

## Chapter 1: Introduction

### 1.1 Background and overview

Due to declining profit margins (cf. Deutsche Bundesbank, 2020)<sup>1</sup>, German cooperative banks are facing increasing threats to their existence. However, the disappearance of cooperative banks from the German banking landscape would have serious consequences. Cooperative banks fulfil important functions in the German financial and economic system. Their dense branch network enables a large part of the population to participate in payment transactions and they are a key employer in many regions (BVR, 2022a, 2021a). Thanks to their unique structure, German cooperative banks also played an important role in supporting the European banking system during the financial crisis in 2007/2008. Their simple and clearly structured business model, restriction to regional markets and cooperative form of organisation, which prevents individual shareholders from achieving majority voting shares, are the factors which made this possible (Böhnke, 2010; Otte, 2010; VR-Bank in Südniedersachsen eG, 2019). The success of these cooperative banks is influenced by those leading them. Because of the strategic and operational roles they play these leaders play a decisive role, as these banks tend to be small in terms of their balance sheet and in international comparison.

Given that the success of a bank depends on its leaders, there is a case for examining the qualities of the board members and the board that might enable that success.

This chapter presents the topic of this thesis and outlines the research context. It then explains the importance of examining German cooperative banks and what significance the sustainability of this banking group has not only for banking in Germany, but also for the wider European banking system. This is followed by a discussion of factors that could potentially have an influence on the sustainability of the German cooperative banks. Reasons are given as to why certain factors have been selected in this thesis, while others are not pursued further. Then the research question is for-

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<sup>1</sup> The majority of the sources cited have not explicitly analysed or examined German cooperative banks. However, their content is applied to the current work in the context of German cooperative banks and such references are marked with the prefix "cf.".

ulated and the research objectives are presented. The theoretical and practical implications of the results are also discussed. The chapter concludes with an overview of the structure of the rest of this thesis.

The next section introduces the subject of the research and the related context, and explains the role played by German cooperative banks in the German economy.

## 1.2 Research context: German cooperative banks and board members

Banks have always played a critical role in the local and national economy (Baumgartner, 2022; Schmidt, 2021) and a well-functioning banking system has an impact on a variety of stakeholders, including owners, business partners, employees, customers, members, investors, the public and other banks as stated by Theurl and Böttiger (2007, p. 18). Furthermore, the essential task of the financial system and the participating banks is to pass on and bring together funds from providers and consumers. The funds collected are converted into loans in the form of cash or deposits (Deutsche Bundesbank, 2017). The explanations outlined above can be applied to different banks in different countries. However, this thesis investigates cooperative banks in the context of the German banking system.

Furthermore, the specific focus of this thesis is on executive board members of cooperative banks and the qualities of these executive board members. In this context, it is the executive board members in a cooperative bank who make the decisions in the day-to-day business (supervised by the supervisory board, which only participates in strategic decisions (cf. Ziechhaus, 2020; DG Verlag, 2018a) and is not active in the day-to-day business). The decisions taken by the board members have an impact on the banks' success (Hall and Pedace, 2016; Bertrand and Schoar, 2003), which in turn ensures the sustainability of the bank. By law, the executive board of a German cooperative bank (§ 24 (2) GenG) always consists of at least two persons, in contrast to large banks and Anglo-American banks, which often are represented by just a single CEO (cf. Böhm *et al.*, 2012). Having people in management roles who can be expected to perform well due to their qualities is crucial to ensuring the long-term sustainability of cooperative banks. At first, it is not obvious what these qualities actually are, as business leaders have many hidden qualities. The approach of this thesis is

to focus on the objectively measurable qualities of age, gender, experience and education, as well as board size and composition. The measurable qualities can shed some light on the influences of the hidden qualities.

