack, while 35% do not, indicating that the membership strategy is very important, however, not a sole factor. A total of 60% have also introduced special loyalty programmes for their members as an additional benefit.

Regarding ways to further develop loyalty, 72% of banks rely on national campaigns, coordinated by the BVR, to introduce awareness. In contrast, 56% regard local campaigns as important. Price is not deemed a very decisive factor with only 38% of banks indicating that the price/product mix is in need for improvement. However, quality improvements are deemed important by an overwhelming 80%. The need to enhance product mix is not seen to be very important with 25% of banks deeming improvement as necessary, while 38% see no need for improvement.

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<sup>65</sup> see <http://werte-schaffen-werte.de/>

	5	4	3	2	1
Members deem our value concept important	63%	33%	4%	0%	0%
Emotional factors are essential	40%	33%	14%	11%	2%
We lack a clear differentiation from competition	19%	29%	17%	24%	11%
Members benefit from special loyalty initiatives	23%	37%	35%	5%	0%
Local marketing	22%	34%	23%	18%	3%
National marketing	29%	43%	17%	8%	3%
Improve Price/Product Strategies	15%	23%	43%	13%	6%
Improve advisory quality	43%	37%	12%	8%	0%
Enhance product offerings	9%	16%	37%	22%	16%

#### d) Conclusion

Findings confirm the overwhelming importance of the membership concept for cooperative banks and indicate that current products offered are sufficient and do not require price adjustment, presumably because the member value is deemed to outweigh costs being slightly higher than from competitors. However, membership alone is clearly not seen to be the sole factor determining the future direction. The key concepts are further promotion of membership, predominantly by the BVR as the direct interchange with the market, offered with the need to provide for loyalty and bonus programmes while especially improving quality perceived by the customer.

#### 7.3.1.4 Cost

Analysing the development of the cooperative banking sector until now, it becomes obvious that there has been a great image gain, however, no significant sales gains. This is also a direct consequence from the uncertain economic outlook forcing customers to cut back on investments and other financial services. Also, there is intense competition coming from direct banks set up by foreign banks.

The cooperative banking sector has discussed possible reactions and measures in this context. While there are the usual measures, i.e. process optimization and cost cutting measures, business process outsourcing (BPO) has been on the agenda especially since 2010 due to tax incentives. Discussed in more detail has been the creation of so-called Regional Service Centers (RSC), i.e. joint operations for the

handling of back-office operations<sup>66</sup>. Especially consulting companies regularly analyse the current situation and suggest ways to enhance efficiency, mainly via automation (e.g. McKinsey, 2012c). Related measures are not as easy to implement as measures to increase sales, especially with regard to the cooperative sector with its special status. It is, therefore, important to introduce this topic with a more detailed review of restrictions involved (see section 6.2 for an advanced discussion of options).

As discussed in chapter 3, cooperative banks comprise different stakeholder groups compared to private banks. The closure of individual branches or banks is to be prevented if not enforced by strong economic forces. Also, there is a close interaction between banks and their staff with the region making the maintenance of a performance culture basically not possible. The biggest problem of cost is cost structures themselves. Around two thirds of costs are staff costs, which are heavily prescribed by union rates<sup>67</sup>. Other administration costs relate mainly to network contribution, audit costs and processing costs. All costs are strongly related to the cooperative bank business model and difficult to adjust, which is also assumed to be the reason why cost management has been neglected compared to growth management.

<b>Question 7:</b>	<b>Cost</b>
<b>Process management has been on the agenda of your network to control costs (e.g. VR Process by BVR). How do you evaluate the following issues in this regard? (5 = fully applies; 1 = does not apply)</b>	

a) Motive

Process management is regarded one of the strategic milestones of the BVR outlook. In this context, the BVR has recently implemented a concept that supports local banks in optimizing certain sales processes. Prerequisite is an analysis of the current process environment.

<sup>66</sup> mainly process related activities and other support activities that do not generate direct income, e.g. IT, Personnel, compliance, etc.

<sup>67</sup> Unlike private banks and savings banks, cooperative bank staff is organized in the union DBV (Deutscher Bankangestellten Verband)

## b) Hypothesis

Aim of this question is to find out, how far a process orientation has been adapted by primary banks and where the focus lies.

## c) Results

Results indicate that 42% of cooperative banks have analysed their processes, being not significantly higher than the 37% of banks that have not. Elaborating further, only 30% of banks are permanently reviewing their processes, while 36% of banks do not. Overall, banks do see more potential regarding process efficiency in terms of back office activities compared to sales activities.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
We have modelled and visualized our processes	13%	29%	21%	27%	10%
We are permanently optimizing our processes	8%	22%	34%	21%	15%
Process potential with regard to sales	29%	22%	14%	21%	14%
Process potential with regard to back office	31%	27%	15%	16%	11%

## d) Conclusion

Overall, a significant process orientation could not be confirmed. While awareness is still low, this does not come unexpected given the relatively new prominence of this topic. However, the findings indicate that potential is seen, hence untapped. The strategic ratio is to take the next step and convince bank managers to actually take actions in terms of change management.

<b>Question 8:</b>	<b>Cost</b>
How do you evaluate the following cost cutting strategies on an organisational level? (5 = very important; 1 = not important)	



### a) Motive

While question 7 deals with measures that are internal to primary banks, question 8 deals with issues that are external. The theory behind the question is the assumption that processes and costs can be optimized when carried out by specialists. In this context, there are two options. One, services are performed by an external entity providing the quality required at lower costs and with more flexibility. The practical problem is that there are hardly providers that offer all bank related services, i.e. most providers focus on certain individual processes, e.g. security processing. Two, banks set up their own service centres. A pilot project was conducted in 2009 by Berliner Volksbank, which transferred all back office processes and 400 employees to the newly set up VR FinanzDienstleistung<sup>68</sup>.

### b) Hypothesis

In order to concentrate more on core competencies, being customer orientation and sale efforts, banks are willing to transfer processes out of their banks.

### c) Results

Even though often addressed, the outsourcing of services does not find a majority among banks. Setting up regional services centres or central bank oriented production centres are not significantly different with 38% and 34%. The option to cooperate with network external entities only finds support of 29%, while 38% do not consider it important. On the other side, 60% of banks consider it important to keep processes in-house while trying to optimize it.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Regional production center	17%	21%	34%	20%	8%
Central Bank oriented production center	16%	18%	39%	23%	4%
Network external solution	13%	16%	33%	31%	7%
Optimization of own production as internal profit center	26%	34%	21%	12%	7%

<sup>68</sup> see <http://www.vr-finanzdienstleistung.de>

#### d) Conclusion

The set-up of external service centres does not seem to be a generally accepted measure. Two reasons can be applied. One, primary banks consider themselves as independent universal banks that want to operate independently and in full control. Sharing resources and responsibilities is contrary to the still prevailing culture. Two, external measures are extensive projects that require the leadership of certain core institutions. The example of Berliner Volksbank is not considered a general example for all regions. Berliner Volksbank is one of the biggest individual cooperative banks that has the necessary business volume and resources to make outsourcing worthwhile. Most other cooperative banks lack the necessary scope.

However, the creation of back-office "factories" is deemed by the author to be one of the measures that needs to be pursued and actively promoted to lower the stiff cost block. After dividing banks into regional clusters it is essential to set up joint operational centres that take over processes, which have been centralized and streamlined beforehand as a means of preparing for the transfer. The biggest obstacle, being the image problem as a consequence of staff issues associated with the transfer, can be mitigated by actually offering services for other banks and non-banks, hence accessing new sources of income instead of only reducing costs. Needed in this context is the definition of a vision, not on a network level, but on a regional level by regional market leaders.

<b>Question 9:</b>	<b>Cost</b>
<b>Please evaluate the following statements regarding the status of cost cutting and process related measures in your bank. (5 = fully applies; 1 = not intended)</b>	

#### a) Motive

Question 9 was designed as a follow up and to further assess the urgency and willingness of banks to address relevant cost matters. The motive in connection with the previous questions was to identify consulting potential and further enhance sensitivity for further actions.

## b) Hypothesis

Given the cooperative network communication in terms of lower profitability and high competition it is expected that the need to cut costs and optimize processes is considered high.

## c) Results

The majority of banks, 54%, consider the need to change the status quo as high. The results on the way measures are derived at are not conclusive, i.e. it is not clear whether banks want to discuss matters predominantly internally or with external advisors, even though discussions with external parties received more importance with 43% compared to 21% that do not consider it.

	5	4	3	2	1
We consider the urgency to adjust our processes as high	23%	31%	26%	15%	5%
We aim to discuss these measures internally	16%	21%	28%	29%	6%
We aim to discuss these measures externally	16%	27%	36%	16%	5%

## d) Conclusion

Research indicates that there is not only the awareness to change processes but also a willingness to bring in external support and advise. This requires or enables the development of a systematic approach to a standardized cost and process management. Based on the strategic management process, the approach should have the following elements.

**Analysis of cost situation and efficiency:** Based on the current situation it should be simulated, which costs and income streams have to be adapted. In the course of a benchmark comparison it is essential to identify the areas for improvement.

**Choice of optimization measures:** First, all possible cost reduction measures should be discussed. It is important to bring all options on the table, i.e. also measures that

do not appear feasible at first sight. Second, an impact analysis and evaluation of measures is to be carried out. Thirdly, a priority of measures is to be established.

**Implementation of measures:** A coherent project plan is to be agreed upon with roles and responsibilities to be defined and controlling measures to be designed.

**Design of sustainable framework:** To avoid a bounce back effect, it is important to change the cost culture overall and establish long-term goals and behaviours. It is important to have the board as a first mover in this process.

### 7.3.2 Strategic choice in cooperative banks

After the analysis of strengths and weaknesses as well as opportunities and threats is done, the next step is to discuss how the current strategy has to be adjusted. Strategic alternatives are to be identified in order to fill strategic gaps and enable positioning for the future. Methods usually used in strategy formulation are portfolio method and scenario technique (Johnson/Scholes, 1993). Strategies to be formulated can be categorized as corporate strategies, business unit strategies and functional strategies.

Literature discusses the extent to which individual parties are involved in the strategic management process in context of a shareholder and/or stakeholder approach that is very special within the cooperative banking sector (see chapter 3). The influence of the stakeholder on the strategy formulation and decision process is further analysed in the following question.

#### 7.3.2.1 Formulation

Question 10:	Formulation
What is the extent to which the following parties are included in the strategic management process?	

a) Motive

For the purpose of this survey, stakeholders have and the determination of their influence been clustered as follows: Members and supervisory board as the owner

group. Board, staff council and staff as employee group. Consultants as network external group. Network auditors and the cooperative network as internal consultants and auditors.

#### b) Hypothesis

The stakeholder approach, which is pursued by cooperative banks, prefers a collective decision-making process, limited, however, by the requirement that people involved are also capable of strategic thinking. It also needs to be taken into account that the collective decision-making process turns inefficient from a certain level on (Kreikebaum, 1993).

Due to their mission, the inclusion of owner groups is essential. However, staff support is also essential in terms of strategy acceptance increasing the chances of a successful strategy implementation. Furthermore, advice from parties external to the primary bank is deemed necessary and relevant to provide for a broader picture.

#### c) Results

Member inclusion predominantly occurs via the supervisory board, i.e. while only 5% of banks stated a stronger involvement of members and a strong 84% denied an involvement of members, there was a solid 54% of banks indicating supervisory board involvement.

Strongest involvement is provided by the employee group with board involvement at 99% indicating that the strategy process is predominantly an upper management task that, however, also includes second tier management level with involvement of 78%. Regular staff does not find significant involvement with 18%.

Stakeholders external to the primary bank do not play a significant role in the strategy process, i.e. network external as well as internal parties all show shares of less than 20%.

	5	4	3	2	1
Members	1%	4%	11%	21%	63%
Supervisory board	23%	31%	30%	11%	5%
Board	95%	4%	1%	0%	0%
2nd level managerial staff	45%	33%	11%	8%	3%
Regular staff	4%	14%	33%	28%	21%
Staff council	5%	20%	23%	16%	36%
Consultants	6%	13%	17%	22%	42%
Network auditors	4%	11%	28%	25%	32%
Cooperative Financial Network	3%	8%	31%	34%	24%

#### d) Conclusion

Overall results confirm the decentralized status of primary banks and the almost sole responsibility of the board as primary strategy setting instance. Nevertheless, further influence of subordinated management layers depending on their qualification and responsibility level is indicated. Regular staff plays virtually no role in the decision making process. The results also indicate that middle level staff is used as multiples that is considered capable of strategic thinking. Surprisingly, owners' interests do not play an overriding role. Given the strategy of the network to enhance the attractive of ownership it should be reassessed whether more influence of the owners is required.

In the same context, the level of branch autonomy can be discussed. Evidence from other countries points to a higher degree of autonomy enjoyed by branch managers (e.g. see Institutional Investor (February 2014) referring to Svenska Handelsbanken). Even though the example of Svenska Handelsbanken and its focus on the "branch in the heart of Stockholm" does not indicate whether this high degree of autonomy has resulted in higher profitability, it is not considered by this author to be a good example for an alternative approach among cooperative banks. Svenska Handelsbanken per 30 June 2014, had the equivalent of EUR 118 billion in total loans granted by 462 branches, which results in average loans by branch of ap. EUR 250 million. The "branch in the heart of Stockholm's financial district" is expected to show considerably higher volumes. In comparison with the statistics in section 3.2.4 it becomes evident that this branch must be in size equal to the biggest individual cooperative banks. Taking into account size and region of Svenska bank branch and

an equivalent cooperative banks, a high degree of congruence is actually derived at, i.e. a branch with sufficient volume in a certain region is equivalent to a cooperative bank conducting the same business, however, as an individual legal entity. Due to the regional principle, a higher degree of autonomy for branches of cooperative banks is not deemed to result in better performance in connection with enhanced local knowledge. As a matter of fact, more autonomy for branches within a limited region would result in a loss of control by the coordinating regional head quarter and subsequently inefficiency as concluded by Kreikebaum (1993).

Question 11:	Formulation
In what way is the strategic choice of your bank influenced?	

a) Motive

Cooperative banks are the primary banks of the cooperative network and as such part of interconnections. Even though the parties concerned are not directly involved in the strategy management process, it is nevertheless important to further analyse the impact of their services on it. In this context, it is distinguished between network internal influences, being network partners, auditors and BVR itself, and external influences, being competitors and financial markets.

b) Hypothesis

Primary banks know or have realised that their ideas and opinions are not the sole way of managing their bank. What is expected is the influence on a subject level rather than on an object level.

c) Results

The results indicate there is in fact an influence of network internal as well as external parties, i.e. of their findings and ideas that are provided on an indirect basis and not asked for actively. Internal factors refer to a low influence of BVR studies with 41% of banks and targets with network partners at 47%. Network auditors show

53%, pointing to the fact that findings from parties that are directly working at the primary bank, show the highest influence. External parties have an impact of slightly above 50% indicating that just half of the banks look beyond the boundaries of their bank.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Targets set with network partners	10%	37%	29%	13%	11%
Findings by the audit networks	15%	38%	31%	13%	3%
BVR studies	6%	35%	34%	17%	8%
Competitor activities	23%	28%	20%	16%	13%
Financial market development	19%	33%	24%	16%	8%

#### d) Conclusion

Results indicate that primary banks do depend on additional information from other parties to set-up their strategy. However, a significant influence is not given. In combination with the findings from the previous question, it is questionable whether there is sufficient consideration of other parties and information. In order to better formulate the strategy for future direction, it is recommended to look further beyond the borders of the bank to identify options not actively pursued in the past.

