The Role of Institutions in the Financing of Cooperative Firms

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Abstract

The problems faced by cooperatives in funding their investments with the scant contributions of their partners can be systematically solved by creating the assumptions for collaboration between labour and capital. The approach of the Mondragon group of cooperatives in Spain – a success story to which cooperatives from other countries look for inspiration – provides evidence that the odds can be beaten at group level, by putting in place organisational measures purposely devised to protect external providers of funds through the assignment of co-decision powers. The effect of these measures is to apportion powers among different factors of production through a system enabling capital owners to safeguard their interests.

Keywords: cooperatives, labour-managed firms, financing, institutions

1. Introduction

This paper shows that the problems faced by cooperatives in funding their investments with the scant contributions of their partners can be systematically solved by creating the assumptions for a collaboration between labour and capital. The approach of the Mondragon group of cooperatives in Spain – a success story to which cooperatives from other countries look for inspiration – provides evidence that the odds can be beaten at group level, by putting in place organisational measures purposely devised to protect external providers of funds through the assignment of co-decision powers.

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The effect of these measures is to apportion powers among different factors of production through a system enabling capital owners to safeguard their interests.

Meade (1989, 1993) has theorised a special form of business enterprise, the Discriminating Labour-Capital Partnership, which is founded on this same principle, though it transfers the collaboration between capitalists and workers from the group to the level of individual cooperatives. In point of fact, since experience has shown that existing cooperatives tend to deal with funding problems through inter-firm arrangements, it would seem that this model has not been particularly influential. On closer analysis, though, empirical evidence in support of the usefulness of Meade's model is offered by a myriad small-size collective firms which are jointly run by working partners and investor-members and, like cooperatives, fit within the general description of enterprises in which management functions are vested in the workers. At any rate, Meade's model may prove to be an effective tool for framing group policies and ensuring the capitalisation of independent, viz., non-group cooperatives².

This paper is mainly concerned with the solution fine-tuned by the Spanish Mondragón group of cooperatives, while Meade's model cooperative will be covered in a separate study. Its contents are organised as follows. The next section sums up the salient aspects of major solutions to the financing problems of large-size cooperatives discussed in the literature. Section 3 describes the successful approach developed by the Mondragón group of cooperatives in Spain to deal with its financing problems. Section 4 suggests a key for a correct appraisal of the reasons behind the success of the Mondragón Group's approach. Section 5 states a number of closing reflections.

2. Solutions to the Financing Difficulties of Cooperatives Suggested in the Literature

Vanek (1975a) was the first to theorise a cooperative firm model imagined to be entirely funded with loan capital.

² It is worth mentioning that some aspects of Meade's model seem to have influenced a number of legislative measures which have recently been enforced in some European countries to regulate the investment financing operations of cooperative firms. In Italy, Law no. 59 of 1992, which was then transposed into the new Business law Code of 2003, introduces the 'investor-member', a new membership status comparable to that of the patron shareholder of limited companies, provides that the voting rights of this new member must not exceed one-third of the aggregate voting rights vested in all the partners and fixes at plus 2% the difference between the share return of this member and the return to which the remaining partners are entitled.
In his approach, the investments of this firm would neither be funded with member contributions nor with the retained earnings that cooperatives set aside, with a view to alleviating the underinvestment problems typically associated with the short time horizons of the partners. In point of fact, in his essay, Vanek failed to address financing problems stemming from the structural undercapitalisation of cooperatives.

A different solution, quasi-share financing, was first suggested by Vanek himself (1975b) and then taken over by McCain (1977). On closer analysis, however, the proposal to finance the firm with non-voting shares, while offering the advantage of relieving the firm of the obligation to reimburse the borrowed funds, seems ill-suited to attract third-party loans when the partners of the firm are not in a position to contribute the resources for the firm-specific capital. In point of fact, under such circumstances external lenders would play an entrepreneurial function in terms of financing firm-specific capital assets notwithstanding the awareness that their value, being specific, would hardly be recoverable in case of need and that they have no effective tools to monitor the uses to which these assets will be applied.

