Building on theories of finance and distribution, and the political economy of finance, this book explains the influence of financial cooperatives on wealth and income distribution, and institutional factors that determine the development of financial cooperatives. The book discusses the dynamics of income and wealth distribution with and without financial cooperatives and defines the economic objective for financial cooperatives. Through explaining the influence of political institutions and regulations on the development of financial cooperatives, this book examines why financial cooperatives grew in some emerging economies and not in other similar ones.

The book is of interest to scholars interested in financial economics, political economy of finance, alternative banking and development finance, and banking regulation. The book also gives valuable output to central bankers and financial and monetary policy makers in underdeveloped economies. In addition, it will be of particular interest to practitioners in international development institutions, especially those engaged in development finance and rural finance.

Amr Khafagy works at the Countryside and Community Research Institute, University of Gloucestershire, UK. His research explores the political economy of finance and the dynamics of income and wealth distribution, the economics of cooperatives, and the political economy of the Middle East. He has worked in the banking and microfinance sectors in Egypt and India.
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The Economics of Financial Cooperatives
Income Distribution, Political Economy and Regulation

Amr Khafagy
To Wahiba and Mohamed
“Once we were present, then we were defeated, and meaning was defeated with us. But nothing will constrain the strong, nor shape the margins of freedom and justice, nor define spaces of beauty and possibilities for a common life except the weak, who insist that meaning should prevail — even after defeat.

Seizing opportunities to produce meaning remains a necessity. Without it we will never get beyond defeat.”

—Alaa Abd El Fattah
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I first became interested in cooperatives after reading an article by Wael Gamal published on 1 May 2011 in the Egyptian newspaper El Shorouk entitled ‘It is time to regain our economy from aliens’. I am thankful to him and many other authors and scholars who have transformed the way I engage with politics and economics, shaped my thinking and been an inspiration for me.

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Acronyms

Autoregressive Distributed Lag  ARDL
Error-Correction Model  ECM
European Association of Co-operative Banks  EACB
First Difference Instrumental Variable  FD-IV
Financial Cooperatives  FC
Fixed Effects  FE
Fixed Effects Instrumental Variable  FE-IV
Generalized Method of Moments  GMM
Gross Domestic Product  GDP
Gross National Income  GNI
Independent and Identically Distributed  IID
Instrumental Variable  IV
International Labour Organization  ILO
International Monetary Fund  IMF
Luxembourg Income Study  LIS
 Ordinary Least Squares  OLS
Organisation for Economic Co-operation and Development  OECD
Random Effects  RE
Savings and Credit Cooperatives  SACCOS
Small and Medium Enterprises  SMEs
Standardized World Income Inequality Database  SWIID
Structural Vector Autoregressive  SVAR
Two-Stage Least Squares  2SLS
Unrestricted Error Correction Model  UECM
World Council of Credit Unions  WOCCCU
World Income Inequality Database  WIID
1 Introduction

Why financial cooperatives matter now

1.1. Introduction

Financial cooperatives are financial intermediaries owned by the same people they intend to serve. Founded in the mid-nineteenth century, the focus on communal solidarity and unlimited liability of members enabled Raiffeisen’s and Schulze-Delitzsch’s cooperative models to overcome information asymmetry problems and provide credit, savings, and insurance services for low-income farmers and artisans at times when access to credit was nearly impossible. Financial cooperatives hold a significant market share in Europe and Latin America, as well as a few countries in Sub-Saharan Africa. They also have a strong presence in Asia, Australia, and the United States. According to the World Council of Credit Unions (WOCCU), there were 68,882 financial cooperatives in 109 countries in 2016, serving more than 235 million members, with total assets exceeding 1.7 trillion dollars. It is worth noting that the WOCCU’s data do not include some major financial cooperative networks in Europe, such as Germany, Finland, France, Denmark, and Italy. In many high-income economies, financial cooperatives hold significant market shares of the banking sector. The market share of financial cooperatives in the Small and Medium Enterprises (SMEs) credit market by the end of 2016 was 37% in Finland, 45% in France, 33% in Germany, 43% in the Netherlands, and 22% in Canada. In Germany, Volksbanken-Raiffeisen banks have a market share of approximately 21% of domestic credit and domestic deposits. In the Netherlands, RaboBank holds 34% of deposits, and in France cooperative banks (Crédit Agricole, Crédit Mutuel and BPCE Group) possess more than 59% of domestic credit and 61% of domestic deposits. In Finland, OP financial group holds 35% and 38% of domestic credit and deposits, respectively, and in Canada, Desjardins holds around 42% of domestic deposits and 22% of domestic credit (EACB, 2017; WOCCU, 2017). There are many types of cooperative financial institutions with different names across the world, including financial cooperatives (‘cooperativa financiera’ is the Spanish term used in Latin America), cooperative banks, credit unions, and savings and credit cooperatives (‘cooperativa de ahorro
Introduction

