

McKinsey on **COOPERATIVES**

McKinsey on Cooperatives is published by McKinsey & Company. The research behind this publication was partially underwritten by Desjardins Group, Crédit Agricole, and CIBP, but conducted solely by McKinsey & Company.

To send comments or request copies, e-mail us at McKinsey_on_Cooperatives@McKinsey.com.

Editorial Board: Arnaud de Bertier, Eric Lamarre, Jean-Christophe Mieszala, Mike Pritula, Andrea Zocchi

Editor: Michael T. Borruso

Contributing Editors: David Bolchover, Caitlin Gallagher, Marie Glenn, Allan Gold, Mark Staples, Monica Toriello

Art Direction and Design: Cary Shoda

Editorial Production: Elizabeth Brown, Heather Byer, Torea Frey, Ashwati Michael, John C. Sanchez, Venetia Simcock, Sneha Vats

Illustrations by Gérard DuBois

**McKinsey & Company
Industry Publications**

Editors-in-Chief:

Allan Gold, Mark Staples

Managing Editor: Lucia Rahilly

This publication is not intended to be used as the basis for trading in the shares of any company or for undertaking any other complex or significant financial transaction without consulting appropriate professional advisers.

No part of this publication may be copied or redistributed in any form without the prior written consent of McKinsey & Company.

Copyright © 2012 McKinsey & Company.
All rights reserved.

McKinsey on
COOPERATIVES
Autumn 2012

2
Introduction

As markets shift, technology develops, and tastes change, the agricultural sector must adapt. Coops need to find their place in this new world.

4
How cooperatives grow

Contrary to popular belief, cooperatives and mutuals grow at similar rates as publicly traded companies. But the way they grow and their key opportunities are different.

12
Improving cooperatives' agility

Coops excel at gaining organizational alignment and mobilizing employees but can be slow in responding to emerging challenges and opportunities. Some leading coops are finding ways to beat the odds.

52
How great companies think differently

A Harvard Business School professor sees parallels between the great public companies she identified in her research and the cooperative movement.



22
The future of cooperatives: An executive roundtable
The current economic environment presents an opportunity for cooperatives, but they need to stay true to their values and adjust to the new realities of a busy, online world.

60
Another way to do business: An interview with the president and CEO of Desjardins Group
Monique F. Leroux talks about the role cooperatives play in democratizing business and giving individuals and communities a means for shaping their future.

29
Change is opportunity: Cooperative banks on the cusp of a new era
Profound change is roiling the financial sector, and coops are faced with several strategic questions.

68
Capitalism for the long term
In this article from the *Harvard Business Review*, the global managing director of McKinsey & Company called for public companies to make changes that share some similarities with ways coops operate.

38
Retail coops: Staying competitive in a changing world
Six global trends are reshaping the retail industry, presenting retail coops with new challenges and opportunities. Now is the time to think through the implications.

Introduction

**Eric Lamarre,
Tarek Mansour, and
Jonathan Tétrault**

Welcome to the inaugural edition of *McKinsey on Cooperatives*. While most people have shopped at, consumed products from, or been a member of a cooperative, they often don't realize that these organizations have a significant economic footprint in our modern economy—a presence that may be poised to expand due to a growing dissatisfaction with the short-term orientation of stock-traded companies. Cooperatives represent approximately 3 to 5 percent of the world's GDP. They are present in nearly all economic sectors, from agriculture to retail to financial services. Their unique member-ownership structure and democratic governance model make for organizations that are powerfully aligned on mission and strategy, with a focus on preserving long-term stability.

The United Nations has designated 2012 the International Year of Cooperatives. In the spirit of raising public awareness about this business model, we embarked on a major research effort to better understand how cooperatives work, celebrate their successes, and explore the opportunities they may wish to pursue in today's fast-changing world. As far as we are aware, it is the first time that a major management-consulting firm has undertaken such an in-depth analysis of the cooperative model.



This publication offers a wealth of new thinking on a wide range of topics, including how cooperatives grow, the global trends they face, and the organizational and governance challenges they must overcome. We have also included discussions with several CEOs of cooperatives that bring some of these opportunities and challenges to life. Finally, two articles reflect on the importance of having a long-term view for sustained economic development and how the cooperative model might contribute to solving modern-day socioeconomic problems.

We are grateful to all of the cooperatives that participated in this research and that have been so generous in sharing their experiences

with us. Many of the leaders with whom we spoke are actively shaping and renewing their cooperative model. We hope their stories will inspire you.

McKinsey on Cooperatives was written, first and foremost, for coop managers and senior executives who are passionate about their organizations' development and success. We hope that you find these perspectives helpful as you chart your own course. ◦



Eric Lamarre

Director

Eric_Lamarre@McKinsey.com



Tarek Mansour

Principal

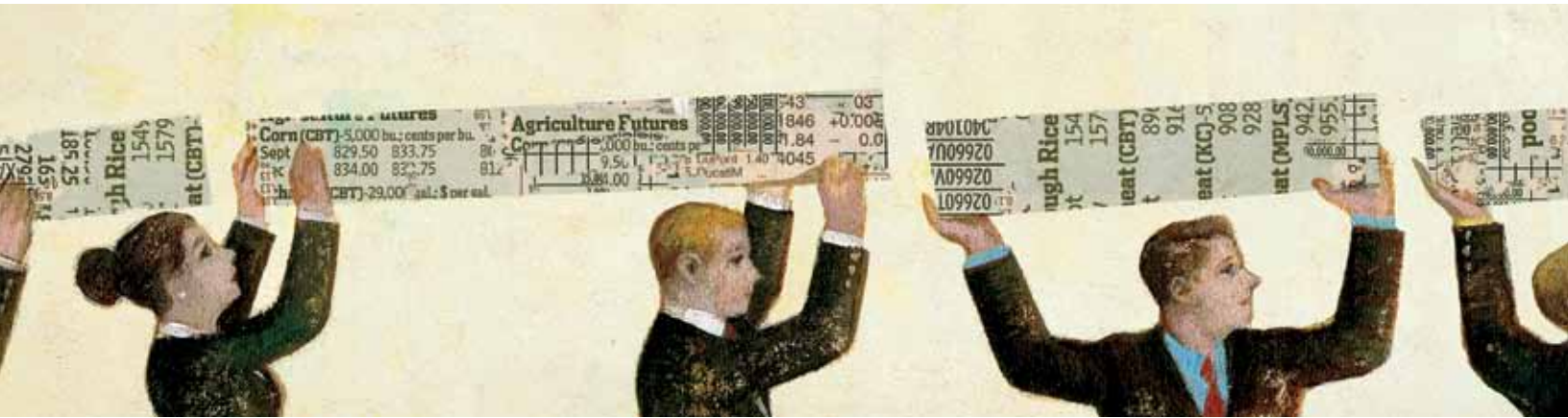
Tarek_Mansour@McKinsey.com



Jonathan Tétrault

Principal

Jonathan_Tétrault@McKinsey.com



How cooperatives grow

Contrary to popular belief, cooperatives and mutuals grow at similar rates as publicly traded companies. But the way they grow and their key opportunities are different.

**Vincent Bérubé,
Andrew Grant, and
Tarek Mansour**

Historically, commercial cooperatives and mutuals have been formed to serve individuals whose needs have not been met by the free-enterprise system. Whereas the primary purpose of a public company is to maximize profits for the benefit of its shareholders, a coop’s¹ priority is to provide goods and services to its members over the long term and at the lowest cost possible. This is not to say that all coops behave the same way, but they do tend to have a more long-term, community-oriented focus that often results in less risk taking and a more measured approach to growth.

As a result, coops are often perceived as slower-growing organizations than their publicly

owned counterparts. The data tell a different story. Our research shows that coops’ growth rates are similar to those of publicly traded companies. However, the way coops grow is different. Using McKinsey’s granular-growth-decomposition database (see “Our methodology,” page 9), we analyzed how 47 coops grew and compared those results with results for 54 publicly listed companies in the same industries and geographies. Our research covered the four industries where cooperatives have a substantial presence—insurance, banking, retail, and agriculture—spanning Asia, Europe, North America, and emerging markets.

¹ For simplicity’s sake, we use “coops” to refer to both cooperatives and mutuals.



Our analysis identifies how much of a company's growth can be attributed to the three main drivers. The first two drivers account for an organization's organic growth. These are gains in *market share* and growth through what we call *portfolio momentum*. Portfolio momentum is the revenue growth that a company experiences through the underlying market growth of the business segments in its portfolio (entering new, high-growth market segments can increase a portfolio's momentum).² The third driver is inorganic growth through *mergers and acquisitions*. After assessing the data, we made site visits and conducted additional interviews to document case examples of successful growth strategies by coops. In this article, we outline our findings with respect to each driver and then discuss ideas about where coops might want to focus their growth efforts.

²For more information, see Mehrdad Baghai, Sven Smit, and Patrick Viguerie, "The granularity of growth," *mckinseyquarterly.com*, May 2007.

Coop growth patterns

Our research produced some surprising results. From 2005 to 2010, coops grew at nearly the same rate as their publicly held counterparts, with some variation by industry and geography (Exhibit 1).

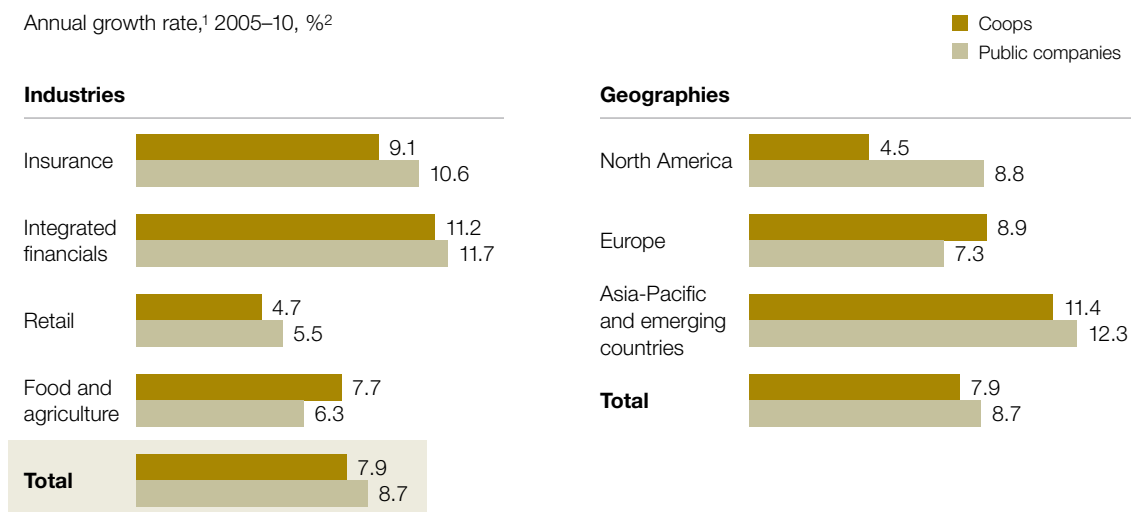
Although overall growth rates are similar in the aggregate, the composition of that growth is different between these two types of organizations. As Exhibit 2 shows, coops outperformed publicly listed companies on market-share gains, underperformed on portfolio momentum, and were roughly on par in M&A (although their M&A performance was mostly driven by large mergers rather than by acquisitions).

It is not surprising that coops enjoy greater market-share gains. Coops traditionally focus on the

Exhibit 1

Coops have growth rates comparable to public companies.

Annual growth rate,¹ 2005–10, %²



¹Analysis based on 47 cooperatives and 54 publicly listed companies.

²Considering sample size and availability of data, growth numbers are within 1% confidence interval 75% of the time.

Source: Annual reports; McKinsey analysis

Exhibit 2

Overall, coops are better than publicly listed companies at growing market share.Annualized growth, 2005–10, %¹

	Public companies	Cooperatives	Spread
Market-share gain	1.1	2.2	1.1
Portfolio momentum	5.0	3.3	-1.7
Mergers and acquisitions	2.6	2.4	-0.2

¹Considering sample size and availability of data, growth numbers are within 0.7% confidence interval 75% of the time.

Source: Annual reports; McKinsey analysis

needs of their members, have better proximity to and knowledge of their markets, and generally adhere to a strong set of social values that benefit their members. When we looked at performance by sector, we saw that these advantages were strongest in insurance and diversified financials, where the majority of the coops' customers are also their owners. Retail coops were on par with public companies with respect to market-share gains, and agricultural coops actually fared worse than their public competitors.

Weaker performance on portfolio momentum is a concern for coops. For the companies in our database, portfolio momentum is the most important of the three growth drivers we measure (accounting for over 55 percent of total growth), which should be unsurprising since the ability of a company to grow is primarily related to the health of the sectors and regions in which it operates. In addition, portfolio-momentum growth is strongly driven by an institution's capacity to position its activities against sectors, regions, or segments that are growing fast (for example, by expanding into fast-growing emerging markets or focusing activities on rapidly expanding online channels). Coops under-

performed their publicly held counterparts on this measure regardless of industry. We believe there are two reasons for this. First, coops focus more on their members' current needs than on developing innovative new products or actively searching for new markets to serve. Second, because coops tend to have a governance structure that favors consensus over executive decision making, it is more difficult for them to redeploy capital as quickly as public companies can—especially to new market segments where there may not be immediate benefits to the coop's current membership base.

As noted earlier, cooperatives have grown inorganically at roughly the same rate as public companies, and have done better on this measure in sectors where mergers, acquisitions, and alliances brought clear value to their member bases. This has been the case in agriculture, for example, where M&A has helped players develop global distribution channels for their members. The primary laggard on this measure was the insurance industry, where regulations and the lack of access to capital limit inorganic growth. Cooperatives that have successfully grown through M&A have sought out

targets that create strong synergies with members' needs, carefully assessed the cultural fit and future governance scenarios, and, in many cases, developed innovative alliances to take advantage of scale without sacrificing autonomy. Such alliances have been formed to pool risk to reduce reinsurance costs for small mutuals, set up rotation programs among coops with different regional footprints to offer high-performing employees international development opportunities, combine procurement efforts to increase purchasing power, and work together to develop and manufacture products when the coops operate in different markets.

Growth opportunities for coops

Based on our analysis, we see two primary growth opportunities for cooperatives. First, coops should play to their natural strengths and continue to pursue market-share gains by delivering a unique member and customer experience. The other big growth opportunity for coops, and probably the one with the most potential, is to more actively pursue opportunities in fast-growing adjacent markets (products, customers, or geographies). As noted earlier, most coops lagged behind their public-company competition on this measure.

Deliver a unique member and customer experience

The coop ownership model—in which customers are also owners—provides a true competitive advantage for growing market share. The cooperatives that stood out from their peers on this type of growth typically displayed three characteristics. First, they placed the interests of their members ahead of the organization's short-term financial interests. Second, they leveraged their proximity to their members to serve them better. Finally, they broke down

organizational silos to maximize benefits for their members.

Members first. In exchange for placing the interests of customers ahead of short-term financial gains, a coop can win member loyalty and grow its membership base. Take the example of NTUC Income, a coop insurer in Singapore. In 2006, NTUC's market share had dropped from 16 to 14 percent. It was ranked fourth in Singapore in gross written premiums. To improve its position, in 2007, NTUC decided to focus on being recognized as “the honest insurer.” In other words, the coop decided that it was in the business of paying members' claims based on what common sense and goodwill would dictate. NTUC instructed its agents that their job was to find reasons to pay the member.

The organization transformed its customer-service and core processes, simplified its insurance contracts, installed new quick and fair settlement mechanisms, and increased transparency by taking more time to educate its customers about its products and claims decisions. It also stopped paying its agents commissions and instead motivated them to offer the best service and tailored products to members.

To increase customer satisfaction, NTUC also sought to improve its responsiveness. The insurer deployed a special “accident response team,” a group of claims agents who patrol Singapore on scooters so they can quickly get to the site whenever a member has an accident. All these strategies required an up-front investment or a reduced focus on short-term profitability, but in the long run, NTUC clearly benefited from the increased loyalty and trust of its members. The insurer's market share grew to 22 per-

cent and its total income has grown annually by more than 17 percent since 2007. By 2010, NTUC ranked first in gross written premiums; it is now Singapore's third-largest insurer.

The proximity advantage. A core advantage of cooperatives is their proximity to their members and customers. By this we do not necessarily mean physical proximity, but rather—and more important—a closer relationship with customers and a deeper understanding of their expectations and needs. This operating model allows coops to tailor products, services, and operations accordingly, leading to a real competitive advantage. For example, BPCE was formed through the 2009 merger of two French financial cooperatives. This created the largest network of branches in Europe. After the merger, the organization established decision-making and performance-management mechanisms that fostered local leadership while leveraging the strength of the group. In the coop's hiring processes, regional entities have the power to hire key executives but must do so from a pool of candidates that the central organization has qualified. As a result, the leader's qualities fit with the local members' and customers' needs, while group standards for the skill profile of the coop's leaders are maintained.

Breaking down organizational silos. When they offer multiple products or services, cooperatives can serve more of their members' needs, increase members' benefits, and grow as a result. But this requires breaking down organizational silos to enable greater cross-servicing opportunities. The Co-operative Group, the largest coop in the United Kingdom, has a strong presence in food retail, banking, insurance, funeral care, pharmacy, travel, and other services. The organization launched a groupwide loyalty and branding effort to make customers more aware of all the different products and services it offers. The Co-operative Group converted its membership card to a "loyalty card" so that members would get additional benefits from doing more business with it. This strategy boosted membership from 800,000 in 2005 to nearly 7,000,000 in 2012. It also allowed the coop to drive member loyalty, deliver maximum value to its members across all product types, and generate a good deal of organic growth.

Organize to grow in attractive adjacent markets Portfolio momentum is typically one of the strongest growth drivers for public companies, but it's the weakest for cooperatives—regardless of the industry in which they operate. The search for new products and new markets appears to be secondary to serving existing members.

A core advantage of cooperatives is their proximity to customers—they have a closer relationship with customers and a deeper understanding of their expectations and needs.

Our methodology

In 2007, McKinsey published a book on growth strategy, *The Granularity of Growth*.¹ In their research for the book, the authors found that companies that fail to grow are likely to underperform and are less likely to survive in the long term. They argued that to drive and sustain growth, large companies should look beyond industry averages—which can obscure and hide pockets of growth—and be more granular when analyzing markets in which they might want to compete. The book advocates the creation of organizational mechanisms that would allow companies to find these granular opportunities while retaining the benefits of scale.

The first step in determining where granular-growth opportunities lie is to analyze a company's

historical sources and possible future drivers of growth. This granular-growth-decomposition analysis divides a company's growth into three parts: market-share gains, portfolio momentum, and mergers and acquisitions. The analysis is particularly useful in large multibusiness companies, which may not recognize their true sources of growth or find it difficult to make meaningful comparisons to their competitors. McKinsey has conducted this analysis for 776 major global companies and maintains a granular-growth-decomposition database that allows companies to benchmark their growth-performance record.

¹For more information, see Mehrdad Baghai, Sven Smit, and Patrick Viguerie, *The Granularity of Growth*, first published in 2007 by Cyan Books (republished in 2008 by Wiley). For more insight based on the ongoing research using the granular-growth-decomposition database, see Sumit Dora, Sven Smit, and Patrick Viguerie, "Drawing a new road map for growth," *mckinseyquarterly.com*, April 2011, and Yuval Atsmon, Michael Kloss, and Sven Smit, "Parsing the growth advantage of emerging-market companies," *mckinseyquarterly.com*, May 2012.