This thesis focuses on German cooperative banks, which constitute 49.16% (844 banks and 9,315 branches) of the German banking landscape (Deutsche Bundesbank, 2021; Arts, 2016). At the end of 2019, there were 1,717 banks in Germany. This total consisted of 275 credit banks, 6 regional banks, 380 savings banks, 10 real estate credit institutions, 19 banks with special functions, 19 building societies, 163 other banks, and 844 cooperative banks (Deutsche Bundesbank, 2021, p. 1). On the one hand, their high share in the overall German banking system and their dense branch network mean that they play a fundamental role in the German economy. On the other hand, their simple and risk-averse business model makes them resistant to crises (Fechtner, 2022; Otte, 2010, p. 89).<sup>2</sup> During the financial crisis of 2007/2008, the German cooperative banks not only supported the banking system in Germany, but in the whole of Europe<sup>3</sup>.

Furthermore, “rural areas often only have cooperative and savings banks, which secure access to the banking system for all regions and population groups” (Fischer, 2011, p. 33). This means that these banks are crucial for the local ecosystem (cf. Klein, 2020).

It is therefore all the more important that they can continue to perform this function sustainably in the future. However, various developments over the years have made this more difficult.

Firstly, cooperative banks, like other banking groups, are struggling with declining interest margins (cf. Deutsche Bundesbank, 2020)<sup>4</sup>. This is because the main source of income for banks is the difference between their lending rates and their deposit rates: the *interest margin*. Due to their low-risk business model (cf. Barkey, 2018), which mainly consists of collecting funds and granting loans, cooperative banks are

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<sup>2</sup> According to Otte (2010), the advantage of the cooperative banking structure is that the banks are diversified; for example, they do not focus solely on risky investment banking but on ensuring that they have sufficient capital resources and are mostly active in local markets that are familiar to them. Otte (2010, p. 95) states that this advantage also applies to the savings banks, which operate a similarly simple and clearly structured business model.

<sup>3</sup> A comparison of the German cooperative banking system with other European countries, especially with regard to size, structure and importance in the respective country, is presented in Appendix 4 on page 279.

<sup>4</sup> Due to several significant key interest rate increases by the ECB (triggered by various factors such as the war in Ukraine, inflation, etc.), the situation is currently changing, i.e. the interest rate level is gradually rising again (cf. Otte, 2022; Fölsche, 2022).

dependent on adequate interest margins. However, due to the ECB's long-term policy of low interest rates, this interest margin has been decreasing for years, and the existence of some banks is now under threat (Geißdörfer, 2012a, p. 4). Furthermore, Geißdörfer (2012b, p. 4) states, that "The euro crisis and the budget crises of the southerners make it even more difficult to generate income. In the customer business too, margins continue to decline (due to the high level of competition between banks), which is also attributable to tighter investor protection guidelines in the securities business and high market volatility".

Secondly, cooperative banks are under additional pressure from the increasing digitalisation of the banking business (Kolak, 2022). In principle, digitalisation affects all banking groups, but it has a particular effect on cooperative banks, as they maintain denser branch networks than other banking groups due to their history (BVR, 2022e, 2022a). Both in the past and now, these dense branch networks have ensured the provision of banking services to the population (cf. Klein, 2020). Due to increasing digitalisation and the resulting decline in the number of branches, the cooperative banks are faced with a dilemma. The dense branch networks continue to be a key differentiating factor of cooperative banks (BVR, 2022a; Deutsche Bundesbank, 2021), but maintaining these dense branch networks incurs higher costs.

Furthermore, increasing regulation, which is primarily geared to the business models of large international banks (cf. Holtermann and Osman, 2020), affects cooperative banks disproportionately compared to other banking groups (cf. Genossenschaftsverband and Verband der Regionen, 2017). In terms of number, cooperative banks represent the largest share of all banks in Germany. In terms of size (expressed in terms of total assets), however, they are much smaller than the big banks and savings banks and thus play only a subordinate role nationally and internationally (cf. Deutsche Bundesbank, 2021). Nevertheless, all regulations apply equally to cooperative banks. Large banks maintain central teams of specialist employees who implement the regulations for the entire group. Each cooperative bank is legally independent and acts for itself. Consequently, each individual cooperative bank must train and maintain the appropriate staff to implement the regulations. This represents an organisational and personnel challenge for the cooperative banks (cf. Krüger, 2022).