<b>Question 12:</b>	<b>Formulation</b>
<b>In what way are strategies in your bank evaluated? (5 = fully applies; 1 = does not apply)</b>	

#### a) Motive

There is general consent that strategies receive higher acceptance when formulated in a wider group, i.e. when there is not only a pure top-down approach. This makes special sense with regard to cooperative banks that heavily depend on their closeness with the regional population and market provided through interaction of staff. Sales staff has the highest market knowledge, which contributes towards future business orientation.



## b) Hypothesis

It is assumed that cooperative bank management takes advantage of the market knowledge and is willing to let staff participate in order to also enhance personal commitment.

## c) Results

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
At board meetings	31%	33%	18%	11%	7%
At meetings with board and other management staff	18%	24%	13%	27%	18%
At workshops with internal staff	13%	14%	36%	28%	9%
At workshops with external assistance	6%	12%	36%	35%	11%

Findings indicate that strategy evaluation is predominantly a matter of board decisions only. 64% of banks stated that decisions are made on board level only, while 42% of banks also stated additional managerial staff input. Further elaborating on this topic, 27% of banks use strategic workshops with internal staff, while only 18% use workshops with external support (e.g. network partners).

## d) Conclusion

While the distribution of results itself is not surprising due to the long-lived culture of smaller cooperative banks having an independently run board, it is surprising after all that banks do not value the knowledge of their field staff and also do not follow a proper coherent and structured venture to think about future strategies. Both issues, being a lack from a strategy point of view, do represent a chance for optimization and are recommended to be put into practice.

<b>Question 13:</b>	<b>Formulation</b>
<b>In what intervals are the strategic direction and agreed upon targets adjusted?</b>	

a) Motive

Question 13 is closely connected with question 12. When, while evaluating possible strategies, it is concluded that there is a gap in strategy, adjustments become necessary, being possible via (a) the adjustment of targets or (b) adjustment of measures to achieve targets. Strategic adjustments can be conducted on different layers. For the purpose of this question, five dimensions have been chosen with their adjustment frequency to be analysed.

b) Hypothesis

A frequent adjustment of targets is not recommended, since this would limit their function as orientation and management dimension.

c) Results

Frequency for all strategy layers tends to be annual. However, 25% of banks apply an interval of over one year for their strategy adjustments. Surprisingly and indicating a more thorough approach to monitor the strategy process, the use of scenarios and forecasts on an at least quarterly basis is conducted by 58% of banks.

	<b>ongoing</b>	<b>monthly</b>	<b>quarterly</b>	<b>annually</b>	<b>less</b>
Overall bank strategy	5%	2%	5%	63%	25%
Targets with network partners	3%	2%	10%	84%	1%
Contribution margin targets	12%	8%	23%	49%	8%
Quality targets	18%	2%	34%	44%	2%
Scenarios and forecasts	11%	21%	26%	23%	9%

d) Conclusion

Most banks adjust their strategic targets on an annual basis, which is typically at the end of the business year. Deemed critical are banks with shorter frequencies since these lack the necessary long-term orientation as required by their business model. However, due to the competitive forces, this rather classic approach should be reconsidered after all, i.e. it should be considered whether a short-term orientation

would be useful as supplement in order to more flexibly react to the changing environment. Also, when there is a dynamic market with other leading competitors that are more advanced in their operations, success cannot be achieved sustainably with classic strategy thinking. Many small initiatives are necessary on an on-going basis, also at the same time. Cooperative banks are subject to this development, hence, should apply a new orientation towards managing their operations.

### 7.3.2.2 Decision

Decision is closely related with formulation. Alternative strategy formulations are evaluated based on predefined criteria that are influenced by their impact and compliance with the long-term strategy (Johnson/Scholes, 1993).

<b>Question 13:</b>	<b>Decision</b>
What are your success factors and Unique Selling Propositions (USPs)? (5 = fully applies; 1 = does not apply)	

#### a) Motive

Management literature on a general level points to the need to create USP in order to differentiate from competitors (Großklaus, 2006). Literature over the past years on the cooperative banking sector refers to the classic features, being close to the customers, person orientation and the offering of membership (e.g. Bonus, 1999). The BVR on a national level especially points to the cooperation with the network and the flexibility in terms of sales. For the long-term strategy is important to analyse where primary banks put a premium on.

#### b) Hypothesis

If cooperative banks predominantly follow a member value strategy, classic features will be of higher importance. If BVR features are followed with a high degree, it indicates more orientation towards centralisation.

### c) Results

Results are very clear regarding closeness to the customer with 87% and person orientation with 88% indicating the strong bond with the regional principle. Strong, but with sufficient distance to the two first features, it is flexibility with 77% and only 57% with part of network. The simplicity in their products is regarded by 84% of banks, with membership valued by a very high 87%. Offering protection via the cooperative protection scheme receives also very high attention with 85% indicating their special focus on providing a safe haven in terms of economic uncertainty.

	5	4	3	2	1
Close to the customer	81%	6%	9%	4%	0%
Person orientation	76%	12%	9%	3%	0%
Flexibility	34%	43%	12%	5%	6%
Part of network	41%	16%	32%	10%	1%
Non-complex products and services	71%	13%	15%	1%	0%
Offering of membership	78%	9%	11%	2%	0%
Network deposit protection scheme	48%	37%	14%	1%	0%

### d) Conclusion

According to the findings, cooperative banks still predominantly follow a member strategy. The relatively low attention of being part of the network indicates that there is more efforts required in order to be perceived in the market as one unit. Overall, results confirm their status as conservative banking. Having a focus on standing for unity, cooperative marketing has been successful on gaining the image as a counterpart to the purely shareholder oriented banks by providing membership. It is up to the cooperative banks to convert the clearly described advantages into practical benefits.

Question 14:	Decision
Cost are regarding key factors in evaluating future strategies. What factors do you see critical regarding the success of future cost cutting or process adjustment measures?	

#### a) Motive

As discussed before, costs play a decisive role in the future strategic orientation. When deciding upon new strategies, it is important to anticipate resistance and come up with appropriate countermeasures before deciding upon directions.

#### b) Hypothesis

The identification of bottlenecks will lead to a focused set of measures that will help strategy implementation and, before, the choice of measures.

#### c) Results

Overall, statements indicate a rather even distribution with high indications towards the recognition of obstacles, with cost/benefit implications being the most important factor with 56%.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Lack of board support	18%	23%	28%	21%	10%
Lack of staff awareness	19%	27%	32%	13%	9%
Implementation cost compared to perceived benefit	23%	33%	21%	17%	6%
Resistance from staff unions	17%	31%	32%	15%	5%
Congruence with cooperative mission and spirit	24%	29%	22%	21%	4%

#### d) Conclusion

Findings indicate that there is reason to put more efforts into the considerations of obstacles when deciding upon measures. The high ratios of support also point towards the potential of making no relevant decisions because resistance in general is considered high, making a better communication of strategy necessary.

### **7.3.2.3 Operations**

In terms of strategic planning, the most important issues to be considered when evaluating strategies in terms of operations are regulatory issues and their consequences on Asset Liability Management (ALM).

<b>Question 16:</b>	<b>Operations</b>
<b>What is the influence of Basel III on your strategic planning process?</b>	

a) Motive

The elements of Basel III and all related requirements will require a lot of resources in order to ensure compliance. In order to project future resource requirements as good as possible it is essential to identify the importance of Basel III on the strategy process.

c) Hypothesis

Cooperative banks need to incorporate Basel III into their regular management process in order to provide for long-term compliance.

c) Results

Statements indicate that Basel III is being regarded an essential influence, which is discussed most commonly on a regular, but not structured, way with 64% of banks. This is higher than the share of banks with 48% that actively incorporate Basel III into the strategy process. The low 20% of banks asking for external advise supports the perceived lack of a coherent approach.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
We discuss Basel III requirements on a regular basis	23%	41%	21%	12%	3%
We actively incorporate Basel III into our SPP	17%	31%	41%	6%	5%
We look for external advise for compliance	11%	9%	39%	33%	8%

d) Conclusion

The importance of a structured approach to deal with current and future requirements is pressing. There is a generally high awareness, which is, however, not followed sufficiently in practice. It is assumed that better compliance can be achieved when defining a proper way of action.

<b>Question 17:</b>	<b>Operations</b>
<b>With regard to ALM, how do you rate the importance of the following?</b>	

a) Motive

Preliminary research indicates a higher importance of the Treasury function in the future and more attention towards the finance function within the banks. This is in contrast to the traditional strategy of cooperative banks following a member and customer oriented strategy with the finance function to be of minor importance. The overall economic situation, competition and regulation forces banks to reconsider this approach and think about measures to deal with requirements efficiently.

b) Hypothesis

Cooperative banks do need an enhanced Treasury function for future business optimization.

c) Results

The management of the bank's Depot A is considered the most important factor with 65%. The remaining factors are not considered considerably important with percentages below 40%. Most factors are considered to be not important with equity and risk issues showing little importance under 50%. Also, a further restriction of loan granting also does not seem to be of further importance in terms of future strategy setting.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Depot A management	34%	31%	27%	7%	1%
Funding sources	16%	19%	41%	21%	3%
Equity restructuring	19%	14%	21%	26%	20%
Risk measuring	9%	16%	30%	23%	22%
Selective loan granting	11%	28%	11%	26%	24%

#### d) Conclusion

The high importance of Depot A management has been confirmed as outlined in section 6.1. Especially the importance of maturity transformation has to be met and dealt with in structured projects. In this regard it needs to be stated, that the maximization of maturity transformation should not be the main target, but rather the optimization from the perspective of risk/return aspects as well as the internal risk appetite.

### **7.3.3 Strategy implementation in cooperative banks**

The final element of the strategy process is implementation. Academic literature emphasizes the importance of an effective organisational structure and internal processes as well as behaviour of management personnel (Johnson/Scholes, 1993). Regarding this research and cooperative banks, organisational structure is deemed important, however, not a critical success factor. Schulte-Zurhausen (1995) divided organisational types into functional, divisional matrix organisation and profit centre organisation. Even though not addressed in the questionnaire, cooperative banks, due to their size and business model, typically apply a divisional structure, i.e. there are business units organized by either products or customers.

For the purpose of this research, critical success factors have been identified to be *communication, the linkage of strategy with staff and other operational issues, and steering concepts.*

#### **7.3.3.1 Communication**

The strategy decided upon needs to be communicated to staff in order to become effective. Given the size and structure of sample banks that are not perceived to follow advanced communication structures, this topic is one of the most pressing ones.



<b>Question 18:</b>	<b>Communication</b>
<b>Which instruments do you use to communicate your strategy to your employees?</b>	

a) Motive

The aim of communication is to inform staff about the future strategic direction of the bank. By doing so, staff is informed how they are supposed to contribute towards it. Communication, therefore, serves as orientation, which can be made transparent via several instruments, e.g. by circular or via oral information. If these instruments are not used, strategic decisions cannot be put into practice as envisaged.

b) Hypothesis

It is expected that the board informs staff in a structured way in order to communicate targets and find acceptance. In the best case, several instruments are used in different intensity in order to achieve the highest degree of transparency.

c) Results

Results indicate that verbal communication is mostly used with staff meetings being the predominant instrument with 67%, whereas, circular as means of written communication is only used by 26%. Also, a solid share of 54% uses presentations by department heads as additional instrument, presumably on a more granular level. The use of IT related instruments is still relatively low with 33% of banks mostly using it, while 29% do not. Being by far the lowest, 5% of banks indicate that strategy is only available to the board.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Circular	12%	14%	30%	19%	25%
Staff meeting	38%	29%	23%	9%	1%
Presentation department head	19%	35%	33%	11%	2%
E-Mail / Intranet	16%	17%	38%	22%	7%
Knowledge of strategy is available to board only	2%	3%	29%	25%	41%

#### d) Conclusion

Overall, 95% of banks have used instruments to inform staff about their strategy. The distribution of results indicates that there is banks size related issues to consider and to optimize. The use of IT related measures should be enhanced, not only to improve information but also to improve the overall approach perceived by staff and other parties, which especially applies to smaller banks.

While analysing the results, this researcher analysed the websites of the sample banks. One of the very few examples identified was one bank that also published their strategic orientation and direction online<sup>69</sup>. This is a good example as the strategy process cannot only be used as direction but also as a sales instrument in order to differentiate itself from local and regional competitors.

#### 7.3.3.2 Linkage

The transfer of the strategy into operational day-to-day routines is one of the most important steps in strategy implementation (Johnson/Scholes, 1993). An essential element is to implement milestones that are used for controlling and steering of staff.

<b>Question 19:</b>	<b>Linkage</b>
<b>On which basis are targets with your staff agreed upon?</b>	

#### a) Motive

Targets with staff depend on the intensity of the strategic planning process. The sole exploration of prior year targets means that findings from the analysis process are not regarded and the choice of strategy has no influence on operations. The consideration of potential, being internal in the form of staff capabilities and external in the form of demand, means that findings from the analysis process are regarded, however, not further considered in the formulation and choice of strategy. Applying the overall

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<sup>69</sup> [http://www.vbcloppenburg.de/wir\\_fuer\\_sie0/werte\\_prozess.html](http://www.vbcloppenburg.de/wir_fuer_sie0/werte_prozess.html); accessible in German only

bank strategy as basis of targets would lead to the most comprehensive basis for operational targets.

#### b) Hypothesis

Operational and strategic planning can be combined efficiently and effectively by applying the overall bank strategy as a basis in deriving individual staff targets.

#### c) Results

Overall, findings indicate that the majority of banks has considered the linkage between strategy and operations. 63% of banks indicate that they use the overall bank strategy as a basis. The number of banks that do not regard the strategic planning process and only use prior year targets as a basis was surprisingly high with 33%. In this regard, 31% of banks stated that prior year targets do not play a significant role, balancing the findings out. 27% of banks consider existing potentials as a basis, being lower than anticipated. Also surprising was the result of 19% of banks not setting any targets, hence, avoiding proper means of controlling and steering.

	5	4	3	2	1
Extrapolation of prior year targets	14%	19%	36%	23%	8%
Internal and external potentials	11%	16%	43%	21%	9%
Overall bank strategy	34%	29%	23%	11%	3%
No targets agreed	8%	11%	24%	44%	13%

#### d) Conclusion

With a great number of banks, there is a break between strategic planning and operations. The lack of agreeing on comprehensive targets does not only mean that potentials are not used sufficiently, but also that there is a motivational problem since success and failure are not accounted for. Overall, indicating to the need for further enhancement of the transfer of strategy to operations.

<b>Question 20:</b>	<b>Linkage</b>
<b>What are consequences of non-achievement? ( 5 = fully applies; 1 = least applies)</b>	

a) Motive

Question 20 is directly linked with question 19. Targets are only effective when achievement or non-achievement is measured and rewarded or punished. The severity of consequences can vary from mild, being coaching, to more serious ones, being cuts of money or responsibility. As outlined before, the cooperative banking sector is run on different principles as private sector companies. The aim of this question is to analyse what consequences are typically used in order to identify possible areas of improvement.

b) Hypothesis

Being limited in terms of numbers, it is expected that staff receives proper options in terms of further development, learning and coaching in order to improve existing workforce.

c) Results

Results indicate that coaching is not common amount cooperative banks with 13%. However, on a more serious side, warnings are used by 50% of banks. Lower variable components are applied by 42%, indicating a high usage of monetary instruments. Less responsibilities are applied by 7%, no consequences by 34%, both indicating a low willingness to actually change or improve matters.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Coaching	4%	9%	34%	39%	14%
Warning	18%	32%	23%	16%	11%
Lower variable components	16%	26%	37%	12%	9%
Less responsibilities	1%	6%	23%	36%	34%
No consequences	13%	21%	43%	21%	2%

#### d) Conclusion

In total, the use of consequences is not predominant among cooperative banks. While being a sign of unused potential, this situation is not surprising giving the envisaged stable development and business model of the network. However, since change is required due to the pressing forces from outside, it must be discussed whether not only unpopular decisions are necessary, but also measures to in cooperation with staff, i.e. focused personal development, requiring also investments in staff.