After the publication of Vanek's and McCain's contributions, the subject of the financing problems of cooperatives was covered in a variety of studies which basically followed in their wake (Jay 1980; Gui 1982, 1985; Thomas & Defourny, 1990; Jossa 2010, 2012, 2014). To work out solutions to the financing issue, these authors suggest the adoption of financial instruments in-between bonds and shares in order to prevent both the financial constraints associated with the former and the deficit in democracy that would result from the assignment of voting rights to third parties other than the working partners. The solutions proposed may prove effective on condition that the securities are underwritten by the worker partners at least in part and provided this portion is enough to cover the cost of a considerable part of the firm-specific assets. Failing this, they barely seem suited to solve the problem discussed in this paper.

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4 Basically, non-voting shares are irredeemable bonds which bear interest at a rate linked to the income of the issuing firm. Compared to traditional bonds, they offer two main advantages: a) in the event the issuer should report a loss, their holders would not be entitled to any interest payments; and b) redemption is only envisaged upon the dissolution of the issuing firm. As a result, their use is devoid of constraints for the debtor firm.
Moreover, although large-size cooperatives face lesser financing problems and are hence exceptions within the overall cooperative sector, in recent years the theoretical debate has been preferably revolving around them. In point of fact, a firm wishing to finance its investments by issuing tradable debt securities must meet a number of requirements that are often beyond the reach of small and/or medium-size cooperatives: they must be financially stable and recognisable on markets, enjoy a good reputation and have available the resources required to meet with substantial issuance costs. As a result, the solutions in the literature would ultimately leave the financing problems of smaller-size cooperatives undiminished. In the main, these solutions strive to pinpoint the best possible financial instruments available to firms for fund-raising purposes, but require firms to have easy access to financial markets and to operate at efficiency levels enabling them to use a variety of financial channels and select optimal lenders.

One proposal that fits within this group is the issuance of bonds indexed to the average profit rate of the industry, which Waldmann and Smith (1999) hold to offer the additional advantage of averting the risk that the choice of non-voting shares should encourage the working partners to free ride. Indeed, in the latter case the partners might opt for cutting the firm’s profit by boosting wage and fringe benefit costs to the detriment of the dividends payable to the holders of the non-voting shares. In point of fact, Waldmann and Smith’s solution is intended to attenuate the conflict between the partners and holders of non-voting shares. A different proposal tries to solve the conflict between the interests of the latter and the targets pursued by managers, as theorised by managerial theories. By way of example, if a large-size cooperative should resolve to work towards maximising total sales, it is highly unlikely that lenders would be satisfied with the lower incomes afforded by quasi-shares indexed to the profit of the firm. This rationale underlies the proposal of a new type of bond indexed to the rate of growth in total sales (Mazzoli 1998, Mazzoli & Negrini 2001). On the one hand, it is argued, this new security would help to create a consensus between managers and lenders concerning the goals to be pursued; on the other, it would add to transparency since total sales are a flat amount which rules out the exercise of discretionary powers on the part of the insiders computing the firm’s residual.

At any rate, neither of these proposals would greatly alleviate the difficulties of relatively small-size cooperatives which, due to their low asset values and scant market recognition levels, can barely be supposed to choose their providers of funds and are usually compelled to raise funds through the banking system only.
Moreover, even if we assume that a small-size cooperative is able to cover high fixed costs, the issue of non-voting shares would avoid assuming binding financial commitments or curtailing the sovereign rights of its workers, but there is little doubt that its lenders would not rate this situation as equally advantageous. And as the funds would have to be loaned for indefinite periods of time and the uses of the financed assets would be difficult to monitor, lenders would both lack control over the assets and have to accept conditions of strongly asymmetrical information and the risks stemming from the likely scant market recognition of the debtor firm.

An effective solution to the firm-specific capital funding issue would be at hand if the firm should issue common stock, so assigning lenders the voting right, but such a solution would both interfere with the working partners’ sovereign rights and turn the cooperative into an altogether different firm. In addition to this, where the firm should attempt to sidestep these obstacles by fixing a maximum ceiling to the voting rights of external lenders and, consequently, limiting their prospective power positions, potential providers of funds might lose interest in the operation and the fund raising efforts of the cooperative would not come to much.

