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**German legislation with special emphasis
on co-operative groups**

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« German legislation with special emphasis on co-operative groups »

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Abstract

In this paper the author investigates the limits set by co-operative legislation to preserve the special character of co-operatives on the one hand and to allow adjustment to presumed and real needs of the global markets on the other, using the German case.

It is argued that co-operatives like any other enterprises are free to form groups and super-structures and to co-operate with other enterprises in any lawful form and that they can use the tool box developed for economic co-operation among enterprises by investor-led firms, as long as this does not contradict the main and only legitimate purpose of co-operative societies, which is to promote the interests of their members by service relations.

Many of the provisions of conventional co-operative laws, made to preserve the unique character of co-operatives as self-help organisations of their members are seen by professional managers as burdens of the past to be removed, if co-operatives are to survive as enterprises, even with a low co-operative profile. The author suggests that preserving a clear profile as member-oriented and member-controlled organisation may be the competitive advantage, which – together with special rules of doing business the co-operative way – will allow co-operatives to succeed as stable and reliable poles of local development in our rapidly changing environment, dominated by highly mobile and largely anonymous conglomerates.

The analysis is carried out in three steps:

- Autonomy of co-operatives to co-operate, federate or network is described as a matter of freedom of association more than of co-operative legislation.
- A closer look is taken at the tool box developed for co-operation among enterprises and general as well as legal issues related to practical use of these tools by co-operatives and their federations are discussed.
- The author comes to the conclusion that not all forms of economic co-operation designed by investor-led organisations are in conformity with the special character of co-operatives. It is argued that co-operatives cannot strengthen their position in the market by levelling or even eliminating their unique profile and their internal propelling forces, namely member-commitment and member-support. By approximation to companies and by abandoning the co-operative model, such co-operative enterprises lose their reason for being and demutualise assets accumulated by generations of members. They may possibly survive as “employees’ enterprises” but not as co-operatives.

The current problems within the integrated system of German co-operative banks are illustrated by translation of a relevant article from the German press, reproduced as an annex.

Key words

Co-operative groups, co-operative advantage, co-operative profile, integrated system, economic co-operation, co-operation along co-operative lines, Germany, European Union.

1. Introduction

In an economic system based on markets and competition, private law elements are the primary factors of regulation. Even where the law of business organisations sets certain standards and rules, private initiative and freedom of association are essential dynamic elements of the German legal system. Private property is protected but is at the same time subject to the obligation to be used (also) for the benefit of the public. Cartels are prohibited, mergers are controlled.

Assuming that there is a consistent concept underlying the entire legal system, private initiative to undertake economic activities is encouraged and perceived as the main propelling force of economic development. The state offers a legal framework within which such private initiatives can be put into practice.

On the other hand, private initiative is restrained where necessary to guarantee that legitimate interests and the rights of all actors can be balanced, e. g. by agreement, by property rights, by setting up binding rules of private and – where necessary – public law including penal law. The law of organisations is part of such framework (Schultz/Reinhardt 1981, p. 392).

In Germany the phenomenon of groups of enterprises including co-operative groups is common practice. E. g. the term “group” appears in the firm name of the central (national) federation of traders’, retailers’ and service providers’ co-operatives ZGV “Zentralverband genossenschaftlicher Verbundgruppen” and members of this apex organisations have formed co-operative groups among themselves.

Groups of enterprises used to interest economists more than lawyers. The law of combined enterprises (Recht der verbundenen Unternehmen) has been vague for a long time and is gradually taking more shape. Under co-operative law, co-operation among co-operatives has always been seen as a necessary part of co-operative structure (Genossenschaftsverbund). There are relatively recent provisions governing cartels and combinations, referring mainly to companies. These provisions are influenced by EU Law. It is still debated, how far these provisions also apply to co-operative societies.

Do we need a law for co-operative groups?

First of all, a word of caution against overregulation:

Montesquieu: If it is not absolutely necessary to make a law, it is absolutely necessary not to make such law.