#### 7.3.3.3 Steering concepts

Academic literature, in the context of strategy implementation, often refers to the concept of the *Balance Scorecard* as originally promoted by Kaplan/Norton (1992), which aims at combining strategic direction with evaluation and steering parameters. While the development of an effective Scorecard is discussed in the following chapter, the aim of this section is to identify the status quo of BSC related topics within cooperative banks.

<b>Question 22:</b>	<b>Steering</b>
<b>Where do you see obstacles with regard to strategy implementation?</b>	

#### a) Motive

Kaplan/Norton (1996) described specific obstacles with regard to strategy implementation, being non-suitability of visions and strategies within the company, missing linkage between strategy and resource allocation, etc. From a more practical perspective, external advisors often see the lack of staff knowledge and acceptance of staff as well as the missing organisational structure as critical (Ahlert/Zelewski (2004)). The situation among cooperative banks is to be analysed.

## b) Hypothesis

It is assumed that cooperative banks are subject to high levels of perceived obstacles given their size and organization.

## c) Results

The biggest obstacle of strategy implementation is seen in the lack of acceptance by staff with 63% followed by the lack of written documentation with 55%. At the same time, 59% of banks do not consider the lack of knowledge to be a major obstacle. The remaining options, i.e. lack of competence of staff, controlling organisational flexibility and counselling do not appear to be of major significance with strategy implementation.

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Lack of written documentation	13%	42%	29%	11%	5%
Lack of knowledge by staff	9%	13%	19%	36%	23%
Lack of acceptance by staff	22%	41%	29%	7%	1%
Lack of competence of staff	16%	12%	41%	23%	8%
Lack of controlling	12%	21%	34%	23%	10%
Lack of counseling by management	1%	3%	45%	39%	12%
Lack of organisational flexibility	17%	22%	31%	26%	4%

## d) Conclusion

Results indicate that cooperative banks are subject to the same obstacles and there is need for the implementation of a steering concept that enhances written documentation and staff acceptance.

<b>Question 23:</b>	<b>Steering</b>
<b>Which indicators are used for measuring strategy process? (5 = fully applies; 1 = least applies)</b>	

#### a) Motive

The use of quantitative ratios is essential for tracking the success of strategy and implementing corrective actions. As outlined in section 3.3, cooperative banks are not subject to the financial pressure of private banks, which usually measure their success by looking at RoE. The purpose of this question is to find out, which financial measures are used by cooperative banks. To find out, the most common performance indicators have been listed.

#### b) Hypothesis

Given the business model of cooperative banks, it is assumed that profit related indicators are of lower importance.

#### c) Results

The most important indicator is regarded to be the interest margin with 79%, which is not surprising giving the emphasis on interest related products. Business growth is also deemed important with 66% as well as operating profit before/after valuation effect with 68%/59%. Cost-Income Ratio, even though behind with 47%, is also considered significant, while RoE with 29% and especially dividends with 3% do not play a significant role.

	5	4	3	2	1
Business growth	35%	31%	21%	9%	4%
RoE	6%	23%	42%	27%	2%
Operating profit before valuation effects	35%	33%	19%	11%	2%
Operating profit after valuation effects	31%	28%	26%	14%	1%
Dividend potential	1%	2%	26%	53%	18%
Interest Margin	42%	37%	19%	2%	0%
Cost-Income-Ratio	21%	26%	31%	21%	1%

#### d) Conclusion

Findings confirm the low focus on profit related indicators. While the focus on growth and operating profit is appreciated, measures should be implemented to

enhance focus on RoE and CIR in order to support cost and income optimization strategies.

<b>Question 24:</b>	<b>Steering</b>
<b>What influence does your strategy implementation have on the cooperations with partners (network, external partners)?</b>	

a) Motive

As was confirmed in the question before, growth is one of the most important performance indicators. From a strategy perspective, it is essential to understand how the envisaged performance is supposed to be achieved. Business model and mission point towards an independent approach. However, being part of the cooperative network that has come under cost pressure (see comments on strategic analysis), new options, which still represent the cooperative credo, should be considered on an individual bank level.

b) Hypothesis

In order to achieve growth, cooperative banks have at least considered cooperation with other entities, opening the door to new pathways.

c) Results

Overall results indicate a surprising low willingness to cooperate. Joint service companies are not considered an option with only 8% in favour and 73% against. Cooperation with other cooperative banks, which would be neighbouring banks, are considered by only 9% of banks with 23% against any cooperation and 44% against mergers. Cooperation with the network is considered more viable with 32%, which is, however, not a significant share. External partners, e.g. savings banks, also find only low acceptance with 20% in favour and 43% against.



	5	4	3	2	1
Increased cooperation with other cooperative banks	1%	8%	68%	22%	1%
Setting up of joint service companies	2%	6%	19%	59%	14%
Merger with other cooperative banks	4%	5%	47%	42%	2%
Increased cooperation with network partners	11%	21%	56%	8%	4%
Increased cooperation with external partners	6%	14%	37%	37%	6%

#### d) Conclusion

The low willingness for cooperation is considered to be one of the major areas for improvement on an individual bank level. Given the pressures, primary banks cannot afford to refuse mergers and other measures of cooperation. Each banks needs to calculate the required scale of operations for future business with a time scale of up to 2019 and then considers, what path can be taken on a regional level. Joining forces on a low level with other non-profit oriented banks, e.g. savings banks, in terms of branch network should be considered, with most of strategic effort to be put in cooperation with neighbouring primary banks in order to achieve scale. Mergers have taken place, however, mainly due to losses that are to be avoided in the first place.

#### 7.4 Summary and conclusion

It was this researcher's aim to identify the characteristics of the management process within cooperative banks. The aim was based on the conclusion that there is little known about the management process, which made it difficult to comment on potential reform requirements in the light of current regulatory forces. In addition, it was aimed to identify instruments, focus and mind set of primary bank managers.

Regarding strategy *analysis*, primary banks do acknowledge the importance of trends as outlined by the BVR. As concluded in chapter 6, regulatory issues are considered important, however, not as important as economic changes. Money market policy and GDP development are considered to have a clear negative impact, while equity requirements are not considered to be negative. Regarding strategy, instruments for market, customers and especially member expectations are considered very important. However, evidence suggests that use of relevant identification tools is not

done on a regular or structured basis (**Potential**). Regarding sales, commission income is considered to be of higher importance in the future. Simultaneously, the general need to use social media tools and improve advisory quality, backed by a continuously heavily supported value concept, are considered key in a future income diversification strategy. The perceived need to adjust sales channels is recognized, while leaving existing product range and pricing basically unadjusted. However, a clear and concrete application or combination of existing and new products with a coherent internet strategy could not be concluded (**Potential**). Regarding cost, significant willingness to adjust status quo could not be concluded. While this indicates the still prevailing lack of cost awareness, this also points to the requirement and potential to adjust and improve processes as outlined in chapter 6 (**Potential**).

Regarding strategy *choice*, the formulation process is overwhelmingly done by the first and second tier bank management. This confirms the perceived approach that primary banks want to conduct their own business and make their own decisions. In order to further enhance cooperative values, the various stakeholders should be further considered (**potential**). Evidence points to the awareness for USPs. However, the clear definition and communication could not be identified (**potential**). While evidence points to the awareness for Basel III issues, most of the importance is seen in managing Depot A, i.e. bank owned securities, with less importance given to equity and risk restructuring, hence, confirming preliminary conclusions of chapter 6 and pointing to the need to enhance the bank internal treasury function (**potential**).

Regarding strategy *implementation*, several tools are used for communication. Evidence points to a better use of IT based systems and communication systems (**potential**). Also, evidence points to the need to better link strategy with tighter staff management, i.e. while a strategy is derived (strategic level), evidence points to a lack of transfer of the strategy down to the operational level (**potential**). Regarding steering, evidence points to the coherent use of indicators that depend, however, on staff acceptance and the written form highlighting the need for a structured and hands-on approach for performance management (**potential**).

As final consideration it can be stated that basically all evidence points to a very high awareness of issues that are to be considered. However, it could be confirmed that the necessary change and adjustments are not yet sufficiently progressed. This confirms the initial thoughts by this author that an advanced management system is locally required. Choice and implementation of such an advanced management system is further analysed in the next chapter.

## 8. Implementation of a BSC concept in cooperative banks

Research conducted in the previous chapter has confirmed a number of hypotheses and revealed numerous areas of improvement or potential for optimization that cooperative banks not only *can* opt to follow on but rather *need to* in order to deal with the current competitive environment. Chapter 8 aims to design a concept of how a balanced scorecard can be implemented in cooperative banks to support the development and enhancement of the strategic orientation by means of case studies and field research.

While this concept is not new and is, in fact, a popular steering concept among private banks, it is still not sufficiently recognized in the cooperative bank sector. The aim of this work is also to enhance recognition by pointing towards the benefits of it for the individual primary bank. In order to approach the project from an academic/research as well as advisory/consulting perspective, relevant findings have been discussed with a senior member (MC1) of the researcher's workplace, i.e. from the Management Consulting division who has relevant implementation experience from similar project, yet without connection to the financial service sector.

- Section 8.1 describes the BSC concept in general, narrows it down to the banking sector and identifies reasons for the implementation among cooperative banks.
- Section 8.2 outlines and describes the case study framework, i.e. the approach to the case study is outlined as well as the participating banks with their relative characteristics.
- Section 8.3 describes the step-by-step approach to derive at the envisaged outcome. It outlines individual elements of the steps that were carried out in real life in cooperation with the cooperation banks. Due to timing, this section focuses on the conceptual framework only as well as the implementation.
- Section 8.4, researched several months after completion of section 8.3, outlines preliminary results from the implemented BSC concept providing for actual results in terms of the envisaged outcome.

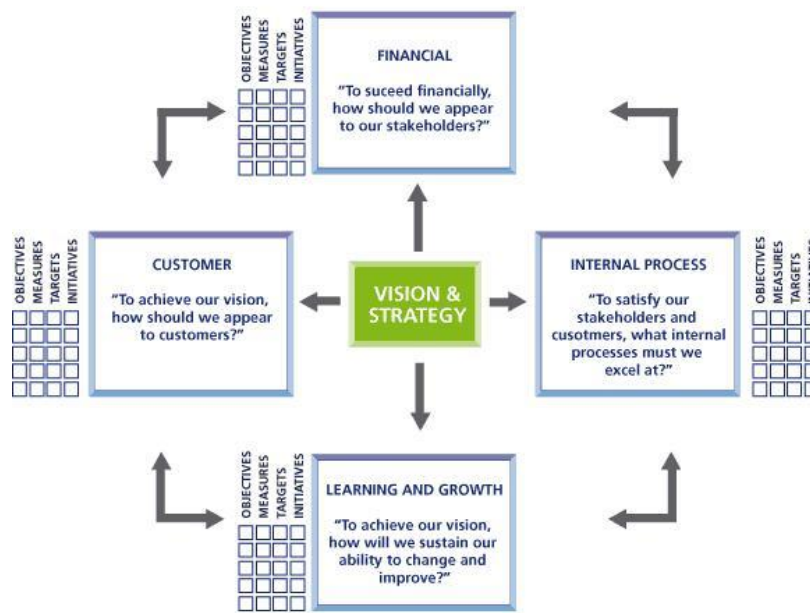
## 8.1 Applicable theory: Balanced Scorecard

### 8.1.1 Development of the BSC

In 1990, the Nolan Norton Institute, being part of audit company KPMG, conducted a study on performance measurement supervised by David Norton and Robert Kaplan (2001). The aim by looking at twelve companies was to come up with a steering concept that also considered the management and evaluation of future economic activities and, eventually, resulted in the development of the *Balanced Scorecard*. The latter is a concept that enables management to navigate through the competitive environment by emphasising strategy and vision step by step. Information are gathered systematically and communicated in a comprehensive way. This is to enable staff to understand the rationale behind corporate actions and keep them informed about the performance progress. By doing so, the problem of traditional performance measurement systems, being the focus on past performance, is overcome. "The Balanced Scorecard complements financial measures of past performance with measures of the drivers of the future performance" (Kaplan/Norton, 1996).

The classic view on the Balanced Scorecard comprises four perspectives. The first perspective is typically the *Financial* perspective, which concentrates on measures to improve financial standing. The second perspective is typically *Customer* or *Market* or a combination of both, which comprises an external view on how the bank is seen. The third perspective is the *Processes* perspective, which comprises an internal view on processes are run and which processes need to be enhanced. The fourth and final perspective is *Learning and Growth* perspective, often also referred to as *Staff* perspective or *Potential* perspective. For each of the perspectives, there is one core question to be considered. When the perspectives are set, the next step is to identify key processes and metrics, i.e. for each process the *objective, measures, targets* and *initiatives* are to be established.

Figure 52: Classic elements of Balanced Scorecard



Once the strategy is categorized based on the four perspective, the next step is to determine the link between the strategies and how the strategies support vision and mission of the company. This is usually done via a strategy map for visualization of cause-and-effect relationships. Linked are typically human, information and organizational capital.

The concept of the BSC has been further adjusted by academic as well as practical theory. The Balanced Scorecard Institute has developed the *Nine Steps to Success*® framework with a focus on coaching that consists of Assessment, Strategy, Objectives, Strategy Map, Performance Measure, Initiatives, Performance Analysis, Alignment and Evaluation ([www.balancedscorecard.org](http://www.balancedscorecard.org) accessed on 20 May 2013). Kaplan, in the follow up to his book on strategy maps (Kaplan/Norton, 2004), further collaborated with management consultancy McKinsey by combining his thoughts with McKinsey's 7-S model (Kaplan, 2005).

### 8.1.2 Balanced Scorecard from a bank perspective

The use and acceptance of the BSC has been confirmed by various studies with special attention in USA, Europe (ex-Germany) and Australia (e.g. Janota, 2008). With regard to Germany, the use has also been confirmed (Wellmann, 2012; Greiling, 2010). That is, while recent studies look at the as-is situation, older studies focused more on the introduction of new projects and strategic directions. E.g. Kim/Davidson (2004) investigated the effects of IT expenditures on banks' business performance. Also, most of the recent studies are found to have a focus on banks in emerging countries indicating that the BSC have also found its way in their management thinking.

Chwan-Yi/Lin (2009), Zhang/Li (2009) and Huang/Lin (2006) examined financial institutions in China and suggested to use BSC in combination with other analytical techniques (e.g. Data Envelopment Analyses) and as a means to improve performance. Panicker/Seshadri (2012) analysed Standard Chartered Bank in India by looking at publicly available information mostly with regard to financial statements concluding the need for further usage in the Indian banking sector. Dave/Dave (2012) while looking at the State Bank of India and further elaborating on the complication in terms of measuring individual aspects also called for the BSC due to the need for establishing a comprehensive performance evaluation system. Besides China and India as the most powerful emerging countries, studies have also been conducted with regard to less prominent countries. Al-Najjar/Kalaf (2012) investigated how BSC is developed to evaluate performance of a leading bank in Iraq. Fakhri et al. (2011) analysed usefulness of BSC among banks in Libya and concluded that it was beneficial. The same was concluded by Ahmed et al. (2011) by looking on banks in Pakistan. Wu (2012) used the DEMATEL<sup>70</sup> method to help prioritizing performance indicators.