The proposal to vest voting rights in lenders has meanwhile been brought into fresh focus by Meade’s theorisation of the already mentioned capital-labour partnership. Although this new business form is not easy to establish without the concomitant enforcement of radical institutional reforms, it is the first to offer an instrument to protect labour and capital at the individual firm level.

3. The Financial Structure of the Mondragón Group: a Success Story

On closer analysis, the financing problems of cooperative firms stem from the fact that within a system of capitalistic enterprises they make up a sub-system of firms that typically apply for credit to the traditional banking system and fail to raise sufficient resources for the reasons mentioned above. In situations where the cooperatives themselves should manage to establish one or more credit institutions able to liaise with a variety of economic actors and safeguard the capital resources of the cooperatives by means of suitable financial intermediation services, this drawback would be overcome and funding problems would be effectively solved.

Major (1998, p. 207) has suggested an interesting intermediate solution, namely a particular kind of non-voting share and the concomitant adoption of a mechanism allowing the holders to negotiate a residual distribution arrangement envisaging the assignment of voting rights in the event the dividend available for distribution should drop below a pre-fixed threshold level.
This is the lesson taught by the Mondragón group of cooperatives, which is headquartered in the Spanish Basque Region and whose excellent performance was to a large extent determined by the operations of a bank, the Caja Laboral. Originally set up in 1959, the Caja operated as a universal bank until 1987, when it was converted into a multi-function group coordinated by a central structure which today is known as the ‘Mondragon Corporation’. Throughout the twenty-eight years following its establishment the Caja acted as a development agency, in terms of playing a decisive role in promoting new cooperatives or converting defaulting traditional enterprises into cooperative firms. In most cases it proved able to take effective action in situations of crisis by promoting a wide range of initiatives and supporting the launch of new projects. Although the Caja greatly contributed to the consolidation of the group and the establishment of over a hundred new cooperatives, the greatest achievement to its credit is the role it played in conveying financial resources to the group on a permanent basis through services which are veritable textbook examples of financial intermediation. As a result, an in-depth analysis of the relationships between the Caja and the Mondragón cooperatives on the one hand and the rest of the Spanish economy on the other may help pinpoint the true strong points of the organisational arrangement which provided a major impetus for the growth of the group and the removal of the financial obstacles it used to face.

The Caja Laboral is a mixed credit and labour cooperative which was jointly established by the other group cooperatives and is controlled by them. Each of the firms is a member of the Caja, which means it cashes a pro-rata share of the bank’s operating income. The relations between the Caja and its debtor cooperatives are governed by an association agreement which vests in the Caja both monitoring powers and authority to take over management functions, co-determine management choices and, in case of need, even curtail the sovereign rights of the partners.

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6 The case of the Mondragón Group is analysed in a considerable body of literature which includes, inter alia, Oakeshott (1975, 1982); Whyte & Whyte (1991); Kasmir (1996); Roelants (2000b); Basterretxea & Martínez (2012).
7 The financial coordination structure of the Mondragón Group can be described as an intermediate-level support institution after the model theorised by Vanek (1985, p. 101). These are placed between the firms and the political-administrative institutions. In their relations with firms, these mesostructures act as service providers. Consistency with corporate objectives is ensured by the fact that they are set up and run by the firms themselves. In Italy and France, comparable entities operate in a variety of industries within the cooperative sector (see Roelants 2000a).
8 At meetings of Directors, 60% of the votes are cast by representatives of the member cooperatives; the rest of the voting rights are vested in representatives of the bank staff (Roelants 2000b).
Accordingly, the Caja's role is not confined to that of a provider of funds, but includes a real and proper control function with which the debtor firms have to put up since it is performed for the account of the group as a whole. In terms of effectiveness, this relationship is comparable to the usual relation between an investment bank and the capitalistic enterprises financed by it: the bank temporarily takes over the control of the latter by underwriting a share of its capital and holding it until the pre-fixed results are achieved. In the case of the Mondragón Group, this arrangement leads to a form of collaboration between capital and labour which is both designed to ensure the correct management of the debtor firm and to provide support to it at critical stages of its existence, for instance during start-up and in periods of growth, by means of tools which in terms of effectiveness are on a par with those used by traditional enterprises.