Improving on this growth driver is the largest challenge cooperatives face, and it's also their most significant opportunity. Some cooperatives have done better than the rest using one or more of three practices: systematically exploring members' unmet needs, leveraging distinctive capabilities to expand in new markets or geographies, and designing formal mechanisms to help finance new opportunities.

Understand unmet needs. To effectively explore adjacent markets, coops must systematically research the unmet needs of their present customer base. We have found that many coops lack the marketing expertise to do this effectively, often as a result of their highly decentralized

structure. But E.Leclerc, a merchant cooperative and one of the leading food companies in France, provides a good example of a coop that has done this type of research by leveraging the entrepreneurial nature of its store owners. E.Leclerc's store owners are encouraged to seek out opportunities to make certain markets more accessible (for example, by reducing prices or improving distribution) and thus create value for customers. When an opportunity explored by one of these store owners succeeds in providing value to members, it is rapidly scaled up throughout the group.

Following this model, the company entered the gasoline-distribution market during the global oil

crisis in the mid-1970s. Taking advantage of its scale, E.Leclerc focused on serving customers and combating high gas prices instead of exploiting short-term profit opportunities. In the 1980s, E.Leclerc entered jewelry retailing to make this product category more affordable for its mostly middle-class customers (under the slogan “Gold for everyone”). Again, this was made possible by the coop’s ability to operate at lower margins than many competitors. Today, E.Leclerc is the largest jewelry retailer in France.

Leverage distinctive capabilities. Some cooperatives have been able to expand into new geographies or markets based on unique expertise. For example, Netherlands-based Rabobank is a federation of 141 financial cooperatives with roots in the Dutch agricultural sector. After a failed attempt to compete in traditional investment banking during the 1990s, the bank decided to focus on becoming a global financial leader for the agricultural sector. This strategy to go international was built on two core beliefs: that pursuit of any such opportunity had to be relevant to existing members and that the opportunity had to be related to the organization’s distinctive expertise. By leveraging its 100-plus years of domestic expertise serving agricultural cooperatives throughout the world and focusing its international growth in cities where large agricultural members were present and needed banking services, Rabobank achieved its goal. Eighteen percent of Rabobank’s growth is now attributable to its activity in the global food and agriculture sector. The challenge for most coops is to recognize which of their capabilities really provide a competitive advantage and are truly exportable.

Crédit Mutuel, one of Europe’s largest banking cooperatives, is another example of a cooperative

that systematically explores adjacent market opportunities and pursues them by leveraging core competencies. In one case, Crédit Mutuel realized that it could leverage its broad retail network and advanced IT capabilities to enter the rapidly growing mobile-communications market in France as a mobile virtual-network operator. The coop does not own the wireless infrastructure, but rather enters a contract with the owner and then uses its existing expertise in billing, customer service, and sales and marketing to provide mobile-phone services to its members. This arrangement allowed Crédit Mutuel to serve more of its members’ needs and position itself to compete in the fast-changing payments market.

Use formal mechanisms to finance new opportunities. Successful growth in adjacent or international markets naturally requires that investments be allocated to these opportunities. That’s not always easy for coops because of their democratic decision-making processes and the fact that these adjacent opportunities might not immediately benefit members. FrieslandCampina is a Dutch dairy cooperative whose capital-management strategy has enhanced its ability to fuel long-term growth. The coop holds back 40 percent of its profits as retained earnings and keeps another 30 percent of its earnings as nonnegotiable member bonds that pay a coupon to members. This gives the company access to a major source of capital to finance its growth.

To ensure that investments are made in the long-term interest of members, FrieslandCampina evaluates all potential investments against two metrics. One metric is whether the investment promises high profitability (the performance potential of earnings before interest and taxes)

so that it can contribute to performance-premium payments for the coop's member farmers. The second metric is whether the investment will result in higher sales of milk so that it will boost farmers' regular income. An investment that satisfies both criteria will be prioritized. But these criteria also allow FrieslandCampina to build a diversified portfolio that will deliver benefits to members through either higher margins or more sales.



Cooperatives have different shareholder structures, governance mechanisms, and incentive systems from those of public companies. Yet, just like public companies, coops have a strong

desire for growth. In fact, 95 percent of the 48 cooperative leaders we surveyed told us that growth is a top priority for them. In increasingly liberalized markets, coops that don't grow will lose the economies of scale they need to remain competitive. And to better serve and protect the interests of their members, coops must be market leaders who can offer all the products and services their clients need. Those that double down on their unique relationships with their members and organize themselves to fully capitalize on adjacent-market opportunities will substantially outgrow the market. ○



Improving cooperatives' agility

Coops excel at gaining organizational alignment and mobilizing employees but can be slow in responding to emerging challenges and opportunities. Some leading coops are finding ways to beat the odds.

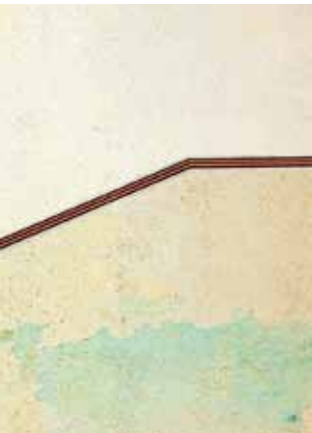
**Vincent Bérubé,
Eric Lamarre, and
Scott Rutherford**

Cooperatives differ substantially from publicly owned companies in their ownership structures and governance models. Coops limit ownership to their members, who in many cases are also the organization's customers or suppliers. And they are also known for their participatory and democratic decision-making processes—one member, one vote.

But do these characteristics translate into any differences between cooperatives and their publicly owned counterparts with respect to organizational effectiveness, which we define as the ability to align around a strategy, to execute it, and to renew a company faster than competitors do? The answer is yes. The ownership and

governance construct of cooperatives provides them with some clear advantages over public companies, but the model also creates distinct challenges.

We set out to explore these differences in more depth using McKinsey's organizational-health index, a proven tool for diagnosing the nine elements of organizational health (see "An introduction to the organizational-health index (OHI)," page 16). We surveyed over 600 employees from nine cooperatives in different industries and compared the aggregated results against a comparable set of 4,133 respondents from 136 publicly listed companies with a similar industry profile. We supplemented this analysis with



50 interviews with senior executives (chairmen, CEOs, and executive vice presidents) from leading cooperatives around the world. These interviews helped us interpret the results and gain a better understanding of the governance and managerial practices these executives employ to strengthen their organizations.

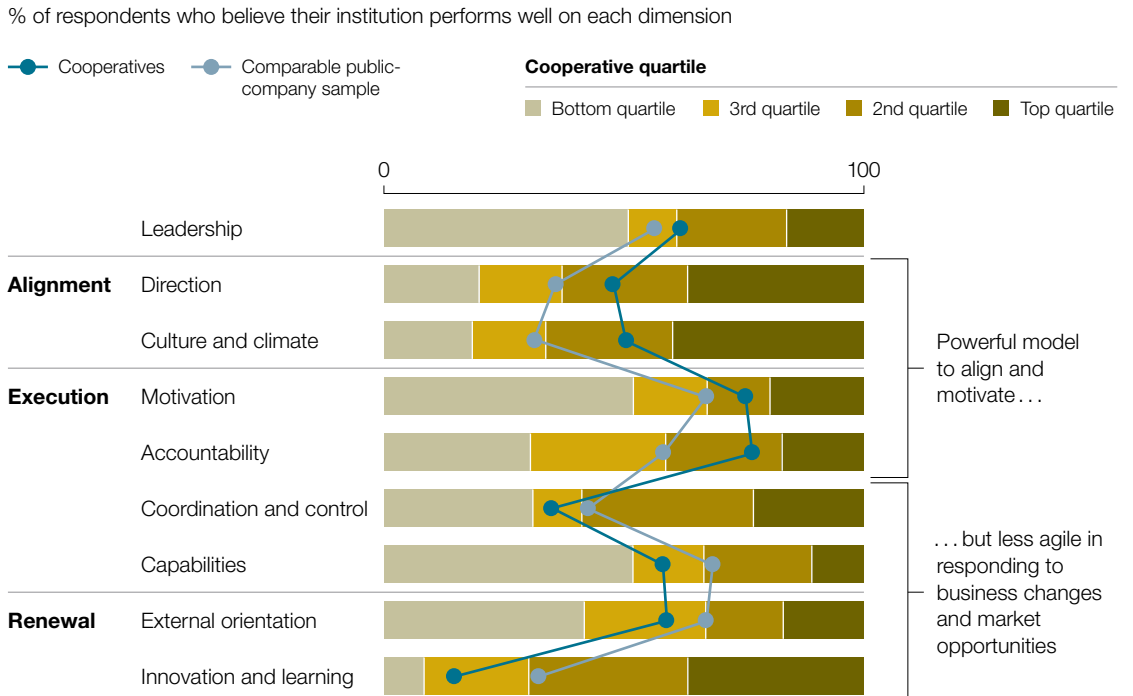
A powerful model to align and mobilize

We found the cooperative model to be particularly effective in creating organizational alignment and employee mobilization (Exhibit 1). Because owners are also members, and because members participate in the cooperative’s direction-setting process, the organization’s strategy is usually well aligned with members’ needs. In addition, the

fact that cooperatives adhere to a service-oriented mission (as opposed to public companies’ mission of creating value for shareholders) tends to create a sense of higher purpose, which appeals to and mobilizes coop employees. As a result, coop employees experience a strong sense of ownership of, and belonging to, their organization. This explains why cooperatives outperform publicly owned companies in customer-satisfaction surveys. For example, Exhibit 2 shows the results from 2009 through 2011 from McKinsey’s customer-satisfaction survey for North American banks. Credit unions, which operate under a cooperative model, have consistently achieved higher customer-satisfaction scores than their rivals over this period.

Exhibit 1

Coops do well on alignment and motivation but need to improve their agility.



The coop model also has its challenges, particularly with regard to organizational agility, as the lower part of Exhibit 1 suggests. Coops' lower score on *coordination and control* indicates that they less consistently measure and manage business performance, translating into slower action to address problems or opportunities as they arise. Part of this is attributable to less effective performance-management systems and part is—according to our interviews—due to the naturally slower pace of democratic decision-making processes. Their lower scores on *external orientation* and *innovation* mean that cooperatives are slower and less agile when it comes to renewing themselves (that is, their organizations change more slowly) than their publicly traded cousins. Finally, a lower score on *capabilities* shows that coops place less emphasis on ensuring that they have the institutional skills and talent to execute

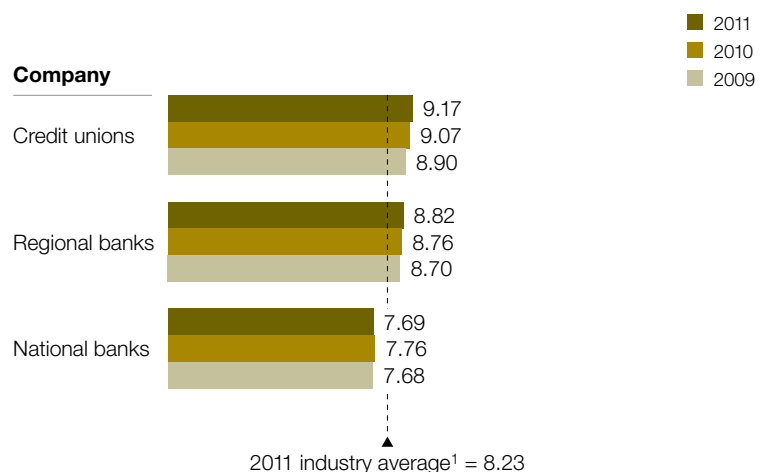
the strategy and create competitive advantage than their publicly owned competitors. In essence, coops are less agile in hiring and developing the talent they need.

To illustrate at a more granular level the agility challenge that cooperatives face, we have compiled in Exhibit 3 a sample of practices measured in the OHI survey and the specific questions regarding those practices for which coop employees reported important gaps (as will be discussed below, “consultative leadership” is noted in the exhibit as a strength, but it also creates agility-related challenges). Based on cooperatives' performance on these practices and on our interviews with senior coop executives, we see three areas in which coops can improve their agility: making decisions, pursuing new opportunities, and sourcing and developing talent.

Exhibit 2

North American coop banks outperform rivals on customer satisfaction.

Customer satisfaction

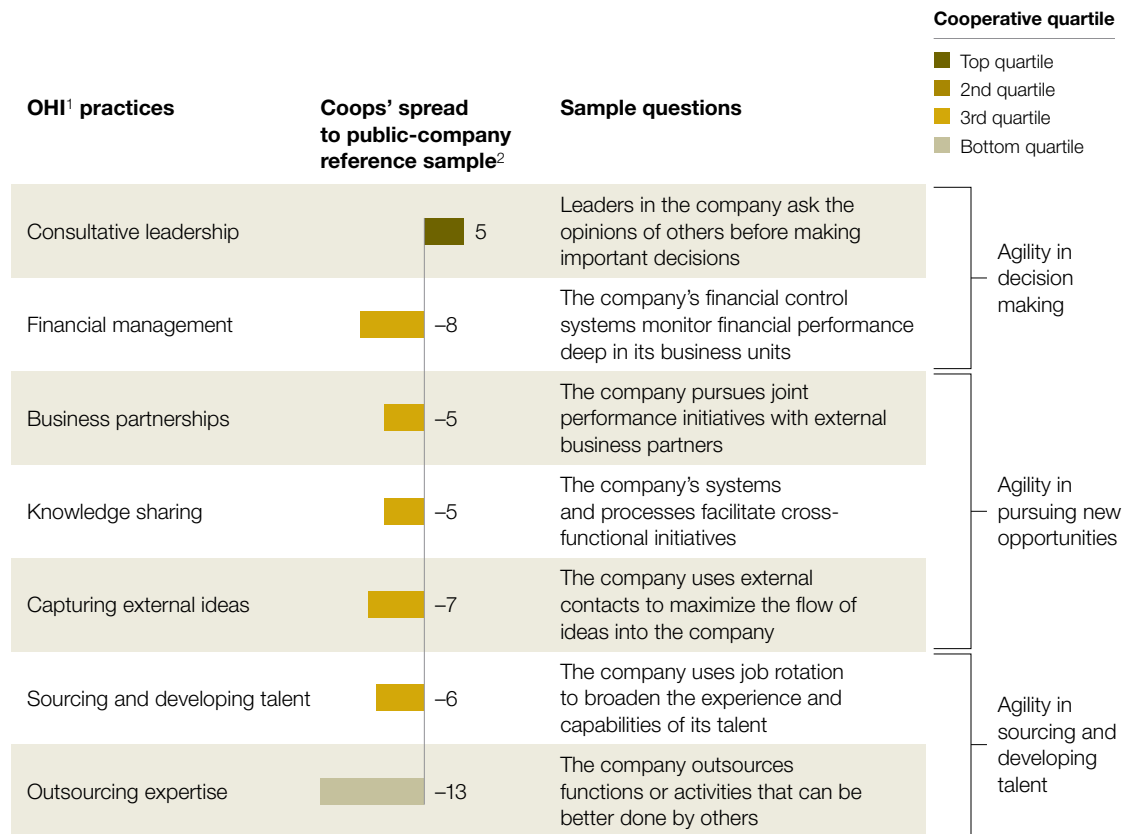


¹Customer satisfaction was measured on a scale of 1–10; all data are weighted.

Source: 2009–11 McKinsey survey of cross-industry customer experience

Exhibit 3

Coops face particular challenges in seven areas related to agility.



¹Organizational-health index.
²Percentage-point differences in respondents' answers.

Increasing organizational agility

In our interviews with coop senior executives, they told us how they were responding to these challenges, which allowed us to distill a few effective managerial and governance practices. The rest of this article will outline some ideas coops might consider implementing based on the successes of their peers.

Agility in decision making

One of the main strengths of cooperatives, their consensual and consultative decision-making processes (Exhibit 3), also contributes to one of

their greatest weaknesses—delayed action due to healthy but lengthy debates that take place at multiple levels of the organization. To increase their responsiveness to changing conditions, coops must strike a better balance between their democratic nature and executive agility. Leading coops are finding three actions to be helpful: clearly distinguish the respective roles and responsibilities of executive officers and elected officials (such as board members), create more efficient processes for consulting with members on strategic direction, and improve performance-management systems to

An introduction to the organizational-health index (OHI)

Drawing on extensive research of academic literature and decades of work with institutions across the public, private, and social sectors, we have identified nine dimensions by which we judge an organization's ability to sustain performance over time (exhibit).

First, organizational effectiveness requires alignment: everyone must be working toward the same goal in a shared context, and in a shared way. This requires **direction** (a clear sense of where the organization is heading and how it will get there that is meaningful to all employees), successful **leadership** (including, among other things, the quality of decision making and the ability of leaders to inspire action), and a strong **culture and climate** (the shared beliefs and quality of interactions within and across organizational units).

Second, an effective organization can consistently execute its strategy because, in addition to strong leadership, it maintains the necessary **capabilities** (individuals with practical and leadership skills, as well as institutional enablers), **motivation** (the enthusiasm that drives employees to put in extraordinary effort to deliver results), **accountability** (the extent to which individuals understand what is expected of them, have

authority, and take responsibility for delivering results), and **coordination and control** (the ability to evaluate organizational performance and risk, and to address issues and opportunities when they arise).

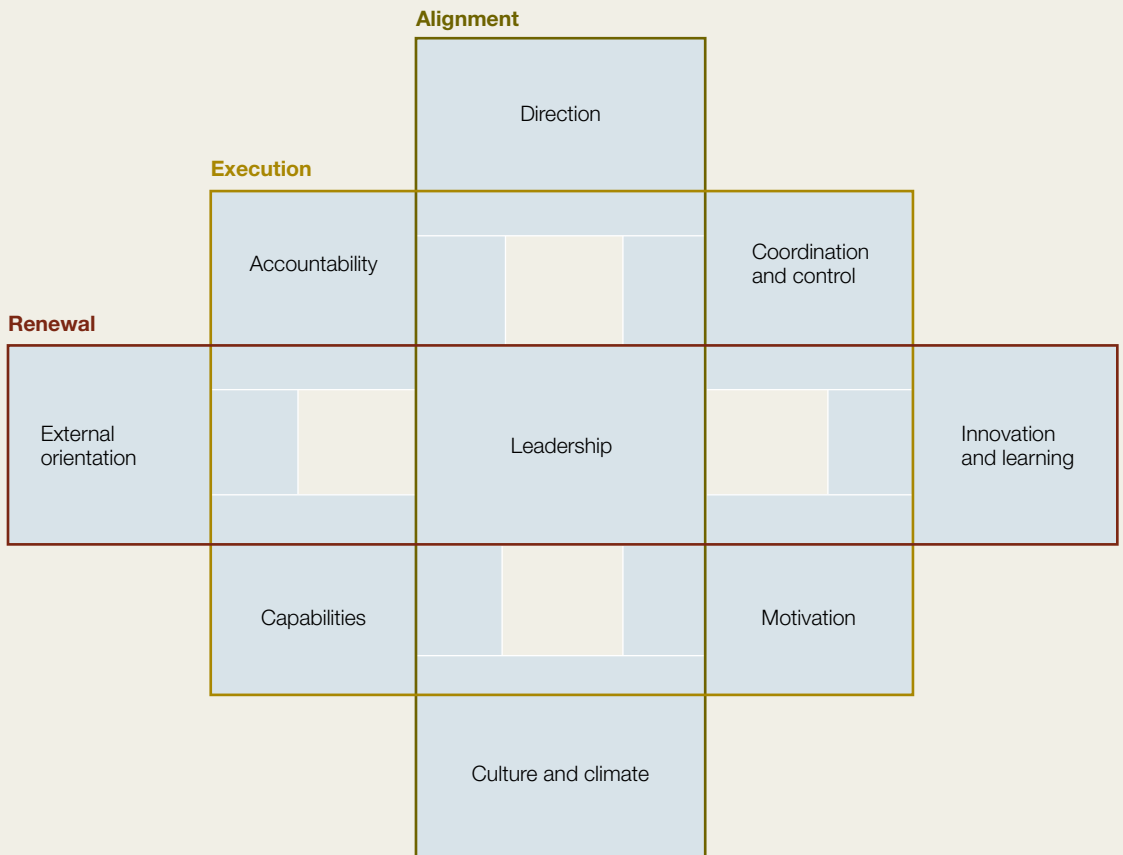
Finally, an effective organization can renew itself. Leadership affects the ability to renew as well. In addition, a healthy organization has the ability to adapt and change over time, because it is **externally oriented** (it engages well with customers, suppliers, partners, and other external stakeholders to reach the organization's objectives, and it is sensitive to market trends and the competitive landscape) and has practices in place to systematically drive **innovation and learning** (new ideas flow into and through the organization, and help to adapt and shape the organization as needed).