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<sup>70</sup> Decision Making Trial and Evaluation Laboratory

Analysing existing studies it is noted that there is a shift from the studies up until ap. 2003, which look at the BSC as a management tool to more recent studies, which look at it as a performance measurement tool. Most of these studies use mainly financial ratios to evaluate bank performance that are based on annual or quarterly reports. Kaplan/Norton (2001a) stated that "...an exclusive reliance on financial measures in a management system is insufficient." This is also confirmed by the author with regard to this research. As described before, cooperative banks need to accomplish a comprehensive and integrated transformation. The way to overcome this challenge was provided by Kaplan/Norton (2001b). No comprehensive examples of the relevant approach have been come across by the author, which is yet not surprising giving significant internal data required. In connection with the research problem this study will address this issue by developing a balanced scorecard for a cooperative bank in the light of the challenges identified in the previous chapter and test whether previous statements regarding the non-applicability of a standard BSC, made e.g. by Kipker (2004), hold true.

### **8.1.3 Reasons for cooperative banks to opt for usage of BSC**

Prior to deciding upon application of the BSC, different instruments for strategy implementation were reviewed. These included mainly *Six Sigma* as developed by electronic company Motorola, , *Performance Prism* as developed by Andy Neely and Chris Adams, *TQM* as developed by W. Edwards Deming, Joseph M. Juan and Armand V. Feigenbaum, the *EFQM Excellence Model* as developed by the European Foundation for Quality Management, and the *BSC*. Based on preliminary talks with cooperative managers and MC1 as well as the review of existing (practical) literature with regard to strategy implementation it has been concluded that all models but EFQM and BSC should be ruled out. The reason for this was simply the reason that, giving that all models are comprehensive, EFQM and BSC have been considered the most acceptable and successful ways for performance measurement (Lamotte/Carter, 2008). In addition and with this author being open to all ways, these were the only ways that were also known to cooperative managers in talks with. As being told, this was due to impulses coming from the BVR and other network staff.



Both methods also had one benefit perceived beneficial by banks staff: they work on ratios or indicators, i.e. are quantitative. Bank staff on all levels is used to make decisions on numbers and, hence, can relate easier than on otherwise qualitative based indicators.

Based on this, it was recalled with cooperative managers and MC1 as well as based on previous findings what the instrument is envisaged to achieve, i.e. what concrete points need to be covered. Three dimensions in reference to Kipker (2004) were identified in this context with concrete points as follows:

#### *Vision, Strategy and Targets*

- Formulation of a missing vision and strategy
- better strategy communication
- better common understanding of strategy
- improved strategic learning

#### *Situation related reasons*

- Measuring and improving performance in terms of management and operations
- support of possible mergers
- formulation of KPI
- setting up of a performance culture

#### *Strategy implementation*

- set up of an efficient planning process
- better acceptance by staff
- operationalization of strategic targets
- measurement of targets and progress

Based on all information, strategy implementation was identified to be the most important factor. This was also the driver why it was opted for the BSC. Giving the issues identified in previous chapters, a forward looking and strategy driven approach was deemed necessary with operational and measurable terms that can be tailored to the uniqueness of every organization. The EFQM with the focus on processes in the present and uniform criteria for measurement were deemed to lack the necessary flexibility and applicability.

The BSC is often regarded as a nice-to-have tool with its capability underestimated. However, especially in times of economic uncertainty with pressure on cost and income, a structured approach is necessary. MC1 stated:

*"Usually, working on something already existing is easier than working on something new. The most important asset of the BSC is its potential to optimize existing operations. Make things better."*

In this regard, it is also important to demonstrate the interconnection and impact of initiatives to be undertaken. For example, when a cost reduction measure is decided in the Finance perspective, it is linked to the Customer level to make sure that this will not lead to lower income or reputation, linked to the Process level to make sure implementation is initiated and to the Employee level to make sure that cost awareness is enhanced.

As found out and demonstrated in the previous section, the overriding problem of primary banks is not the awareness of a sub-optimal situation but instead the willingness to implement CHANGE. MC1 stated:

*"The BSC gives management a tool, an instrument to hold on, to actually transfer their ideas by applying practicability and focus."*

The mention of *focus* is of special importance. Given time and cost constraints, it is essential to focus on the most pressing initiatives to be undertaken. The BSC helps to

prioritize measures and also to identify topics that need no change after all. MC1 stated:

*"The BSC helps to provide transparency in the performance process."*

Evidence in chapters 6 and 7 stated that most cooperative banks have an operational and medium-term planning process. However, as confirmed in the previous section, this process predominantly focuses on financial indicators that are reviewed annually. There is, however, no process that explains the as-is development to identify potential lacks in the analysis process.

Also, the conclusions from section 3.2.1.3 in terms of tangible and intangible resources were considered, i.e. the BSC allowed to approach this issue in a structured way. A 100% congruent reconciliation between the resource concept and the BSC was not identified to be possible. However, congruence was considered to be very high and sufficient giving the four perspectives of the BSC basically provide for a pre-defined separation.

- The financial perspective refers to tangible resources only, in particular to assets and liabilities as well as capital.
- The internal perspective refers to tangible processes.
- The learning and growth as well as customer perspective refer primarily to intangible resources and secondarily to tangible processes.

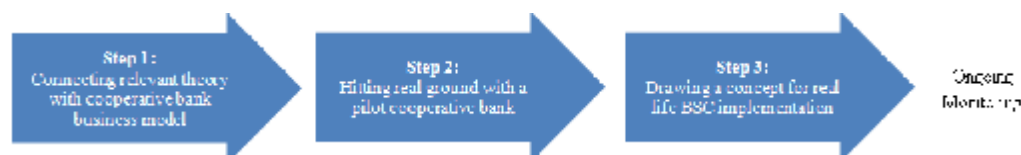
## **8.2 Balanced Scorecard in cooperative banks: Case Study**

One of the main goals of this research is to develop an ideal type or benchmark BSC for a cooperative bank. Given the fact that cooperative banks in general have a very comparable business model, it is assumed that this task can be achieved by drawing up a concept based on academic and practical experience and test it on a real-life object. The development of the concept took place while discussing the individual elements with the case study banks.

## 8.2.1 Approach to the case studies

It was concluded by the author that the best way to address the issue would be multi-step approach. Each step was meant to be the basis for the next step, i.e. issues contemplated were further developed and narrowed down in order to conclude the biggest common denominator.

Figure 53: Multi-step approach to development



At the beginning (Step 1), it was necessary to connect the relevant theory with the cooperative banking business reality. On the one hand, this meant that BSC issues had to be contemplated in the light of the specific characteristics of cooperative banks, being business model and stakeholders as discussed in chapter 3.

Following this, the conclusions had to be tested in practice. It was concluded by the author that one bank only would in fact be sufficient to conduct the project. However, due to the fact that it is envisaged that conclusions and concepts can be transferred to virtually all cooperative banks up to a specific size it was concluded that preliminary conclusions needed to be tested first and then used as a basis for a second cooperative bank. Given the fact that the first hit-on-ground needed a lot of flexibility, the professional/employment status of this researcher was incorporated.

Part of the regular work of an auditor, even though not compulsory by law for non-listed companies, is to conduct a half-year review of bank business operation. In this connection, half-year reviews were and are conducted with three audit clients, being cooperative banks with total assets between EUR 50 million and EUR 200 million. Discussions were held with one bank's management (Bank1) to discuss the implementation of a BSC in their bank (Step 2). It was envisaged to discuss basic issues of implementation only due to the before mentioned research approach but also due to the legal restrictions professional auditors are subject to with regard to

independence<sup>71</sup>. Discussions aimed to test how the conclusions made before hold up in practical discussions. In particular, it was not aimed to draw a concept for the actual implementation but rather cover the most relevant aspects with regard to a cooperative bank.

In order to further elaborate on the research topic and to overcome the limitations of Bank1, the combined findings were aimed to be transferred to a third-party bank to which there are no connections (Step 3). Via a personal contact with one cooperative bank, i.e. with the head of internal audit, in a different federal state of Germany, contact could be established resulting in the approval by management to conduct a project that would help to strengthen the strategic position (Bank2). It was aimed to conduct a full project regarding the implementation of a specific BSC and conclude, how the previous work can be used for this bank and for other cooperative banks in general.

Giving that both banks, as virtually all cooperative banks, showed the same business model, it was just size that was different. In the following, both banks are described in order to present a basis for comparison. As agreed upon, names have been disclosed. After this, details and descriptions are provided regarding the activities undertaken with a focus on Bank2 as being the most important real-life case.

## **8.2.2 Introduction to the case study banks**

### **8.2.2.1 Bank1**

The following characteristics of Bank1 can be summarized:

- It is located in a Southern federal state and belongs to a regional authority with the main city comprising ap. 8.000 citizens. Next to its head quarter it maintains one branch.
- As with almost all cooperative banks of this size, business sectors comprise private customers (retail) and corporate customers (Mittelstand). Share of private customers of customer receivables is ap. 80%.

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<sup>71</sup> According to section 2 of the Statute of Auditors and section 43 of the Public Accountant Act the auditor needs to be independent from restrictions. Auditors are prohibited from "self-audit", i.e. it is prohibited to audit work that has been implemented by the same auditor before.

- Within its region, main competitor is one savings bank with one branch that is, however, not in the direct district of Bank1. There are no private banks.
- In terms of financials, the following KPI are summarized (in mEUR):

	2012	2011	change	in %
Customer receivables	49	48	1	2
Bank receivables	2	1	1	100
Bonds	4	5	-1	-20
Participations	1	1	-	-
Total Assets	58	57	1	2
Customer liabilities	34	31	3	10
Bank liabilities	13	16	-3	-19
Equity	5	4	1	25
Interest income	1,9	2,0	-0,1	-5
Non-interest income	0,4	0,4	-	-
Administration expenses	1,1	1,2	-0,1	8
Operating profit before tax	1,5	0,5	1,0	>100
Increase funds for general bank risks	0,5	-	0,5	-
Liabile capital	7,6	7,3	0,3	5
Solvability ratio	16,7%	17,1%	-	-0,4
Staff	11	11	-	-

Bank1 is typical rural bank with virtually no competition from other banks. Population is stable. Asset as well as liability structure are also very stable. 84% of total assets are customer receivables, which are, however, covered by customer liabilities only by 69%. CEO1 stated:

*"Due to the still on-going uncertainty regarding the overall economic development we have again seen a higher increase of deposits. We are well capitalized and will pay out a dividend of 5%".*

Income situation heavily depends on interest income. Overall, income has been stable, which is also due to lower administration expenses and better results from loan loss valuations. CEO1 stated:

*"Interest income is only slightly lower than the year before and stabilizing this will be the major effort for the next two years especially due to the increased competition from direct banks. Giving that our development is heavily*

*influenced by the regional economic development, which also has a stable outlook, we assume a continuing stable development in the next two years".*

Overall, Bank1's development was just satisfying, i.e. there was no growth in revenues with the outlook being further negative.

### 8.2.2.2 Bank2

The following characteristics of Bank2 can be summarized:

- It is located in a Northern federal state and belongs to a regional authority with the main city comprising ap. 12.000 citizens. Next to its head quarter it maintains seven branches.
- As with almost all cooperative banks of this size, business sectors comprise private customers (retail) and corporate customers (Mittelstand). Share of private customers of customer receivables is ap. 60%.
- Within its region, main competitors are one savings banks with three branches with its head quarter in the next larger city ap. 60 km away comprising ap. 120.000 citizens. The other competitor is Deutsche Postbank with one branch.
- In terms of financials, the following KPI are summarized (in mEUR):

Figure 54: Bank2 bank characteristics

	2012	2011	change	in %
Customer receivables	81	79	2	3%
Bank receivables	34	32	2	6%
Bonds	57	45	12	27%
Participations	4	4	-	-
Total Assets	192	174	18	10%
Customer liabilities	155	138	17	12%
Bank liabilities	12	11	1	9%
Equity	16	15	1	7%
Interest income	4,6	4,8	-0,2	-4%
Non-interest income	1,1	1,0	0,1	10%
Administration expenses	3,8	3,4	0,4	12%
Operating profit before tax	1,0	3,7	-2,7	-73%
Increase funds for general bank risks	0	2,6	-	-
Liabile capital	25,6	24,0	1,6	7
Solvability ratio	25,2%	24,8%	-	0,4
Staff	31	32	-1	-3

Due to its characteristics, Bank2 ideally suits the focus of this research. Next to its suitability for this research, it is also a good example for the current development discussed in previous sections. Bank2 is well capitalized and has no issues with Basel III compliance. Assets are dominated by customer money. However, while customer liabilities, usually deposits, grew by EUR 17 million or 12%, customer receivables, usually loans, grew only by EUR 2 million or 3%. The reason was higher investments in bonds, which grew EUR 12 million or 27%. CEO2 stated:

*"Due to profitability reasons we invested liquidity in bonds rather than deposits with our central bank. Loan growth was still friendly. Due to special options customers make significant use of their repayment rights, i.e. higher priced loans are replaced with fresh money due to the on-going low interest level".*

Income situation is characterized by interest income that has decreased by 4% in 2012 due to the overall lower interest level. Positive was the increase of non-interest income by 10%. Administration expense increased significantly due to modernization efforts of existing branches. Also due to loan provisioning, operating profit decreased significantly. CEO2 stated:

*"Last year's income situation was characterized by one-off effects with regard to loan provisions, resulting in extraordinary profits. Also taking into account this year's normalized situation, we are still fully satisfied with the profit level that is sufficient to meet our members' expectations".*

What is meant by the Bank2 executive is the fact that only kEUR 450 of equity stems from members' capital with the remaining share coming from reserves. Applying a dividend rate of 6%, only ap. kEUR 27 in profits are required to cover dividends. With capital base already in very good shape and investments already financed.



## 8.3 Introduction to the project

### 8.3.1 Step 1

In reference to Porter (1996), strategies for retail banking can be summarized as cost leadership, customer proximity and complete service. In order to follow these strategies, strategic goals need to be defined.

#### 8.3.1.1 Learning and development perspective

As derived from relevant literature, there are common features of a successful strategy that can be used for setting the base of future income and success sources, thus helping to provide for a uniformed BSC (Harengel/Hess, 1999).

##### *Motivated staff*

Motivated staff leads to positive profit contributions and help to support the personal development of individuals<sup>72</sup>. Given the static and complaisant situation among cooperative staff, measures to help creating motivation is regarded the most important challenge with regard to successfully implement the BSC. Measures are responsibility of management and comprise compensation, own responsibilities, career development and variability of staff.

##### *Access to information*

Banks are information providers. To improve performance, banks need to have up-to-date information that Priewasser (2009) divided into *external* and *internal*. Internal information are customer data such as income, profession, wealth, family status, product data, etc. External information are competitor actions, regional economic data, population development, etc. In order to enhance sales, it is essential that these information are to filtered by relevance and provided on a regular basis with permanent access by sales staff (e.g. laptop, internet, etc.).

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<sup>72</sup> refer to the work of Sarah Burgard (University of Michigan) for a comprehensive overview

### 8.3.1.2 Internal perspective

In order to provide for more details measures, the overall three strategies need to be further distinguished. An appropriate way to do this was to use dimensions looked at by customers when considering bank relationships. Sträter (2005) summarized the following:

Table 34: Dimensions influencing bank choice

Dimension	Content
Conditions	Rates, transparency
Products	Range, quality
Advisory	Professional and social competence Confidentiality
Availability	Branch network, opening hours, parking spaces, internet, machines
Image	PR, social engagements
Internal processes	Speed and quality of queries, obligingness

In reference to the overall position of the BVR, the following focus strategies have been concluded:

- Cost Leadership
  - Concentration on basis products
  - Increase automation
  - Increase branch usage
- Customer proximity
  - Increase use of all sales channels
- Complete service
  - "Allfinanz" Total service and service quality

#### *Concentration on basis products*

In order to provide for focused actions, there needs to be transparency, which products provide most sales and profit contributions. As a rule of thumb, products that account for 80% of the sales, should represent basis products. By doing so, it is expected that resources can be pooled, thus, making processes more efficient and reduce costs. Products that do not contribute, should be eliminated.