At first sight, the workers' waiver of part of their sovereign rights may justify the doubt that this form of collaboration is actually at odds with the very principles of cooperation, but this doubt would be ruled out if focus is shifted from individual firms to the entire group of cooperatives. Bearing in mind that cooperatives which are not members of a group are widely held to have few, if any, prospects of growth, it is worth noting that the partners of each Mondragón Group firm doubtless transfer to it part of their sovereign rights, but thereby secure the advantage of obtaining credit facilities that would otherwise be out of their reach due to information asymmetries.

For many years running, the Caja Laboral grew at a faster pace than the other groups firms because it expanded its commercial bank business well beyond the limits of the Mondragón Group by enlarging its catchment area to investor-owned firms and households. Thanks to this successful strategy, today it ranks as one of Spain’s leading banking institutions and over these past years, its aggregate total lending resources have constantly been in excess of the actual requirements of the group cooperatives. All this was made possibility by the Caja’s ability to gain a reputation for reliability in target areas other than those strictly associated with its origin and mission as a bank established to meet the funding requirements of cooperative firms. Its brisk pace of growth is a clear sign that the customers of its reference market did not look on its within-group operations with bias, but classed the relevant lending operations as ordinary market transactions.

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9 This characteristic reflects one of the universal principles of cooperation stated by the International Cooperative Alliance (2014).
An additional reason explaining the success of the Caja is a very low ratio of default on its loans to the group cooperatives - which proves that it did not unduly favour non-creditworthy firms.

In all probability, the success of the Caja Laboral remains unequalled throughout the world because it stems from a number of peculiar factors: the cooperative firms with which it is associated operate in a comparatively small geographical area whose distinct linguistic and cultural traditions make for closer interpersonal relations. Moreover, the fast-growth period of the Caja falls in years of minimal financial regulation, which explains why it could cover a variety of different roles\textsuperscript{10} that today are strictly kept apart and venture into high-risk operations, both private and social, whose successful results added impetus to its growth. In sum, if a measure of excessive risk proneness is left out of count, the collaboration between the Caja and the Mondragón cooperatives may set an example for other groups to follow.

4. The constituent parts of the Mondragon financing model

The Mondragon model is basically structured as follows. Acting as an interface between the cooperatives of the group and outside economic actors, the Caja Laboral is in a position to convey a sufficient amount of financial resources from the latter to the former. Thanks to association agreements, the Caja monitors the operations of the group firms and the resulting lack of asymmetrical information determines that financial support is only provided to viable firms and projects. In this way, its services help overcome most of the disadvantages that are usually faced not only by cooperatives, but also by capitalistic enterprises in their dealings with the traditional banking system.

Based on the foregoing reflections, the requirements to be met by a financial institution intending to move in the wake of the Caja Laboral can be summed up as follows.

\textsuperscript{10} For many years running, the Caja Laboral operated as a universal bank and an institution in charge of managing the social security charges of the workers of the group cooperatives.
Essential requirements include:

- the status of a group subsidiary, which ensures that the bank will effectively implement its mission, i.e. finance the group firms in manners that will not induce them to lose faith in an entity performing the dual function of monitor and lender;
- authority to really monitor its debtor firms, to take over part of a firm’s management functions in case of need, to suggest solutions which, though probably not welcomed by the partners, will nevertheless be implemented since they have been authorised by the group’s top-tear organisation and, lastly, to withhold financing if no agreement is reached;
- substantial banking relations with non-group customers primarily for fund-raising purposes, but also to diversify the sources of funds and the lending operations and create the assumptions for its own growth, considering that the dimensions of the financial intermediary are a significant factor, though not essential;
- the consistent adoption of best practices in all dealings with group cooperatives and capitalistic non-group borrowers, with the aim of gaining a reputation and extending its business range well beyond the limits of the group;
- the adoption of possibly stringent risk management parameters. This requirement can be met by confining loans to cooperatives to a pre-fixed proportion of the bank’s net worth and total loans. So, as the aim of such a conduct is to prevent doubts concerning the bank’s solidity, the ratio of loans to cooperatives and the bank’s aggregate capital resources will at all times have to be confined within limits that will not put the bank at risk, should more than one cooperative experience crises simultaneously.

