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The Portuguese Agricultural Credit Cooperatives Governance Model

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Abstract

The Portuguese Agricultural Credit Cooperatives (ACC) play a significant role in the national banking system. At the present, they face the challenge of matching the application of the traditional cooperative rules (which leads to a resulting set of vaguely defined property rights) with being successful in an ever more strong and competitive banking sector.

The main objective of this paper is to understand the Portuguese ACC governance model, focusing on the strategies used to ameliorate the decision and investment problems arising from the strict application of traditional cooperative rules.

Contrary to most of their pairs, Portuguese ACC choose to focus their efforts on the cooperative activity and performance rather than on the cooperative rules it selves.

Although that strategy proved to be financial fruitful, it drives Portuguese ACC to a growing conflict of interests and to an identity crisis.

Keywords: cooperatives, cooperative principles, governance, performance, property rights

Résumé

Les Coopératives de Crédit Agricole (CCA) Portugaises jouent un rôle significatif dans le système bancaire national. Aujourd'hui, le CCA défie est le ajustement de l'application des règles coopératives traditionnelles et son résultat droit de propriété vaguement définies avec être victorieux dans un secteur bancaire toujours plus fort et concurrentiel.

L'objectif principal de cet article est comprendre le modèle de gouvernement du CCA portugais, se concentrant sur les stratégies employées pour améliorer les problèmes de décision et d'investissement résultant de l'application stricte des règles coopératives traditionnelles.

Contraire à la majeure partie de leurs pairs, le CCA portugais a choisi de concentrer leurs efforts sur l'activité coopérative et la performance à l'opposé de sur le gouvernement de la coopérative. Bien que cette stratégie a démontré être financièrement fructueuse elle conduit le CCA portugais à un progressif conflit d'intérêts et une crise d'identité.

Mots-clés: coopératives, principes coopératifs, gouvernement, performance, droites de propriété.

Resumen

Las Cooperativas de Crédito Agrícola (CCA) Portuguesas desempeñan un papel significativo en el sistema bancario nacional. Al presente, las CCA enfrentan el desafío de cómo ajustar la aplicación de las reglas cooperativas tradicionales y sus consecuentes derechos de la propiedad vagamente definidos con el éxito en un sector bancario cada vez más fuerte y competitivo.

El objetivo principal de este estudio es entender el modelo del gobierno del CCA portugués, centrándose en las estrategias empleadas para mejorar los problemas de la decisión y de la inversión que resultan de la aplicación de las reglas cooperativas tradicionales.

Contrario a la mayoría de sus pares, el CCA portugués optó por centrar sus esfuerzos en la actividad cooperativa y en la *performance* más que en el gobierno de la cooperativa. Aunque esa estrategia demostró ser financieramente fructuosa, condujo el CCA portugués a un cada vez mayor conflicto de intereses y a una crisis de identidad.

Palabras claves: cooperativas, principios cooperativos, gobierno, performance, derechos de la propiedad.

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1. Introduction

Cooperative banks have their roots in agriculture and rural life. Portuguese Agricultural Credit Cooperatives (ACC) are the way to oil the wheels of the Portuguese rural economy. Their origins go back to the 16th century, however, until the eighties of last century ACC played a minor role in the Portuguese banking activity, with a share of only 1% of total deposits and credit. During that decade ACC were placed in the framework of a financing strategy for the development of the agricultural sector, and thus, they experienced a spectacular growth in their activity (Cabo and Rebelo, 2005a).

Except concerning banking operations, the Portuguese ACC are ruled following the traditional cooperative structure with open membership, democratic control and restricted residual claims. The strict application of these rules can promote a set of vaguely defined property rights with negative effects on the transaction costs (Cook and Iliopoulos, 2001).

Like cooperatives in other sectors, the ACC increasingly face survival challenges related to financial issues linked with equity capital. Being not-for-profit enterprises ACC do not remunerate equity and do not have access to publicly raised capital. Thus, ACC capital base growth is supported by their retained profits. During 1990s the solution adopted by them to overcome this constraint was based in the creation of an economic group and an intense process of mergers. This strategy allowed the ACC to benefit of scale and scope economies and improve their financial health. Additionally, law changes regarding ACC supervision allowing that part of supervision task remained in the ACC system itself, proved to be beneficial to control the ACC management.

However, while positive to the financial health of ACC, those developments are driving the ACC away from the cooperative identity and inflaming the problems linked to the application of traditional cooperative rules, i. e., free-rider, horizon, portfolio, control problems and influence costs.