### *Increase automation*

Automation is referred to as IT systems substituting staff activities (e.g. cash ins, cash outs, transfers, interest and tax forms, etc.), thus reducing staff costs and speeding up processes. Costs are only saved when investments are lower than the opportunity costs. Also to be considered is the fact that automation leads to lower error rates, thus improving customer satisfaction.

### *Increase branch usage*

The extensive physical branch network represents the biggest cost block among cooperative banks. To increase efficiency, measures need to be implemented that increase contracts per employee within the branches. This can either be achieved via the before mentioned automation or the optimization of the physical branches, i.e. an analysis of the branch density needs to be carried out with the aim to close down unprofitable ones and transfer or combine business with neighbouring ones. Negative effects of losing customers need to be contemplated with regard to cost savings.

### *Increase use of all sales channels*

Own experience/observation and other research has shown that branches within the network are often not sufficiently utilised. Alternative sales channels are self-service terminals, mobile sales force or internet that all comprise lower cost levels than physical presence. At the same time, customer proximity is to be considered. Many customers, especially younger ones, want contact independent of time and place.

### *"Allfinanz" i.e. Total service and service quality*

Customers have a need for all financial services products, i.e. deposits, accountants, loans, insurances, securities, etc. Cooperative banks through the cooperative network are in a position to offer all these products, thus having the advantage to intensify the relations through follow-up business and to increase profitability through additional sales initiatives. At the same time it is essential to ensure high quality management.

Market research indicates that customers remember predominantly negative aspects of past experiences, e.g. wrong settlements, long processing times, as opposed to positive aspects, e.g. good conditions. Bearing in mind the necessary concentration on core products combined with increased automation it is essential to analyse the situation thoroughly to ensure a solid balance.

### **8.3.1.3 Customer perspective**

Upon considering this perspective, three sub-strategies were identified:

#### *Supply the best price-performance ratio*

Market research confirmed, most recently by Ernst & Young (2014), that German customer are, in comparison to other European customers, the most price sensitive customers. Therefore, the initial idea, especially in retail banking, is to provide the lowest prices possible as far as the cost level provides for this. However, low prices alone will not lead to competitive advantages if errors, low quality and too little product offerings are the consequence.

#### *Increase customer satisfaction*

Not being specific to cooperative banks, this is a goal to be followed by all companies. Customer expectations have increased, as has competition. To retain a customer, it is essential that he is satisfied and has no reason to change the bank. Prerequisite for this is that the bank knows the expectations in order to engage in appropriate measures.

#### *Increase of customer profitability*

A big problem in retail banking is the fact that many customers are not profitable. When all strategies mentioned before are fulfilled then returns per client shall increase automatically. However, it is deemed important that this indicator is monitored separately.

Even if all strategies from the internal perspective are fulfilled it still is possible that a large number of clients is still unprofitable, while already profitable customers are becoming even more profitable. Economic principles prescribe to get rid of these customers. Observing the market, a few examples have been made public where banks terminated customer contracts since the underlying products have become unprofitable for them (SpiegelOnline, 13 September 2013). Given the cooperative principles, this approach is not possible for primary banks. It is, however, necessary to carry out these analyses in order to confirm the success of measures initiated and cluster existing customers for further sets of measures.

#### **8.3.1.4 Financial perspective**

Despite the principles of the cooperative sector and giving the current development of the economic climate, the most important goal needs to be PROFIT, i.e. profits needs to be maintained or, if possible, increased. Achieved via the increase of sales and reduction of costs. In order to get in shape for the future structure, i.e. automation, reorganisation of branch network, improve social media, etc., investments are necessary and have to be financed. Thinking two steps ahead, it is also necessary to "brush up" the bank in order to become more attractive for further cooperation, e.g. mergers or acquisitions.

#### **8.3.1.5 Possible indicators**

Hereafter is a summary of indicators that can be used to make strategic targets operational. The indicators are the essence of observations, discussions, experience and literature mentioned previously. They were not chosen based on the premises that they are already in use but rather whether it makes sense to implement. Whether these can be used in practice depends on the real-life test cases.

Table 35: Performance indicators in retail banking

Perspective	Indicator
Learning and development	Fluctuation rate, number improvement suggestions, appraisal by superiors, number of employees in job rotation, further education of employees, succession planning

Perspective	Indicator
Internal	Number of customers or accounts managed by employee, time used per customer, number of products sold to customers, number of automated transactions, time used for loan application process, process costs per application, cross selling reatio, use of electronic sales channels

Perspective	Indicator
Customer	Change in market share, number of new customers, number of customers lost, customer satisfaction index, number of customer complaints, number of profitable customers, number of profitable products sold

Perspective	Indicator
Financial	Profit per employee, cost per employee, cost income ratio, gross performance before risk, gross performance afte risk, return on equity, economic profit, risk income ratio

### 8.3.2 Step 2

Discussions with bank management were held on a very pragmatic level. Being a first step and giving the legal restrictions, it was agreed upon to develop a first BSC on an overall bank level that matches the bank's strategic orientation and serves as a tool to collect information.

Given size of the bank operations, the following propositions were to be complied with:

- Bank1's strategy had to be illustratable via the perspectives and measures or ratios
- The number of indicators/measures shall not exceed 15 in total
- Calculation of measures shall be straight-forward and easy to understand

Discussions were held with the entire management personnel as size and staff structure allowed. There was no defined schedule for those discussions and no formal agenda had been communicated. The process included presenting the rationale of the BSC and their perspective and the ideas by this researcher's pre-case study considerations in form of a brainstorming session. In total, there were two brainstorming sessions over a period of two weeks. At the end, the following preliminary BSC was developed.

**Table 36: Bank1's BSC (first draft)**

<b>Learning and Growth</b>		
<b>Indicator</b>	<b>Definition</b>	<b>Objective</b>
Online ratio	Online customers / all customers	Indicator for channel usage
Fluctuation ratio	Staff leaving / all staff	Indicators for staff
Content ratio	% of staff being satisfied	satisfaction
<b>Internal process</b>		
<b>Indicator</b>	<b>Definition</b>	<b>Objective</b>
Process intensity	Account applications / sales staff	Indicators of productivity
Staff relation	Sales staff / Admin staff	
<b>Customer perspective</b>		
<b>Indicator</b>	<b>Definition</b>	<b>Objective</b>
Volume per customer	av. Business volume / number of customers	Indicator of volume intensity
Income per customer	gross income / number of customers	Indicator of income intensity
<b>Financial perspective</b>		
<b>Indicator</b>	<b>Definition</b>	<b>Objective</b>
Cost-Income Ratio	see section 4.2.3.2	Indicator of profitability
Income intensity	Income per employee	Indicator of staff productivity
Cost intensity	Cost per employee	Indicator of staff productivity
NPV	NPV / total assets	Indicator of value
Growth	Growth in assets and liabilities	Indicator for acquisition
Valuation adjustments	Loan/securities adjustments / operating income before valuation	Indicator for Risk/Return situation

In discussions with neighbouring cooperative banks, BSC1 was compared and elaborated on by their managers, also upon request by this researcher. Bank1's manager replied:

*"It was overall consensus that the indicators defined cover the most important issues of our businesses, however, need a higher level of detail. This comes as no surprise giving the same business model".*

The handling process was monitored over a period of four weeks. While observing how the first draft was further discussed internally it was especially helpful to gain insights into how the BSC was planned to be implemented into real-life business operations. Overall, the following conclusions can be drawn:

- It is important to make a start. Once started, the project kicks off with input provided by virtually all employees.
- As far as the first BSC is concerned, a pragmatic draft is sufficient. It is important to make easily comprehensible and accessible without setting expectations high.
- Indicators/measures that do not concern the financial perspective are difficult to design and require more considerations.
- Discussing elements with partner banks are helpful. Giving the regional principle, thus reducing competition, no threat in terms of sharing confidential data is seen.

The valuable insight gained was, as expected, that without setting concrete targets and initiatives, efforts in connection with the BSC will not be fruitful. The more individual measures and perspectives are discussed, the more increase the expectations in terms of their content.

### **8.3.3 Step 3**

After wrapping up the information, insights and conclusions from Bank1, the agenda for Bank2 was drafted.

In cooperation with Bank2 and in connection with this research being undertaken, it was agreed that a project can be conducted in order to assist the management board going forward into 2014 as part of a strategic reorientation programme that,



otherwise, would have been carried out internally only, i.e. without the assistance of external advisors. The project included the application of previous findings and connection with relevant practical and academic experience with regard to the BSC.

As a starting point, the idea and concept was introduced to the board. After deciding upon the project it was agreed upon that a BSC on the overall bank level was to be drafted, which fits the strategic orientation of Bank2.

In total, five workshops with a duration of one day each have been planned and conducted between June 2013 and October 2013 with the topics outlined below. The workshops were attended by bank employees of all levels:

- Definition of vision, mission, values and strategy
- Setting strategic targets for customers, processes, finance, employees and member
- Setting performance indicators for strategic targets
- Setting measures and initiatives
- Integrating the concept into the bank's controlling system

In the following, the content and conclusions of the individual workshops are outlined. The workshops were set up to build on each other, thus enhancing the idea behind the research.

#### **8.3.3.1 Vision as starting point**

The strategic reorientation of Bank2 grounded in management's concept regarding vision and mission. The concepts for vision and mission were discussed with the bank's management, hereby combining grounded management theory with practical implications of the cooperative sector. Upon this, considerations and rationale were discussed with selected employees of all hierarchy levels. Vision and mission were not only aimed to be an internal guideline, but also a means to transfer the reorganisation externally.

After discussing the above and also considering findings by the author from prior research, the following was finally agreed upon:

The formulated vision, answering the question "Where does the bank want to go?", was summarized to be:

*We want to work in a successful bank*

- *that serves as benchmark for customer region within our region*
- *in which satisfied customers can become enthusiastic ones*
- *in which humans place a premium on the interests of others*
- *in which everyone supports everyone*
- *in which new ideas are welcome and success is acknowledged*

The *mission*, answering the question "How does the bank want to be seen by the market?", was formulated as follows:

*We have accepted the challenges of the market. We will further improve our market position in the region in order to offer to our members and customers today and tomorrow solutions to financial questions, good products at fair prices and a tailor-made service.*

### **8.3.3.2 Setting strategic targets**

Based on the formulated vision and mission, the strategy was formulated and defined with management. The core idea of the discussions, which were primarily held with the bank management, was how the chosen strategy can be implemented and the degree to which it is coherent with vision and mission. A permanent reflection of all aspects took place.

Given the changes in the banking sector, the strategy discussed and defined is not supposed to be carved in stone. After the envisaged time horizon it is expected and required that the strategy needs to be updated and adjusted. The same applies to the BSC.

The strategy was summarized in three sections.

#### 1) Sales

- Increase of sales potential by increasing sales time und reduction of service time
- Realising cost reduction potential stemming from service and management processes

#### 2) Competitive strategy

- Differentiation strategy in terms of advisory
- Cost optimization in service

#### 3) Risk minimization

- Increase of quality via clear rules and interfaces
- Introduction of instruments for early risk identification and steering

Upon this, considerations and rationale were discussed with selected employees of the next management level as well as the supervisory board. After this, a presentation was given to all bank staff. The presentation was part of the annual summer break out. While it was not communicated that the reorientation was an economic necessity with no alternative, it was made clear that this approach was considered the most attractive option for all stakeholders. An essential part of the communication was the clear definition of roles and responsibilities. The bank management made a clear commitment that they are in charge and are open for every question and thought that arises in the course of the process.

#### **8.3.3.3 Setting performance indicators**

Based on the strategic orientation, strategic targets were defined and allocated to the selected perspectives. The following considerations were discussed with management:

- Will the defined targets match the bank strategy?
- Is the relation cause - impact regarded?
- Are the "classic" perspectives enough or shall a "risk" perspective be added?
- Is it enough to have one overall BSC or shall individual department scorecards be defined?

In our opinion, the envisaged targets are in compliance with the strategy with a sufficient cause - impact relevance. The idea of adding a fifth perspective, "risk", was abandoned due to the overall negative meaning of the word and the otherwise low-risk situation and orientation of the bank. The implementation of department BSC was, in general, advocated, however, postponed to a later point in time, i.e. after the annual strategy workshop. The reason for this was especially the still on-going organisation reorientation by setting up new departments with relevant processes.

#### Definition of relevant indicators

In discussions with management it was concluded that there should be 25 indicators at maximum to be distributed among the perspectives. The number of indicators was influenced by the effort necessary to calculate it. Another feature was the requirements that the calculation of the indicator can be done at any time with current data and high quality. Also, a balance between early and late indicators was deemed necessary.

#### Definition of targets

Based on this author's experience from other banks, mainly large-sized banks, targets are often set very ambitiously, not taking into account the company's real capability. Also, since a bank's strategy as well as the BSC is a long-term process, it is and was deemed necessary to define interim targets.

Targets within the perspectives should have different deadlines. Due to the nature of the project, targets of the learning and internal perspective need to be set short-term,

while targets of the customer and financial perspective are to be set long-term since these are built upon the success of the prior two ones.

### Strategic measures

"Targets can only be met, when strategic measures are introduced helping to achieve these and succeed." This statement by the bank's manager was sent out to the staff pointing out the importance of their cooperation. It was deemed crucial to send out this message and point out to the fact that the wheel will not be reinvented and their previous work be appreciated. That means, measures already in place needed to be analysed in terms of suitability and then allocated to the perspectives. New measures had to be achievable and acceptable to staff and other stakeholders. In order to connect strategic with operational measures, this part was discussed in workshops with staff of all levels. Budgets were applied for the realization of measures.

#### **8.3.3.4 Presentation of the BSC**

Based on all discussions, interviews and workshops, the following BSC was developed and agreed upon. The focus was on the customer, learning and internal process perspective. Intentionally, for the financial perspective no measures have been drafted since the outcome and results from the other perspectives are to be regarded and analysed first. Since targets are internal and confidential information, the final numbers cannot be presented.

Table 37: Bank2's BSC

Financial perspective			
Strategic target	Indicator	Target	Measure
Increase overall bank profitability	Cost Income Ratio (CIR)	< x %	n/a
Increase overall value	Overall net present value	+ x % p.a.	n/a
Increase profit contribution (DB) III	DB III	+ x %	n/a
Lower risk costs	Valuation result	- x %	n/a
Increase staff profitability	Income / employee	+ x %	n/a

Customer perspective			
Strategic target	Indicator	Target	Measure
Acquisition of new customers	Share new of total customers	+ x % p.a.	Marketing initiatives (ads, internet, radio, social media) Increased contact (more time in the market, less in bank) New visiting hours (employee visit customers at home)
Maintain advisory quality	Customer satisfaction index	+ % of index	Customer surveys Customer satisfaction questionnaires
Increase customer profitability	Usage of total customer assets	x % of assets	Customer survey Complaint management and numbers
Increased usage of existing customers	Number of daily communications Direct customer contact time / number of customers	x per day Increase of x % p.a.	Analysing customer lists and reporting Setting appointments by bank assistants Initiate project to monitor and improve internal processes
Increase sales skills			

Internal perspective			
Strategic target	Indicator	Target	Measure
First class customer service	Number of customer complaints	- x % p.a.	Maintain advanced complaint management
Market and customer orientation	Staff in market / operations	x / x	Process analysis; check outsourcing
Increase process efficiency	Reduction of unit costs	- x % p.a.	Process analysis and optimization
Reduction of throughput times	Days per credit application	- x % p.a.	Process analysis and standardization
Use existing product offerings	Cross selling rate	Increase of x % p.a.	Improve product expertise and information flow

Learning and growth perspective			
Strategic target	Indicator	Target	Measure
Increase staff satisfaction	Fluctuation rate	< x %	Staff surveys
Increase staff qualification	Seminar days / employees	+ x %	Internal and external further education
Increase qualified staff	Ratio of staff with certain qualifications	+ x %	Develop qualification matrix
Increase innovations	Number of improvement suggestions	+ x %	Introduce reward system
Recognize performance	Number of staff discussions	x % p.a.	Introduce evaluation system Adjust compensation system

### 8.3.3.5 Implementing the concept

"Let us make it real" was the last statement of Bank2's manager when wrapping up all previous findings, conclusions and efforts that also marked the end of the concept phase being part of this research's field work. The final part of the BSC project was discussions regarding the implementation of the project. As outlined by Horvath & Partner (2008), the most important issue to consider is to comfortably embed and integrate the BSC into the planning process and steering systems in order to release its potential. In this regard, MC1 confirmed:

*"Most criticism with regard to the BSC stems from the fact that many data, mostly from the operational controlling, are aggregated in the hope to derive at steering relevant indicators. However, often data are aggregated from different departments without being reconciled, hence, only providing information regarding the actual situation. The key questions regarding interdependence of various indicators, i.e. information with steering relevance, often remain unanswered".*

In discussions with management, questions and challenges were identified to which the implementation of the BSC has to deliver answers:

*How are the strategic targets, indicators and measures of the BSC integrated into daily operations?*

*How is the progress of the strategy implementation monitored with the BSC?*

*How are strategy, indicators and measures linked to target agreements and incentives?*

*How is the reporting structure to be modified to capture all relevant information?*

*How can BSC usage be improved with the assistance of IT tools?*

With IT related issues not further regarded in this research, the two issues contemplated were the integration into the planning and steering process as well as the transfer of the BSC to the staff and the mobilization and monitoring of their resources and input.