McKinsey has shown empirically that over time organizations that score well on the OHI outperform those with poor OHI scores financially and operationally. Organizations with a top-quartile OHI score, for example, are more than twice as likely to deliver above-median financial performance as those with bottom-quartile performance.¹

¹ Scott Keller and Colin Price, "Organizational health: The ultimate competitive advantage," mckinseyquarterly.com, June 2011.

Exhibit

The organizational-health index measures nine dimensions related to organizational alignment, execution, and renewal.



Agile decision making requires effective performance-management systems that surface issues quickly and enable corrective action.

enable rapid identification and correction of the sources of underperformance.

FrieslandCampina, the Dutch dairy cooperative, provides a good example of how a cooperative clarified the roles between executive and elected officials to remove bottlenecks from decision-making processes. The cooperative formed a separate operating company with its own board. The cooperative remained a full owner of the new operating company but, by creating a separate entity, it created a healthy distance between the cooperative democratic processes and the day-to-day rapid operating decisions required to compete effectively in the market. The cooperative's members elect 9 of the operating company's 13 board members, giving them continued control over that company by virtue of their two-thirds majority vote on the board. However, these board members' roles are well defined, and in fact are identical to those of publicly traded companies' board members under Dutch law. As one senior executive puts it, "Although there is limited interference in the daily management of each other's business between the executive team and the cooperative members, we feel very close to our members."

The Co-operative Group—a UK-based diversified coop involved in retail and financial services—is a good example of how to use technology to gain efficiency in consultative processes related to key strategic decisions. The consensus-driven

processes that define most cooperatives' governance models are fundamental to creating organizational alignment, but unfortunately, they often take too much time. The Co-operative Group has found that technology can help get members more quickly and directly involved in key strategic decisions: it uses the "crowd" to inform its decisions. For example, when the organization wanted to open 300 new food stores over the course of three years, it asked its seven million members to suggest new sites through a technology solution that helped capture and synthesize the voluminous input received from members. This initiative significantly accelerated the consultative process and allowed members to be more broadly involved in setting the direction of the coop.

Agile decision making also requires effective performance-management systems that surface issues quickly and enable corrective action. Many coops find this to be a challenge because they are often decentralized and their managerial (executive) and board (democratic) structures often overlap. BPCE, a financial coop based in France, offers a good example of effective performance management. It created a transparent data warehouse that allows its 37 regional cooperative banks to compare their performance on key indicators and share best practices. The indicators include internal benchmarks to favor transparency and internal competition (banks are ranked based on their

scores and performance is tracked over time), as well as external benchmarks that ensure the group considers outside best practices.

Agility in pursuing adjacent opportunities

One of the founding principles of the coop model is to provide services to members at an attractive price point. If a new business opportunity falls outside the immediate needs of the membership base, a coop can have difficulty seizing it. Members may not be willing to spend their capital pursuing opportunities that do not offer them direct tangible benefits. This explains, in large part, why coops do better at gaining market share than publicly owned companies but underperform at growing in adjacent product or customer segments (see “How cooperatives grow,” page 4). Our interviews highlighted three managerial practices that can help coops become more agile in their pursuit of new opportunities: expose the cooperative to more external perspectives, put in place explicit processes enabling different parts of the organization to work together and share ideas, and develop mechanisms to finance emerging opportunities that may not have immediate or direct benefits to the current membership base.

One way that cooperatives can bring in external perspectives is to invite independent professionals from outside the organization’s membership to serve on the board of directors. CBH Group, a cooperative of grain farmers (and the largest coop in Australia), has found that by appointing 3 of its 12 board members from outside the organization, it has enriched the board’s composition with knowledge and skills it needed for continued success. For example, as CBH Group was investing to reform its grain-rail network in Western Australia, the recently added external board members were able to help evaluate several technical questions that could not have been answered as easily using only internal expertise. One such question related to financial deal structures for infrastructure projects, which have become extremely important to the future success of this agricultural coop.

The MONDRAGON Corporation—a worker-federation cooperative in Spain that is involved in manufacturing, retail, and financial services—is a cooperative that pursues new business opportunities with agility. This cooperative, whose slogan is “humanity at work,” was created to support employment for residents of the Basque



region. Faced with increasing competitive threats that resulted from the liberalization of European markets in the early 1990s, MONDRAGON put in place three practices to increase its business innovation, productivity, and capacity to create jobs. First, it created research-and-development “networks” dedicated to developing new products and services: 14 technology centers and R&D units specialized in fields relevant to MONDRAGON, such as lifting systems, packaging machines, and thermoplastics.

Second, it developed processes at all levels of the cooperative to encourage cross-functional and cross-business-unit innovation. For example, MONDRAGON has established three groups that specialize in cross-product initiatives. These groups convene employees from different divisions to explore new business ideas, which are eventually elevated to the coop-wide level for production and commercialization. These interdivision initiatives are made possible by clear coordination among top managers to ensure appropriate transfer of technology and know-how among divisions.

Finally, MONDRAGON put in place funding mechanisms to ensure the survival and success of new initiatives. The coop invests a minimum of 10 percent of its gross profits into a “development fund” that finances innovation, research, and international business development. According to MONDRAGON, 21 percent of its sales are from products that are less than five years old.

[Agility in developing and sourcing talent](#)

Public companies have become much more agile in sourcing and developing talent. They systematically hire outside talent. They outsource noncore activities. They create job-rotation and mobility programs to broaden the experience

and capabilities of their top talent. They provide leadership training to develop their high-potential executives. Of course, cooperatives also do all these things, but our survey and interviews suggest that they are less agile at doing it than publicly owned companies, as Exhibit 3 showed. Our interviews highlighted two practices that can help cooperatives be more agile in talent management: first, actively identify top talent and create leadership-development tracks combining experiential and “classroom” learning, and second, adopt recruiting and training practices that change how the younger generation of potential employees views coops in comparison with public companies.

Mouvement Desjardins, a diversified financial cooperative based in Québec, offers a good example in the area of leadership development. It created a renewed mandate for its institute, the Institut coopératif Desjardins, and expanded its education mission to include programs for leadership development and technical skill building. The institute offers its courses to both elected and executive leaders, separately or jointly, depending on the topic. In the organization’s leadership and performance program, for example, over the course of three months, the top 400 executive leaders attend a series of workshops and field-based training sessions focused on honing their leadership skills at the personal, team, and organizational levels. In another program, elected and executive participants work together to develop their performance-dialogue skills—each set of participants improves these skills in a way that’s relevant to its members’ roles, but the goal is to get the two groups to more effectively work together for the betterment of the whole organization. Over the course of just two years, the institute launched 13 strategic talent-

development programs. Many participants have taken on more senior leadership roles in the organization. In formal feedback, a vast majority are finding the institute an invaluable contributor to their career development.

Coop employees and leaders told us that their organizations have a difficult time attracting talented young people, who tend to view them as less exciting than public companies. But some cooperatives display great agility in adapting their recruiting and training practices to suit the needs and interests of younger people. For example, P&V, a Belgian insurance coop, recognized that its more local focus put it at a disadvantage when competing with multinationals for top talent (many coops face this issue, as they tend to limit their operations to a single region or country). The coop overcame this challenge by joining Euresa, an alliance of European insurance cooperatives and mutuals, the members of which offer a rotational program that allows selected early-tenure managers to work in other countries and get international exposure.

Another way to connect with the younger generation is to move to where the talent is. Farmers Cooperative (FC), a coop of grain farmers in Iowa, was experiencing explosive growth of 23 percent per year but was finding it difficult to attract the young talent that could help it stay on this trajectory. Beginning in 2008, the coop rolled out a bold recruiting campaign

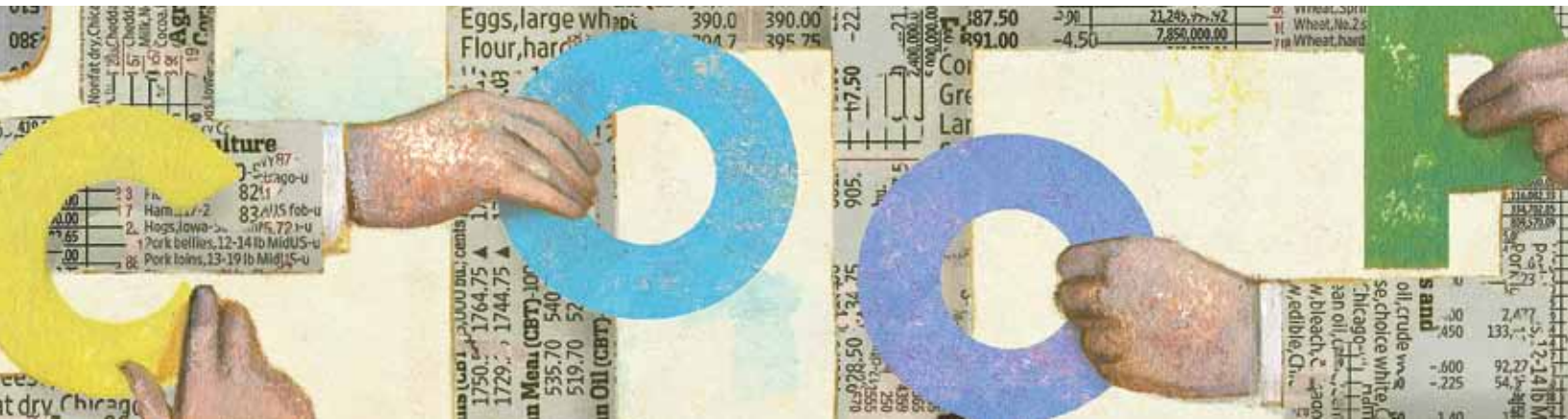
in collaboration with Iowa State University, which has one of the most prestigious agriculture schools in the United States. Every quarter, the CEO and his executive council organize events with high-potential students to offer mentoring and networking opportunities. FC offers scholarships to increase its visibility among college students and gives the best students paid internships. The organization even moved its headquarters close to the university to help make these programs accessible. The move allowed FC to double its intern pools and improve retention by hiring people who already had ties to the areas in which the coop operates.



As cooperatives continue to grow and become large enterprises, organizational agility will increasingly determine their ability to competitively serve members in a fast-changing world. Improving their organizational agility while preserving their mission and principles is a fundamental organizational challenge of modern cooperatives. The examples illustrated in this article may not be suited for all cooperatives, but to be more agile each cooperative ought to evaluate the effectiveness of its decision-making processes, its capacity to innovate and mobilize to pursue adjacent opportunities, and its ability to source and develop the best talent in its industry. ○

The authors wish to thank Lili Duan and Krzysztof Siuda for their contributions to this article.

Vincent Bérubé (Vincent_Bérubé@McKinsey.com) is an associate principal in McKinsey's Montréal office, where **Eric Lamarre** (Eric_Lamarre@McKinsey.com) is a director. **Scott Rutherford** (Scott_Rutherford@McKinsey.com) is a principal in the Washington, DC, office. Copyright © 2012 McKinsey & Company. All rights reserved.



The future of cooperatives:

An executive roundtable

The current economic environment presents an opportunity for cooperatives, but they need to stay true to their values and adjust to the new realities of a busy, online world.

Jonathan Tétrault

The financial crisis, and the severity of the ensuing economic downturn in some Western economies, has sparked some debate about the fundamental nature of the capitalist system and the purpose of the companies that operate within it. The notion that companies have tended to concentrate too much on short-term profitability and too little on their own long-term viability has lodged itself in the public mind-set.

Arguably, such disaffection may lead to an opportunity for cooperatives, which often claim to have stricter governance practices and decision-making processes that give primacy to the long-term interests of their members. McKinsey brought together three leaders from

high-profile cooperatives to discuss the prospects for their unique business model in the current climate. The panelists were Philippe Brassac, CEO of Crédit Agricole's regional bank in Provence Côte d'Azur and deputy chairman of the board of directors of the National Federation of Crédit Agricole; Cees 't Hart, CEO of the Dutch dairy cooperative FrieslandCampina; and Peter Marks, CEO of The Co-operative Group.

Along with their views on the future for cooperatives, the panelists also discussed topics such as the benefits and possible drawbacks of international expansion and the considerable challenge of getting members more actively engaged in coop governance when the modern



world offers so many competing distractions. Jonathan Tétrault, a partner in McKinsey's Montréal office, moderated the discussion.

McKinsey on Cooperatives: *In the aftermath of the financial crisis, several commentators in the Western media have pronounced that capitalism is now a system in crisis, or have questioned the publicly owned corporate model. Do you believe that this represents an opportunity for cooperatives?*

Peter Marks: Absolutely. There is a strong sense that major institutions, particularly in financial services, have lost the trust of the general public. As a result, popular curiosity in different forms of organization has certainly increased since the financial crisis took hold, and the cooperative model has become more fashionable.

There have already been some practical, commercial consequences for us. We've seen a significant increase in people in the United Kingdom showing an interest in transferring their accounts to our bank.

Cees 't Hart: I agree that changing perceptions do present an opening, but the extent of this opportunity somewhat depends on the sector. I fully appreciate that the cooperative model has become more attractive for banking customers because it is seen as less greedy and more reliable than much of the competition. Our company, however, operates in the food business, which functions in a very different way. Consumers obviously want a safe supplier, but I can't honestly say that people think we are any different from companies like Unilever in that respect.

In general, though, we can say that the financial crisis has served to highlight the dangers of

excessive emphasis on the short term. Working for a cooperative has confirmed to me the vital importance of long-term planning and protecting stakeholder interests. The more stable ownership of cooperatives does help to relieve short-term pressure and allows more of this long-term focus.

Philippe Brassac: In the banking sector, the essential link between the profitability of a company and the usefulness of its products has been broken in recent years. I see this development as the ultimate cause of the financial crisis.

This collapse in the relationship between profitability and usefulness is, however, not just confined to banking. When I ask people what the ultimate goal of their company is, they all seem to reply that they want to make money. "We want to be profitable," they say. Not a single one of them will say "I want to make airplanes; I want to make cars; I want to make clothes; I want to do something useful."

We need to reintroduce the essential law of the market, which holds that if you are not useful to customers, you will disappear. A cooperative's primary focus is being useful to its customers. If we can get this reality across, then yes, we do have a real opportunity.

McKinsey on Cooperatives: *If the public has concerns with the traditional capitalist model, do you think cooperatives should be more assertive in promoting the alternative model they provide to potential members or customers?*

Cees 't Hart: We can certainly say that cooperatives in certain industries have a positive public image at the moment, and perhaps

Biographies



Philippe Brassac is the CEO of Crédit Agricole's regional bank in Provence Côte d'Azur (2001–present), as well as the deputy chairman of the board of directors of the National Federation of Crédit Agricole. In 2009, he was awarded the Officier de l'Ordre du Mérite Agricole medal by France's minister of agriculture.



Cees 't Hart is the CEO of FrieslandCampina (2009–present). Previously, he spent 24 years at Unilever in several marketing and general-management roles, including senior vice president of marketing operations on the Unilever Europe executive board. His tenure at Unilever was spent in different countries, such as Hungary, Italy, Poland, and Singapore.



Peter Marks, CEO of the The Co-operative Group (2007–present), has spent his whole working life within the cooperative movement, having originally joined what became Yorkshire Co-operatives in 1967 as a management trainee in the food-retail business. In his career, he has managed a wide variety of businesses and functions, including department stores, food, funeral homes, human relations, and travel.

some competitive advantage can be gained because of that.

But I think we should be a little careful about generalizing about business models. You do get banks that think for the long term and consider all their stakeholders in their decision making. Although control mechanisms may be tighter in a cooperative, an organization's behavior depends not just on a model but on the individuals at the top.

Peter Marks: I agree entirely. The cooperative business model, and what we consider to be its superior governance, can only be the icing on the cake, or the tiebreaker. We need, first and foremost, to be efficient and commercial, to give customers the right product at the right price at the right time. What has held UK cooperatives back in the past is that they have often failed at these basics. But if we do all this as well as the competition, then we can use our strengths—the concepts of trust, more transparent governance, and a longer-term outlook—as a potential differentiator.

But cooperatives shouldn't think that customers are going to come flocking to our door just because we have a different model of governance, because that won't happen.

McKinsey on Cooperatives: *In our discussions with many cooperatives around the world, we hear leaders debating how much they want to explore new sources of revenue, particularly in emerging markets. On the one hand, this diversification might aid growth, especially since many coops' competitors are doing it. On the other hand, it might be difficult to persuade existing members that this is the right course of action. How do you think coops can resolve this possible conflict?*

Peter Marks: As far as my own organization is concerned, we're already quite diverse, but we're not necessarily looking to grow internationally. In principle, I don't see that there is a conflict between international expansion and members' interests. If any business venture, whether domestic or international, leads to better financial performance, then higher profits can be distributed to members.

Cees 't Hart: FrieslandCampina started its international expansion many years ago, and it has so far been very successful. The principal objective of our cooperative is to get the most value for the milk provided by our farmers. We do this by trading that milk, and derivatives of milk, across the globe. We operate in more than 25 countries and are still continuing our expansion. We are building our business in China, and have just purchased a company in the Philippines.

Philippe Brassac: On the question of international expansion, I would like to revert to my point about the importance of being useful to the customer. In a benign economic environment, cross-border growth seems an obvious course of action. But when conditions get tougher, you are not going to survive

over time unless you prove yourself useful to the local market.

It's fine to expand internationally in order to increase returns for your members. But we must always remember that we are in China to serve the Chinese, in Brazil to serve the Brazilians, in the United States to serve the US members; we must be useful to each market in which we operate. We must always retain our *raison d'être* and establish our own governance procedures, wherever we are.

McKinsey on Cooperatives: *Research suggests that a key differentiating factor for cooperatives in various industries is that they are perceived to be closer to the customer. But how much does this notion of proximity continue to matter as more communications and transactions are taking place online?*

Peter Marks: I think this depends on what business you are in. We operate a very large chain of convenience stores, and for us proximity is very important. Having a store in a physical location that is convenient for customers is the core element of the business model. Although online shopping is having an adverse effect on hypermarkets because people are buying bulk

But cooperatives shouldn't think that customers are going to come flocking to our door just because we have a different model of governance, because that won't happen.

merchandise on the Internet, they still want to buy their fresh food locally.