Additional useful, though not absolutely necessary characteristics include:

- the presence, within the group, of one or more firms (e.g. consumer cooperatives operating as large distribution chains or in the insurance sector) which conduct operations that structurally generate excess liquidity for the bank to feed into the financing circuits of the group.
- assets over-commensurate with respect to the size of the group, in order to ensure cash flows sufficient to meet all the group’s funding requirements.
The distinctiveness of the Mondragón Group lies in Caja’s full conformance to the basic and accessory requirements mentioned above and its ability to meet all the funding requirements of the group firms for thirty years running. In 1996, for instance, the proportion of the Caja’s credits to cooperative firms stood at no more than 6% of its total loans (Roelants 2000b).

An interesting observation is that within the large, admittedly complex and multifarious cooperative sectors of some European countries, for instance Italy and France, some of the existing groups of cooperatives show some of the basic and accessory characteristics mentioned above. In all probability, it is these that account for the positive performance of these firms, whereas their non-compliance with other requirements listed above may explain a persisting gap in performance compared to the Spanish group.

5. Concluding Remarks

The need for financial institutions combining their core business with the mission of mediating between capital and labour can be expressed focusing on the power relations between the two factors of production (Pagano 1992). In such a way we reach a different deeper explanation by involving the role of incomplete contracts and, in even more general terms, the categories introduced by Coase (1937) and Vanek (1970). Both the Ward-Vanek model cooperative and capitalistic company are entities in which one factor uses the other within the framework of a contract which conceals the power relations arising in connection with the way existing resources are distributed. With respect to situations not specifically provided for in the contract, it rests with the factor using the other in an entrepreneurial capacity to make a choice from a whole range of possible options compliant with the laws in force. Contracts of employment and financial agreements, in all their variants, are the tools through which the power to make use of a factor is exercised. The former are used by the traditional business enterprise, whereas the latter should be specific to the cooperative. In actual fact, due to the unequal distribution of wealth it is only solutions associated with the traditional sway of capital over labour that are seen to be practicable, whereas the supremacy of labour over capital that should be the distinctive feature of the cooperative sector remains a theoretical ideal, as indicated by the financing difficulties analysed in this paper.
Accordingly, in real-world conditions of asymmetrically distributed resources no labour-capital relations originating from the former factor can be established unless capital owners have satisfied themselves that they are sufficiently safeguarded.

Within the Mondragon Group, capital resources are effectively protected at system level since the sovereign powers of the partners of the cooperative using the relevant capital resources are scaled down by degrees and handed over to lenders. In theory, such a process should barely be tolerable since it would turn the cooperative into a different form of business, but in specific cases it becomes feasible since the entity that is gradually involved in the management of the debtor firm is a member of the group and acts in the name of the group as a whole. The partners of the debtor cooperative hand over part of their powers to an entity in which they exercise part of the management functions. In return for this, they obtain loan capital which would otherwise be out of their reach. As mentioned before, this exchange of mutual benefits is made under the control of the group and is governed by an association agreement.\footnote{In Italy, comparable forms of inter-cooperative control are sometimes arranged by apportioning administrative functions between the group cooperatives and the central management of the group (Mazzoli 1998, p. 155).} Thanks to the organisational structure of the group, the provider of funds is in a position to co-determine the debtor firm’s operations as long as this is necessary in view of the implementation of a project. As a result, the information asymmetries which usually prevent firms from securing an optimal volume of funds from external lenders will not arise.

References


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