This book discusses the influence of cooperative financial institutions on income distribution and the institutional factors that determine the development of cooperative financial institutions. It responds to the following questions: does the ownership structure of financial institutions affect income inequality? If so, then how can member-owned financial institutions promote a more egalitarian distribution of income? If cooperative financial institutions have a comparative advantage over other banking models when it comes to micro, SME lending, and accordingly with regard to income distribution, then why did financial cooperatives grow in some emerging economies and not in other similar economies? The book addresses two institutional factors that may influence the development and growth of financial cooperatives. In particular, it explores how political institutions can dictate the development of financial cooperatives and the motives behind the behaviour of these political institutions. In addition, it explores the regulatory and supervisory approaches that would better support the growth and resilience of the sector in underdeveloped economies. This book contributes to literature on the political economy of finance (Nienhaus, 1993; Pagano and Volpin, 2001; Rajan and Zingales, 2003; Perotti, 2014), finance and income distribution (Greenwood and Jovanovic, 1990; Banerjee and Newman, 1993; Galor and Zeira, 1993; Aghion and Bolton, 1997; Piketty, 1997), financial sector regulations (Vittas, 1992; Brunnermeier et al., 2009), as well as the economics of cooperative financial institutions (Münkner, 1986; Ferguson and McKillop, 1997; Poyo, 2000; Cuevas and Fischer, 2006; Ferri et al., 2014).

1.2. Financialization, distribution, and the political economy of finance

The essential motive behind the interest in the economics of financial cooperatives is to explore aspects related to control over financial resources and how that influences the distribution of wealth and political power. Financial cooperatives can mobilise local financial resources and attract external funds for the benefit of local economies. In many low- and middle-income economies, deposits are channelled from small depositors, farmers, pensioners, and workers to big banks outside the local communities of the original depositors (money owners). Original owners of these funds are rarely able to benefit from them, as the concentration of banks’ ownership serves the interests of a few large shareholders or narrow corporatists commonly linked to the governing political authorities. That makes financial cooperatives not only important for financial inclusion and economic growth, but their distinctive ownership structure also allows them to be practical instruments for redistributing economic resources and political bargaining power. This book aims to highlight and recognise the political and economic potentials.
Introduction

3

of financial cooperative, as grassroots organisations owned by the people they are supposed to serve, and which have the ability to represent their interests and strengthen their political bargaining power.

While the financial sector should respond to the needs and interests of societies, especially low- and middle-income classes, the sector seems to be functioning for the sole interest of a narrow group of rentiers. There are growing concerns about unequal income and wealth distributions, especially in the current period of financial capitalism, and the rapid expansion of the sector is a heated topic at the heart of the current political and economic debate over wealth and income distribution. The 2007–08 financial crisis intensified criticism over the financialization of the economy and the role of the financial sector in causing a global economic crisis, with ruinous economic and political consequences that are still being experienced. Banks and capital markets became disconnected from their societies, pursuing short-term profits at the expense of the longer-term macroeconomic benefits, with privatised gains for a few financiers and shareholders and socialised losses that are disproportionately distributed on the rest of the society with lower classes bearing higher burdens. A number of recent studies suggest that too much finance harms the real economy and tends to have negative impacts on economic growth (Law and Singh, 2014; Arcand et al., 2015; Cecchetti and Kharroubi, 2015).