### 8.3.3.6 Integration into planning and steering

The strategy setting and adjustment process is usually conducted annually as laid out in the planning calendar. The BSC is aimed at improving the process that usually encompasses a time horizon of ap. eleven months and, thus, overcoming the problem of many small banks, i.e. the inflexibility to react to changes. Discussed with management and outlined hereafter is a draft process regarding the changes of the strategy status quo, being predominantly an unstructured approach, upon BSC implementation. The most important changes and also benefits for the banks are:

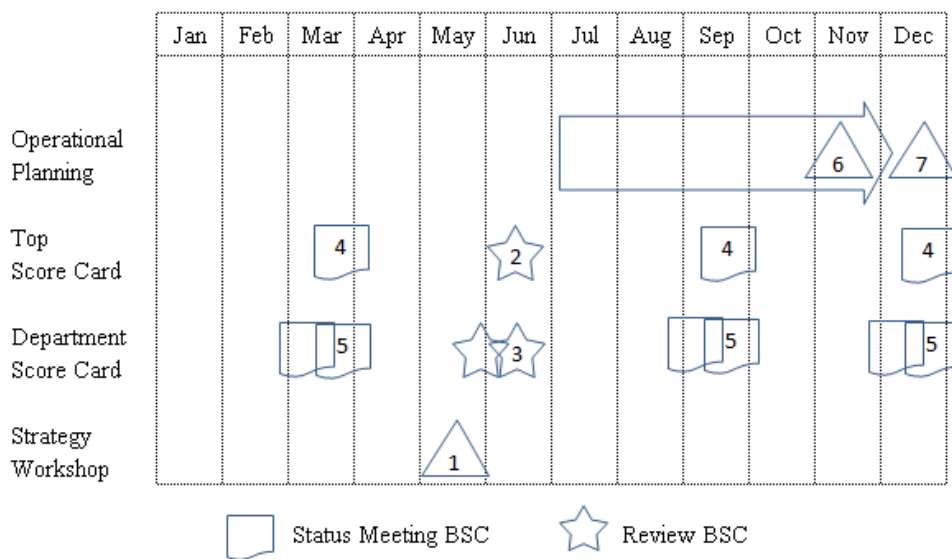
*The BSC process becomes integral part of the strategic management process.*

*Via the implementation of the BSC, the strategic planning process is usually extended, the operational planning process, however, shortened.*

*The entire planning period and resources required can be shortened. Through the shortening of the planning period, the actual planning can start later, hence, enabling the existence of more up-to-date information about markets and competitors and shorter response times.*

In reference to Kipker (2004), the following adjusted planning process has been discussed with management. According to the information provided to the author, a respective meeting agenda with responsible persons for 2014 has already been fixed.

Figure 55: Adjusted strategy process after BSC implementation





### Strategy definition

Starting point of the planning process is an annual strategy workshop (1) in May, i.e. after the past financial year has been finalized and indications of the current financial year are available. Here, strengths and weaknesses as well as opportunities and threats (SWOT) are analysed and evaluated in order to strategically react. Next to the overall situation analysis, most pressing topics need to be discussed on board level (e.g. multi-channel sale, optimization potential, etc.).

### Strategic planning

The adjustment of the strategy and the definition of the new strategic initiatives will be discussed in the subsequent review meeting (2) with regard to the top scorecard (TSC) resulting in adjustments of strategic targets, indicators and measurements. This task shall be conducted by the TSC review team consisting of first and second tier management staff. This will also serve as blueprint for the department scorecards (DSC) discussed in subsequent meetings (3) that further elaborates operations. At the same time, there will be a review of the difference between projection and outturn regarding the individual targets, indicators and measures with corrections carried out serving as the planning base for the next year.

### Operational planning

Strategic targets from the TSC and the DSCs serve as milestones for operational planning. Income indicators and targets are broken down to sales targets. The wrap-up of the operational planning process will be the supervisory board meeting (SBM) (7) at the end of the year after deciding upon by the board and management staff in the following Management Workshop (MW) (6). Upon finalizing the MW, department targets are to be transferred to and discussed with the individual staff level, which is considered one of the crucial task of this process (see following section). Since the targets are discussed between second tier and third tier staff, past practice, being solely top-down, are avoided, thus enhancing staff awareness and acceptance through involvement.

### Strategic controlling and steering

Next to the annual review meetings for the TSC and DSC, there will be regular meetings regarding target achievement (4) (5). It is important to schedule the DSC meetings before the TSC meetings, so that failures in achievement can be analysed before and reasons be discussed. Regular RAG classifications shall be applied and presented by the department heads. In order to achieve efficiency, meetings shall be attended by first and second layer staff and held in conjunction with regular management meetings.

### Reporting

Next to the status meetings, there should be up-to-date reports with regard to BSC achievement focussing on the targets and indicators outlined. The reports should enable management to drill down the individual numbers.

#### **8.3.3.7 Linkage with target agreements and incentives**

Based on previous findings by this author, it was discussed with management that acceptance by staff is the most important task. Every employee knows about the current situation, however, is usually too complacent to act. It was concluded that this statement is in general applicable.

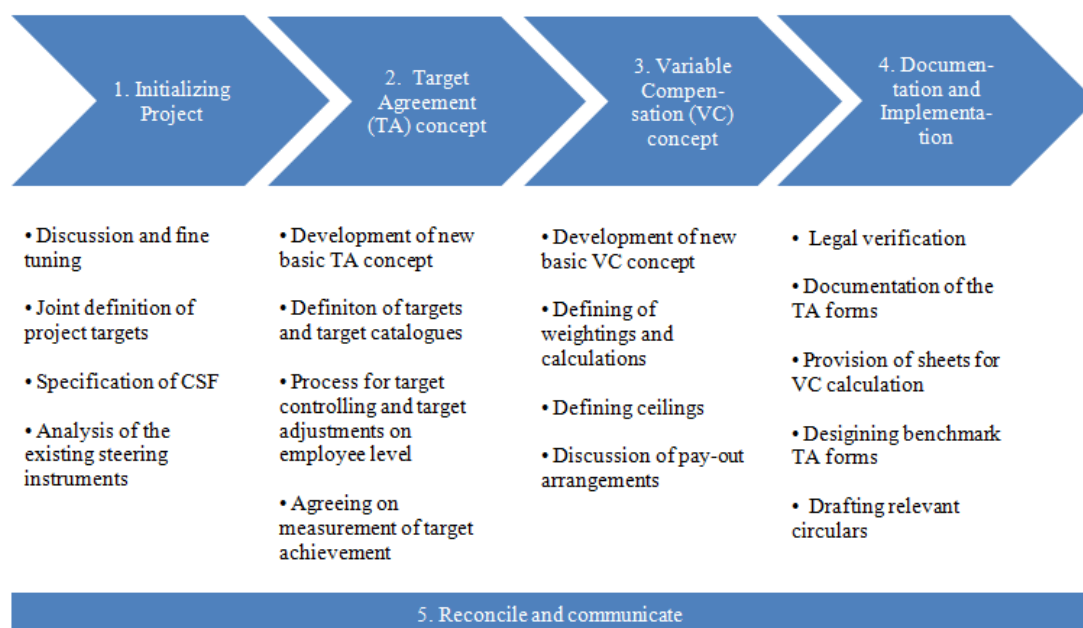
At the same time, the reason for the overall lack of coherent performance measurement is the difficulties seen in implementing an acceptable target and incentive framework. This holds especially true in terms of designing suitable variable compensation frameworks as a direct consequence of the circumstance that most banks only implement a TSC and do not further elaborate down to the department level. However, this is exactly where the benefit of the BSC lies for the bank. With the compensation headroom given, banks need to make enhanced use of this instrument as a means to control costs.

It is, therefore, crucial to link BSC or strategy with the internal steering or management system. The linkage shall ensure that suitable DSCs are derived from

the TSC building the basis for target agreements with employees. The sum of all targets agreements with employees needs to equal the overall target of the bank. This process shall ensure that staff get aware of the strategy and see their contribution towards the overall targets.

With regard to the linkage, the multiple-step approach by Horvath& Partner (2008) was discussed, recommended and decided upon.

Figure 56: Model for linking BSC with internal management



At the beginning, it is important to discuss targets and what the expectations of the management board are (1.). By doing so, it is expected that conflicts can be identified early. Especially from staff representatives it is expected that resistance will occur due to the need to change individual behaviour.

For the development of the TA and VC concept (2./3.) it was suggested to conduct workshops with the most important elements of the management teams including people from the Controlling department and from the union. The on-going information exchange is expected to reduce reconciliation requirements at the end of the project. It was communicated to deal with the two concepts separately and finalize the TA concept first. When discussing VC, it must be clear to all staff how

the result of the target agreement shall look like. It must be transparent, which achievement levels will lead to the individual RAG classification. The quantitative impact on employee level also needs to be discussed and made transparent. It was recommended to conduct simulations regarding various outcomes and the impact on Bank2's income and liquidity situation.

When documenting targets, concepts and processes (4.) it is important to provide guidelines and circulars as a means of reference for staff.

The transfer from the DSC to the target agreements were considered the most delicate plan since this means a change in philosophy of how staff is dealt with. In a first step it was discussed with management to which groups the targets agreements are aimed at bearing in mind the new overall target orientation.

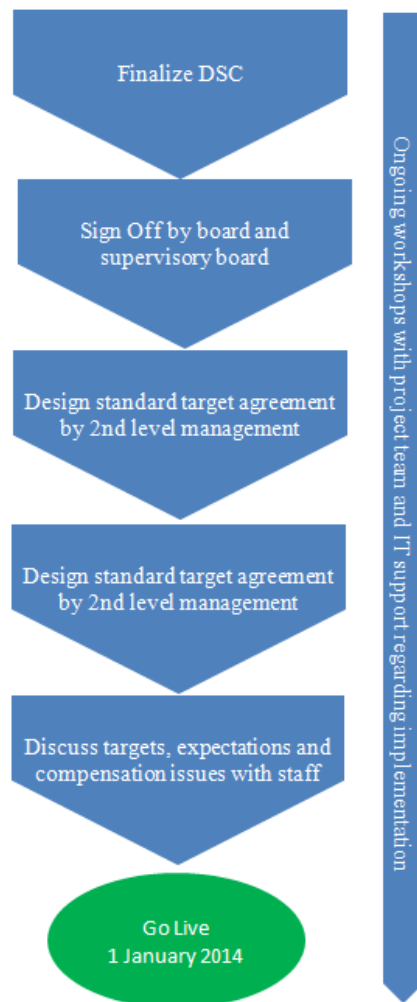
*"Target orientated management means setting targets and monitoring progress. Giving our overall approach this means that EACH employee will get a target agreement".*

Discussions with individual employees are to occur with the direct superior based on a standard format with the form to be signed by both persons. Targets needs to consider employee's tasks, capacity, current compensation level as defined by union contract, customer base and potential. It was recommended that the number of targets shall not exceed five.

After supporting Bank2 with their strategic reorientation, the project and this research has come to a state where theory has been transferred into practical use with the next steps defined. The next steps have been defined and designed in the form of a road map, i.e. the management knows what to do over the next three months. The structure created needs to be filled with real numbers. The philosophical question left is when to go live with the target agreements, i.e. when is the time to change the holy cow of certain routines and income. This question is of special relevance for cooperative banks in general, since target agreements are not part of the regular employment process. Kaplan/Norton (2001a/2001b) suggest a two-year transition

period before target agreements are directly linked to variable compensation. Other authors, based on their experience with the BSC, recommend to implement this link right from the start since only in this way employees take it seriously, adjust their behaviour and, hence, accelerate a successful introduction (Fink/Heineke, 2006). This issue was discussed with management and it was agreed upon that management by BSC shall start on 1 January 2014 with all remaining tasks to be finished before. Even though realizing that this is a very ambitious goal with a number of risks involved, it is seen as the only alternative to react to the already on-going adverse development in a suitable way.

Figure 57: Remaining tasks



## 8.4 Preliminary findings

Being part of the longitudinal case it was researched how the situation has changed. This approach was done via a meeting in May 2014 with Bank1 and Bank2. The original set for these meetings were the annual discussion of prior year financial performance with the supervisory board. Given the size of the banks under review, these meetings fit well with the requirements of the annual strategy workshop as outlined as (1) in figure 56. Next to discussions of financial performance (from an accounting and regulatory perspective), it was agreed with the supervisory board that a number of questions were to be discussed that related to the previous BSC discussions and provide also a better understanding for the future financial development of the bank.

*1) Presentation by responsible bank staff regarding the development of TSC*

*2) Preliminary findings*

The first insight in this process was that during the past months the BSC has found its way into the monthly steering system. In the context of this research, evidence has been gathered and acknowledge by this author regarding the suitability and feasibility of the BSC. Targets as well as appropriate measuring methods have been derived. For a number of targets, actuals have already gathered over the previous six months and brought into comparison with historical data as far as available. It was envisaged to provide to the supervisory board success indicators by showing the positive development in the past months. Even though progress is deemed a success, it must be taken into account that this predominantly is harvesting "low hanging fruits". This author provided assistance in the measurement of numbers and on their relevance. These were predominantly related to non-Financial perspectives. These comparisons are no final basis but provide useful indications regarding the trend. In summary, preliminary findings were as follows:

**Table 38: Bank2's preliminary progress**

<b>Strategic target</b>	<b>Indicator</b>	<b>Preliminary progress</b>
Acquisition of new customers	Share new of total customers	+6%
Increase customer profitability	Usage of total customer assets	+5%
Increased usage of existing customers	Number of daily communications	+7%
Increase sales skills	Direct customer contact time /number of customers	+7%
First class customer service	Number of customer complaints	-8%
Reduction of throughput times	Days per credit application	-5%
Use existing product offerings	Cross selling rate	+4%
Increase qualified staff	Ratio of staff with certain qualifications	+3%
Increase innovations	Number of improvement suggestions	+11%
Recognize performance	Number of staff discussions	+9%

Regarding Bank1, the same progress could not be confirmed during the follow up in May 2014. While evidence could be obtained regarding the development of the project, no preliminary and measurable findings with regard to quantitative improvement could be confirmed. This author discussed the issue with board and supervisory board, where the project is being handled on utmost managerial level. Even though, there was no quantification yet, the BSC concept was deemed a success by this author due to the further development of performance targets. Bank1 decided to adjust their business model in a way that emphasis is put on ethical values and investments. In this regard, Bank1 has discussed measures on how to measure intangible performance. A focus is the development of performance indicators via the inclusion of customer related input, i.e. perception. This approach also enhanced this author's view that a focus solely on the financial perspective is outdated, i.e. there is more potential of the BSC if used and in place. It is envisaged to transfer ethics related soft facts (qualitative) into product related hard facts (quantitative), hence, improving performance and reputation.