However, for the financial system to function and to continue to exercise its functions of trust<sup>5</sup>, price stabilisation and payment processing, it is essential that banks can sustain in the long term (cf. Gleber, 2020); in other words, they must generate sufficient profit. Cooperative banks therefore play an important role in the ecosystem of the German economy and its banking system, especially in the respective business area in which these banks are locally present, i.e. in the local ecosystem. They ensure the German population's access to essential financial services: processing of payment transactions, supply of cash, advice on financial investments and financing, etc.. It is crucial that they remain viable businesses in order to be able to operate independently (cf. Gleber, 2020).

Due to the reasons mentioned, it is therefore important to identify the influencing factors which can contribute to making German cooperative banks sustainable in the long term.

However, before discussing this in detail, the importance of cooperative banks to the German financial system must further be examined.

As previously stated, German cooperative banks played an important role during the financial crisis. Due to their low-risk business model, German cooperative banks provided support and stability during the 2007/2008 financial crisis and ensured international payment flows (cf. Jungmeister *et al.*, 2015). In this respect, it is reasonable to assume that German cooperative banks could have a similar stabilising influence in future financial crises.

Furthermore, the stability described above is also evident in the fact that for more than 200 years, German cooperative banks ensured the "local supply" of financial services for the normal population and small and medium-sized enterprises, i.e. they secured the local financial ecosystem by providing financial services (cf. Matt and

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<sup>5</sup> In Germany, the financial system is mainly bank-based, i.e. capital is not invested directly in companies as funds, but provided to banks, which in turn finance companies. This is true for *Mittelstand*<sup>6</sup> financing in particular. Because there is a large volume of long-term financing in this sector, it is essential that providers and buyers can trust in the stability of the financial system. The financial system therefore has a trust function. The German banking system consists of the individual banks and the central banks (the Deutsche Bundesbank and the European Central Bank [ECB]). The central banks are mainly responsible for price stability, which is ensured by the issue of legal tender, among other things. In addition, the central bank supplies the individual banks with liquid funds. In this way, the financial system functions as a payment processor and ensures price stability (cf. Deutsche Bundesbank, 2017).

Mocha, 2021). This was achieved by their small-scale nature, with a branch of a co-operative bank in almost every small town (and city). While large commercial banks have always concentrated on the middle class or even large industrial companies as customers, cooperative banks have always been banks for workers, employees, farmers and craftsmen (cf. BVR, 2022e). In principle, the cooperative banks still perform all these tasks and services today. Due to the challenges mentioned above, however, the pressure on the cooperative banks has increased considerably in recent years. To meet these challenges, many cooperative banks have merged into larger units and reduced their branch network considerably (cf. BVR, 2019a). If this development were to continue and a further withdrawal from the countryside were to take place, it may become more difficult to provide financial services to rural communities.

Another reason why German cooperative banks are important is that the older population<sup>6</sup>, which does not always have access to or make use of modern services such as online banking, benefits from the dense branch networks of cooperative banks (cf. Benkelberg, 2020). The reason for the dense branch network lies in the historical development of cooperative banks, which itself was influenced by farmers and craftsmen organising themselves into small village communities. The resulting promotional mission, with the motto "help people to help themselves", showed how small savers could accumulate assets through savings (cf. Otto, 2020). In this context, it should be mentioned that the cooperative structure also enables small savers to even become owners of "their" bank with modest financial means (through membership). At the same time, they influence the decisions of "their" bank, but not according to the number of shares they hold, as is the case with joint-stock companies. In cooperative banks, each member has one vote (cf. BVR, 2022c). If cooperative banks no longer existed, it may be more difficult for small savers to accumulate assets. Larger commercial banks are unlikely to be able (or willing) to close this gap, as they usually have a different target group, for example wealthy private customers or SMEs, which helps them generate corresponding returns (cf. Wischmeyer, 2022).