The allocation of capital by the financial system directly affects the rate of economic growth and the demand for labour, both of which have direct implications on poverty and income distribution (Demirgüç-Kunt and Levine, 2009). Economic theory and recent empirical literature provide contradictory results on the impact of the financial sector on income distribution. A number of theories suggest that financial sector growth would have a positive influence on economic growth and would reduce income inequality. In a perfect credit market, financial institutions channel money from agents who have surplus savings to agents who have high-return investment opportunities. The assumption of diminishing marginal returns on capital suggests that low-capital investments should be more preferable to lend as they yield higher marginal returns than high-capital investments, and consequently, low-income agents will have the opportunity to benefit from the capital channelled through financial intermediaries coming from wealthy agents (Beck et al., 2007; Ben Naceur and Zhang, 2016). But this is not how financial sectors work in the real world of imperfect credit markets. Financial institutions usually serve those who have sufficient collaterals or political connections to acquire credit, while low- and middle-income agents are more likely to be excluded from the credit market, especially in the early stages of economic development. Limited access to capital has long been recognised as a reason for persistent and increasing income inequality. Low- and middle-income agents are likely to be credit rationed from the credit market because information asymmetries and weak contract enforcement institutions discourage banks from lending to them and from exploiting
potential high-return investments. Figures 1.1–1.4 show how domestic credit and capital markets as a percentage of Gross Domestic Product (GDP) have remarkably increased globally during the last 25 years, as well as the parallel growth in the share of the top 1 and 10% earners as percentage of pre-tax national incomes. These data were obtained from the World Inequality Database and the World Bank Open database.

Overcoming credit constraints would benefit the lower income classes, reduce wealth inequality, foster economic growth, and improve the efficiency of capital allocation (Banerjee and Newman, 1993; Galor and Zeira, 1993; Aghion and Bolton, 1997; Piketty, 1997). However, empirical studies on finance and inequality have focused only on the size and not the structure of the financial sector. Existing empirical literature on finance and income inequality tends to treat the financial sector as consisting of homogeneous lenders and does not account for the heterogeneity among financial institutions in terms of ownership structure. The influence of the financial sector structure and banks’ ownership on wealth and income distribution remains remarkably understudied.

*Figure 1.1* Domestic credit and top 1% share of pre-tax income (global).

*Figure 1.2* Domestic credit and top 10% share of pre-tax income (global).
Lenin (1999: 45 [1916]), building on Hilferding’s (1981 [1910]) seminal thesis on finance capitalism, argued that a key feature of the growth of capitalism is the expansion of the banking industry and the tendency to become concentrated in a small number of institutions. Banks underwent a transformation from simple financial intermediaries into powerful monopolies controlling a large proportion of money capital in the economy, which originally belonged to capitalists and small businesses, as well as wage and salaried workers. Concentration of the financial sector and concentration of ownership over these institutions placed a large proportion of the means of production and sources of raw materials in the hands of small elite that allocates financial resources according to its narrow interests, and there is no guarantee or incentive for banks to pursue social or communal goals. Existing literature that discusses ownership structures focuses only on the comparison between private and state ownership, or between domestic and
foreign ownership, but the concentration of ownership and its influence on distribution is nearly neglected from current academic or political debates. Concentration of ownership is mainly discussed focusing on the efficiency and stability of banks and the financial sector. For instance, diffused ownership is thought to decrease the effective control of shareholders over the firm and transfers the control to the management because shareholders will not have enough incentives to monitor the management of the firm. Besides, conflicting interests between several controlling shareholders may affect timely and efficient decision-making. On the other hand, the concentration of ownership improves corporate control by strengthening monitoring over management because large shareholders bear most of the failure cost and they have a strong incentive to monitor the management (Berle and Means, 1933; Shleifer and Vishny, 1986). But large shareholders are also capable of expropriating minority shareholders if conflicting interests exist between both shareholding groups (Gomes and Novaes, 1999; 2005). Overall, ownership and management monitoring can be substituted by increased regulation. In comprehensively regulated industries, like the financial sector, managers may be efficiently monitored by the regulators, which in turn reduce the potential risks and benefits of controlling ownership (Demsetz and Lehen, 1985; Elyasiani and Jia, 2008). Iannotta et al. (2007) showed that concentrated ownership of banks is correlated with lower asset and insolvency risks and improved loan quality. Recently, Sawyer and Passarella (2017) developed an interesting Stock Flow Consistent model for the financial sector, based on the Monetary Circuit theory, presenting a modernised financialized economy with endogenous money creation by commercial banks. They divided the financial sector into commercial banks, which are able to create money, and other financial institutions that can provide financial services but cannot create money. They differentiated between ‘workers’ and ‘rentiers’ to highlight changes in income distribution and showed how financialization in advanced economies increased the probability that households become net borrowers while non-financial firms become net lenders. This transformation, along with access to bank credit based on class, is the main factors for widening income inequality and increasing households’ debt. However, Sawyer and Passarella’s model does not examine the influence of the banks’ concentration of ownership but the influence of money creation by commercial banks. Decisions concerning credit allocation among different groups, classes, industries and regions, and the type and features of credit in terms of amount, period, instalments, and price are subject to the ownership structure of financial institutions. Control over financial resources is crucial for economic growth and income distribution as well as political power structure; however, it is remarkably absent from current political and institutional economics discourses.