Beuthien: Every provision of organisation law that is not needed to protect the members, the creditors and the public interest is an unjustified restriction of freedom of association.

The Danish example shows that there can be a strong co-operative movement without a special law for co-operatives.

In Germany the need for such a law is not strongly felt, however, many of the issues discussed in France around the topic of “co-operative groups” are also interesting in the German context.

If, as proposed the UN “Guidelines aimed at creating a supportive environment for the development of co-operatives” of December 2001(A/RES/56/14), co-operatives are treated on an equal footing with other enterprises or organisation, co-operatives could use the entire tool box that has been developed over the years for economic co-operation among enterprises:

- New legal patterns, e.g. producer groups or economic interest groups,
- contracts, i.e. co-operation agreements,
- joint ventures,
- franchising,
- networking (functional and strategic networking),
- Integration (both horizontal and/or vertical over several tiers).
- How far co-operative societies can be part of combinations, remains a debated issue.

The question of whether co-operatives can become dependent on other co-operative or non-co-operative organisations can be answered differently if seen from a legal or from a co-operative point of view.

According to Beuthien (Genossenschaftsrecht 2000 N° 79 f.) the answer is yes.

From a legal point of view, co-operatives have full autonomy to federate on mutually agreed terms, they can enter into binding agreements, they can agree to the power of a “hub-firm” to give directives to the co-operative society’s board and can even accept a subordinate position within a network or system as long as the internal decision-making powers of the co-operative society correspond to the legal minimum and the agreement was accepted by a qualified majority of members required for amendment of by-laws.

From the co-operative point of view, the economic and legal construction chosen must serve the object of member-promotion. A basic rule of the law of organisations is that the objects determine the form. Under German co-operative law (section 1) the only legitimate object of co-operatives is to promote the interests of their members. Where this condition is not met, the organisation leaves the co-operative model and should not be allowed to continue to exist as a registered co-operative society.

With regard to its objects, the co-operative society as a legal pattern differs from other legal patterns (like the company) which can be used for every lawful purpose. Co-operative society is a pattern specifically designed for a specific purpose. Elements of this special design are reflected in the co-operative principles as international standards and include: identity of owners and users, ultimate democratic member control, non-transferable shares, indivisible reserves, patronage refund, increase of member-value).

In practice there is no standard type but rather a great variety of co-operatives with the object of member-promotion being the unifying element, starting from the difference between:

- **service co-operatives**, i.e. co-operatives providing goods and services to the independent businesses or households of their members (the most common type) and
- **workers’ productive co-operatives** (industrial co-operatives) in which the members create their own employment.

Among service co-operatives Duelfer has identified three “structural types”:

- The **traditional co-operative**, being member-dominated and following the classical rules, having a strong co-operative profile.
- The **market-oriented co-operative** with steady approximation to the company model (counting on growth, increasing business with non-members and keeping a low co-operative profile, also referred to as “open co-operatives” and a transitory stage to companisation).

The **integrated co-operative**, management-dominated type of co-operative with a strong co-operative profile, in which members depend on advice and guidance by the elected directors of their joint co-operative enterprise in order to survive in the market (e.g. retail traders co-operatives, co-operatives of specialised agricultural producers), also referred to as profession-based or “closed co-operatives”, a model of growing importance for the future, including “new generation co-operatives”.

Where the specifically co-operative purpose of member-promotion is abandoned, the specific rules meant to support and safeguard pursuit of the typically co-operative purpose become obstacles in the way of pursuing such other purpose.

In this case, rather than approximating the co-operative legal form to the company model (companisation), as was the policy of the German co-operative federations in the 1970s, the better solution would be to leave the co-operative form and convert the organisation into other (better suited) forms like limited partnership (GmbH und Co. KG), company with co-operative character, non-profit association or a new form of “co-operation society” (Bialek 1995), still to be created.

To cope with problems of globalised markets and increased competition, co-operatives are called upon to build super-structures based on economic reasoning, namely strategic networks (where the conventional functional networks based on voluntary submission to group discipline do not work, as stated recently by Walter Weinkauf, president of a regional co-operative audit federation (see Annex).