## 8.5 Summary and Conclusion

It was this researcher's aim to identify whether the BSC can be effectively used in cooperative banks to enhance performance. The aim was based on the assumption that there is pressure on primary banks to conduct measures on a short-term basis, preferably in-house. The BSC is a tool that was deemed to be feasible due to its simplicity and transparency.

Based on the field work conducted the following conclusions could be made:

Acceptance among cooperative banks and personnel was high. It is assumed that this researcher could establish an open environment that was necessary to achieve acceptance. It was observed that acceptance by staff increased, once it was made transparent that the BSC is not just a fancy or nice-to-have instrument that costs money and would lead to more work and even jobs to be made redundant. It has also been observed that reservations about change as identified before decrease when there is communication an appearance on eye-level, even though coming externally. It could be observed that acceptance is not only a function of project content but also of project ownership. "Big names", e.g. BVR or leading consulting companies, do lead to hesitation, especially among rural cooperative banks.

Preliminary findings confirm that progress in performance can be made once it becomes clear where to bring in change.

Overall, evidence points to the conclusion that the BSC is a suitable tool to deal with measures identified before via its multidimensional and future oriented approach of all bank aspects. It helped to put structure into the most important variable, staff, by defining roles & responsibilities. As identified, vision and mission were discussed on management level, however, without staff being aware of it. Upon step 3, concretisation could be achieved. In this connection, two more issues were identified to be of importance:



First, it was important to get all levels of staff integrated into the process and provide or even enforce their participation. Lower level staff often does not want to play an active role, however, possesses a high level of market knowledge. Hence, their inclusion is vital.

Second, the above mentioned structured way is beneficial to the process. However, the usual top-down approach must be adjusted to map bank and especially cooperative bank reality. Lower level staff possess more advanced knowledge about individual aspects of the social network. It is the task of upper management to link this knowledge with their more advanced knowledge about bank management.

However, based on findings, observations and experience, it cannot be concluded that a uniform BSC with corresponding indicators can be applied. Evidence points to the fact that a standard or basic BSC set-up can be used, i.e. uniformity is high. This especially relates to operational measures in Back Office activities, e.g. loan processing and administration. Still, due to individual management styles and concepts, adjustments are necessary in order to fully incorporate the individual situation.

## 9. Overall conclusion and further research

### 9.1 Background, findings and contribution

*"Nothing is as bad as it looks."*

The major aim of this research was to evaluate the impact of Basel III on cooperative banks. It contributed to knowledge by providing more transparency about the cooperative banking sector by combining bank strategy, business management and regulation to not only increase existing information level but also providing hands-on, i.e. feasible, measures to deal with future impacts.

As opposed to most research and works with regard to cooperative banks, it was concluded from the findings of *chapter 3* that a pure stakeholder value approach is not pursued, neither is it deemed possible. Evidence provided points to the need for a higher orientation towards a comprehensive performance management approach that aggregates and communicates the strategic management process. Further, evidence provided pointed to the fact that, due to the development building up until Basel III, cooperative banks actually do not make profits with customers anymore. While it has been illustrated that this is in fact in compliance with cooperative values, it also lead to intensive maturity transformation (see section 3.1.1), hence, an elevated interest rate risk among cooperative banks.

*Chapter 4* illustrated that increased diversity in banking sectors with the cooperative banking sector in particular does add to diversity and a more sustainable financial performance. Before and during the financial crisis, cooperative banks provided for a stable development that has balanced the real economy. Even if the structure of the German banking market does not concur with free market principles, this research highlighted or pointed to the idea that national banking markets should not be purely based on profit maximization to avoid deep impacts, e.g. like in Great Britain. This research also confirmed prior research stating that Germany is overbanked. However, as was illustrated, a dynamic development, more than in other European countries, is taking place.

*Chapter 5*, upon illustrating the new Basel III accord, provided conclusions about the applicability of the accord to cooperative banks. It was concluded that the intention of the accord is certainly right and will help to smoothen further crises. The identified lack of regulation is the missing preventive element, i.e. instead of making sure financial distress is balanced, there should be more effort in preventing risk in the first place. Even though not in the scope of this research, initiatives to further reduce moral hazard need to be discussed. Based on analyses provided it was concluded that Basel III, due to its missing risk-orientation, is not justifiable for cooperative banks with their low risk business model. The additional contribution was that cooperative banks themselves do struggle more with regulation other than Basel III, i.e. regulation that increases cost in their operational day-to-day routines. With the BaFin being more transformed into a consumer protection authority, further operational burdens are expected.

*Chapter 6* contributed to knowledge by identifying, discussing and performing measures that are of practical relevance for cooperative banks while also identifying and dismissing measures typically discussed in the banking world. Evidence was provided in quantitative form evaluating the impact of Basel III to be lower than initially expected. In addition, measures were discussed with management on how to improve profitability. This research provided a comprehensive analysis on key topics that cooperative bank managers can and should pursue in order to maintain performance. While it is accepted that external measures are still limited due to the internal focus of primary bank managers, a hierarchy of initiatives has been concluded, i.e. achieving operational excellence in the short-term with implementing further external measures as time and pressure builds up. Evidence provided points to the fact that cooperative further open themselves to external measures as also smaller banks realize that financial prospects are negative.

*Chapter 7* contributed to knowledge by providing enhanced transparency with regard to the generally unknown process of strategic management among primary banks. Based on the results it could be concluded that cooperative banks are well aware of forces and trends to be considered for future performance, especially via support

from the cooperative network, however, lack the step of conducting real initiatives. Business is still primarily done like always without adjusting to the changing environment. This research identified several potentials that can and should be pursued in order to maximize benefits from the strategic management process.

*Chapter 8* was conducted as part of a comprehensive field study. Based on the experience and findings from the projects, it was concluded that the BSC is a feasible tool for the adjustment of the strategic management process. It was also concluded that willingness and readiness of smaller banks is high, once a first comprehensive step has been initiated. It was concluded that willingness to change also increases with the degree of simplicity of measures and commitment by management. While a high degree of standardisation was concluded to be practicable, the final composition of the BSC is to be adjusted on an individual basis. Through to these practical findings, empirical findings from chapter 7 with regard to the complacency of cooperative banks could partly be balanced.

## **9.2 Reflection on research**

As described in chapter 2, the origin of this research is this author's professional occupation and situation that had a strong influence on the way research conducted from an advisory perspective. Due to this, research conducted was very practically oriented and might differ from interpretations by academics. Especially regulators might not concur with several statements made regarding the usefulness and design of recent regulation with regard to cooperative banks. Also, bank managers might not concur with measures identified that are necessary to sustain competitiveness, especially when giving up some independence or implementing new and hurting staff measures are concerned. Overall, it was not attempted to take a single position but rather identify what needs to be done as best practice regardless of what obstacles in practice exist.

This leads to the question what this researcher has benefit from the most coming from this project and what this means going forward for this work and that of others working in this sector.

One of the most interesting finding for this author can be summarized as "complaining on a high comfort level". The cooperative banking sector has been highly profitable and did not show any weaknesses upon the last introduction of similar measures, i.e. Basel II. The degree to which Basel III will have a direct and measurable impact is still to be determined, however, is firmly expected to come. The other interesting fact was the level of envisaged independence that is expressed locally by the cooperative banks, i.e. the reluctance to cooperate with other cooperative banks and potentially giving up some of the decision making authority. Other professionals and researchers need to take this situation into account when conducting further activities.

Something that other accounting or audit professionals can refer to are the findings in terms of capital management. By providing a comprehensive analysis of Basel III implication on capital and liquidity, guidance is provided when it comes down to assessing regulatory compliance.

Next to guidelines for regulatory compliance, bank managers can also benefit from the operational measures that have been identified in course of chapter 8 that can help improve performance. Internal discussions can be held if similar improvements can be achieved.

Contemplating validity, this researcher deems minimum requirements not only achieved but well exceeded. Research design and conduction achieved the desired outputs. This was the result of discussions with interview partners that were consulted upon finalising this research. From discussions with other professionals that were not involved in this research project this author found a lot of confirmation for his finding. This especially applies to discussions with other cooperative bank managers. Discussing findings with several managers in August 2014, new contacts could be made, i.e. further advisory project opportunities dealing with the issue of capital management and balance sheet optimization as well as cost cutting initiatives.

### 9.3 Future research

This research has contributed to existing knowledge through the evaluation and concretisation of the regulatory impact on cooperative banks, being lower than expected, and thus added to the discussion about governance of stakeholder banks from the perspective of regulators and bank managers. Several streams of future research with regard to the chapters outlined should be considered being the conclusion of two factors: a) the just about the be implemented regulatory framework that is subject to an observation period and b) limitations as stated before, i.e. additional evidence.

It should be stated that this research was specifically designed to identify further areas of research that were not apparent before-hand. Besides chapter 3, which analysed the overall framework of operations for cooperative banks, all chapters are practically moving targets due to the changing conditions of the financial and economic environment.

One important research opportunity (chapter 4) is to monitor the quantitative effect on overall financial performance upon actual implementation of Basel III, beginning in 2014 in order to conclude whether the intended outcome is achieved. Due to the on-going negative monetary climate, this will represent a challenge in terms of distinguishing between regulatory and monetary effects. Future research could aim at analysing the development of administrative expenses in order to quantify the relationship between higher requirements and resources required to deal with them. Further, given the three-pillar structure of the German banking market, benchmark or best practice can be identified to provide indications for improvements. Further, there is gap with regard to inter-cooperative banking sector comparisons. Within Germany, cross-network studies between regular primary banks, SPARDA banks and PSD banks should be conducted. Within Europe, cross-country comparisons between national cooperative banking sectors should also be conducted in order to identify room for improvement or issues to avoid in national network management. Additionally, benefits for practitioners and academics can be achieved by monitoring the brand Cooperative Bank with associated values and principles.

While it has been observed that the brand image has improved and certainly contributed to financial success, it will be interesting to investigate how customer behaviour and perception will change once the financial crisis is over, the overall economic climate improved and performance of private banks has stabilized.

In connection with the monitoring of the quantitative effect, further research opportunities exist with regard to the actual and final design of Basel III and especially the consideration of institution networks such as the German cooperative banking sector for special rules (chapter 5). This research's findings pointed to a lower impact of Basel III, however, with several burdens still to be considered, especially with regard to liquidity. In the same instance, it must be researched how other regulatory initiatives (e.g. banking union) have an impact on the operating model of the sector in order to identify need for the adjustment of protection mechanisms.

Identifying and further evaluating opportunities to enhance performance by either increasing sales or decreasing costs will be the biggest challenge (chapter 6). Findings of this research provided for a currently low level of initiatives actually undertaken. Research opportunities, especially with regard to practical advisors, exist with regard to offering best practice in connection with cooperative banks. All Key Topics identified and analysed offer great opportunities for additional research, which requires enhanced case studies and in-depth insights into each individual initiative over a medium-term time horizon in order to evaluate feasibility and success. As a result of this research, improving operational excellence is the highest priority initiative.

Future research is based on the findings that even though trends and change drivers are sufficiently identified by primary banks, there is a large gap with regard to implementing change as part of the management process (chapter 7). A follow-up to the survey with an adjusted questionnaire could be conducted in order to identify whether the potentials identified have been utilised in order to improve performance and competitiveness.

Maintaining the focus on performance improvement, additional research opportunities exist with regard to the use of BSC (chapter 8). This study pointed out that the BSC can be used as a support tool to manage performance, also in the short-term. However, the use of a benchmark BSC needs to be tested on an additional sample of banks. Also, it needs to be investigated whether the case study banks do achieve better performance or at least perceive the BSC as a success if a quantitative effect is not available.

Due to this researcher's professional connection with most of the banks being part of this research, it is possible and envisaged to further elaborate on the opportunities identified. While these are certainly not all, these are deemed the most important ones by this author. In order to broaden expertise by this author and his respective employer, responsibilities for individual opportunities have been distributed to junior staff, also being involved in academics, to conduct on-going analysis and monitoring. This is especially to provide for training material required by this author for external workshops offered to small and regional bank managers.

Another area for further research, which combines all existing chapters, lies within the future direction of financial regulation. The regulatory framework so far has set a focus on capital and risk management, enhanced by liquidity in the course of Basel III. In the course of the submission of this work, statements have been originally made by German regulators that point towards a new dimension, i.e. the focus on business model and related income management (Dombret, 12 November 2014). This confirmed the idea and expectation of this author upon drafting this research as outlined in section 1.2. The task in this context will be the design of advanced quantitative models for the analysis and optimization of the income and cost mix ("Business Model Analytics"). While profitability will certainly be an issue on an overall bank level, it is assumed that there will be individual thresholds on portfolio or product level to comply with. A major task, hence, will be the further development of the financial model as outlined in section 6.1.4.

In this context, the status of intangible resources as outlined in the coherent model in section 3.2.1.3 needs to find a higher degree of attention. In this context, this author



would like to point towards the concept of sustainability that is becoming increasingly important especially for cooperative banks that would like to foster their strategy of good corporate citizenship. A pull-effect is noted coming from the outside to put more attention towards non-financial information and other diversity related issues. The value chain as outlined in section 3.2.3 serves as a good framework to incorporate new ideas in this context. Especially support functions are deemed practicable since these react more directly to implemented changes. Strategy development should especially consider ethics and code of conducts as well as Corporate Governance. Personnel management should deal with human capital, diversity and equal opportunities. Product and Process Development should incorporate socially responsible investments, sustainability score and demand oriented products. Procurement should consider resource consumption. Doing this it is important to take into account that this concept is not limited to ecology and social issues, hence causing costs and bureaucracy, but can also provide for value creation, income and competitive advantage. This requires a new mindset that links economic performance with social performance on an elevated level. While this is all positive, also the risks of advanced social awareness needs to be further investigated.