Nowadays, ACC face the challenge of matching the application of the traditional cooperative rules (along with its resulting set of vaguely defined property rights) with being successful in an ever more strong and competitive banking sector.

The perception of that dilemma passes by the comprehension of ACC characteristics and its influence on ACC's social, economic and financial life, especially on the decision making and investment incentive problems. Only then we would be able to propose a way to succeed on that challenge.

The main objective of this paper is understand the Portuguese ACC governance model, focusing on the issues arising from the strict application of traditional cooperative rules and its influence on the decision and investment problems.

Thus, the remainder of this paper consists of four sections. Section 2 shows a brief review of the literature on cooperatives governance focusing on the decision and investment-related problems. Section 3 describes the Portuguese ACC governance model; and section 4 offers some concluding remarks.

2. Governance and Cooperatives: A literature review

The traditional cooperative is a user-owned and user-controlled business that distributes benefits on the basis of use (Barton, 1989). As a result, is an organization by and for members. While an investor-owned-firm (IOF) goal is to give its owners the highest return on investment, a cooperative goal is to provide the best service to its members.

The supply of an efficient and sustainable financial service to rural populations implies the accomplishment of a range of conditions, specially the reduction of transaction costs, which was difficult to achieve for banks in the earlier years. It was complicated to set up healthy financial relationships and it was costly to gather “informational capital” about the clients. Cooperatives have two competitive advantages: their clients are their members, so the costs of gathering “informational capital” were reduced, furthermore, because all cooperative members’ solidarity respond to the cooperative losses, they actively monitor each others. In addition, the social and informal network of members or potential members is also relevant as a determining factor in decreasing transaction costs and in the process of establishing and running of the activity of a cooperative (Cabo *et. al.*, 2006, Guinnane, 2001).

For the development of the organization tasks the governance structure is critical, once it allocates income rights and decision rights, i.e., it determines who receives income from the use of the organization's assets and who may decide over these assets (Hansmann, 1996). Other governance attributes are the supply of equity capital, the assignment of ownership title, and the owners' control of the management. Taking the IOF as the standard, a cooperative has a deviant ownership structure and a deviant control structure (Bijman, 2002). These differences result from

the organization goal and, as a result, cooperatives experience problems related with decision making and investment incentives.

Decision-related incentive problems

Because a cooperative is a voluntary organization all members participate in strategic decision-making. All members elect, in general assembly, the board of directors. Democratic decision-making costs rise as membership becomes more heterogeneous, which reduces the commitment and increases the free rider problem (Bijman, 2002; Spøgaard, 1994). Although collective decision-making has the advantage of keeping all members committed and making implementation of policies relatively easy, it has several disadvantages, namely, inflexibility, inertia, and a reluctance to start new business activities (Bijman, 2002; Hendrikse, 1998; Reynolds, 1997). Subsequently, decision-related incentive problems may occur.

These incentive problems are related more directly to the decision mechanisms in cooperatives and are derived from agency control issues. There is some evidence that the main problem will be more severe in a cooperative than in IOF since the ability of members to monitor management seems more limited (Gorton and Schmid, 1999). More specifically, a number of intimately related decision problems are commonly found in cooperative organizations, such as the monitoring problem, the follow-up problem, the influence cost problem and the decision problem (van Bakkum, 2001; Borgen, 2004).

The particular agency problem in the cooperative organizations emanates from the rigidity of the ownership structure, consequence of two main constraints (Gorton and Schmid, 1999): first, equity can only be traded at face value and only between the cooperative and the members; second, votes cannot be accumulated into blocks (because of the one-member-one-vote rule) and

there can be no monitoring by block shareholders (as suggested by Becht *et al.* (2002)). Consequently, the costs of changing control on cooperative organizations are high.

Rasmusen (1988) and Fama and Jensen (1983 a, b) argued that cooperative members may be less likely than stockholders to exercise control over management by participating in board meetings or voting. Also, the cooperative boards of directors are less likely than the boards of IOF to monitor or replace management. While, Kane and Hendershott (1996) argued that the field of membership and cooperative structure of a credit union encourages management to align its objectives with those of membership, curbing managerial excesses. That suggestion is not confirmed by the empirical evidence (Mester, 1991; Stewart, 1997; Gorton and Schmid, 1999; Leggett and Strand, 1999).