Conventional tools to organise such co-operative groups based on agreement are:

- A mission statement, which all members of the system support.
- A Chart of group discipline within the integrated system (Charta der Verbunddisziplin).
- A code of conduct for group members.
- A set of measures and sanctions to ensure compliance.

The Deposit Guarantee Fund of the German Co-operative Banks (Sicherungseinrichtung) can serve as an example for such trend from voluntary group discipline to organised co-operation with rights and obligations of members clearly defined.

Recognition and respect of the special character of co-operatives in the legal and administrative framework as requested by the UN Guidelines of 2001 sets limits for companisation and requests that only genuine (bona fide) co-operatives can be registered. This would require pre-registration audit in case of new societies and de-registration of false co-operatives. For instance in Germany co-operative societies which have transferred all their economic activities to daughter societies, only serve as a holding of co-operative assets and promote their members by payment of dividend on invested capital (Haltegenossenschaften) should not remain on the register.

Recognition of the special character of co-operatives in the legal framework would mean to allow what corresponds to the special object of co-operatives and to prohibit what runs counter. Business with non-members is a case in point. Originally, such transactions were not allowed (e.g. in Germany business with non-members became allowed for consumer co-operatives in 1954 and for credit co-operatives in 1973; they remain prohibited in the large Japanese consumer co-operatives up until today). It must be seen that transactions with non-members dilute the principle of identity, devalue membership, level the co-operative profile and in the last analysis call the reason for being of the co-operative into question.

2. Main Problem constellations and Issues with regard to co-operative groups

2.1. Typical cases

(a) **Federated structures**, unions, federations, central co-operative organisations, horizontally and vertically integrated systems (Verbund) are typical for the German co-operative movement. Membership of primary co-operative societies in co-operative audit federations is prescribed by law as compulsory since 1934 (section 54 GenG). If all members of such systems are co-operatives, it is easier to maintain co-operative orientation and identity. If other than co-operative or co-operative-owned organisations participate, problems of control (by shares or votes, by agreement, by economic power) are more difficult to solve. Co-operative integrated systems can be seen as a top-down pyramid (Konzern verkehrt).

(b) **Combinations** among co-operatives as equal partners under joint leadership from within (Gleichordnungskonzern), by capital contributions (problems in case of plural voting) or by agreement, internal regulations or by-laws. By definition the problem of domination and subordination does not arise as long as the partners are in fact equal.

In combinations among co-operatives and other legal bodies (owned by co-operatives or not owned by co-operatives), problems of domination/control and subordination arise, based on share holding and votes, agreement and/or the right to appoint directors.

(c) **Cartels** among co-operatives and other legal bodies by agreement, concerted action or unfair competition effects. Criteria for prohibition or tolerance of such structures: Market domination (prohibited), countervailing power effects in case of SME (tolerated).

(d) **Consortia**, the loosest form of co-operation among enterprises for carrying out a special task jointly and on common account, or common interest groups for special projects, for a certain time.

(e) **Special forms of co-operation among enterprises**: joint investment organisations or common profit organisations (section 292 subsection 1 Nr. 1 German Companies Act).

(f) **Mother and daughter societies**, subsidiaries of co-operatives in different legal forms. Outsourcing of certain activities or services from the co-operative society to daughter societies or subsidiaries in the form of company or limited partnership (e.g. GmbH & Co. KG). Problems are to maintain the co-operative orientation, member-promotion as the main object, e. g. the problem of daughter society dominating the mother society, mother society transferring all economic activities to subsidiaries leaving the mother society as an empty shell (Haltegenossenschaften, co-operative holding). A clear relationship between mother society and daughter societies needs to be preserved.

(g) Concentration by **merger**.

2.2. Issues

The key issue – Is there a special co-operative way of doing business?

Is there a difference between

co-operative economics or economics of co-operation (or of promotion-oriented / user-driven enterprises) serving other enterprises on the one hand and

general business administration and management of individual, investor-oriented enterprises on the other?