The long-term sustainability of German cooperative banks is also important because another key feature of cooperative banks is the advice they provide to their members

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<sup>6</sup> The demographic development in Germany is characterised by an increasingly ageing population (cf. Statistisches Bundesamt, 2019).

in the deposit and lending business. The advisors of the cooperative banks have always been close to the customer and on site, with some building up relationships with customers over several decades (cf. Knappkötter and Schönau, 2022). Good customer relations also exist at commercial banks, however, they employ a different business model (cf. Mayer, 2022). In addition, the branches of cooperative banks also serve as a point of social contact and mutual exchange. Due to the decades-long relationships they have with customers, it is common for children to open an account at the local cooperative bank. Children are slowly introduced to financial topics, for example through contact with their parents and the bank, with cooperative banks providing financial education outside of school education (cf. Schulz, 2021). A withdrawal or elimination of cooperative banks may mean a reduction in the financial education and advice available to certain parts of the population.

Another critical reason for German cooperative banks being sustainable is that many savers have placed deposits with cooperative banks due to the better deposit guarantees at cooperative banks. German cooperative banks have a unique institutional guarantee (cf. BVR, 2014). Unlike other (European) banking systems, they not only guarantee deposits up to the amount of 100 thousand euros, but to an unlimited amount. Cooperative banks have always had their own deposit guarantee fund, which intervenes in the event of bank defaults. This means security for depositors, especially in times of crisis (cf. Gleber, 2020). The continued existence of cooperative banks is therefore important because small savers benefit from their deposit guarantee.

Finally, German cooperative banks are important because they employ many thousands of people. Although the focus of this thesis is not primarily on cooperative banks as employers, the high number of jobs German cooperative banks provide is significant from a macroeconomic perspective. As of 31 December 2021, they employed more than 135,000 people and are thus an important employer and taxpayer (cf. BVR, 2022d). It is therefore critical that these banks continue to exist in the long term, providing a large number of people with a secure job, often close to home.

### 1.3 Factors influencing the sustainability of German cooperative banks

There are numerous factors that could have a greater or lesser influence on the sustainability of German cooperative banks. In order to examine these factors in more detail, it is necessary to identify the factors which could affect sustainability over which the bank<sup>7</sup> has no direct influence and, in contrast, factors over which the bank has a degree of influence.

#### 1.3.1 Factors over which the bank<sup>8</sup> has no direct influence

As a result of the financial crisis of 2007/2008, international policy-makers felt compelled to regulate banks more strongly, since it was mainly large international banks that caused the financial crisis (cf. Marx and Bender, 2020). In the following years, banking regulations were tightened considerably. For example, capital requirements were strongly increased. Even though the financial crisis was caused by big banks with a completely different business model, the stricter regulations also apply to German cooperative banks (cf. Gianfagna *et al.*, 2021), which operate a low-risk business model (Fechtner, 2022; Barkey, 2018) and are considerably smaller (in terms of their balance sheet) than big banks (Deutsche Bundesbank, 2021). Thus, further regulations could create further difficulties for German cooperative banks. However, German cooperative banks have no direct influence on regulation.

In addition to regulation, German cooperative banks are also subject to laws introduced to protect customers. This has occurred several times in recent years. These laws aim to strengthen consumer rights and hold banks accountable. Such changes in the law have often been made retroactively, i.e. banks were obliged to repay amounts that had been found to be wrongly collected (cf. Trares, 2021). The loss of future income and retroactive refunds to customers put banks under additional pressure and makes their business survival harder.