Investment-related incentive problems

Ownership of assets leads to efficient decisions about using these assets. Because the owner both holds the residual control rights and receives the residual returns, he bears the full financial impact of his choices. However, if property rights are not well defined, not tradable or not well protected, inefficient choices may be made (Milgrom and Roberts, 1992: 294). *“If no one clearly owns a valuable asset, then no one has an incentive to guard its value properly. If property rights are not tradable, then there is little hope that assets will end up with those people who can make the best use of them and therefore value them most. If property rights are not secure, then owners will not invest great amounts, in assets that they may lose with no compensation, or they may sink valuable resources into protecting their claims.”* Property rights that are ill defined, badly enforceable and non-tradable will lead to inefficient decisions, because decision maker no longer bears the full impact of his choices.

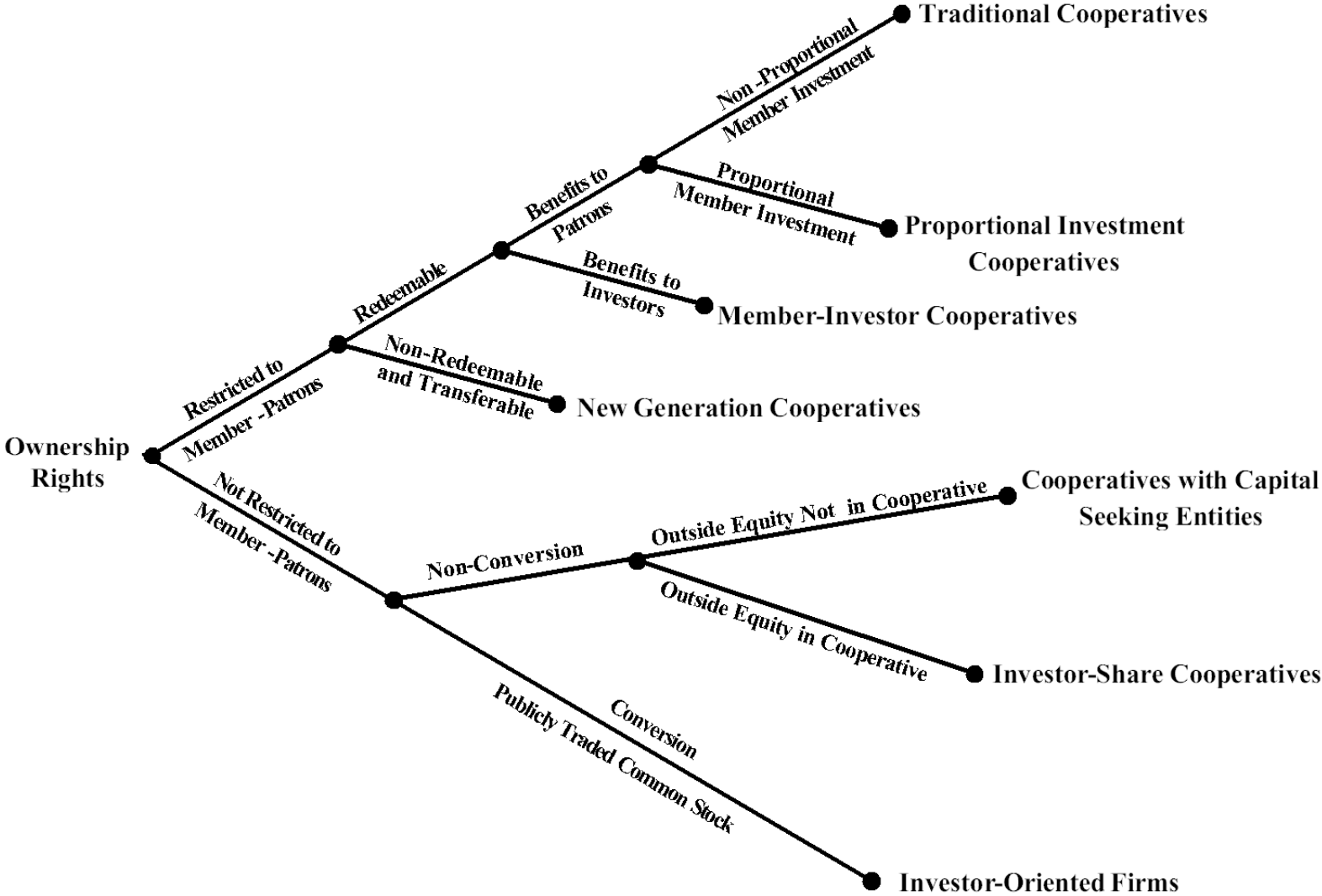
Cooperatives are collectively owned by the members. Collective ownership means that control rights and return rights are not assigned to any member individually, but are held by all members together. Most cooperatives have no or limited options for trading property rights. Thus, property rights in cooperatives are ill defined and non-tradable, which may lead to inefficient decisions. Cook (1995) distinguishes three investment related efficiency problems: the free rider problem, the horizon problem, and the portfolio problem.