Is there a difference between

“economics of co-operation” among profit-oriented enterprises and enterprises serving such enterprises (in case of group enterprises) on the one hand and

“co-operative economics” being the special way in which co-operative enterprises are run in accordance with co-operative principles on the other?

Can those studying the relatively new issue “economics of co-operation among enterprises” learn from the long experience of co-operative economics and use synergetic effects?

How can co-operative identity be preserved in co-operative groups?

General issues for all groups of enterprises are:

- Transparency, obligation to publish reports and returns with prescribed minimum contents. Publish combined or consolidated accounts.
- Protection of minority shareholders.
- Protection against financial risks, e.g. if assets and management of the mother society and daughter societies are not clearly separated. In transnational structures the risk increases.
- The choice of appropriate control mechanisms (special co-operative audit, i.e. performance audit in addition to financial audit, measuring member-oriented effectiveness, social audit, bilan sociétal). Taking account of the different logic of co-operative control and investor-oriented control (those who own most of the capital hold the power to control). Does commercial law apply to all enterprises including co-operatives? What kind of joint control is applicable to co-operatives and co-operative unions? Control by agreement among members to harmonise decisions or to carry out concerted action. Factual control based on power to appoint directors.
- Accounting, combined or consolidated accounts, need to give a full picture of the entire group, based on economic performance, not (only) on legal structures. Where a central governing body exists, need to present consolidated accounts, irrespective of capital links. Consolidated accounts are more than an addition of the accounts: They have to show the influence one society has over the other(s), to give a comprehensive picture of the group, show how surplus is allocated and the status of indivisible reserves.

Legal issues of co-operative group activities

Do we need a legal definition of what are co-operative groups?

“Group” is more an economic and sociological term than a legal one.

If we have problems in defining co-operative groups in clear terms, do we need a special law for co-operative groups?

Laws governing combinations and cartels are mainly directed towards companies. Where co-operatives join together to form their own companies, they come under such laws.

Co-operative law allows co-operatives at all levels to federate, to build unions and central organisations, consortia and ad hoc groupings.

Co-operative law also allows co-operatives to form subsidiaries or daughter societies, which, however, in Germany have to be related to the main activity of the mother co-operative (section 1 II GenG).

There is a set of rules to protect co-operative enterprises against hostile take-over:

- Voting according to the principle “one member - one vote” in primary societies, restricted transferability of co-operative shares,
- indivisible reserves (no participation of departing members in accumulated reserves),
- special rules for surplus allocation favouring users rather than investors.
- In Germany, plural voting in primary co-operatives is still strictly limited to a maximum of three votes per member, such restriction is, however, not applicable in secondary and tertiary societies (which often use the legal form of company). This is very different from the rules prevailing in France and Austria.

Where all these rules remain intact, hostile take-over of co-operatives is excluded. Where these rules are abandoned: plural voting, investor-members, transferable shares and other participation certificates, preferred non-voting stock etc., co-operatives and co-operative groups lose their special character as member-oriented self-help organisations and become ordinary commercial (i.e. investor-driven, shareholder value-oriented) enterprises for which the commercial law rightly applies.

3. Conclusion

Co-operative groups are necessary and an integral part of co-operative organisation culture, as the principle of co-operation among co-operatives implies.

But it is not possible to level the specific co-operative profile and to approximate co-operatives increasingly and without limits to commercial (i.e. investor-oriented, de-ideologised) enterprises, in order to compete with commercial conglomerates, combinations, franchising systems and global players of all kinds and still remain co-operative.

Co-operatives have to preserve their unique profile, stick to their members, have to insist on value-based management and their core-competency which is member-relation management. Co-operatives have to use and develop further their own arsenal of weapons to fight their investor-driven commercial competitors.

The question is not for co-operatives:

- to become investor-oriented, shareholder value-oriented organisations - opting for companisation (go commercial) and even go public **and** remain co-operative (i.e. member-value oriented) **but rather**
- to go commercial and even public **or** remain co-operative.