Proximity is important in banking, too. Our research tells us that although most people engage in online transactions, they want the feeling of security provided by bricks and mortar, to know that there's a bank branch nearby if they need help or advice.

Philippe Brassac: I agree that cooperatives do have better proximity—not necessarily physical proximity, however, but something less obvious: proximity to the customer's expectations.

When you ask cooperative members how long they want a service for, they usually reply that they want it for as long as possible, not just for tomorrow morning. And when we ask them what the ultimate goal of the company is, they say that it should be run in customers' interests.

I'll give you a concrete example. Every year for the past 12 years, I have made a presentation about our bank's pricing policy. Because we are a cooperative bank, I always get asked whether our prices are too expensive. Members never suggest increasing the rate to make more money. And they always want to open more branches. They never argue that we should close a branch

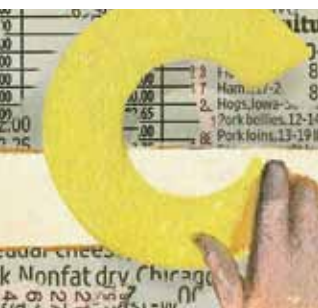
because it's not sufficiently profitable. When I talk about the staff, they always say that we need sufficient people to provide good service. They never say that we should cut our staffing levels in order to improve profitability.

This really illustrates the essential difference between the kind of governance applied in the shareholder model and our type of governance, in which customers have more control.

McKinsey on Cooperatives: *Do you think this notion of proximity could be used to cooperatives' advantage in the coming years in a world where customers are potentially less loyal?*

Philippe Brassac: I certainly think that we need to increase the general awareness of what we offer.

Customers want companies that they think can be controlled locally and won't become an ungovernable, sprawling global entity. We need to make sure that people understand that our model can offer this local control. In the banking sector, for example, there is a very real danger that customers no longer believe there is an alternative model available. We must get the message across that this alternative does exist, that the cooperative model is still available, and it doesn't just belong in the past.



we need to make certain long-term investments in relation to sustainability, whether driven by government or by our own desire to remain accepted by society at large. In this respect, for the farmers I do see a dichotomy between their commercial interests and our responsibilities as a cooperative.

McKinsey on Cooperatives: *If you had one piece of advice to give to the CEO of a fast-growing cooperative on how to be successful over the next decade, what would it be?*

Cees 't Hart: Remain close to your members, and never forget their needs. In such a fast-growing environment, it will be particularly easy to lose sight of why you became a cooperative in the first place. The management is there for the benefit of the members, not the other way round.

Philippe Brassac: My main advice would be to remain aware that our business model makes our organizations more sustainable. Listed companies are constrained by the short-term financial demands of shareholders. But CEOs of banking cooperatives have the freedom to use their resources in another way, offering a wider range of products to many customers. You might sacrifice some short-term profit, but this greater diversification will make the business more stable and resilient, more able to withstand crises.

There are real grounds for optimism at the moment. Whereas listed banks are currently subject to severe criticism, the cooperative

model should enable us to ensure that our organizations are useful to customers. Indeed, it is perhaps the only model that safeguards this customer focus.

Peter Marks: First, I think you need to be very clear about your long-term strategic goals and make sure that the management and the members—those who are elected, who are active, and who sit on the boards of directors—are absolutely united on those goals. Second, you have to be as efficient as your best competitor, otherwise you will fail. In the United Kingdom, many cooperatives have failed because they've been inefficient, bureaucratic, and slow to react to changing circumstances.

The global economic crisis has certainly raised interest in the cooperative model, and this does present an opportunity. But I want to emphasize that the business model itself is not a readymade formula for success. Whatever business you're in—whether you are running a cooperative in finance, retail, or farming—your products, services, and prices have to be as good as your competition. And if that's the case, the cooperative model may well persuade people to choose to do business with you instead of someone else. On the other hand, there's no point using the cooperative model as a differentiator if your products and services are not as good as those offered by competitors. ○



Change is opportunity: Cooperative banks on the cusp of a new era

Profound change is roiling the financial sector, and coops are faced with several strategic questions.

**Pierre-Ignace
Bernard and
Jonathan Tétrault**

After decades of rapid growth that has given the world a much more finance-based economy, the banking sector is now entering a new era. Banks are starting to grapple with comprehensive banking reforms in Europe and the United States, which have begun to impose heavy costs and may force a radical revision of their business models. At the same time, emerging markets are maintaining relatively robust growth rates even as developed markets remain stagnant; new nonbank firms are encroaching on banks' traditional turf; and technological advances and evolving customer preferences are setting the stage for an important revolution in retail banking. Taken together, these changes seem likely to usher in a new phase of slower growth and tougher competition.

For cooperative banks to successfully navigate this new environment, it is essential for their leaders to understand fully the underlying trends and their implications. In particular, cooperative bankers must be aware of the new opportunities that these secular changes will create; the pursuit of these should form the basis of new strategies to help cooperative banks fulfill their mission.

Banking in 2020

We argue that five trends will transform the banking industry over the next decade.

1. Right-sizing the platform

Following the crisis, many countries introduced new regulations in the hope of making their

Exhibit 1

New regulations are lowering European retail-banking ROE.

Regulations' effects on retail-banking ROE,¹ %²

	France	United Kingdom	Germany	Italy	Average ³
Preregulation	13.5	13.6	6.6	5.1	10.1
Basel III	-2.9	-2.8	-2.1	-1.4	-2.4
EU Mortgage Directive	-0.4	-0.4	-0.1	-0.3	-0.3
EU payments regulation (SEPA ⁴)	-0.2	-0.1	-0.1	-0.1	-0.1
EU investment regulation (MIFID ⁵ II)	-0.4	-0.5	-0.4	-0.1	-0.4
National regulation	N/A	-2.8	-0.3	N/A	-1.0
Postregulation	9.5	7.0	3.5	3.1	5.8

¹Return on equity.

²Figures do not sum due to the effects of rounding.

³Weighted average based on the volume of risk-weighted assets (RWAs) held by banks in each country in 2011.

⁴Single Euro Payments Area.

⁵Markets in Financial Instruments Directive.

banking systems sounder and more robust. Although this goal may well be achieved, these new regulations have begun to exert a material negative impact on banks' return on equity (ROE) and will continue to do so: for example, we estimate that the new rules will lower ROE for retail banking in Europe's four largest markets from about 10 to 6 percent on average, before any mitigation action (Exhibit 1). Basel III will affect ROE the most and will require higher capitalization, stronger capital quality, and more funding and liquidity for banks. Its impact will be particularly large for banks' capital market businesses and, in the United States, the Dodd-Frank Act will impose additional capital market restrictions.¹ At the same time, we expect that capital will become scarcer and hence more

expensive—worldwide and in all sectors—due mainly to an investment boom in emerging markets but also to aging populations in many parts of the world and a rebalancing of China's economy toward consumption, reducing its savings rate.²

This combination of lower ROE and higher cost of equity puts banks in a bind. In the past, banks have been able to grow out of their problems; today, some may again be pinning their hopes on a recovery in revenues. However, we think this is unlikely. We expect that the prospect of a long period of unprofitability will force banks to restructure their operations. Primarily, this will mean further cost cuts. We estimate that on average, European and US banks would need to reduce

¹For more, see McKinsey Banking and Securities (Europe) practice, "Day of reckoning for European retail banking," July 2012; and McKinsey Working Papers on Risk, Numbers 25, 26, 27, and 29, all available at mckinsey.com.

²Richard Dobbs et al., "Farewell to cheap capital? The implications of long-term shifts in global investment and saving," McKinsey Global Institute, December 2010 (mckinsey.com).

costs by more than 20 percent over the next five years to return their ROE to 12 percent. Other steps include allocating capital more strategically, maximizing capital efficiency, and limiting capital-intensive operations, especially in capital market businesses.

account for over 60 percent of global banking-revenue growth from 2010 to 2020 and that by 2020, emerging markets will represent about half the world's banking revenue (up from 34 percent in 2010).⁵

The picture is rather different in advanced economies; many are still deleveraging, trying to work off high levels of household and public debt, and most are plagued by high unemployment. After decades of rapid expansion, their banking markets have become saturated and entered a new phase of slower growth. As Exhibit 2 shows, global banking revenue, which increased as a share of GDP from less than 3 percent in 1980 to more than 5.5 percent in 2008, is now expected to grow no faster than GDP and to remain at its post-crisis level of

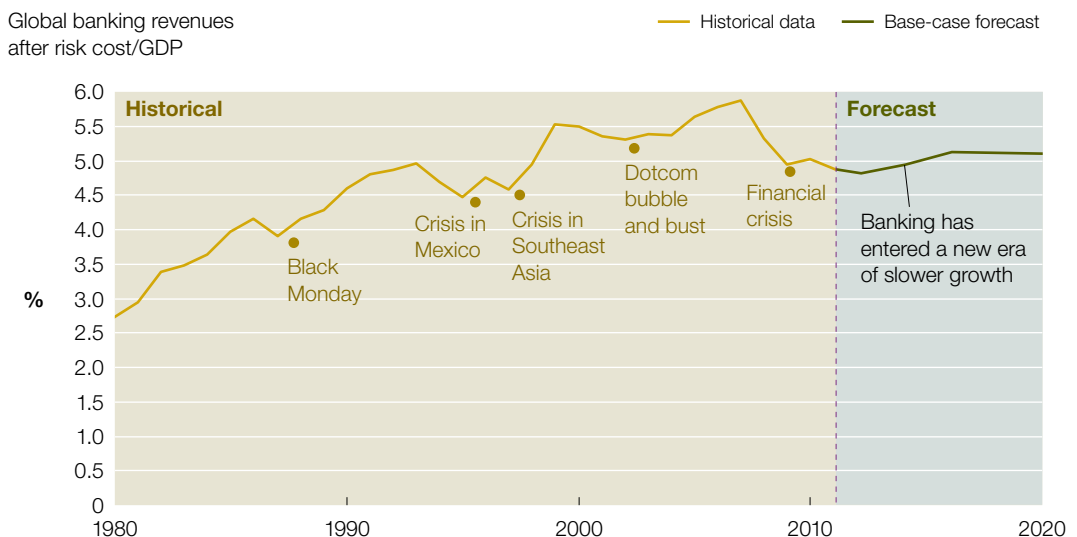
2. Revenues and profits shift to emerging markets

The emerging markets' share of global GDP is rapidly increasing, and their burgeoning middle classes are poised for a massive new wave of consumption of all kinds of goods and services, including financial products.³ Demand is rising and will continue, as 2.5 billion adults still do not use formal financial services and over one billion people have a mobile phone but no bank account.⁴ We estimate that emerging markets will

³For a compendium of McKinsey research drawn from the past ten years of experience with companies in emerging markets and more than 60 proprietary databases and knowledge investments, see Yuval Atsmon et al., "Winning the \$30 trillion decathlon: Going for gold in emerging markets," August 2012 (mckinsey.com).
⁴Alberto Chaia, Tony Goland, and Robert Schiff, "Counting the world's unbanked," mckinseyquarterly.com, March 2010.
⁵McKinsey Global Banking Pools (solutions.mckinsey.com).

Exhibit 2

Banks will be unable to grow as quickly as they have in recent years.



Source: Thomson Reuters; McKinsey Global Financial Initiative

approximately 5 percent of GDP over the next decade.

Although banks from advanced economies will be tempted to seize rapid growth opportunities in emerging markets, they will face high barriers to entry, including limits on foreign control of banks.

3. A seamless multichannel customer experience

The growing use of the Internet, smartphones, and social media is rapidly changing the nature of social and business interactions. As customers become more and more comfortable using the Web and their phones to deal with their banks, they will increasingly expect and demand that other channels (phone and video calls, branches, and banks' presence in social media) match that personalized experience in an integrated way, without exception.

To meet these expectations, even as they are cutting costs, banks must be agile. Most will attempt to build the experience that customers want, redefined as a consistent and seamless offering across all channels. Although the vast majority of transactions will take place on the Internet and on mobile phones, bank branches will still play an important if complementary role, for example, in the handling of complex transactions, and in the provision of high-quality financial advice needed to support complex sales, such as bancassurance products.

But banks' branch networks will be smaller, with fewer and less heavily staffed outlets. In Europe, for example, we expect the average number of full-time equivalents per branch to decrease from ten to fewer than five and the

average branch density to decrease from 475 to 350 per million inhabitants from 2010 to 2015. Formats will also change, with banks deploying a wide variety to accommodate the needs of different customer segments.

4. New competitive threats arise

Over the coming decade, retail banks will face off in a new round of tougher competition. Universal banks' renewed focus on retail will raise the stakes, and saturation and stagnant growth in developed markets will drive more fierce competition for market share. The rise in competitive pressure will be abetted by new digital tools. As customers increasingly use online price and product-comparison tools, they will become more comfortable buying products from several banks, rather than awarding all their business to their main bank. Traditional banking products will become even more commoditized, and pricing will be highly competitive—with few degrees of freedom in a low-interest-rate environment—and banks will have to compete on customer service.

Moreover, many firms, especially some new nonbank players, will use data, innovative technologies, and new business models to threaten lucrative niches currently dominated by banks. For instance, in the payments industry, remote payments, new currencies, business-to-business payments, and e-invoicing are transforming the landscape and will encroach on banks' payments businesses.⁶ Also, integrator tools are increasing the distance between financial institutions and their customers and may threaten banks with partial disintermediation. Direct banks—whose deposits grew more than 20 percent per year

⁶Michael Chui, Robert Mau, and Samantha Test, "The impact of big data on payments," *McKinsey on Payments*, March 2012 (mckinsey.com).

Cooperatives should aim to use flexibility to deliver best-in-class service to their members at a competitive price.

from 2000 to 2010 and could reach \$500 billion by 2015—will continue to snare business from young, wealthy, Web-savvy consumers.

5. Big data transforms banking products and pricing

By 2020, the world's stored data are expected to have increased by a factor of 30, and computational capacity will continue to expand exponentially.⁷ This will allow new opportunities for banks to improve management, decision making, and operations, provided they can develop the talent and skills that big data requires. For instance, they will fully exploit their customer data to accomplish a range of goals. Data on buying and borrowing patterns in micromarkets can help them build better risk models and allocate capital more strategically and dynamically.⁸ By tracking customers' online behavior and shopping patterns, they will be able to make real-time, customer-specific offers through the customer's channel of choice at point of sale and servicing. They will also be able to assess credit risk in real time and use integrated risk modeling to price products (for example, they will incorporate customer information into home-equity risk models to identify "bad" opportunities and reduce loan losses by an estimated 25 percent).

Similarly, they will launch programs that transform internal and external data to develop

a single, accurate, consistent, and current "golden source" of data, used by every business in the bank.⁹ At one bank, such a single master data repository reduced the cost of data-related problem resolution by about 8 percent.

Implications for cooperative banks

In this section, we ask key questions and offer guiding thoughts that we believe leaders of the world's cooperative banks should consider as they develop strategies to respond to these five trends.

1. How can cooperative banks exploit their focus on customer satisfaction to gain market share?

As public banks face pressure to cut costs to increase ROE, some of their customer satisfaction initiatives may be delayed or suffer. While cooperatives will also need to reduce their costs to remain competitive, we believe that their cooperative mission (as opposed to the imperative to create shareholder value) and their longer-term orientation may give them flexibility to sacrifice some short-term returns. As a result, cooperatives should aim to use that flexibility to deliver best-in-class service to their members at a competitive price.

To that end, cooperatives should, among other things, identify the dimensions of customer satisfaction that are of greatest importance to their members and make corresponding

⁷Brad Brown et al., "Big data: The next frontier for innovation, competition, and productivity," McKinsey Global Institute, May 2011 (mckinsey.com).

⁸Tobias Baer, Tony Goland, and Robert Schiff, "New credit-risk models for the unbanked," McKinsey Working Papers on Risk, Number 30, January 2012 (mckinsey.com).

⁹Institute of International Finance and McKinsey & Company, *Risk IT and Operations: Strengthening Capabilities*, June 17, 2011 (iif.com and mckinsey.com).

long-term investments, especially in areas where competitors are delaying investments. They might ask how they can better leverage their unique cooperative attributes in defining their promise to their members and therefore make them feel like true owners (for example, by giving them the ability to influence the bank's offering, or by providing flawless complaint management). In an environment in which they must be financially disciplined, how should cooperatives prioritize new investments related to customer satisfaction versus their current portfolio of initiatives? Finally, how can cooperatives leverage their often extensive branch network and workforce to provide new and better customer services that will further distinguish them from traditional banks? Winning on customer satisfaction in such a competitive context will be an everyday battle, but one that cooperatives are uniquely positioned to win.

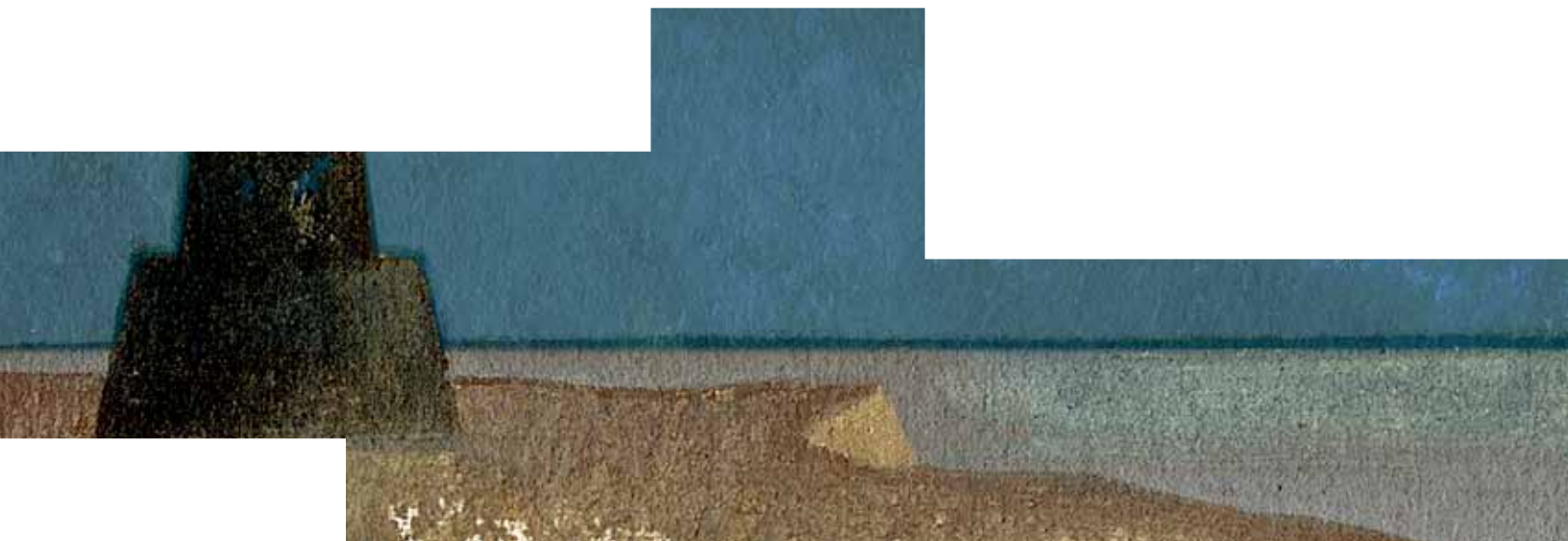
2. Will cooperatives need to look for growth beyond their borders?