The main efficiency problem of collective ownership in a cooperative is that it weakens the incentive for members to supply (additional) equity capital to the cooperative because their investment is illiquid and does not receive adequate returns. Risk-bearing costs are simply too high. This is particularly serious for cooperatives that need to assume risky investments and or with sunk costs.

Chaddad and Cook (2004) argue that by relaxing some of these restrictions on ownership rights, nontraditional cooperatives may provide incentives for member and nonmember investment in organization-specific assets, thereby ameliorating perceived financial constraints.

The authors present a range of alternative cooperative models according to a property rights perspective. They characterize these models on the basis of various organizational attributes, including ownership structure, membership policy, voting rights, governance structures, residual claim rights, distribution of benefits, and the strategy-structure interface. Figure 1 illustrates those alternative cooperative models.

Figure 1 – Alternative cooperative models: an ownership rights perspective (Chaddad and Cook, 2004)



Their analysis of new cooperative models suggests that in general, the solution of perceived financial constraints in cooperatives entails some degree of organizational redesign, rather than the extreme solution of conversion or demutualization. That is, ownership rights related to residual return and control rights of agents tied contractually to the firm are redefined and reassigned. For example, the cooperative may choose to relax the restriction that ownership rights be restricted to members or introduce transferable equity shares to build a permanent equity capital structure. However, when restrictions on traditional cooperative ownership rights are attenuated, new organization costs may surface as agency, collective decision making, and influence costs. In other words, cooperative leaders should be aware of the trade-offs involved in organizational redesign.

Cook and Tong (1997) survey observed that more than 80% of the cooperatives adopted non-traditional cooperative organization characteristics. Moreover:

- (a) 96% reduced the free-rider problem by linking member investment to use;
- (b) 94% allowed members to adjust their asset portfolio by the transference of equity shares;
- (c) 93.6% permitted changes in the cooperative's value upon divestment of equity shares;
- (d) 98% implement a defined membership structure; and
- (e) 98.7% of equity raised took the form of the sale of non-voting equity stock.

Additionally, Van Bekkum (2001) found that cooperatives with a more individualized member-firm relationship (individualized equity capital; tradable and appreciable production rights; external equity; dividend payments on equity shares; linkage of production rights and equity shares; and linkage between equity shares and voting rights) have fewer investment-related incentive problems.

According to Cabo *et al.* (2006) quoting Chaves and Soler (2004) Spanish credit cooperatives manage the weak investment problem compensating the participations exceeding legal minimum shares with remuneration until 6% above the legal interest rate. It works as an incentive to major participations. Additionally, approximately only 60% of the Spanish credit cooperatives make use of the democratic voting rule, the remaining cooperatives prefer the proportional voting or other method (Chaves and Soler, 2004), a strategy that allows to ameliorate the free-rider problem.

Tremblay (2001) refers the creation category B shares as a strategy used by cooperative banks to increase capital investment. Crédit Mutuel, the Caisses Desjardins and CERA, the Belgian cooperative bank, are among the ones that created category B shares. Category B shares offered a limited return, subject to the annual financial results and without vote, according to various terms.

As we saw above, cooperatives have adopted varied strategies to beat of difficulties inherent to the cooperative form. Most of the solutions presented are based in some degree of deviation from the traditional cooperative rules. Portuguese ACC implemented a very different strategy. They opted to focus their efforts on the cooperative activity and performance rather than on the cooperative rules it selves. In the next section we present the case of the Portuguese ACC.

3. Portuguese ACC Governance Model

Like many other cooperatives, the ACC increasingly face survival challenges related to financial issues linked with equity capital. Portuguese Cooperative Code and ACC specific legislation are devoted disciples of the traditional cooperative rules. Consequently, ACC capital base growth is

supported by their retained profits. Unable (or unwilling) to modify the law, Portuguese ACC opted to center their efforts in the improvement of ACC's performance as a way to overcome their financial problems.