This does not exclude high level of co-operative efficiency in organising business activities and using scarce resources like any other enterprise (economisation).

The difference lies in the special objective of co-operative activities, namely to serve its members/users and not (only) capital owners and anonymous investors.

Co-operative groups are part of co-operative organisation culture and have to fit into this culture. To guarantee this “fit” is not primarily a matter of legislation but of value orientation.

But what is left of co-operative organisation culture?

German co-operative federations and the German law-makers guided by them have decided to see co-operatives primarily as enterprises, which have to compete and survive in the market and which promote their members as much as market conditions permit.

Co-operative enterprises react to economic change in almost the same way as their commercial competitors, by merger, combinations, outsourcing of unprofitable activities. They seek new sources of capital to finance growth and the use of modern technologies.

The idea that primary co-operatives are by their nature locally rooted and small and reliable economic units based on personal relationships and that they can be used as local poles of stability in times of rapid change and increasing insecurity and as a counter-program against unlimited mobility and unrestricted growth is seen by most co-operative managers as an illusion. However, where government services and commercial firms withdraw from villages and small towns, new co-operatives are formed for exactly such reasons.

In search for new approaches to develop co-operative enterprises further and to make them fit to survive in global markets, company style solutions are seen by many as the only viable venue. It is often forgotten that a co-operative enterprise is not an end in itself but rather a means to promote the interests of the co-operators. Instead, it is assumed that the assets of co-operative enterprises are a kind of “neutralised” capital with “atomised” ownership of thousands of members and collective reserves, hence assets without effective owner-control.

These assets are managed by externally recruited managers and professional board members, acting as quasi-trustees on behalf of the members, for whom the interests of the enterprise, the interests of the employees and their own personal interests have priority over the interests of the members which – at best – rank second, if they play a role at all.

In this approach to co-operative management the internal motivating forces of co-operatives – members’ self-interest and self-help by organised group action – cease to work, the co-operative enterprise turns into an “employees enterprise”, following its own rules.

It is also overlooked in much of the discussions on co-operative law reform that there are the limits for modifying the co-operative legal pattern with a view to adjust it to needs of the market. How much adjustment can the co-operative model support without breaking

up? When does quantity of adjustments change quality of the organisation? Can we give co-operatives a future by changing their objects and levelling their profile?

Is it too late for a reorientation? In this context, Oswald Hahn can be quoted who said: “A good step back is better than a wrong step ahead”.

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Definitions:

Group: A total of legally independent enterprises under joint leadership and joint control. The group itself is not a legal body. This lack of certainty of co-operative groups and groups of enterprises reflects their quality. Where co-operatives group together with other legal bodies, there is the danger that co-operatives lose their co-operative identity.

Gleichordnungskonzern – combination among equal partners under joint leadership:

Combination of legally independent enterprises under joint leadership, without one becoming dependent on the other (section 18 subsection 2 German Companies Act); not only with regard to certain aspects or certain units of the enterprises but regarding to the combined enterprises as a whole.

Different from:

the usual combination, where there is a dominating enterprise or

a strategic networks, where there is a jointly established hub firm, with power to influence the performance of the other (lower) elements of such a system.

E.g. in German co-operative banking there is a trend towards a classical combination (DZ BANK AG Konzern) mainly owned by primary co-operatives but with a largely independent governance structure.

The Integrated System of German Co-operative Banks needs new rules

by Weinkauff, Walter, president of the regional co-operative audit federation
Hessen/Thüringen, in: Frankfurter Allgemeine Zeitung, May 3, 2005, p. 16

There is need to reorganise the relationship between the primary co-operative banks and those who provide products and services for them: The Central Co-operative Banks (DZ BANK AG and WGZ eG), the saving for housing organisation/building society Schwäbisch Hall and the Union Fund and to put the system on a new basis.

Weinkauff stated in an interview with FAZ: “New rules of the game are needed in order to avoid that the integrated co-operative system suffers further losses of market shares.” This need exists, irrespective of the outcome of the struggle between DZ BANK and WGZ on the future structure of the German Central Co-operative Bank.