Cooperative banks, like their public competitors, must decide whether to expand abroad or focus their resources and management

attention on their potentially saturated home markets. More generally, they should develop a view on how globalization and the shift of economic power toward emerging markets—and competitors' strategies in these markets—will affect their current activities. By staying on the sidelines, some cooperatives might be putting themselves at a strategic disadvantage, at risk of losing high-growth opportunities or additional scale to finance future investments.

Given that cooperatives—in most cases—do not have an explicit mission to seek international growth, they should begin by determining how, and by how much (if at all), their current domestic members stand to benefit from international expansion. Given the nature of these opportunities, cooperatives will, of course, need to assess them on a risk-adjusted basis: opportunities in home markets are typically easier to capture than those in new geographies.¹⁰ In parallel, cooperatives must also assess alternative growth opportunities related to their current member base that could better match members' interests while providing adequate return on capi-

¹⁰ Toby Gibbs, Suzanne Heywood, and Leigh Weiss, "Organizing for an emerging world," mckinseyquarterly.com, June 2012.



tal. In short, international expansion is neither a panacea for growth nor a concept that coops should ignore altogether: it may very well suit members' interests at some cooperatives, and not at others. For the former, the next step is to explore all available entry strategies (for example, form an alliance with small local cooperatives, follow corporate members with international activities into new markets, make a targeted push in a new market leveraging a high-performing subsidiary or business unit, and so on). The coop should opt for the one that best matches its competitive advantages to the challenges of international growth.

3. How can the branch network preserve the advantage of proximity while remaining profitable?

As virtualization reduces branch visits and makes the physical network less central to the client relationship, an oversupply of branches will put pressure on coops and their public cousins: they will need either to shrink the network or to find a new role for their branches. Cooperatives are entering a pivotal period in which the branch network could become either a financial liability or a point of differentiation.

For their branches to remain relevant, coops will first have to find compelling reasons for consumers to visit. How can coops take advantage of the changes we expect public competitors to make—reshaping networks to make them leaner and sparser—to develop comparatively stronger relationships with communities and their members? What products or services could be introduced to transform local branches from a fading channel to a competitive advantage?

Coops are decentralized organizations with a good deal of flexibility. Parts of the branch network can readily serve as testing grounds for new concepts and management models. How can coops use this flexibility to unleash creativity?

Coops should consider other questions too. How could branches become knowledge centers that provide truly personalized financial advice and planning? Could branches also expand their offerings to adjacent products and services that their members desire (for example, mobile services and travel services)? The answer to these questions will vary for each cooperative, but it will be critical for all of them to ensure that their branch network remains a key differentiating factor rather than a growing liability.

4. How can cooperative banks use their Web presence and social media to improve relationships with members?

Coops have traditionally relied on their physical presence at the heart of the communities they serve. But they may also have to find new ways to engage members through online and social-media channels as their physical links erode.

Social media and online tools will allow members to communicate with their cooperatives more easily. They will also allow cooperatives to quickly receive member input on a larger scale than previously possible. How can cooperatives best take advantage of these changes to deepen their relationship with their members and better respond to their needs? Could cooperatives reinvent or at least modernize their democratic processes such that they might become as simple as logging in

to a social network? If so, how can cooperatives leverage this new kind of proximity to unleash the bottom-up innovation that has been at the core of the cooperative movement's genesis? While thinking through their response to these social changes, cooperatives will also have to consider how to take advantage of the opportunity while maintaining enough control of the positioning of their brand to limit potential reputation risk.

5. [How can cooperatives retain their privileged relationships with members in the face of new nonbank competition?](#)

The threat from nonbanks (for example, financial integrators, payment-services providers) is elevated for coops, whose unique identity depends primarily on their close relationships with their members. To fight this trend, cooperatives will have to consider alternative ways to engage their members and protect their relationship with them. For example, how can coops put in place powerful loyalty programs, leverage interactions across business lines, and develop new high-frequency services (such as financial budgeting), which might serve as platforms to increase loyalty and create additional opportunities to engage with members on the entire service offering? Should coops develop for themselves the same kind of technology-based products offered by nonbank entrants or even consider acquiring new players? Could they strike alliances with other coops to get the scale needed to be a credible alternative, for example, in the payments business? Cooperatives will have the option of either getting pulled along by this trend—which poses the risk of becoming slowly disintermediated by incumbents—or working to counter it, by shaping and further strengthening their relationships with their members.

6. [How can cooperative banks develop a common voice to better protect their interests during regulatory reform?](#)

As a result of the 2008–09 crisis, all banks are facing a stricter regulatory landscape that will affect their operations and their competitiveness. With their different ownership models, coops may face the risk of some unintended consequences from new rules on capital and should consider whether their interests are sufficiently well represented and defended. How can cooperatives ensure that new regulation will take into account the specificities of their ownership and capital-structure models, and therefore ensure that these reforms will not be detrimental to the cooperative movement? How can cooperatives raise awareness with policy makers and the general public about the particular features of their models in a way that is consistent with cooperative values? Can existing forums or associations carry that responsibility or should new ones be formed and, if so, what are the appropriate mandates and governance structures to ensure their legitimacy? The cooperative movement has too much to lose; coops must ensure that all stakeholders have a sufficient understanding of their distinctive financial and governance features.

7. [Can cooperatives exploit their unique attributes to optimize their balance sheets?](#)

Regulatory changes will make it imperative for banks to optimize their balance sheets and to strengthen their capital base. Given their nature, coops must find innovative ways to do so and take advantage of their specific attributes.

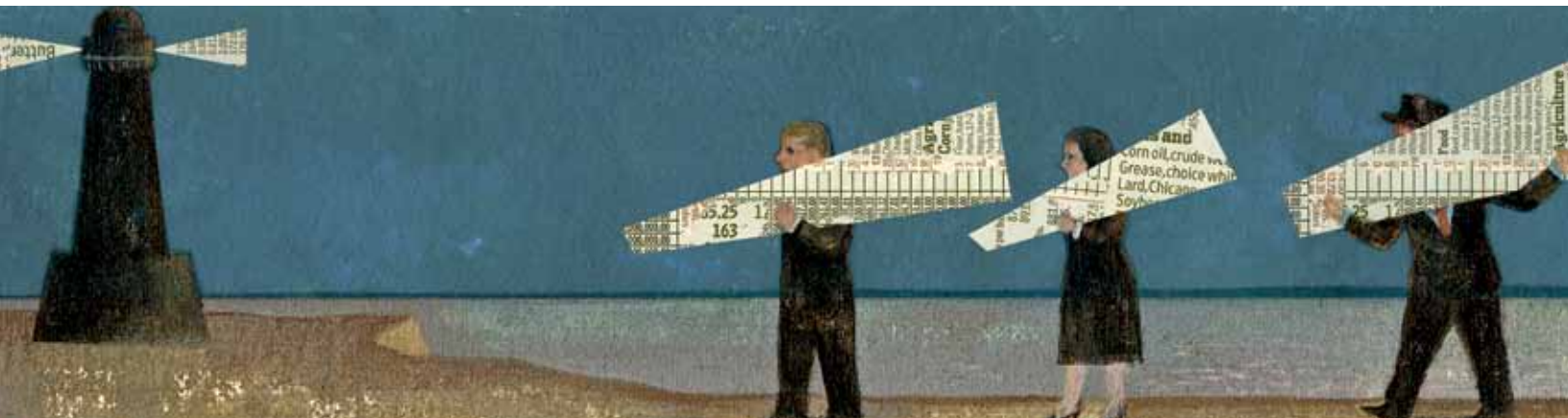
Coops are blessed with direct access to a pool of investors that can help solidify their balance sheets: their members. In a time of low interest

rates, cooperatives need to explore how they can tap into this natural pool of investors, for example, by creating “permanent shares” designed in such a way that they qualify as Tier 1 capital while providing attractive long-term returns for the members. As such, cooperatives also need to explore how they could leverage their relationships with their members to gather more deposits, for example, by creating savings products that could better compete with money-market products. Similarly, cooperatives should explore how they can use future earnings to strengthen their capital structure in the most cost-effective way; these might be distributed to members, converted into some form of permanent shares, or capitalized on the balance sheet. Finally, cooperatives

should also consider options to optimize their balance sheets by tapping into the capital markets under today’s attractive conditions (especially those with strong ratings).



The coming decade will see a radical transformation of the banking sector and will present unprecedented challenges for bank leaders. As they tackle them, cooperatives’ leaders should leverage their organizations’ unique characteristics to ensure their continued relevance for members and the continuous growth of the cooperative model in the long run. ○



Retail coops: Staying competitive in a changing world

Six global trends are reshaping the retail industry, presenting retail coops with new challenges and opportunities. Now is the time to think through the implications.

**Tarek Mansour and
Andrea Zocchi**

Retail is undergoing a rapid transformation. Consumers' shopping expectations, preferences, and behaviors are evolving—in large part due to the advent of the Internet and new mobile technologies, which are making price and product information ever more accessible. Rapidly expanding middle classes in emerging markets are driving consumption, while developed countries struggle to find growth. Intensifying competition, margin pressure, and volatility in commodity costs are challenging retailers to innovate—or risk being left behind by more flexible and agile players.

These changes present both threats and opportunities to coop retailers. To succeed in this new

retail landscape, coops will need to offer a distinctive experience to their members and customers, rethink the role of their physical-store networks, and make deliberate decisions as to whether and how to pursue growth.

The retail sector in 2020

In the coming decade, six global trends will fundamentally reshape the retail sector. These trends—many of which have already begun to upend the traditional retail business—will only intensify.

1. The “all channel” experience

Consumers no longer make purchasing decisions in the same way they did a decade ago. Today,



the Internet has become an entrenched part of daily life, and it is changing how and what people buy. In the United States, for example, online and online-influenced sales accounted for 46 percent of total retail sales in 2011, up from 22 percent in 2006.¹ This shift into the digital battleground isn't confined to a handful of product and service categories—it's almost universal (Exhibit 1).

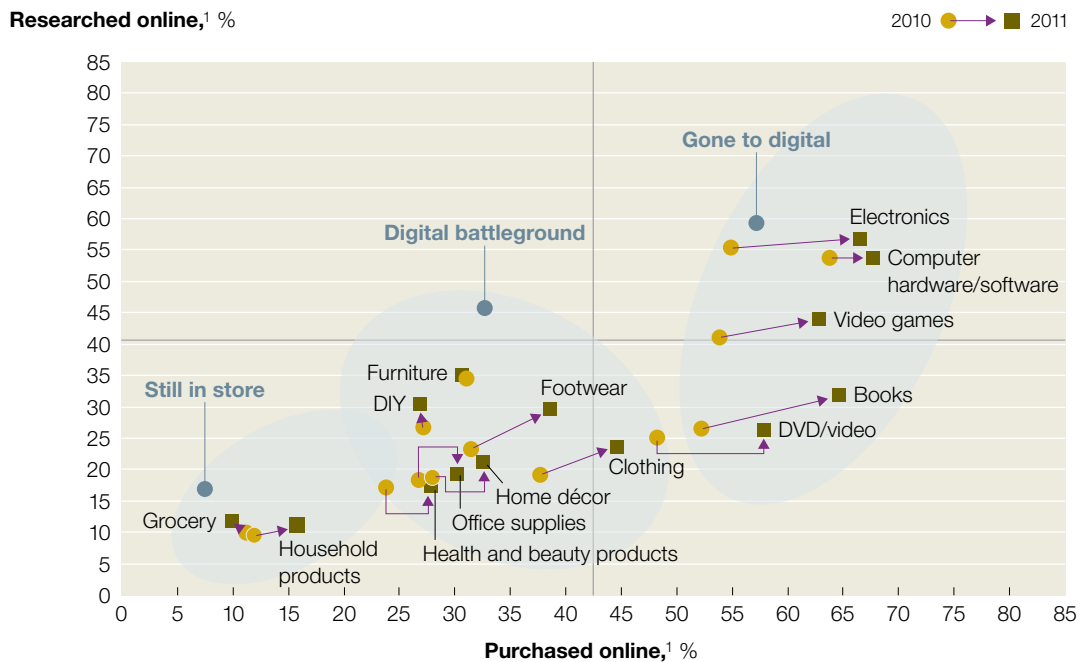
devices—simultaneously and in sequence at each stage of their purchasing journey. Winning retailers will capitalize on all of these customer touch points and ensure that these channels integrate with and complement one another. Channel boundaries will blur; retailers will seek to engage customers across all channels, not only to achieve business results but also to develop a deeper understanding of—and deeper relationships with—their customers. Consumers will come to expect a personalized, seamless all-channel experience—and the best retailers will meet this expectation.

Consumers will increasingly use multiple channels—including brick-and-mortar stores, the Internet, social media, and mobile

¹According to McKinsey analysis based on Forrester Research data.

Exhibit 1

Many product and service categories are transitioning, or have already gone, to digital.



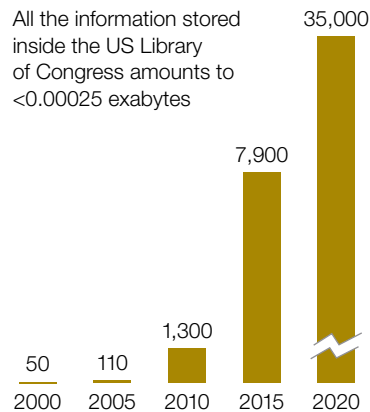
¹As a % of those who bought a product in the respective category in the prior six months. Source: iConsumer 2011

Exhibit 2

Businesses will leverage the explosive growth of available data and computational capacity.

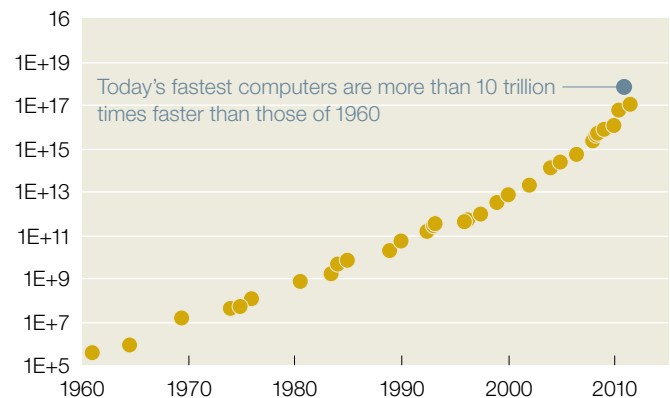
Data generated worldwide

Exabytes (= 1 billion gigabytes)



Computation capacity of the world's fastest computers

Rmax FLOPS,¹ log scale



Available data will be characterized by their scale, distribution, diversity, and timeliness

- **Scale:** data sets will be massive (>1 multipetabyte (1 million gigabytes)) and built to be easily scaled up
- **Distribution:** data will come from and be distributed both within and outside the organization
- **Diversity:** data will be semistructured, unstructured, or a combination of different types
- **Timeliness:** data will be captured and analyzed in real time, allowing for immediate response

¹Floating-point operations per second; measurement based on achievable (as opposed to theoretical) throughput.

Source: IDC digital universe study, 2011 and 2010; McKinsey Global Institute; Martin Hilbert and Priscila López, "The world's technological capacity to store, communicate, and compute information," *Science*, February 2011; vetta.org; McKinsey analysis

2. Strategies and execution driven by big data

Between 2010 and 2020, the amount of data generated worldwide is expected to increase by a factor of 30, accompanied by similarly rapid growth in computation capacity (Exhibit 2). By harnessing the power of big data—large, complex data sets too big to manage with standard database-management tools and systems—retailers will be able to make better management and planning decisions, improve operations, and more precisely tailor their products, services, prices, and marketing to various consumer segments. The demographic markers (such as age, gender, and

ethnic or linguistic group) traditionally used for customer segmentation will become less relevant, as big data enables the creation of more precise behavioral markers regarding purchasing and usage.²

Retailers have started—and will continue—to make substantive investments in data, analytical tools, and processing centers, as well as in the talent to lead data-mining efforts: data analysts, IT specialists, statisticians, and marketers will be in high demand. We estimate that by 2018 the supply of talent in sophisticated data analytics will be approx-

²For more, see "Big data: The next frontier for innovation, competition, and productivity," McKinsey Global Institute, May 2011 (mckinsey.com). Also see Jacques Bughin, John Livingston, and Sam Marwaha, "Seizing the potential of 'big data,'" mckinseyquarterly.com, October 2011.

imately 30 percent less than the demand, thus driving intense competition for these skills.³

3. Power to the people

Gone are the days when a convenient location, high in-stock rates, and adequate staffing were surefire ways for a retailer to ensure that a customer entering a store would actually buy something there. In 2012, 44 percent of respondents to our proprietary iConsumer survey reported conducting product research on their mobile device while shopping in a store.⁴ Consumers are constantly seeking and receiving a variety of signals—such as user reviews, price comparisons, and product ratings—that influence their buying decisions on the spot, thus diluting the power of the information that a retailer provides both in stores and online.

This price and product transparency makes it imperative for retailers to develop, consistently execute, and “get credit” from the consumer for truly distinctive product-price-service offers. Retailers will increasingly look to differentiate themselves through unique offerings such as private-label products, specially sourced items, and exclusive designer lines.

4. Growth in emerging markets

Many developed economies are still struggling to recover from the global economic crisis.

Discretionary spending has not returned to pre-crisis levels, and newly (perhaps permanently) price-conscious consumers are tamping down prices. Consumers have just begun a slow process of deleveraging that could drag down consumer spending and retail growth for years to come.

Growth in emerging markets, by contrast, is expected to be strong and sustained, with the burgeoning middle class driving the bulk of consumption. By 2020 the number of middle-class households in emerging markets will double to more than 300 million, and emerging markets will account for more than half of the world’s retail-revenue growth between 2010 and 2020. By 2020, more than a third of the world’s retail revenue will come from emerging markets. It remains to be seen whether leading retailers from the developed world will overcome restrictive regulation and cultural differences to succeed in emerging markets or whether homegrown mega-retailers will dominate these markets.

5. Pressure on margins and capital productivity in developed economies

Amid slow growth in developed markets and intensifying competition worldwide, retailers face tremendous margin pressure. At the same time, they will need margins to fund their battle for market share.

³US Bureau of Labor Statistics; US Census; Dun & Bradstreet; company interviews; McKinsey Global Institute analysis.

⁴For more, see our iConsumer reports on mckinsey.com.

By 2020, more than a third of the world’s retail revenue will come from emerging markets.

To remain competitive, retailers will need to increase operational efficiency through both technological and nontechnological means. New technologies (electronic shelf labels, for instance, or mobile points of sale) could lead to significant cost savings and service improvements, but continued optimization of large investments—such as smart pricing and promotions—will generate significant value.

Furthermore, a major transformation in physical retail space will be necessary to drive capital productivity. Retailers will experiment with new, more capital-efficient formats (such as smaller, denser, and leaner stores) and actively manage the size and design of their store network so that it works in tandem with digital channels and helps deliver a seamless all-channel experience.

6. Volatility in input costs

Volatility in commodity input costs will continue to challenge retailers. From 1990 to 2010, the implied annual volatility of wheat, maize, and soybeans increased from about 10 percent to more than 30 percent; in 2010 and 2011, volatility in cotton prices was the highest it has been in decades. The structural factors that drove this volatility are still relevant and show no signs of abating: rising demand from China and India coupled with tight supply conditions, an influx of money from speculators, exchange-rate volatility, and—in the case of food—climate variability. Retailers must continue to improve their corporate risk-management practices, carefully consider diversification strategies, and prepare to manage through volatility cycles.