So, in the 1990s, following the tendency of other European credit cooperative systems, the ACC engage in the creation of an economic group and, simultaneously, a concentration process thought mergers operations to reach minimum efficient size, a way of achieving scale and scope economies.

Thus, in 1992, the Crédito Agrícola Group¹ is formed by firms covering a wide range of services, from insurance to informatics' services, and so on. In the heart of this economic group is the Agricultural Credit Cooperative Integrated System (ACCIS). The ACCIS is made up of an integrated system of two types of cooperatives: the central and the singles (associated). Central ACC is the pivotal institution in the Crédito Agrícola Group, with a remit that is the mainstay of the Group strategic global coordination and supervision and guidance of the associated ACC.

In terms of the governance, the Central ACC is responsible for the coordination and the control of all the associated singles' operational processes, i. e., it is the guardian of the system with a high capacity to interfere in the management of the singles and even replace their board of management. In cases of gross management failure or fraud, the management can be formally discharged by the Central ACC.

ACC are free to stay out of the ACCIS, but in that situation they must comply with the more strict regulations applied to the other institutions of the Portuguese banking system.

¹ See the organigram of the Credito Agrícola Group in appendix

Single ACC have three governance bodies (Figure 1): general assembly, management board² and audit board. The general assembly includes all the members of the coop and usually meets twice a year, one for the appreciation of the annual activities plan and concomitant budget, and the other for the appreciation of the annual operating activities plan and budget, and the annual activities report which includes the balance sheet and income statements.

The ACC is run by the management board³ that is elected by the general assembly and his main task is to oversee the daily operations of the cooperative. Generally, the management board can delegate some minor management tasks to qualified employees.

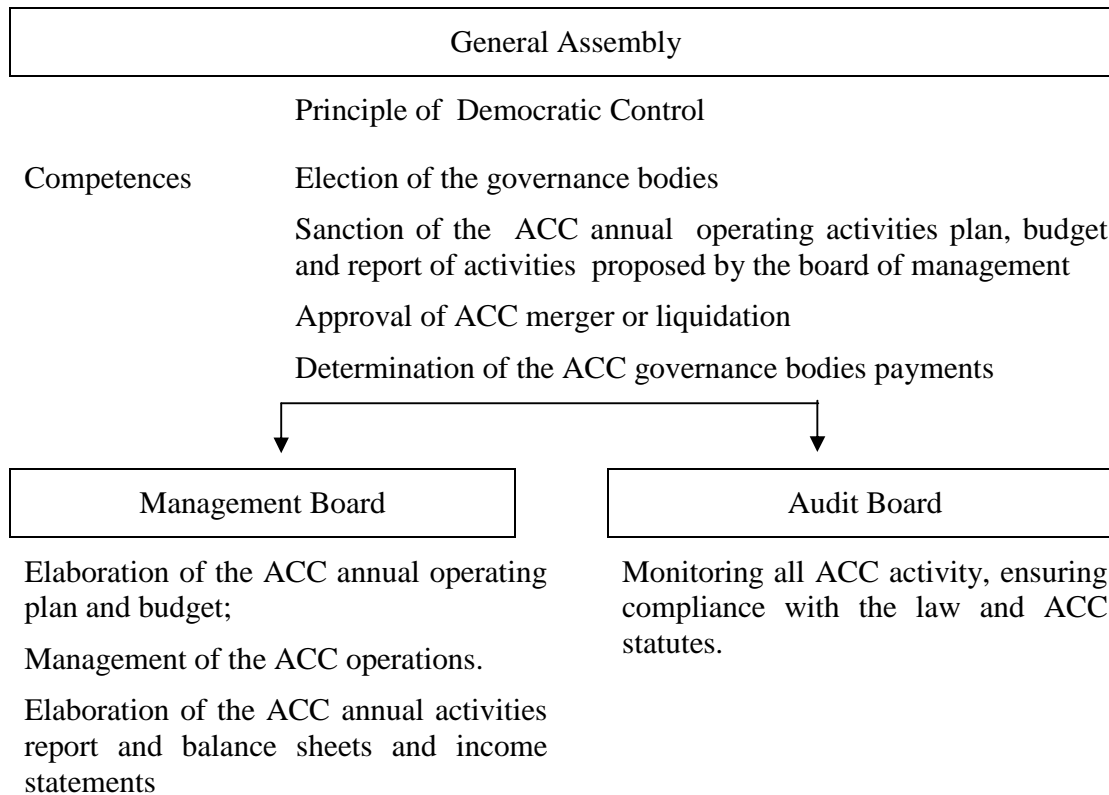
The audit board, also elected by the general assembly, has as main task to assure to the members that the AAC is being managed according to the cooperative principles and that annual balance sheets and income statements reflect the true economic and financial position of the cooperative. To help audit board members to perform their function they will be obligatory assisted by an auditor.