In this context, the interest rate policy of the ECB is an important factor that strongly affects the sustainability of cooperative banks. Due to European and global events

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<sup>7</sup> Note: when "the bank" is referred to in the following sections, it always means the persons acting on its behalf, i.e. the bank's executive board members.

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(inflation, national debt, distortions of financial markets, etc.), the ECB's interest rate policy has been geared towards low interest rates for several years (cf. Berner and Wilkens, 2022). This has had serious consequences for banks, as the difference between lending and deposit interest rates has been their primary source of income. Due to the long period of low interest rates, the (interest) spread continually declined over the years. Besides the big banks, it is mainly the cooperative banks that have suffered from this development, since the deposit and lending business is their traditional source of income (cf. Leichsenring, 2018). The big banks adapted their business models many years ago by expanding or even shifting their sources of income to investment banking, commission business or other areas (cf. Seiwert and Welp, 2022). This historical background of cooperative banks means that they cannot adapt their low-risk business models so quickly. Due to their success over two centuries, it may be the case that they do not wish to adapt them at all. As a result, their ability to counteract the reduction in interest income is limited. The continued decline in interest income means that some cooperative banks are struggling to survive, with cooperative banks powerless to influence this.

Digitalisation is becoming increasingly important and is having a growing influence on the success of cooperative banks. Features such as online banking, self-service devices, video consulting, product transactions via the internet are permanently changing the way banking is done (cf. Kauer and Lehmann, 2022). At the same time as many typical banking transactions are shifting to the digital world, customer footfall in branches decreasing (cf. von Stillfried, 2018). In addition, online services provide increased transparency, enabling potential customers to conduct their banking transactions when and where it is most convenient for them. Although increasing digitalisation is affecting all economic sectors and banks, it is having a disproportionate effect on cooperative banks due to their dense branch network (cf. Deutsche Bundesbank, 2021). This may make maintaining the same number of branches too expensive.

As already mentioned, cooperative banks have historically operated a low-risk business model (cf. Barkey, 2018), which consists of accepting deposits and granting loans. Due to the long-lasting low interest rate policy of the ECB (cf. Berner and Wilkens, 2022) and the associated introduction of negative interest rates within German banks, it is important for customers to at least place their deposits "safely" with the bank. This creates liquidity surpluses at the banks. Either the surplus deposits are

also invested with the central bank at negative interest rates, or the banks try to invest their money on the capital market at the best possible interest rates. If there are disruptions on the capital market and on the stock exchanges due to, for example, wars, natural disasters or Covid-19, banks are also directly affected by such developments, nowadays more than ever, since events that occur in distant countries also have an impact on the financial markets. Therefore, even unpredictable events can have a significant impact on the sustainability of cooperative banks.

Another potential influence on the sustainability of cooperative banks can be the competitive situation in the region in which the bank operates (cf. Ruh and Spachmann, 2021). The number, strategy and size of the competitors can have positive or negative effects on the sustainability of cooperative banks. In this context, the market share of the cooperative bank is in the respective region and thus the market power of the bank is also important.

In the broader context, factors directly related to the particular region in which the bank operates could have an impact on its business performance. These include, for example, the unemployment rate and insolvency rate in the region as well as the gross value added, i.e. the purchasing power of the population. If the unemployment rate is high, it may be difficult to do profitable business with customers due to a lack of income. Similarly, it may be difficult to do good business with companies in regions with high insolvency rates. Gross value added is also a measure of the purchasing power and the potential that the inhabitants of a region have.

Although it can be assumed that good leaders will try to steer their banks prudently and strategically through these challenges, the banks themselves have no influence on these circumstances (cf. Ahtelik and Hofmann, 2021). On the other hand, there are influences over which the bank can have a degree of influence. These are examined in more detail below.

### 1.3.2 Factors over which the bank has a direct influence

An essential factor influencing the sustainability of a cooperative bank is the profit expectation that the executive board has (cf. Macke, 2011). High profit expectations are more likely to provide a secure reserve cushion for future years. This has a positive