Implications for retail cooperatives

These trends will affect all retailers regardless of ownership structure, but they have additional implications specific to coop retailers. Because of the variety of cooperative retail models (client-owned, employee-owned, and merchant-owned) and the variability of the subsectors in which they operate, there is no single strategy that coops should pursue in the face of these trends. There are, however, some common questions for senior executives of coop retailers to consider. In all cases, the answers to these questions should be formulated in the context of local legal and regulatory requirements.

1. How can coops keep their physical-store networks relevant?

The e-commerce boom has made consumers less likely to visit brick-and-mortar stores. Retailers' physical-store networks have thus become less central to the customer relationship. This shift disproportionately affects coops, which have historically relied on their stores as crucial links to the communities they serve.

Coops will have to find a way to preserve the advantage of geographic proximity, even as they



provide an acceptable multichannel experience. How can coops give customers compelling reasons to enter their stores? Options might include in-depth expertise, convenience, or new, high-quality services. Coop retailers must also consider how to leverage the local knowledge and entrepreneurial nature of store owners and store managers. If given enough flexibility, store owners or managers could introduce locally sourced products into the assortment, tailor their offerings to local tastes and preferences, and even identify the optimal store formats for their respective communities.

2. How can coops maintain an edge in customer satisfaction?

Compelled by their mission, governance, and incentives, coop retailers tend to prioritize customer service—but they should prepare to face tougher competition in that dimension. As leading retailers integrate all their channels and leverage new technologies, they will redefine the customer experience and up their game in customer service.

Cooperative retailers should arm themselves against the threat by first identifying the key

elements that members and consumers truly care about when it comes to customer service. What investments should they make to maintain their edge in customer satisfaction? And how can they make shopping in a cooperative a distinctly differentiated experience? Cooperative retailers will need to make deliberate choices—for instance, they may opt to rely mainly on technology and big data, or they may prioritize investing in the local workforce and in their physical network—while containing costs.

3. Can coops use the Internet and social media to improve member relations?

Coops have traditionally relied on their physical presence at the heart of the communities they serve to engage not only customers but also members. Given the rise of online and multichannel retailing, coops' ties with members could potentially weaken. How should cooperatives harness the power of digital channels to strengthen, rather than dilute, their proximity advantage? Can they use social media and online applications to revitalize the democratic dimension of cooperatives—for instance, by letting special committees interact via social media? Could digital

channels facilitate a broader reach and a more engaged member base?

4. How will coops grow?

Cooperatives should decide how aggressively they will pursue growth—particularly in saturated markets and, in some cases, recessionary environments. Healthy growth is essential to the cooperative business model and to continuing to fulfill the cooperative mission to their members. (For a more detailed look into coop growth, see “How cooperatives grow,” page 4.)

Will cooperatives seek growth internationally or in their home markets? What will such growth entail, and what innovations will help them capture it? In certain markets, growth may come as a result of expansion into adjacent products or services; in others, it might consist of taking share from competitors by offering better customer service.

5. Are there opportunities for alliances among noncompeting cooperatives?

Many retail cooperatives face larger, more powerful competitors that enjoy economies of scale. While coops may not wish to grow quite as big as their competitors, they could potentially access the benefits of size through alliances or joint ventures.

Similar but noncompeting retailers can consider avenues of collaboration within their current lines of business, again within the local legal and regulatory context. For example, pooling purchases could increase their bargaining power; a joint private label could be more cost-effective and create a stronger brand than a product line launched by a single coop. Alliances could also be beneficial when it comes to identifying and sharing best practices, establishing academies for employee training, educating policy makers, or entering new markets. By thinking carefully about such opportunities and ensuring that any alliances are structured and executed in a sustainable way, coop retailers can exploit synergies, promote their common agenda, and create competitive advantage.



Major structural forces are redefining the retail sector and will continue to do so over the next decade. As leaders of retail cooperatives react and adjust to these forces, they should give careful thought to how the distinct characteristics of their organizations can help them gain a competitive advantage and better fulfill their mission in the long run. ○



Five trends and their implications for agricultural coops

As markets shift, technology develops, and tastes change, the agricultural sector must adapt. Coops need to find their place in this new world.

Andrew Grant

The agricultural sector is changing as quickly as the world around it. Emerging markets are growing rapidly and have become major drivers of demand for food. Meanwhile, resource constraints are putting pressure on an already fragile supply-demand equilibrium, new technologies are emerging, and consumers in developed markets are taking a more active role in deciding what the industry produces. A more fundamental shift is redefining the industry, too, and propelling it into a new era: commodity prices, which had long been dormant, have soared over the past several years. This is generating new interest in agriculture from a wider range of stakeholders and is moving food production higher on the agenda for governments regardless of their stage of development.

To remain relevant to their members, agricultural cooperatives will need to quickly grasp and respond to these emerging trends. This article provides our perspective on five major forces shaping the future of agriculture and presents five key questions cooperatives should ask as they plan for the future.

The agriculture sector in 2020

Five major forces will shape the agriculture sector over the next decade.

1. **Feeding the planet: The productivity imperative**
Over the past ten years, food prices—which had been decreasing for several decades—began to increase. By all indications, this trend will

not abate over the coming decade, as demand continues to grow and supply tightens.

Emerging markets will exert the greatest influence on global food demand. These countries will drive 90 percent of the world's population growth, with China and India contributing 35 percent of it. As economic growth in emerging markets pulls an increasing proportion of their populations up into the middle class, per capita consumption will increase at a rate more than three times that of the developed world. These new consumers' entry into the middle class will increase demand for more resource-intensive foods, especially meat.

Meanwhile, agricultural land productivity is decreasing—a problem that will be exacerbated by resource scarcity and climate-related issues. Historically, yield improvements have been strong. But rapid land degradation, serious water deficits, and changes in climate have all contributed to a slowdown in yearly yield improvement, from 2.7 percent in the 1970s to just 1.3 percent in the 2000s. If the industry is to ease pressure on the supply-demand curve and capture the opportunities presented by higher food prices, it will have to find new ways to address the productivity imperative.

2. The rising priority: Governments' food agenda

Food is increasingly part of the government agenda, especially in emerging markets, where two major food crises in the past four years have exposed the fragility of the food supply-demand equilibrium. The factors that led to these crises—including slowing food production, increased population growth, rising oil prices, and adverse weather—are still relevant

today (exhibit). Government leaders in these markets have elevated concerns about food security to the national level, pledging to increase agricultural production and allocating a fixed percentage of their national budgets to agriculture. Already, Tanzania has committed to a target of 9 percent, Ghana to 10 percent, and Ethiopia to 13 percent. Anxious to avoid the social upheaval wrought by previous crises, emerging nations are securing additional agricultural land outside their home countries. Over the past decade, governments and corporations from emerging countries represented six of the top ten land acquirers. Their targets, often uncultivated land,¹ are in sub-Saharan Africa, East Asia, South Asia, and Latin America. Countries whose land is being acquired will likely seek to negotiate more stringent terms with land acquirers, guaranteeing right of first access to land output during leaner times. And land acquirers, for their part, may discover that their foreign-acquisition strategies do not always translate into improved food security.

In developed countries, food is on the political agenda as well, but in a different way. Westerners increasingly want not only to select the ingredients and additives they consume (further discussed below) but also to understand how their food is sourced. Consequently, governments will be asked to increase their focus on ensuring food quality, whether through regulations or supervising bodies. Corporations, in response, will defend their interests and lobby for lower regulatory costs. But companies might also find that new regulations present new opportunities. For example, food-safety requirements may lead to profitable ventures that help satisfy consumers' interest in end-to-end traceability.

¹ Charles Roxburgh et al., "Lions on the move: The progress and potential of African economies," McKinsey Global Institute, July 2010 (mckinsey.com).

3. Farming 2.0: New technologies, new markets

As in many other industries, new technologies are transforming agriculture from a labor-intensive industry to a capital-intensive one. Advanced robotics has helped automate labor-intensive tasks (such as milking cows and driving farm equipment) so that farmers are now able to monitor the technology that executes those tasks and intervene only when problems occur. Sensors and analytics are also increasingly common. Sensors capture key data (for example, nutrients in the soil or crop temperatures during storage and transportation), and dedicated software platforms process and analyze the information. Better data equips the farmer for better decision making. Moreover, these new analytical capabilities have further enabled the

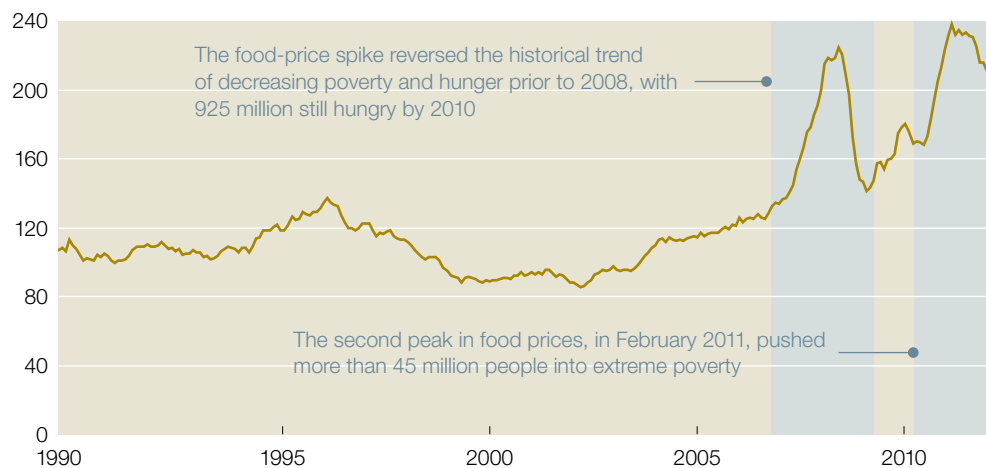
agricultural sector to adopt microsegmenting, a concept that can help farmers maximize performance. Microsegmenting breaks the land into smaller parcels for which a detailed analysis and corresponding course of action are then developed.

Farmers are also operating in a business environment that is increasingly sophisticated and globalized. High volatility in commodity prices, often triggered by a variety of factors—including weather-related events and a rise in protectionist policies—has been especially challenging. We believe not only that commodity prices will remain volatile for the foreseeable future but also that this volatility will be amplified by speculative capital as commodities trading moves from futures

Exhibit

The effects of price increases are putting agriculture higher on the government agenda.

Food-price index, 2003 = 100



Source: Food and Agriculture Organization of the United Nations food-price index; Peter Timmer, "Agriculture and pro-poor growth: An Asian perspective," Center for Global Development working paper number 63, July 2005; Ronald Trostle, US Department of Agriculture; World Bank

The image of farmers peddling their products is no longer an accurate one. Increasingly, consumers ask for specific products and expect producers to adapt.

markets into products (such as exchange-traded funds) that encourage nontraditional participation, extending even to retail investors. To minimize operational impact and stabilize financial performance, farmers will need to develop or gain access to new financial-risk-management capabilities.

4. From push to pull: The upheaval of the agriculture value chain

Until recently, producers were largely in control of what landed on consumers' plates. There was limited public information about products, food was sourced locally, and quality was important but not a primary concern. But consumers, particularly in developed nations, have an increasingly strong say about the industry's production, and producers compete for their business. Consumers now have access to a seemingly unlimited amount of information about food and they are assertive about food quality and attributes, food's value for money, and food-sourcing practices. The image of farmers peddling their products is no longer an accurate one. Increasingly, consumers ask for specific products and expect producers to adapt.

In response, stakeholders throughout the food value chain will soon need to become much more consumer savvy. They will need to learn to distinguish between passing fads and permanent changes in consumer expectations.

(Organic food may best illustrate this point; the organic and natural segment has been the epicenter of the revolt in consumer tastes. Despite all the attention, the segment remains a niche market—its market share in the United States rose just a small amount from 2006 through 2010, from 5 to 6.5 percent.) Becoming more consumer savvy also suggests the ability to quickly deploy marketing and public-relations capabilities to address consumer concerns (being able to react to food scares related to animal diseases in a timely manner, for example).

5. Big ag: Getting bigger

Farming is undergoing an important shift in ownership. In the United States, for example, by 2017 more than half the people who owned a farm in 2007 will be 65 or older, past the age when most people retire. With younger people increasingly reluctant to follow in their parents' footsteps, the farming sector will see an acceleration of consolidation, further increasing the proportion of large farms. This shift will also enable the entry of two new classes of owners. The first new class of owners will be individual strategic investors and countries (primarily those that are emerging) looking to acquire foreign land to secure their national food supply. The second class of owners will be institutional investors and investment firms lured by the potential returns to be gained from increasingly scarce agricultural land and

rising food prices. These new owners will likely have different priorities and requirements from those of traditional farmers.

Implications for agricultural coops

The variety of agricultural cooperative models and the many sectors in which they operate (including input distribution, collectors and traders, and processors) suggest that there is no simple way to present the questions that result from the trends highlighted above, but a few overall themes do emerge. In the following, we discuss five key questions that stakeholders should consider to be prepared for tomorrow's reality.

1. Can cooperatives renew and maintain their membership base in light of shifting trends in ownership?

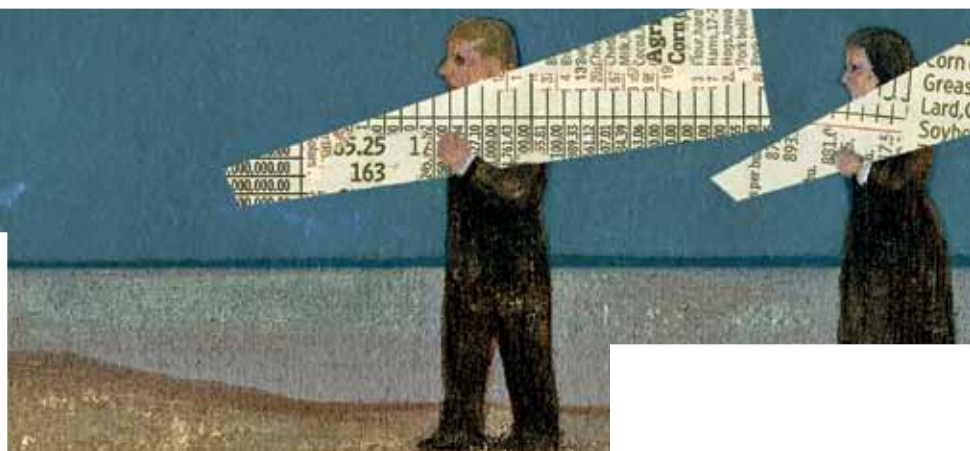
The new generation of younger farmers with different profiles and ambitions, as well as the rise of new kinds of owners such as investors and governments, pose a risk that coops must be ready to mitigate. As the interests of their members start to diverge, coops need to focus on offerings that are relevant to each of their members' segments.

Coops might begin by seeking to understand in more detail the segments to which their

members belong, as well as finding the best way to design an offering that appeals to all of them. Coops might modify their investment approach to ensure that capital investments and returns better reflect utilization and the risks taken by each member segment. They might consider eliminating cross-subsidies between their smaller and larger members to reduce the chances that larger farmers might delay decision making, as well as to ensure long-term alignment of interests and cohesion of membership. Finally, a service model that offers an alternative operating approach for farms looking to consolidate could position the cooperative effectively for the impending generational shift in ownership.

2. How can cooperatives capture the growth opportunity in emerging markets?

Agricultural cooperatives are by nature regional entities, based mainly in developed countries. Because the fastest growth appears to be elsewhere, cooperatives should consider whether they can benefit from increased links with emerging markets. Such a move might offer direct benefits to members through access to higher-value or unique markets for products, or a more diversified customer base. But to do so, cooperatives need a competitive edge that will distinguish



them from the players already operating in these markets. Which business model will work best for cooperatives—a greenfield approach, a partnership with a local or international firm, a joint venture with another cooperative, the purchase of a local distributor or processor, or a partnership with the government of a target market? In the end, coops will need to carefully evaluate the value proposition of each model against the particular needs of the chosen emerging market.

3. Which advanced capabilities could cooperatives turn into a strategic advantage?

Mastering new technologies will require new skills, as will the “financialization” of commodities trading. Coops will need new abilities in financial risk management and advanced analytics in order to serve their members and remain relevant to the full spectrum of grower needs. Cooperatives must determine how to optimally deliver value-added products and services better than traditional players, based on their unique relationships with and insights about their members. Another question concerns how best to offer these skills to their members, in ways that create value for them over the long term. Should the cooperative simply

provide these services to members, or should it help members build these skills for themselves? Can cooperatives develop a significant competitive advantage, increase member loyalty, or preempt competition by positioning themselves as a provider of these services?

4. How can cooperatives anticipate shifts in consumer tastes?

In a consumer-driven environment, agriculture’s stakeholders will need to continually monitor the market to understand changes and identify emerging trends. This will be particularly true for farmers, who require plenty of lead time to adapt. Cooperatives and their members will need to become more consumer savvy and increase their interactions with end customers.

Cooperatives should determine if they have sufficient market intelligence and analytical capabilities to anticipate shifts in customer preferences and value pools. If not, they might consider better collaborations with retailers or food processors. After that, questions arise: how can cooperatives best leverage market information to add value to members? Could cooperatives better coordinate production patterns (timing, characteristics) to ensure all

Coops will need new abilities in financial risk management and advanced analytics in order to serve their members and remain relevant to the full spectrum of grower needs.

members meet quality requirements and are maximizing the value of their production? If not, should they consider new incentives or control mechanisms such as sharing production information among members? Should coops move downstream in the value chain to get better access to new markets, customer information, or control over processing quality?

5. How can cooperatives better prepare members for regulatory change?

Food surpluses in one region can address shortages in another, but many agricultural analysts agree that a revision of tariffs and quotas is critical to boost international trade. Deregulation is not straightforward, however, and support for it varies considerably from sector to sector and country to country. For instance, certain milk-producing countries in Europe would likely oppose deregulation, which they believe would put their farmers at a disadvantage versus others.

To help their members prepare for regulatory change, cooperatives should have a clear understanding of the international regulatory landscape and how changes would impact

the competitive position of their members. They should determine if forums or lobbying efforts could help them play a more active role in shaping the regulatory agenda. They may also consider training programs to help members understand and prepare for impending regulations. Cooperatives could even go so far as to participate in the creation of standards and productivity reforms that will help position them against a new regulatory regime.



Several major structural forces will redefine the agricultural sector over the next decade. As they react and adjust, leaders of agriculture cooperatives should think about how the distinct characteristics of their organizations can help them gain a competitive advantage and better fulfill their mission in the long term. ○



How great companies think differently

A Harvard Business School professor sees parallels between the great public companies she identified in her research and the cooperative movement.

**Rosabeth Moss
Kanter**

There is a growing critique of Western capitalism as far too focused on financial transactions, putting shareholders above other stakeholders and short-term profits above creation of long-term value to society. Critics are calling for a new model of capitalism, one that retains free enterprise and the innovation that stems from it, while acknowledging the relationship of business and society.

My recent research identified a group of companies I called “supercorps” for their ability to combine innovation, profits, growth, and social good. They are publicly traded—listed in their headquarters countries and beyond—but they flourish by emphasizing both financial and social considerations, as well as by seeking long-term sustainability as institutions that contribute to the well-being of multiple stakeholders. Their cultures could be the wave of the future.