General assembly is the main governance body of ACC. It's responsible to control management activities. This control is reinforced by the audit board.

² The common designation (in the literature) is board of directors, but considering the small scale of ACC operations and their organizational structure, management board seems to be more appropriated to describe their role.

³ The board of management usually includes three members who must be elected among the ACC members. Management skills are required. Thus, the board of management can include two additional individuals (management experts) not members of the ACC.

Figure 2 – Governance ACC scheme (Cabo and Rebelo, 2005b)



Decision making-related incentive problem, control mechanisms and performance

In the general assembly, decisions are made respecting the democratic decision making rule. As mentioned in section 2, democratic decision making carries some well known costs: the monitoring problem, the follow-up problem, the influence cost problem and the decision problem

In ACC, member power is always independent of the participation in the equity. By distributing the control rights over the ACC equally across the cooperative members, power is actually passed to the management. Since the equity ownership structure is exogenous, it cannot adjust to eliminate managerial inefficiency (Gorton and Schmid, 1999). The use of the proportional voting rule or the possibility to delegate voting power (frequent among other countries' cooperatives)

that would allow ACC to minor those problems is not an option. Moreover, because equity can only be traded with the ACC itself, a takeover by means of an equity acquisition is not possible.

Furthermore, a scan on the list of the management board and audit board members in the 1996-2006 period allowed us to notice that rotation between both governance bodies is a common practice and that changes in the management board are followed by changes in the audit board. Although these practices are not illegal⁴, they are certainly unethical and a clear violation of the independence and impartiality requirements of the audit board activities.

The net benefit is the main source of ACC equity. Thus, governance control mechanisms and how they can work on correcting bad economic performance is of crucial importance to overcome the ACC's equity constraint. Simultaneously with the creation of the ACCIS, Bank of Portugal delegated part of their supervision powers to Central ACC. This proved to be beneficial to control the ACC management.

Within the ACCIS, the solidarity principle is applied, thus, the entire system responds for the fail of an individual ACC – *all for one* principle. For that purpose there was created a special fund that guarantees the ACC's deposit values. Individual contributions to the fund depend on the ACCIS financial health. Consequently, individual ACC have an incentive to monitor its pairs. Additionally, when an ACC gets into financial distress, Central AAC have an incentive to protect this ACC from default because it is important to maintain the whole ACC system with high reputation and confidence to the different stakeholders (depositors, loaners, Bank of Portugal ...).

⁴ The Portuguese law imposes range of conditions for being an IOF audit board member but regarding the cooperatives audit boards the law is less restrictive.

Cabo and Rebelo (2005b) identify two types of governance control mechanisms in Portuguese ACC: a) internal governance mechanisms as management board or chairman change and b) external governance mechanisms, as Central ACC intervention - by a Central ACC nomination agent or management board replacement, and merger⁵. The authors conclude that the ACC's internal control mechanisms are inefficient.