## 10. Appendix

### 10.1 Abbreviations

ALM	Asset Liability Management
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority; refer to <a href="http://www.bafin.de/EN">www.bafin.de/EN</a> )
BCBS	Basel Committee on Banking Supervision, being part of the Bank for International Settlements "BIS" (refer to <a href="http://www.bis.org/bcbs/">www.bis.org/bcbs/</a> )
BCG	Boston Consulting Group
BIS	Bank for International Settlements
BPO	Business Process Outsourcing
BRRD	Bank Recovery and Resolution Directive
BSC	Balance Scorecard
BVR	Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (Cooperative Financial Network; refer to <a href="http://www.bvr.coop/index.htm">www.bvr.coop/index.htm</a> )
CAD	Capital Adequacy Directive
CAPM	Capital Asset Pricing Model
CCB	Capital Conservation Buffer
CCCB	Countercyclical Capital Buffer
CEBS	Committee of European Banking Supervisors
CEPS	Centre for European Policy Studies
CET	Common Equity Tier
CIBP	International Confederation of Popular Banks
CIR	Cost Income Ratio
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CR5	Concentration Ratio of the five biggest banks
CSC	Customer Service Centre
CVA	Cash Value Added
DCF	Discounted Cash Flow
DGSD	Deposit Guarantee Scheme Directive
DSGV	Deutscher Sparkassen- und Giroverband (Savings Banks Finance Group, refer to <a href="http://www.dsgv.de/en/">www.dsgv.de/en/</a> )
EACB	European Association of Co-operative Banks
EBA	European Banking Authority
EBF	European Banking Federation

EBIC	European Banking Industry Committee
ECB	European Central Bank
ESBG	European Savings Banks Group
ESM	European Stability Mechanism
EVA	Economic Value Added
FCF	Free Cash Flow
FINMA	Eidgenössische Finanzmarktaufsicht (Swiss Market Supervisory Authority)
FMSA	Bundesanstalt für Finanzmarktstabilisierung (Federal Agency for Financial Market Stabilisation)
FSA	Financial Services Authority (in the UK)
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GSE	Government Sponsored Entity
HI	Herfindahl Index
IBF	International Banking Federation
ILO	International Labour Organisation
IMF	International Monetary Fund
IRBA	Internal Rating Based Approach
IFRS	International Financial Reporting Standards
KPI	Key Performance Indicator
LCR	Liquidity Coverage Ratio
MaRisk	Minimum Requirements for Risk Management
MFI	Monetary Financial Institution
MSC	Market Service Centre
MVA	Market Value Added
M&A	Mergers & Acquisitions
NAMA	National Asset Management Agency (Ireland)
NOPAT	Net Operating Profit after Tax
NSFR	Net Stable Funding Ratio
PCM	Price Cost Margin
RoA	Return on Assets
RoE	Return on Equity
ROPO	Research online, purchase offline
RWA	Risk Weighted Assets
SCP	Structure Conduct Performance

SHV	Shareholder value oriented banks
SIV	Structured Investment Vehicle
SLA	Service Level Agreement
SME	Small and Medium
SolvV	Solvabilitätsverordnung (solvability regulation)
SPOC	Single Point of Contact
SRM	Single Resolution Mechanism
SSM	Single Supervising Mechanism
STV	Stakeholder value oriented banks
TSR	Total Shareholder Return
VaR	Value at Risk
WACC	Weighted Average Cost of Capital
ytd	Year-to-date

## 10.2 List of interview partners and other contacts

CEO1	Bank manager of rural cooperative bank with assets of ap. EUR 100 million
CEO2	Bank manager of rural cooperative bank with assets of ap. EUR 190 million; bank also served as pilot case for calculation of LCR and NSFR
CEO3	Bank manager of rural cooperative bank with assets of ap. EUR 140 million
MC1	Senior Manager in the Management Consulting division of this author's employer. MC1 has more than 10 years work experience in process and operational management in several industries. However, there have been no contacts with the Financial Services industry.
P1	Partner in the Audit & Assurance department of this author's employer
NR1	Representative of one regional cooperative network
FM1	General manager of one medium sized bank (non-cooperative) being a client with regard to the financial model designed

All interviews were conducted in German and translated into English by the researcher. Meetings occurred on a face-to-face level, i.e. there were no telephone conferences. Location and timing was built into this researchers work schedule. Duration of the interviews was between 45 and 120 Minutes, with notes taken during the course. Interviews took place between April 2013 and May 2014.

The bulk of interviews occurred with the CEOs described above. In particular, they contributed towards chapter 8 during the field research. In total, ap. 15 interviews were held with the CEOs, hereof 10 that contributed to chapter 8 and 5 that contributed to chapter 3.

MC1 contributed towards chapter 8 by providing insights into consulting work that had not previously been in this researcher's scope. MC1 was consulted during the course of the field study. In total, there were 6 interviews.

NR1 was consulted with regard to chapter 5 and 6 in order to analyse and bring in the view from a network perspective and specialised auditor. In total, there were 4 interviews.

FM1 was consulted with regard to chapter 6. In total, 5 interviews were conducted with the manager. In addition, several discussions were held on an operational level with different staff of the same company that are not specifically referred to as interviews.

P1 was consulted on a regular level during the course of the entire project. The partner, who was no direct contact of this researcher, helped as coach, i.e. with him the overall process and progress was discussed and reflected. In total, ap. 20 interviews were conducted with relevant "to-do lists" produced as outcome.

## 10.3 Questionnaire

**Stefan Fischer**  
**Chartered Accountant**  
**Doctoral Student**

*translated from German by the author*

### **Survey**

**among German cooperative banks regarding  
performance management and  
the impact of recent regulation  
on the strategic management process**

**Note:**

There is a total of 24 questions.

Completion of all questions requires ap. 30 minutes.

Regarding the ratings, 5 means "is highly applicable" and 1 means "not applicable"

Please answer ALL questions completely.

Please do not write your name and your bank's on this paper.

When completed, please return the paper with the enclosed return envelope (paid).

All data will be kept anonymous.

**Thank you very much for your assistance.**

## A. Strategic Analysis

Question 1a:	Trends				
How do you evaluate the importance of the following macro criteria when deciding upon the future strategic direction of your bank?					
	5	4	3	2	1
Legal/Regulatory changes (Basel III)					
Economic changes					
Technological changes					
Social changes					

Question 1b:	Trends				
Elaborating more on the macro criteria above, which specific elements do you consider most important for your future business? (5 = positive impact; 1 = negative impact)					
	5	4	3	2	1
Equity requirements					
Liquidity requirements					
Risk Management (MaRisk)					
Conduct duties					
External service tests					
Economic / GDP development in Germany					
Volatility of financial markets					
Introduction of further economic stability funds					
Money market policy of ECB					
Social Media					
Cloud services					
Mobile applications					
Internet presence					
Social imbalance					
Increasing migration from rural to urban areas					
Decreasing population					
Aging population					
Increasing migration from foreign countries					



**Question 2a:** **Strategy**  
**How do you evaluate the importance of the following instruments within you strategic analysis process of external and internal factors?**

	5	4	3	2	1
Market analysis					
Strategic group analysis					
Customer expectation analysis					
Member expectation analysis					
Value chain analysis					
Customer structure analysis					
Present organisational structure					
Staff potential analysis					

**Question 2b:** **Strategy**  
**How often do you use the following instruments?**

	ongoing	quarterly	anually	2 years	never
Market analysis					
Strategic group analysis					
Customer expectation analysis					
Member expectation analysis					
Value chain analysis					
Customer structure analysis					
Present organisational structure					
Staff potential analysis					

**Question 3:** **Strategy**  
**The BVR has issued several core topics as part of its "Kompass 2013" initiatives. Which of the following have you actively discussed internally?**

	5	4	3	2	1
Cost efficiency and productivity enhancement					
Customer segmentation					
Increase of product usage					
Risk and reward oriented management of Treasury					
Quality improvement in terms of customer protection					
Improvement of the cooperative advisory process					
Improvement of multi-channel distribution					
Offering of products with regard to renewable energies					
Financing of measures to improve energy efficiency					

**Question 4:** **Sales**  
**What do you consider the most important success factors in sales by profit contribution today and in the future (3 year time horizon)? (5 = very important; 1 = not important)**

<b>today</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Interest					
Commission					
Payment services					
Paid advisory services					
Setting up joint operations with other banks					
<b>future</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Interest					
Commission					
Payment services					
Paid advisory services					
Setting up joint operations with other banks					

**Question 5:** **Sales**  
**In 2011, the BVR launched the milestone project "webErfolg". Please comment on the following. (5 = highly agree; 1 = do not agree)**

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
A single direct bank is to be rejected					
Internet presence and services are to be improved					
Branch network services are to be improved					
Social Media content will be of high importance					
Multi-channel distribution is expensive and non-beneficial					
webbank+ is already on our strategic agenda					

**Question 6:** **Sales**  
**Customer loyalty is one of the imperatives of the cooperative network. How do you rate the following statements regard brand management and ways to improve it? (5 = highly agree; 1 = do not agree)**

	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Members deem our value concept important					
Emotional factors are essential					
We lack a clear differentiation from competition					
Members benefit from special loyalty initiatives					
Local marketing					
National marketing					
Improve Price/Product Strategies					
Improve advisory quality					
Enhance product offerings					

<b>Question 7:</b>						<b>Cost</b>
<b>Process management has been on the agenda of your network to control costs (e.g. VR Process by BVR). How do you evaluate the following issues in this regard? (5 = fully applies; 1 = does not apply)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
We have modelled and visualized our processes						
We are permanently optimizing our processes						
Process potential with regard to sales						
Process potential with regard to back office						

<b>Question 8:</b>						<b>Cost</b>
<b>How do you evaluate the following cost cutting strategies on an organisational level? (5 = very important; 1 = not important)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
Regional production center						
Central Bank oriented production center						
Network external solution						
Optimization of own production as internal profit center						

<b>Question 9:</b>						<b>Cost</b>
<b>Please evaluate the following statements regarding the status of cost cutting and process related measures in your bank. (5 = fully applies; 1 = not intended)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
We consider the urgency to adjust our processes as high						
We aim to discuss these measures internally						
We aim to discuss these measures externally						

## B. Strategic Choice

<b>Question 10:</b>	<b>Formulation</b>
<b>What is the extent to which the following parties are included in the strategic management process?</b>	

	5	4	3	2	1
Members					
Supervisory board					
Board					
2nd level managerial staff					
Regular staff					
Staff council					
Consultants					
Network auditors					
Cooperative Financial Network					

<b>Question 11:</b>	<b>Formulation</b>
<b>In what way is the strategic choice of your bank influenced? (5 = fully applies; 1 = does not apply)</b>	

	5	4	3	2	1
Targets set with network partners					
Findings by the audit networks					
BVR studies					
Competitor activities					
Financial market development					

<b>Question 12:</b>	<b>Formulation</b>
<b>In what way are strategies in your bank evaluated? (5 = fully applies; 1 = does not apply)</b>	

	5	4	3	2	1
At board meetings					
At meetings with board and other management staff					
At workshops with internal staff					
At workshops with external assistance					

<b>Question 13:</b>	<b>Formulation</b>
<b>In what intervals are the strategic direction and agreed upon targets adjusted?</b>	

	ongoing	monthly	quarterly	annually	less
Overall bank strategy					
Targets with network partners					
Contribution margin targets					
Quality targets					
Scenarios and forecasts					

<b>Question 14:</b>	<b>Decision</b>
<b>What are your success factors and Unique Selling Propositions (USPs)? (5 = fully applies; 1 = does not apply)</b>	

	5	4	3	2	1
Close to the customer					
Person orientation					
Flexibility					
Part of network					
Non-complex products and services					
Offering of membership					
Network deposit protection scheme					

<b>Question 15:</b>	<b>Decision</b>
<b>Cost are regarding key factors in evaluating future strategies. What factors do you see critical regarding the success of future cost cutting or process adjustment measures?</b>	

	5	4	3	2	1
Lack of board support					
Lack of staff awareness					
Implementation cost compared to perceived benefit					
Resistance from staff unions					
Congruence with cooperative mission and spirit					

<b>Question 16:</b>	<b>Operations</b>
<b>What is the influence of Basel III on your strategic planning process?</b>	

	5	4	3	2	1
We discuss Basel III requirements on a regular basis					
We actively incorporate Basel III into our SPP					
We look for external advise for compliance					

<b>Question 17:</b>	<b>Operations</b>
<b>With regard to ALM, how do you rate the importance of the following?</b>	

	5	4	3	2	1
Depot A management					
Funding sources					
Equity restructuring					
Risk measuring					
Selective loan granting					

### C. Strategy Implementation

<b>Question 18:</b>	<b>Communication</b>
<b>Which instruments do you use to communicate your strategy to your employees? (5 = mostly; 1 = least)</b>	

	5	4	3	2	1
Circular					
Staff meeting					
Presentation department head					
E-Mail / Intranet					
Knowledge of strategy is available to board only					

<b>Question 19:</b>	<b>Linkage</b>
<b>On which basis are targets with your staff agreed upon? (5 = mostly applies; 1 = least applies)</b>	

	5	4	3	2	1
Extrapolation of prior year targets					
Internal and external potentials					
Overall bank strategy					
No targets agreed					

<b>Question 20:</b>	<b>Linkage</b>
<b>What are consequences of non-achievement? (5 = fully applies; 1 = least applies)</b>	

	5	4	3	2	1
Coaching					
Warning					
Lower variable components					
Less responsibilities					
No consequences					

<b>Question 21:</b>	<b>Linkage</b>
<b>How do you consider the following statements regarding implementation in your bank?</b>	

	5	4	3	2	1
Definition of roles & responsibilities.					
Tracking progress on a regular basis					
Discussing progress with staff					
Strict process and control is unproportional					

<b>Question 22:</b>						<b>Steering</b>
<b>Where do you see obstacles with regard to strategy implementation? (5 = fully applies; 1 = least applies)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
Lack of written documentation						
Lack of knowledge by staff						
Lack of acceptance by staff						
Lack of competence of staff						
Lack of controlling						
Lack of counselling by management						
Lack of organisational flexibility						

<b>Question 23:</b>						<b>Steering</b>
<b>Which indicators are used for measuring strategy process? (5 = fully applies; 1 = least applies)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
Business growth						
RoE						
Operating profit before valuation effects						
Operating profit after valuation effects						
Dividend potential						
Interest Margin						
Cost-Income-Ratio						

<b>Question 24:</b>						<b>Steering</b>
<b>What influence does your strategy implementation have on the cooperations with partners (network, external partners)? (5 = fully applies; 1 = least applies)</b>						
	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	
Increased cooperation with other cooperative banks						
Setting up of joint service companies						
Merger with other cooperative banks						
Increased cooperation with network partners						
Increased cooperation with external partners						

<b>General 1:</b>
<b>From which competitors comes most of the competitive pressure?</b>

	very high	high	neutral	low	none
Sparkasse					
Deutsche Bank					
Commerzbank					
HypoVereinsbank					
Postbank					
Other cooperative bank					

<b>General 2:</b>
<b>Statistical data regarding your bank (no detailed info required)</b>

	data
Total assets	
Customer receivables	
Operating profit	
Market share	
Numer of customers	
Number of members	
Number of branches	
Number of employees	
Number of citizens within your region	
How is your region characterized (rural/urban)	



## 10.4 Requirements on strategy according to Section AT 4.2 MaRisk

1 The management board shall define a sustainable business strategy outlining the institution's objectives for each material business activity and the measures to be taken to achieve these objectives. When defining or adjusting the business strategy, the management board shall take account of both external factors (eg market developments, the competitive situation or the regulatory environment) and internal factors (eg internal capital adequacy, liquidity, profit situation, staffing level or technical and organisational resources). It shall make assumptions with regard to how the relevant factors will develop in future. It shall review these assumptions regularly and on an ad hoc basis; it shall adjust the business strategy as and when necessary.

2 The management board shall define a risk strategy that is consistent with the business strategy and the risks resulting therefrom. The risk strategy – where applicable, divided into sub-strategies for the material risks – shall include the risk management objectives for the key business activities and the measures to be taken to achieve these objectives. In particular, risk tolerance levels shall be set for all material risks, taking account of risk concentrations. Risk concentrations shall also be taken into account with regard to the institution's profit situation (profit concentrations). This requires the institution to be able to delineate its sources of income and quantify them (eg with regard to the terms and structural contribution in the interest book).

3 The management board shall be responsible for defining and adjusting the strategies; this responsibility cannot be delegated. The management board shall see to it that the strategies are implemented. The level of detail of the strategies shall depend upon the scale, complexity and riskiness of the planned business activities. The institution may, at its own discretion, integrate the risk strategy into the business strategy.

4 The management board shall set up a strategy process which includes, in particular, the steps for planning, implementing, assessing and adjusting the strategies. To facilitate assessment, the objectives defined in the strategies shall be formulated in a way that allows their achievement to be meaningfully reviewed. The causes of any deviations shall be analysed.

5 The strategies and, where applicable, adjustments to the strategies shall be brought to the attention of and discussed with the institution's supervisory board. In the event of deviations from the objectives, this discussion shall also include an analysis of the causes pursuant to AT 4.2 number 4.

6 The contents of and adjustments to the strategies shall be communicated within the institution in a suitable manner.

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