For some time there is a crisis of confidence among the partners of the integrated system of German co-operative banks. While there has been strong concentration among product and service providers with a de facto monopoly, 1,300 primary co-operative banks continue to drift apart in terms of size.

In meetings of delegates of the National Federation of Peoples Banks and Raiffeisen Banks (BVR) often about one quarter of the affiliated banks refuse to follow the leadership of the BVR board. Interest groups of smaller and larger Peoples Banks and Raiffeisen Banks have been formed. Weinkauff warns that “atomised representation of interests will lead to chaos within the system” and faced with rapidly changing markets he blames BVR for having opted for the wrong strategy.

“It is the task of a regional audit federation to safeguard the effectiveness of local co-operative banks.” Then, the federations will have to supervise compliance with the new rules. However, it is not decided, whether the BVR will adopt these new rules.

What Weinkauff wants are more binding rules, efficiency and transparency. It is true that the many mergers among primary co-operative banks during the past years have improved cost structures, “but what we need is more power in marketing”. Weinkauff sees the co-operative banks cornered between aggressive competitors like financial service providers MCP,

AWD and DVAG on the one side and Car-financing Institutions and Direct Banks on the other. High interest rates on short term money of up to 2.5 % with which Direct Banks lure private customers away from peoples banks raise the question of whether the co-operative integrated financial system would need a Direct Bank.

We do not need this, says Weinkauff. A Direct Bank is not a provider of specialised products like for instance the provider of consumer credit Norisbank. Direct banking aims at the entire customer relations and therefore is a direct competitor of local banks.

However, the co-operative integrated financial system has to react – with new rules. “A local co-operative bank must be able to offer competitive products and services as compared to Direct Banks via internet.” At present, the apex organisation of the Peoples Banks and Raiffeisen Banks, the DZ BANK, is not able to make this possible.

Because the DZ BANK is assessed by rating agencies largely on its own, its creditworthiness is determined, without considering the local banks and the co-operative deposit guarantee fund serving as a link. “What we need is rating of the integrated system” like the savings banks group Hessen/Thüringen. The state bank of Hessen-Thüringen (Helaba) was rated better after having agreed with the savings banks in its area of operation on common rules regarding risk-management and salvage operations. “If the DZ BANK could achieve rating of the integrated system, it would obtain money on the money market at better conditions. This money could be lent out at low interest rates to Peoples Banks and Raiffeisen Banks, which in turn could offer their customers higher interest rates for their deposits.

Plans of a rating of the integrated system will, however, raise even more fears among board members of many primary co-operative banks to become members of a combination and to lose their autonomy. Up until now, primary co-operative banks can sell life-insurance policies or fund certificates of service providers outside the integrated system, if the customers want it or if they can earn more. As a reaction, the service providers of the co-operative integrated financial system have offered special conditions to large primary co-operatives, annoying the others. “We cannot turn into an integrated system of brokers” is Weinkauff’s advice in this discussion full of emotions on transparency and increased economisation. “During the past several years, development trends originating from the

markets have increased pressure on primary co-operatives” he admits. An increasingly large share of loans laid out by primary co-operative banks do no longer show in their balance sheet, but rather in the books of their partners within the integrated system.

In the interest of the system as a whole, this problem has to be considered by offering incentives and exercising control. The Peoples Banks and Raiffeisen Banks should not only receive commissions from products and service providers for new contracts, which tend to favour co-operative banks with a large, largely untapped potential of customers. Instead, co-operative banks with a high market share should receive annual commissions for having made good sales already. This should have the effect that primary co-operative banks which prefer to sell products and services from outside the system will feel this more as a disadvantage. In return, Weinkauf will increase the supervision of the product and service providers of the Peoples Banks and Raiffeisen Banks. Irrespective of rating as an integrated system, their products and services must be compared with those of their competitors. Only in this way can be ascertained that the specialists produce in an efficient manner and offer primary co-operative banks competitive –202.