This is why the book starts in Chapter 2 by proposing an economic model where the structure rather than the size of the financial sector explains its influence on income distribution, in order to show how different ownership
structures of financial institutions can influence the distributional output of the credit market. The model proposed attempts to explain how financial cooperatives can adjust the distributional output of the financial sector. But to do that, we also need to identify an economic objective function for financial cooperatives which maximises the welfare of the members through financial intermediary services. The proposed objective function for financial cooperatives will define a desired deposit and lending interest rates, as well as the optimal total credit supplied for the members and the possibility to seek external borrowing, all of which aim at increasing the income of cooperative members at a rate higher than the average growth rate of the economy. Chapter 3 empirically investigates whether the structure of the financial sector influences income distribution, by exploring the relationship between the market share of financial cooperatives in the financial sector and income inequality, suggesting that the share of financial cooperatives in credit and financial markets has a negative correlation with the level of income inequality only in low- and middle-income countries. In addition, changes in the share of financial cooperatives in credit and financial markets have a negative correlation with changes in income inequality in the entire sample.

Later on, the book focuses on growth determinants or institutional factors that support the development of the financial cooperative sector in low- and middle-income economies. The book addresses two main institutional factors: political institutions and regulatory frameworks. Chapter 4 proposes a political economy theory for financial cooperatives based on the origins and history of cooperatives in developing countries, alongside pressure groups theory and political economy theory of the financial sector. It argues that autocratic regimes deliberately oppose the development of a well-functioning financial cooperative sector to maintain their political influence and prevent the formation of strong pressure groups that can threaten the current political status quo and reduce the governing elites’ economic benefits from an underdeveloped and exclusive financial sector. To empirically examine this theory; Chapter 5 analyses the influence of political institutions on the development of financial cooperatives, showing that democracy, political rights, and civil liberties promote financial cooperative development.

Political economy theories argue that political institutions shape the structure of the financial system. Political and industrial elites use their influence to secure preferential access to finance. The state’s position as a regulator, mediator of financial contracts, and borrower can drive its rules towards opportunistic behaviour. It can be unwilling to enforce contracts to benefit politically connected agents and directly influence the allocation of credit by state banks or allowing concentrated ownership over banks. Neoclassical and heterodox economists have intensively discussed the political economy of finance, yet the political economy of financial cooperatives is overlooked. Financial cooperatives are naturally politicised as they were founded by politicians during a revolutionary period in Germany in
the mid-nineteenth century. Since then, they have been extremely susceptible to both state harassment and support. This has ranged from being over-controlled by the state in many authoritarian regimes or being actively engaged—even indirectly—in local politics in other countries, such as Italy in the present day (Gutiérrez, 2008: 13). In addition, there is a clear observation that large financial cooperative sectors tend to function and grow under non-totalitarian political systems as shown in Chapter 5.