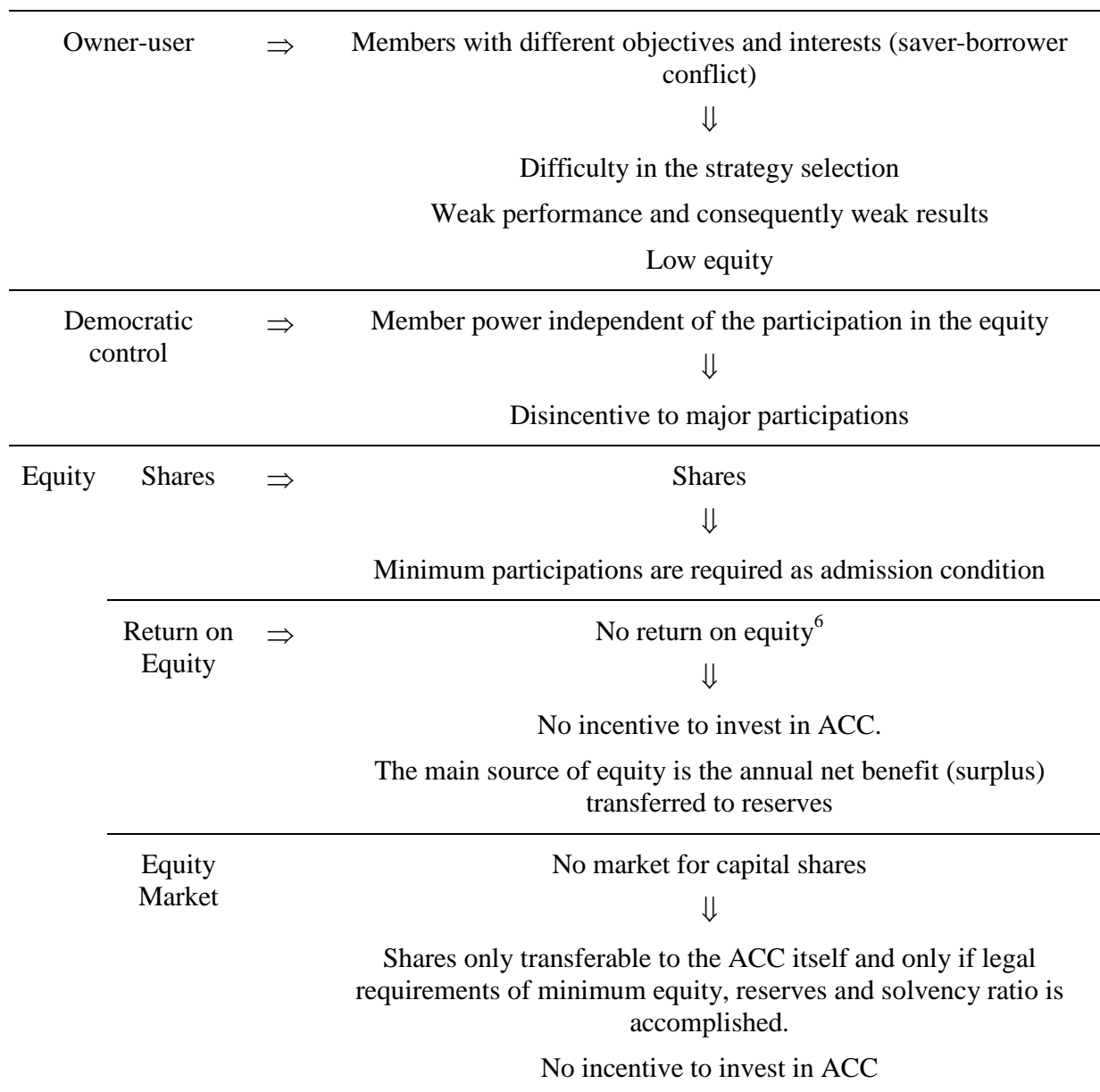
And we must highlight that in the 9 years period (1995-2003) of the study, the authors identified 130 Central ACC interventions: 51 corresponding to an agent nomination and 79 management board replacements.

Investment-related incentive problem, activity and performance

As mentioned, Portuguese ACC are ruled following the traditional cooperative structure with open membership, democratic control and restricted residual claims. Figure 3 contains a description of the consequences/effects of the “cooperative nature” on the financial structure of ACC.

⁵ ACC merger act as an external control mechanism because, although mergers are friendly (they must be approved by the general assembly) the influence of Central ACC is considerable, being this top institution the trigger and even the one that choose the merger partners (Cabo, 2003).

Figure 3 – Cooperative principles and the financial structure of ACC (adapted from Cabo and Rebelo, 2005a)



⁶ Once the legal reserves requirements and solvency ratios are accomplished, the exceeding can be distributed to the members until the maximum 30% of it.

The Portuguese law requires the net benefits to be transferred into reserves, with no return on the invested equity capital. This constitutes a disincentive to invest in the ACC; therefore the participation on the equity has as an exclusive aim: the benefit from the services of the organization, mainly credit. Additionally, member power is always independent of the participation in the equity, which disincentives major participations.

The solution adopted by Portuguese ACC to this investment-related incentive problem was focused (not on property rights adjustments but) on performance improvements. Although single ACC have their activity limited by a range of restrictions, they were able to surpass this by acting as Central ACC agents.

Table 1 next presents the main features of ACC activity with influence on the investment-related incentive problem.

Table 1 – Summary of ACC activity main features

Product	ACC activity is restricted to a limited range of operations connected to the rural world and to Members only - Natural and legal persons allowed but must be connected to agricultural activities
Territory	ACC activity is restricted to the county (“concelho”) where it is located. The expansion outside is only allowed to neighbour counties and if no other ACC operates there.