Among global companies, the supercorps represent a tiny, if growing, fraction, and they are maneuvering against the tide. But there is another set of enterprises that shares many values with these vanguard companies and has proved its viability over the long term. In the cooperative



movement, values-based, stakeholder-sensitive activity is the norm, not the exception. There are even cooperative ventures of large scale and scope that I can call “super coops.”

Super coops are organized to serve the needs of stakeholders as members. Membership is a metaphor sometimes used by supercorps, but for cooperatives, this is a structural requirement and an entitlement. Coops cannot forget their core purpose of service, and this includes a desire to improve the lives of members and the communities in which they operate. Moreover, members have a voice: a role in decision making and in selecting those who represent them in strategic and managerial roles.

Cooperatives think differently, and they share or exceed the standards for good companies that I sought in my research. Any enterprise seeking long-term sustainability would do well to learn from both the supercorps and the super coops that stress purpose, values, principles, partnerships, and member voice. This abridged version of an article I published in the *Harvard Business Review* discusses what I call the “institutional logic” that supercorps follow. Although the examples I cite are of public companies, this same institutional logic applies to the management of super coops.



It’s time that beliefs and theories about business catch up with the way great companies operate. Traditionally, economists and financiers have argued that the sole purpose of business is to make money—the more the better. That conveniently narrow image, deeply embedded in the American capitalist system, molds the actions of most corporations, constraining them to focus on maximizing short-term profits and delivering returns to shareholders. Their decisions are expressed in financial terms.

I say convenient because this lopsided logic forces companies to blank out the fact that their enormous resources influence the world for better or worse, and their strategies shape the lives of the employees, partners, and consumers on whom they depend. Great companies, on the other hand, believe that business is an intrinsic part of society, much like family, government, and

religion. Great companies work to make money, of course, but in their choices of how to do so, they think about building enduring institutions. They invest in the future while being aware of the need to build people and society.

In this article, I turn the spotlight on the social or institutional logic that lies behind the practices of many widely admired, high-performing, and enduring companies. My continuing field research on admired and financially successful companies¹ in more than 20 countries on four continents is the basis for my thinking about the role of institutional logic in business. Institutional logic holds that, beyond generating money, companies are vehicles for providing meaningful livelihoods for their employees and meeting other societal needs. According to this school of thought, the value that a company creates should be measured not just in terms of short-

¹ Rosabeth Moss Kanter, *SuperCorp: How Vanguard Companies Create Innovation, Profits, Growth, and Social Good*, New York: Crown Business, 2009.

term profits but also in its ability to sustain itself and endure.

Great companies believe that corporations meet stakeholders' needs in many ways: by producing goods and services that improve the lives of users; by providing jobs and enhancing workers' quality of life; by developing a strong network of suppliers and business partners; and by ensuring sufficient financial viability to generate improvements, innovations, and investor returns.

In developing an institutional perspective, corporate leaders internalize what economists have usually regarded as externalities and define a firm around its purpose and values. Whereas the aim of financial logic is to maximize the returns on capital, be it shareholder or owner value, the thrust of institutional logic is to balance public interest with financial returns.

Institutional logic should be aligned with economic logic but need not be subordinate to it. For example, all companies require profit to furnish capital for business activities. However, at great companies, profit is not seen as the sole end; rather, it is a way of ensuring that returns will continue. If companies are to serve a purpose beyond their business portfolios, CEOs must expand their investments to include employee empowerment, emotional engagement, values-based leadership, and related societal contributions. That means that well-established practices, such as R&D and marketing, cannot be tied solely to profits in the short or long run, even if analysts applaud such behavior.

An intensely competitive global economy places a high premium on innovation, which depends on human imagination, motivation, and collaboration. Global mergers and acquisitions add

further complexity, since success rests on effectively integrating the organizations. Moreover, aligning corporate objectives with social values has become a business imperative, since corporations that cross borders must gain approval from governmental authorities, opinion leaders, and members of the public wherever they operate. Their employees are both internal actors and the company's representatives in the external community.

Only if leaders think of themselves as builders of social institutions can they master these challenges. For that reason I believe that institutional logic should take its place alongside economic or financial logic as a guiding principle in research, analysis, education, policy, and managerial decision making. In the following pages, I describe six ways in which great companies use institutional logic, the advantage that confers, and the impact on leadership and corporate behavior.

A common purpose

Conceiving of the firm as a social institution provides corporations with a coherent identity that serves as a buffer against uncertainty. As companies grow, acquire, and divest, culture, roles, and processes change along with the business mix. Companies need a coherent identity to stay anchored amid this type of growth and change. Purpose and values—not the widgets made—are the core of an organization's identity, and they can guide people in their efforts to find new widgets that serve society.

Consider the Mahindra Group, an \$11 billion multi-business company based in Mumbai that employs 117,000 people in 100 countries. Like many emerging-market enterprises, the Mahindra Group operates in many industries,

Great companies identify something larger than transactions or business portfolios to provide purpose and meaning.

including automobiles, finance, IT, and several dozen others. And like the great companies, it invests in creating a culture based on a common purpose to provide coherence amid diversity, proclaiming that it is “many companies united by a common purpose—to enable people to rise.”

Leaders can compensate for business uncertainty through institutional grounding. Great companies identify something larger than transactions or business portfolios to provide purpose and meaning. Meaning making is a central function of leaders, and purpose gives coherence to the organization. Institutional grounding involves efforts to build and reinforce organizational culture, but it is more than that. Culture is often a by-product of past actions, a passively generated outgrowth of history. Institutional grounding is an investment in activities and relationships that may not immediately create a direct road to business results but that reflect the values the institution stands for and how it will endure.

Institutional grounding can separate the survivors from those subsumed by global change. A sense of purpose infuses meaning into an organization, “institutionalizing” the company as a fixture in society and providing continuity between the past and the future. The name can change, but the identity and purpose will live on. In 2007, Spain’s Grupo Santander acquired Brazil’s Banco Real and folded it into its Brazilian assets. But Banco Real’s spirit involved much

more than its financial assets. Its then-CEO Fabio Barbosa was put in charge of creating the combined entity, Santander Brazil. Although the new organization faced pressure to increase branch profitability, under Barbosa’s leadership Banco Real’s focus on social and environmental responsibility, along with its private-banking model, were infused throughout Santander Brazil and the parent.

A long-term focus

Companies using institutional logic are often willing to invest in the human side of the organization—investments that cannot be justified by immediate financial returns but that are integral to long-term sustainability. After the Asian financial crisis of the late 1990s, for instance, the South Korean Shinhan Bank set out to acquire the larger but troubled Chohung Bank. The moment the acquisition was announced, 3,500 Chohung union members shaved their heads and piled the hair in front of Shinhan’s headquarters in protest. That put the acquisition in question. To salvage it, Shinhan’s leaders applied institutional logic. They negotiated an agreement with the Chohung union to defer formal integration for three years. They also gave Chohung equal representation on a new management committee and raised Chohung salaries in line with Shinhan’s. In addition, they provided 3,500 caps to cover the heads of the protestors. Shinhan then invested heavily in what it called “emotional integration,” holding a series



of retreats and conferences to foster unity and share strategic and operational information. Within 18 months, Shinhan grew both banks' customer bases and employees were working together on joint task forces and implementing ideas that made branches look more similar. Those moves also stanchied the Chohung union's efforts to foment discontent. By the time the acquisition closed, Shinhan was outperforming the banking industry and the South Korean stock market. Had leaders viewed the transaction purely in financial terms, those early investments might have been seen as a waste of money, but because they applied a broader, institutional logic, they not only rescued the deal but created a flourishing organization.

Emotional engagement

Emotions play a major role in shaping corporate performance and organizational behavior. Moods are contagious, and they can affect such issues as absenteeism, health, and productivity. Likewise, people influence one another, and in doing so can increase or decrease others' performance levels. Well-understood principles can be a source of emotional appeal, which can increase

employee engagement. A statement of values is not sufficient. Companies must articulate those values and apply them in practice day-to-day. The CEOs of companies I studied, for instance, whether headquartered in the United States, Mexico, the United Kingdom, India, or Japan, all allocated considerable resources engaging managers from the top of the organization down in the institutional task of communicating values. The aim was to keep the social purpose at the forefront of the corporate dialogue and ensure employees used those values to guide business decisions.

For example, long an adherent of Procter & Gamble's "Purpose, Values, and Principles" mission statement, Robert McDonald ratcheted up that commitment upon becoming CEO. Within a month of taking the helm, he turned the company's purpose—improving the lives of the world's consumers—into a major business strategy: improving more lives in more places more completely.

In West Africa, for instance, every P&G employee has a quantitatively measurable purpose-driven



goal: how many more lives have I touched this year? In response, P&G West Africa's Baby Care Group set up Pampers mobile clinics to reduce high rates of infant mortality and help babies thrive. A physician and two nurses travel the region in a van, teaching postnatal care, examining babies, and referring mothers to hospitals for follow-ups or immunization shots. They also register mothers for mVillage, a text-message service that offers health tips and the chance to ask health care professionals questions. At the end of each mobile-clinic visit, visitors receive two Pampers diapers. The initiative has proved a great success. P&G employees feel a strong emotional attachment to their work. They are inspired to see how their work saves lives and are proud to know their efforts have placed West Africa among P&G's fastest-growing markets.

Great companies that see themselves as social institutions ensure that work is emotionally compelling and that meaning resides in the organization as a whole. Although top leaders communicate the company's purpose and values, everyone owns them and the values

become embedded in tasks, goals, and performance standards.

Partnering with the public

Expansion into new markets must be accompanied by public-private partnerships that incorporate societal and business interests. To thrive in diverse geographies and political jurisdictions, companies must build relationships with government officials and public intermediaries as well as local suppliers and customers. External stakeholders want to see a company contribute more to the community than just financial benefits. At the same time, great companies want enduring relationships and a seat at the table on policy matters affecting their business. Forging partnerships ensures agendas stay aligned even as circumstances—and public officials—change.

Innovation

Corporate claims of serving society gain credibility when leaders allocate time, talent, and resources to national or community projects without seeking immediate returns. As important, those projects provide knowledge that can lead to innovation back home. At Cemex, for instance, a desire to address local community issues produced innovations such as antibacterial concrete, which is particularly important for hospitals and farms; water-resistant concrete, useful in flood-prone areas; and road surface material derived from old tires, desirable in countries that are building roads rapidly.

Institutional logic can also produce business-model innovation by connecting partners across an ecosystem. For instance, in response to competition from Home Depot and Lowe's, which were then entering Latin America, in 2001 Cemex started Construrama, a distribution program for small hardware stores. Construrama

offers the small stores training, support, a strong brand, and easy access to products. In accordance with its values, Cemex sought dealers who were trusted in their communities, rejecting candidates whose business tactics didn't meet the company's ethics standards. Cemex owns the Construrama brand and handles promotions but doesn't charge distributors, operate stores, or have decision-making authority. It requires, however, that stores meet its service standards. Among those is participation in community-building philanthropic endeavors—expanding an orphanage or improving a school, for instance. By the mid-2000s, Construrama had opened enough stores to qualify as a large retail chain in Latin America and was expanding into other developing countries.

Self-organization

Great companies assume they can trust people and rely on relationships, not just rules and structures. They are more likely to treat employees as self-determining professionals who coordinate and integrate activities by self-organizing and generating new ideas, not as paycheck-hungry shirkers who want to do the bare minimum, nor as robots that can be ordered to produce high performance. Instead, employees make their own choices about which ideas to surface, how much effort to put into them, and where they might contribute beyond their day jobs. Resource

allocation is thus determined not only by formal strategies and budgetary processes but also by the informal relationships, spontaneous actions, and preferences of people at all levels.

Informal, self-organizing, shape-changing, and temporary networks are more flexible and can facilitate faster connections between people and resources. At Shinhan Bank, the two banks self-integrated through social bonds and relationships well in advance of the three-year mark when official integration was to take place. The new connections manifested in such actions as each bank's voluntarily hanging the other's banner in its headquarters. Likewise, had it not been for self-forming networks, IBM might have lagged behind or even missed out on two big business ideas: virtualization and green computing. These emerged among IBM's top strategic priorities in July 2006 after an Innovation Jam, a Web chat spanning several days, to which over 140,000 employees contributed ideas.

Great companies recognize that formal roles act as a home base from which employees can branch out to perform tasks, develop work relationships, and participate in team activities. Matrix organizations—in which individuals report to two or more bosses depending on the project—become what I dub a matrix on steroids when people

Informal, self-organizing, shape-changing, and temporary networks are more flexible and can facilitate faster connections between people and resources.

are accountable along many dimensions simultaneously, attending to multiple projects and using their networks to assemble needed resources, often without going through a decision-making hierarchy. For example, on any given day about 40 percent of IBMers in the United States work at home or at customer sites, moving among locations and taking vacations at times of their choosing.

Institutional logic assumes that people can be trusted to care about the fate of the whole enterprise and to catalyze improvements without sticking to the letter of a job description. They recognize that job descriptions, performance reviews, and salary bands capture only some of the activities through which people add value to an organization.



The six principles I describe in this article demonstrate that great companies sustain high performance by fostering cohesion between corporate and social values and by providing employees with the ability to define their work in a way that is meaningful and in line with the organization's long-term objectives. Although institutions concerned with serving society often come under more scrutiny, great global enterprises are not waiting for the critics to come around. They are already hard at work applying institutional logic to grow their enterprises. In so doing they are showing that while institutional logic cannot be captured by cost-benefit equations or reduced to the language of economics, it is nonetheless a powerful driver of financial performance. ○

Rosabeth Moss Kanter (@RosabethKanter on Twitter) holds the Ernest L. Arbuckle Professorship at Harvard Business School, where she specializes in strategy, innovation, and leadership for change. The full article on which this adaptation is based won a 2011 McKinsey Award, an annual honor that McKinsey and *Harvard Business Review* award to the best articles that appeared in the magazine that year.

Adapted and reprinted with permission from "How great companies think differently," by Rosabeth Moss Kanter, *Harvard Business Review*, November 2011. Copyright © 2011. All rights reserved.



Another way to do business:

An interview with the president and CEO of Desjardins Group

Monique F. Leroux talks about the role cooperatives play in democratizing business and giving individuals and communities a means for shaping their future.

**Vincent Bérubé and
Eric Lamarre**

Desjardins Group is Canada's largest financial cooperative and the sixth largest in the world, with close to 200 billion Canadian dollars in assets. But the cooperative had humble beginnings: it was founded in 1900 to fill the gaps in a financial system that mostly served the wealthy (see "Pioneering a new banking model," page 64). Despite Desjardins' growth, the cooperative remains committed to its founding ideal, with a range of programs aimed at improving economic empowerment. To the casual observer who may have grown accustomed to taking a more cynical view of banking in the aftermath of the global financial crisis, that sense of purpose can seem a departure from the norm. McKinsey's Vincent Bérubé and Eric Lamarre

sat down with the president and CEO of Desjardins, Monique F. Leroux, to talk about the role the cooperative model plays in today's business environment.

McKinsey on Cooperatives: *You see historic parallels between the social and economic conditions that gave rise to Desjardins in 1900 and events unfolding today. Why?*

Monique F. Leroux: I think both periods featured populations who felt disenfranchised, shut out of the dominant financial paradigm, unable to understand the financial issues, and struggling to find a job or to grow their business.



For instance, just as class divides at the start of the 20th century kept many people largely excluded from the banking system, today income inequality and a growing concentration of wealth and power in the hands of a few have given rise to the perception that the interests of a minority of powerful stakeholders outweigh the majority. Back in 1900, the working class had little in the way of savings, making credit difficult to obtain. We have a similar result today, although the present situation, perversely, was caused by too much free-flowing credit and profit-driven attitudes that prioritized growth at any cost.

The irony is that today, despite advances that have made banking widely accessible, many individuals feel more detached than ever from the financial world. Complex financial instruments and pervasive market conditions can be hard enough for seasoned bankers to understand, much less the average person. The combination of events that led to the financial crisis can feel very far removed from the day-to-day life of ordinary people. Yet the results of the crisis, which have included increased government debt, credit worries, and high unemployment, are felt heavily and some believe unevenly by the middle and working classes. The result is that even though people are more sophisticated and educated than they were 100 years ago, the problems we face are similar.

In the same way that the Industrial Revolution was a major transformation for people, changes occurring today—such as technology and enhanced connectivity—mean a major new transformation to which people must adapt. Perhaps we are moving into a new era. The cooperative and mutual model could once again be a good way to help people find solutions

together to their common problems and realize their aspirations.

McKinsey on Cooperatives: *Are cooperatives an answer to the sense of disenfranchisement you describe?*

Monique F. Leroux: Yes, I think so. If we look back then, as well as to now, we see people who felt and feel voiceless and without a mechanism to understand and influence some of the economic changes they need. Cooperatives tend to rise and flourish in periods of unmet needs, specifically the need to have a voice. They give individuals a means to be active and engaged in learning about the economy and in shaping their own financial outcomes by getting involved instead of waiting for governments or others to solve their problems.

The cooperative model, with its member-ownership structure and community-based orientation, requires individual and community engagement to function. That democratizes the process. If you've ever been to one of our general meetings, you'll see this in action. We have more than 6,000 elected officers, each one with a voice in how Desjardins is run. At the end of the day, you have to rally the voice of the community, achieve consensus, and act. That can be challenging, but the ideology is inherently democratic, not only in granting people a say in the process and supporting majority rule but in fostering outcomes that benefit the group as a whole. The coop and mutual model is also based on people values; this brings a certain level of emotion and loyalty toward the organization.

I find this appealing because it really does conform to the democratic ideal of working together

for the common good. I think that is what is responsible in part for the strength and longevity of the cooperative model.

McKinsey on Cooperatives: *Given all that, is it reasonable to think that cooperatives should strive for a bigger role in the global economy and set themselves up as a complement to the current business model?*

Monique F. Leroux: Absolutely. I'm convinced they should. Far be it from me to claim that the cooperative model is the only way to do business, but it truly is a complementary model in a pluralistic economy and one that in my opinion should have better visibility in people's education about business, governmental, and economic matters.

The reason I think cooperatives serve as an effective complement is that the model intrinsically brings people together. They get involved in a collective business to meet the needs of their community. Take a struggling business, for instance. The typical commercial model sometimes has little incentive to keep the business going. It's draining resources and adding risk. Therefore, the vested interests running the business, who may be far removed geographically, may opt to shut it down. By contrast, member-owned cooperatives with deep roots in the community are often much slower to pull the trigger. Elected officers, managers, and employees—who are also members of the cooperative—will analyze the situation differently. The very fact that they have “skin in the game” makes them say, “We have no choice but to fix this. Let's get to work and figure it out.” This is one example; the cooperative model provides many similar opportunities.

I think culturally there is a shift under way in response to the economic upheaval of the past few years. Ordinary people want and need change but lack confidence in those in positions of influence, so they are more inclined to take the initiative and collaborate in a grassroots way to create the financial outcomes they need. In this way, I think there may be a kind of connectivity revolution going on, and I see the cooperative model fitting into it as a way of helping individuals and communities make that transition, to adapt to change.

McKinsey on Cooperatives: *In addition to helping individuals feel more directly connected to the decisions that affect their livelihood, are you suggesting that the cooperative model offers a more natural response to some of the biggest unmet needs today?*

Monique F. Leroux: Yes. The problem is that culturally, we often see social needs as separate from—and sometimes in opposition to—economic needs. The cooperative model can help to connect the two.