1.3. Financial cooperatives for egalitarian development

Control by members may guide financial cooperatives to pursue communal objectives that go beyond traditional financial services. Birchall (2013), and Cuevas and Fischer (2006) explain how control by members promotes sustainability and reduces the chances of engaging in risky investments. Furthermore, members’ involvement in decision-making helps to reduce the problem of information asymmetries, as mutualism can be considered a ‘natural solution’ to the credit rationing problem, enabling cooperatives to provide credit to lower-income members with low or no collaterals, and with very low monitoring costs. Birchall (2013) argues that the advantage of ownership could exist even if cooperative members were poorly involved in management and decision-making, as, even in the absence of direct control, the opinions of members will still count for major decisions. Clearly, that applies only if managers, governments and other interest groups are not over-controlling cooperatives.

Members’ control over financial resources is the distinguishing feature between the cooperative model and modern microfinance, which is highly celebrated by international development agencies and international financial institutions (like the World Bank Group and multilateral development banks). The not-for-profit orientation of modern microfinance has gradually been replaced by full-cost recovery and self-sustainable microfinance approaches. The microfinance model originated in the early 1980s in Bangladesh by Mohamed Yunus to promote economic development and poverty reduction through a micro-scale lending model is being absorbed by market-oriented or for-profit institutions in most underdeveloped economies. The current dominant model of microfinance, whether it is provided by not-for-profit or for-profit institutions, places the control over financial resources and their allocation in the hands of small number of microfinance providers that benefit from the highly profitable sector. Financial cooperatives are different in many aspects from standard microfinance institutions, both for-profit and not-for-profit organisations. Although group lending may seemingly share some similarities with cooperative concepts, in terms of joint liability, the distinctions are much bigger, especially when it comes to autonomy, mobilisation and control over resources, legal and organizational identity, and decision-making. Early financial cooperatives founded in Germany were more able to provide larger loans relative to the borrowers’ income, with longer-term maturity at lower interest rates compared to
modern standard microfinance institutions. The main source of funds for cooperatives are local savings, while microfinance institutions in underdeveloped economies rely heavily on donations, foreign funds, external borrowing, or on retained earnings, which implies high interest rates. High interest rates, short-term maturities, and tight repayment schedules are destructive instruments for low- and middle-income borrowers which may lead to serious debt traps, or in best scenarios will not support any sort of capital accumulation. Without improving the ability of agents to earn, save, and accumulate wealth, there are no real economic gains from financial markets to the lower- and middle-income populations.

Cuevas and Fischer (2006); Fonteyne (2007); Labie and Périlleux (2008); Ferri (2012); and Birchall (2013) have widely discussed the comparative advantages of the ownership structure of cooperatives. Financial cooperatives can have a comparative advantage over other types of financial institutions, since they are formed locally, focusing on narrow geographic areas, and there is usually a degree of homogeneity and previous social relations between the members (Guinnane, 2001: 370), which enable cooperatives to serve agents who were previously credit rationed from state and investor-owned banks. Financial cooperatives are important vehicles for the growth of SMEs compared to commercial banks, and are better able to reach and serve low- and middle-income agents compared to other microfinance institutions. Empirical literature suggests that financial cooperatives provide credit to small businesses at lower costs compared to large domestic commercial banks and foreign-owned banks (Angelini et al., 1998; Hasan et al., 2017). Similarly, many cross-country studies have shown that cooperatives are more likely to charge lower interest rates compared to banks and not-for-profit (like NGOs) or for-profit microfinance institutions. All the literature reviewed for this book has indicated that cooperatives tend to have lower portfolio yield and even sometimes lower operational costs (for recent studies see Cull et al. 2018 and Meyer, 2019). More interestingly, the financial crisis (2007–08) and the sovereign debt crisis (2010–13) did not affect the lending growth of cooperative banks, as they did with commercial and savings banks (Meriläinen, 2016). Financial cooperatives also proved to be more stable compared to other investor-owned banks (Cuevas and Fischer, 2006: 55; Hesse and Cihak, 2007; Ayadi et al., 2010: 116; Birchall, 2013: 24; Hasan et al., 2017). Chiaramonte et al. (2015) found that high market share of cooperative banks in the OECD have positive influence on the stability of the banking system during the financial crises. Butzbach and von Mettenheim (2014: 33–41) provide a comprehensive overview on empirical literature that discusses the comparative performance of financial cooperatives.