The ACC activity, both in deposits and credit, is restricted by a range of limitations regarding their product, territory and members range. These limitations carry the risk of specialization. After Portugal joined the European Union, in 1986, Portuguese agriculture witnessed economic

erosion, negatively conditioning the profitability of the financial institutions more directly involved in agriculture ventures (Cabo and Rebelo, 2005a).

Those constraints were overcome with the creation of the ACCIS. An agency contract is celebrated between the Central ACC and each single ACC⁷. On the banking activity, through the singles, Central ACC, beside deposits and loans, offers a wide range of financial services, including, for instance, insurance operations, financial advice and exchange foreign currency. Acting as Central ACC agent, single ACC can perform various operations out of their product market and “services to members only” restrictions.

This possibility opened the activity of ACC to a wide range of clients and scope of products. Single ACC have now local institutions like schools, fire departments and so on, as costumers. These partnerships opened the ACC’s doors to an even more “out of the range” costumers when those institutions make the payments of salaries through ACC’s banking accounts.

Besides, in the last years, ACCIS is engaged in a very aggressive marketing operation with the goal to increase the notoriety of the “*Crédito Agrícola*” brand and expand its clients range. An example of that is a marketing campaign targeting young people and a financial product offering 10% of return guaranteed. Both directed to members and non members costumers.

The return of this strategy is still to measure. Meanwhile, a change in the ACCIS mission is clear. The development of rural communities seems to be left a side. The 2005 *Crédito Agrícola*

⁷ In 2005, were celebrated 7,515 agency contracts between Central ACC and single ACC generating a total of 341.5 million euro of revenue to the ACC involved (*Crédito Agrícola Group, 2006*), which represents 4% of ACC net assets at that time. At the present banking activity scenario, with increasing interbank competition resulting in a fall in spread on credit operations and smashing the financial margin, this source of revenue assumes a significant importance.

Annual Report refers the expansion of operations in the Lisbon and Oporto conurbations as the next main assignment.

Portuguese ACC option to fight their difficulty in gathering equity through profits increase falls in a growing conflict of interests and on an identity crisis.

The agent service provided to Central ACC is remunerated on a commission basis. Single ACC management can be appealed to favor those operations instead of the ones of the ACC itself. Further, Central ACC can be tempted to interfere in the singles operations for its own benefit. Plus, the ACC's liquidity excesses can only be invested on Central ACC deposits.

Although financial fruitful, that strategy diminished the cooperative advantages mentioned in section 2 and the incentive to participate in the ACC equity. The question is: *What is the advantage of being an ACC member?* The old answer: to benefit from the ACC services - is not valid anymore. The investment-related incentive problem nowadays is not only the old question of minimum participations but the lost of meaning of being an ACC member. Besides, when an ACC pursues profit is not respecting its goal: to provide the best services to its members.

4. Conclusion

In the last decades various structural changes have an impact on the intensity of application of cooperative principles and contribute to its identity crisis. This context results in conflicts in the definition of the ACC' mission and on a deficient ability to raise equity capital, what can jeopardise the ACC survival, at least, their cooperative form.

Except banking operations, ACC are ruled following the traditional cooperative structure with open membership, democratic control and restricted residual claims. The strict application of

cooperative rules can promote a set of vaguely defined property rights, with negative effects on the transaction costs. Like many other cooperatives ACC face decision making and investment related incentive problems.

Most of the cooperatives worldwide move away (in some degree) from the strict application of the traditional cooperative rules in order to face the decision making and investment related incentive problems. Portuguese ACC adopted a different strategy, focusing on performance improvements as a way to increase equity, by the accumulation of returns.

In the 1990s, ACC engage in the creation of an economic group and, simultaneously, a concentration process through mergers operations to achieve minimum efficient size and surround the equity capital constraint. Additionally, law changes regarding ACC supervision allowed that part of supervision task remained in the ACC system itself, proved to be beneficial to control the ACC management. Those policies proved to be positive once they improved the ACC performance, raising the financial health of the ACC system and, thus, solving their investment problem. However, they also diluted the cooperative advantage of ACC.

At the present, Bank of Portugal and ACCIS authorities are negotiating a new legal framework for ACC activity. A reflection on the property rights allocation within the ACC and their governance structure is necessary to construct a legal framework that allows ACC to overcome their problems without losing their identity.

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Figure A - Organigram of the Crédito Agrícola Group