1.4. Avoiding an idealisation trap

This book does not intend to idealise the cooperative banking model. The movement and the sector have witnessed several failures and challenges, similar to other financial institutions, and also because of the distinctive
ownership structure of cooperatives, that can stimulate corporate governance issues and attract political interferences. For instance, the Swiss banking regulator has recently reported that Raiffeisen Schweiz bank has suffered from serious corporate governance drawbacks that included conflict of interests between the supervisory board and the management leading to significant violations of supervisory laws and practices. The British Co-operative Group has lost the ownership of the Co-operative Bank in 2013 to US-based hedge funds that owned its debts, after the Prudential Regulation Authority reported that the bank was not sufficiently capitalised and needs around GBP 1.5 billion. The United Kingdom still has a wide network of building societies and customer-owned banks, like Nationwide Bank. The Cyprus Co-operative Bank has also lost its cooperative status during the country’s financial crisis after being bailed out by the government in 2013 upon suffering from enormously high non-performing loans. The majority ownership went to the State, whereas the Hellenic Bank has purchased the performing portfolio of the cooperative bank. Between the 1980s and 1990s, around one-third of the Savings and Loan Associations in the United States were closed or resolved, in what is known now as the thrift or savings and loan crisis (Curry and Shibut, 2000). Failure of financial cooperatives does not always have to be as massive as the thrift or the Cyprus cooperative bank crises. Several other financial cooperatives have collapsed or struggled with inadequate performance like other financial institutions. The roots of the failure of financial cooperatives can be macroeconomic shocks that affect the entire financial sector, or can be banking failures that are not uniquely associated with cooperatives alone. This may include mismanagements, corporate governance issues, state control, or corrupt and fraudulent practices by the banks’ management. But the cooperative structure imposes additional stress on the governance of financial cooperatives especially that no individual member has a majority control because of the one member one vote rule that may encourage free riding or disengagement of members. Alexopoulos and Goglio (2011) have highlighted the current problems and challenges that may face the sector, pointing out on the challenges to diversify their loan portfolios, agency problems, political aspirations of the board or management members, and governance difficulties.

That is why regulations and supervisions are crucial for the safety and growth of the sector, especially when the sector expands and becomes more complex. Adequate regulatory framework is crucial for the sustainability and effectiveness of financial cooperatives, in order to keep providing the financial services needed by the members, and the community, and also to support the expansion of the sector. Chapters 6 and 7 are devoted to the regulations and supervisions of financial cooperatives in low- and middle-income economies. Chapter 6 gives an overview of the historical background and rational behind financial cooperative regulations, focusing mainly on protection from state interference, overcoming agency problems, setting adequate capital requirements, enabling institutional integration between cooperatives,
and protection of members’ deposits. While Chapter 7 shows how indicators of financial cooperative development are positively correlated with the existence of specialised regulation, supervision under non-bank financial supervisory authorities, and the presence of deposit insurance schemes, whereas the regulations of banking and general cooperative society are negatively correlated with financial cooperative indicators. The econometric methods used in Chapters 3, 5, and 7 are further discussed in the appendix.

Bibliography


Introduction


World Council of Credit Unions. (2017), Statistical Reports. www.woccu.org/our_network/statreport


1 This chapter is largely based on the following publication: Khafagy, A. (2017). Political institutions and financial cooperative development, *Journal of Institutional Economics, 13*(2), 467–498. ‘Reprinted with permission’.

2 For a comprehensive overview on theories of political economy of finance, see Pagano and Volpin (2001) and Perotti (2014).

1 This chapter is largely based on the following publication: Khafagy, A. (2017). Political institutions and financial cooperative development, *Journal of Institutional Economics, 13*(2), 467–498. ‘Reprinted with permission’.

2 Penetration rate is the total number of financial cooperatives’ members as percentage of total population above 15 years old, discussed more in Section 5.3.1.

1 Footnote no. 59 page 45.


3 In Kenya by the SACCO Societies Regulatory Authority since 2008 and South Africa by the Co-operative Banks Development Agency CBDA since 2007.