In many countries, the public sector and government agencies have delivered a range of services over the years that may now have become too costly to sustain given the state of public finances worldwide. As a result, governments may need to start offloading services that affect health, education, or social policies. The private sector doesn't seem the right fit, since these services require social outcomes that extend beyond traditional financial returns. Cooperatives, by contrast, do fit.

As a result, I think we'll see cooperatives supporting a range of services—such as health care, retirement housing, and education—in the years

to come. There may be workers' cooperatives forming around businesses that are in trouble, for instance, and health care cooperatives that perform services that governments can no longer afford to pay.

McKinsey on Cooperatives: *So, in your view, the cooperative model could see a boom because there are holes in the economy?*

Monique F. Leroux: Absolutely. I think coops sit somewhere between the public and the private sector. They are often more efficient in delivering

services than the public sector because they are member owned and close to people, and their members have a financial motive to be efficient. They usually have a longer-term outlook than the private sector because their fate does not hinge as much on stock-market sentiment and quarterly returns. While the global reach of many corporations allows them to do many things that smaller, member-based cooperatives cannot, corporations can sometimes seem removed—at the extreme, one might characterize them as dark pools of finance without a face. Of course, I'm exaggerating for effect, but I like the local

Monique F. Leroux, CM, FCPA, FCA



Vital statistics

Born August 11, 1954, in Montréal, Canada

Married, with 1 child

Education

Conservatoire de musique du Québec à Montréal, diplôme d'études supérieures, 1975

Université du Québec à Chicoutimi, bachelor's in business administration, 1978

Career highlights

Desjardins Group
2001–present

Chair of the board, president, and CEO, 2008–present

Chief financial officer, 2004–08

President and CEO of Desjardins Financial Corporation, 2001–04

RBC Royal Bank
Senior vice president, Québec division

Ernst & Young
Managing partner

Fast facts

President of the Order of Chartered Accountants of Québec, member of the board of directors and governor of the Canadian Institute of Chartered Accountants, 1993–94

Fellow of the Order of Chartered Accountants of Québec and the Québec CMA Order

Member of the Order of Canada

Chevalier (Knight) of the Legion of Honor

President of Conseil québécois de la coopération et de la mutualité

Member of the United Nations International Year of Cooperatives Advisory Group

Member of the board and executive committee of the European Association of Co-operative Banks

Vice president and member of the board of directors of the International Confederation of Popular Banks

Member of the Global Agenda Council, World Economic Forum

Given Woodrow Wilson Award for Corporate Citizenship

Involved in community work and numerous nonprofit organizations

aspect that cooperatives bring. Ultimately, what I like about the principle of the pluralistic economy is that if you have just one model, you get lazy. Having three models—the public sector, the private sector, and coops—keeps the world a little more honest.

I think community ties also make it easier for cooperatives to support responsible development. Because members tend to live in the communities where they do business, they are less likely to engage in massive development projects that could damage the community or drain its natural resources. There's a self-interested component that can help support sustainability. Cooperatives are and have been active in many business sectors, proving that the model can work.

McKinsey on Cooperatives: *But is that community aspect also limiting in some ways? How do you build consensus and make decisions when you have to listen to and negotiate with thousands of members?*

Monique F. Leroux: It takes a lot of time and communication. It is part of the cooperative educational and democratic process. Sometimes it is difficult to obtain a consensus. It's definitely one of the challenges in our model. In a publicly owned company, the goals are more defined: the primary objective is to generate return to shareholders. That financial rationale can clarify and speed decision making. In a cooperative, however, financial considerations are important, but they are not the only factor. We have to

Pioneering a new banking model

Desjardins Group has a history dating back 112 years, to a time when the economy of Eastern Canada and Québec was outgrowing its solidly agricultural roots. At that time, the flood of immigrants that arrived to homestead and farm Eastern Canada created something of a population problem, leading many to move out across Québec, into urban environments such as Montréal, and down into the New England region of the United States. The fresh start they sought was complicated by a banking system that proved largely off limits and catered mainly to the wealthy classes. This left small businesses, farmers, poorer people, and the emerging middle class with few places to store savings and fewer options to secure credit.

Determined to give working-class French Canadians a shot at economic empowerment, Alphonse Desjardins—a journalist and stenographer for the Ottawa House of Commons—founded the first *caisse populaire*, a cooperative, member-owned, savings-and-loan bank intended to offer basic financial services. He also created the first credit union in the United States and has been recognized as the founder of the North American credit-union movement.

We may not hit the highest highs as some in the private sector, but we tend to avoid the lowest lows.

navigate through a range of issues. The onus is on us to manage these points of view and mobilize people around a common vision. It really requires us to demonstrate leadership, conviction, and a solid commitment to long-term goals.

McKinsey on Cooperatives: *To return to three ideas you mentioned earlier, cooperatives can serve as a model for restructuring companies that are in trouble, a model for developing resources that we want to keep collective, and a model for offloading services from the public sector. Success in any one of those requires the cooperative model to redeploy in nontraditional areas. Given the inertia that can result from too much debate and so on, how do you align your membership to innovate?*

Monique F. Leroux: That's true and that is a challenge. There is a natural conservatism that comes from large numbers. That brings pros and cons. We may be slower to mobilize. It takes more effort to convince people to act. But once a decision is made, our model strongly mobilizes its people through change. In addition, better ideas emerge from a larger group of people with different points of view. Our investment horizon is also longer, and our community- and consensus-based model has the effect of balancing risk taking. When it comes to investing in new areas, for instance, we tend to bet on people or groups that we know. We also work with organizations that share the same values. That may make us more cautious, but it allows us to

build a more stable portfolio. We may not hit the highest highs as some in the private sector, but we tend to avoid the lowest lows.

Cooperatives are often particularly well positioned to leverage their understanding of local issues to identify and tap unmet needs. For example, Capital Régional et Coopératif Desjardins is an innovative retail-based fund that supports specific local and regional needs, whether it's providing a backstop to a business that is poised to close or venture capital to help other ones get started. In contrast to the type of blue-sky innovation that characterizes some private-sector pursuits, we provide a ground-level perspective that allows us to fill different niches when it comes to innovation.

McKinsey on Cooperatives: *What strengths should cooperatives look to in positioning themselves for growth?*

Monique F. Leroux: The relationships that cooperatives have forged in their communities is perhaps our greatest strength. Leveraging that will give us a strategic edge as we lay the groundwork to drive innovation. The second factor that stands in our favor is our long-term perspective. I don't believe in growth at all costs. Growth must be balanced, thought through, and lasting. I believe much more in a stable and evolving model than in a model aiming for lightning growth and creating a lot of volatility, both up and down. We do not have to worry about share prices or a hostile takeover,

members and leaders. A solid pool of talent, as well as strong leadership, is essential to the long-term success of cooperatives.

I would like to see the cooperative model be much better known among young people and to see its foundations being taught in school alongside other business models. But more importantly, I would like the youth to learn about the cooperative model and its values, because in the end, cooperation is about self-empowerment and working with others to resolve problems and have a positive impact on society.

McKinsey on Cooperatives: *You came up with the idea of organizing an international summit for cooperatives. What were the reasons to do so?*

Monique F. Leroux: The first reason was that the cooperative model, its performance, and its social and economic impact need to be better known and recognized by decision makers. Second, cooperatives need better data and knowledge to develop and grow. In that sense, the research developed in the context of the summit is a great start. ○





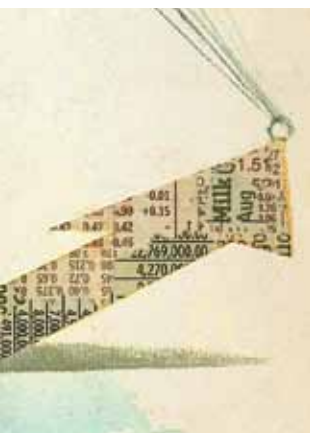
Capitalism for the long term

In this article from the *Harvard Business Review*, the global managing director of McKinsey & Company called for public companies to make changes that share some similarities with ways coops operate.

Dominic Barton

In 2011, I wrote an article (reprinted below) that argued for a series of reforms to the capitalist system. I proposed that public companies should shift the way they think about business' value and its role in society. Executives should alter their focus from the short to the long term. Companies should serve all stakeholders, not just shareholders, in order to maximize long-term value. And corporate boards should behave much more like owners. These behaviors are often found in the cooperative business model—the subject of this publication. I hope that public companies are inspired by the lessons from cooperatives and other organizations to transform the way that the capitalist system is organized.





The near meltdown of the financial system and the ensuing Great Recession have been, and will remain, the defining issue for the current generation of executives. Now that the worst seems to be behind us, it's tempting to feel deep relief—and a strong desire to return to the comfort of business as usual. But that is simply not an option. In the past three years we've already seen a dramatic acceleration in the shifting balance of power between the developed West and the emerging East, a rise in populist politics and social stresses in a number of countries, and significant strains on global governance systems. As the fallout from the crisis continues, we're likely to see increased geopolitical rivalries, new international security challenges, and rising tensions from trade, migration, and resource competition. For business leaders, however, the most consequential outcome of the crisis is the challenge to capitalism itself.

That challenge did not just arise in the wake of the Great Recession. Recall that trust in business hit historically low levels more than a decade ago. But the crisis and the surge in public antagonism it unleashed have exacerbated the friction between business and society. On top of anxiety about persistent problems such as rising income inequality, we now confront understandable anger over high unemployment, spiraling budget deficits, and a host of other issues. Governments feel pressure to reach ever deeper inside businesses to exert control and prevent another system-shattering event.

My goal here is not to offer yet another assessment of the actions policy makers have taken or will take as they try to help restart global growth. The audience I want to engage is my fellow business leaders. After all, much of what went awry before and after the crisis stemmed from failures of

governance, decision making, and leadership within companies. These are failures we can and should address ourselves.

In an ongoing effort that started 18 months ago, I've met with more than 400 business and government leaders across the globe. Those conversations have reinforced my strong sense that, despite a certain amount of frustration on each side, the two groups share the belief that capitalism has been and can continue to be the greatest engine of prosperity ever devised—and that we will need it to be at the top of its job-creating, wealth-generating game in the years to come. At the same time, there is growing concern that if the fundamental issues revealed in the crisis remain unaddressed and the system fails again, the social contract between the capitalist system and the citizenry may truly rupture, with unpredictable but severely damaging results.

Most important, the dialogue has clarified for me the nature of the deep reform that I believe business must lead—nothing less than a shift from what I call quarterly capitalism to what might be referred to as long-term capitalism. (For a rough definition of “long term,” think of the time required to invest in and build a profitable new business, which McKinsey research suggests is at least five to seven years.) This shift is not just about persistently thinking and acting with a next-generation view—although that's a key part of it. It's about rewiring the fundamental ways we govern, manage, and lead corporations. It's also about changing how we view business's value and its role in society.

There are three essential elements of the shift. First, business and finance must jettison their short-term orientation and revamp incen-

tives and structures in order to focus their organizations on the long term. Second, executives must infuse their organizations with the perspective that serving the interests of all major stakeholders—employees, suppliers, customers, creditors, communities, the environment—is not at odds with the goal of maximizing corporate value; on the contrary, it’s essential to achieving that goal. Third, public companies must cure the ills stemming from dispersed and disengaged ownership by bolstering boards’ ability to govern like owners.

None of these ideas, or the specific proposals that follow, are new. What is new is the urgency of the challenge. Business leaders today face a choice: we can reform capitalism, or we can let capitalism be reformed for us, through political measures and the pressure of an angry public. The good news is that the reforms will not only increase trust in the system, they will also strengthen the system itself. They will unleash the innovation needed to tackle the world’s grand challenges, pave the way for a new era of shared prosperity, and restore public faith in business.

Fight the tyranny of short-termism

As a Canadian who for 25 years has counseled business, public-sector, and nonprofit leaders across the globe (I’ve lived in Toronto, Sydney,

Seoul, Shanghai, and now London), I’ve had a privileged glimpse into different societies’ values and how leaders in various cultures think. In my view, the most striking difference between East and West is the time frame leaders consider when making major decisions. Asians typically think in terms of at least 10 to 15 years. For example, in my discussions with the South Korean president Lee Myung-bak shortly after his election in 2008, he asked us to help come up with a 60-year view of his country’s future (though we settled for producing a study called *National Vision 2020*.) In the United States and Europe, nearsightedness is the norm. I believe that having a long-term perspective is the competitive advantage of many Asian economies and businesses today.

Myopia plagues Western institutions in every sector. In business, the mania over quarterly earnings consumes extraordinary amounts of senior-executive time and attention. Average CEO tenure has dropped from ten to six years since 1995, even as the complexity and scale of firms have grown. In politics, democracies lurch from election to election, with candidates proffering dubious short-term panaceas while letting long-term woes in areas such as economic competitiveness, health, and education fester. Even philanthropy often exhibits a fetish for the short term and the new, with grantees expected to become self-sustaining in just a few years.

Business leaders today face a choice: we can reform capitalism, or we can let capitalism be reformed for us.

Lost in the frenzy is the notion that long-term thinking is essential for long-term success. Consider Toyota, whose journey to world-class manufacturing excellence was years in the making. Throughout the 1950s and 1960s it endured low to nonexistent sales in the United States—and it even stopped exporting altogether for one bleak four-year period—before finally emerging in the following decades as a global leader. Think of Hyundai, which experienced quality problems in the late 1990s but made a comeback by reengineering its cars for long-term value—a strategy exemplified by its unprecedented introduction, in 1999, of a ten-year car warranty. That radical move, viewed by some observers as a formula for disaster, helped Hyundai quadruple US sales in three years and paved the way for its surprising entry into the luxury market.

To be sure, long-term perspectives can be found in the West as well. For example, in 1985, in the face of fierce Japanese competition, Intel famously decided to abandon its core business, memory chips, and focus on the then-emerging business of microprocessors. This “wrenching” decision was “nearly inconceivable” at the time, says Andy Grove, who was then the company’s president. Yet by making it, Intel emerged in a few years on top of a new multibillion-dollar industry. Apple represents another case in point. The iPod, released in 2001, sold just 400,000 units in its first year, during which Apple’s share price fell by roughly 25 percent. But the board took the long view. By late 2009 the company had sold 220 million iPods—and revolutionized the music business.

It’s fair to say, however, that such stories are countercultural. In the 1970s the average holding period for US equities was about seven years;

now it’s more like seven months. According to a recent paper by Andrew Haldane, of the Bank of England, such churning has made markets far more volatile and produced yawning gaps between corporations’ market price and their actual value. Then there are the “hyperspeed” traders (some of whom hold stocks for only a few seconds), who now account for 70 percent of all US equities trading, by one estimate. In response to these trends, executives must do a better job of filtering input and should give more weight to the views of investors with a longer-term, buy-and-hold orientation.

If they don’t, short-term capital will beget short-term management through a natural chain of incentives and influence. If CEOs miss their quarterly earnings targets, some big investors agitate for their removal. As a result, CEOs and their top teams work overtime to meet those targets. The unintended upshot is that they manage for only a small portion of their firm’s value. When McKinsey’s finance experts deconstruct the value expectations embedded in share prices, we typically find that 70 to 90 percent of a company’s value is related to cash flows expected three or more years out. If the vast majority of most firms’ value depends on results more than three years from now, but management is preoccupied with what’s reportable three months from now, then capitalism has a problem.

Some rightly resist playing this game. Unilever, Coca-Cola, and Ford, to name just a few, have stopped issuing earnings guidance altogether. Google never did. IBM has created five-year road maps to encourage investors to focus more on whether it will reach its long-term earnings targets than on whether it exceeds or misses this quarter’s target by a few pennies. “I can easily make my numbers by cutting SG&A¹ or R&D, but

¹ Sales, general, and administration.

then we wouldn't get the innovations we need," IBM's former CEO, Sam Palmisano, told us. Mark Wiseman, executive vice president at the Canada Pension Plan Investment Board, advocates investing "for the next quarter century," not the next quarter. And Warren Buffett has quipped that his ideal holding period is "forever." Still, these remain admirable exceptions.

To break free of the tyranny of short-termism, we must start with those who provide capital. Taken together, pension funds, insurance companies, mutual funds, and sovereign-wealth funds hold \$65 trillion, or roughly 35 percent of the world's financial assets. If these players focus too much attention on the short term, capitalism as a whole will, too.

In theory they shouldn't, because the beneficiaries of these funds have an obvious interest in long-term value creation. But although today's standard practices arose from the desire to have a defensible, measurable approach to portfolio management, they have ended up encouraging shortsightedness. Fund trustees, often advised by investment consultants, assess their money managers' performance relative to benchmark indexes and offer only short-term contracts. Those managers' compensation is linked to the amount of assets they manage, which typically rises when short-term performance is strong. Not surprisingly, then, money managers focus on such performance—and pass this emphasis along to the companies in which they invest. And so it goes, on down the line.

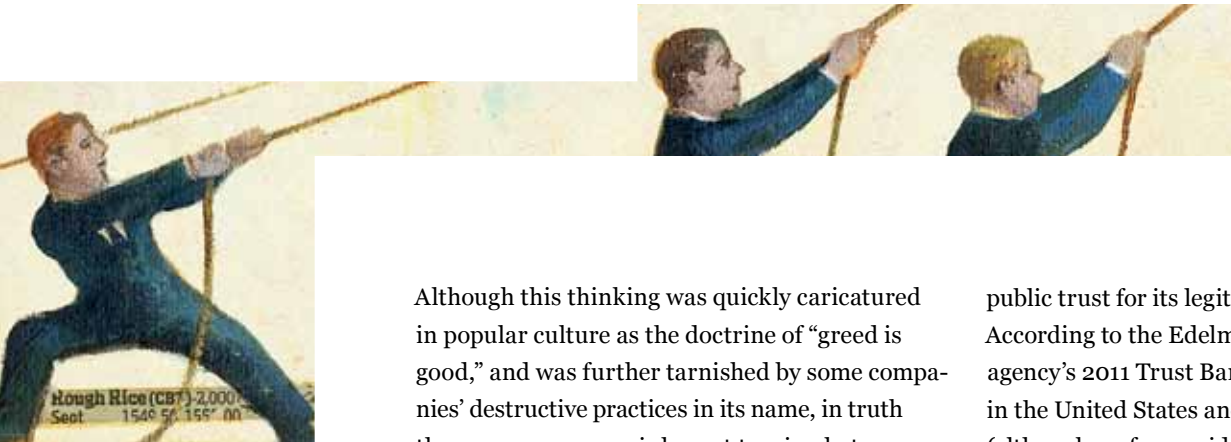
As the stewardship advocate Simon Wong points out, under the current system pension funds deem an asset manager who returns 10 percent to have underperformed if the relevant benchmark index rises by 12 percent. Would it be unthinkable

for institutional investors instead to live with absolute gains on the (perfectly healthy) order of 10 percent—especially if they like the approach that delivered those gains—and review performance every three or five years, instead of dropping the 10 percenter? Might these big funds set targets for the number of holdings and rates of turnover, at least within the "fundamental investing" portion of their portfolios, and more aggressively monitor those targets? More radically, might they end the practice of holding thousands of stocks and achieve the benefits of diversification with fewer than a hundred—thereby increasing their capacity to effectively engage with the businesses they own and improve long-term performance? Finally, could institutional investors beef up their internal skills and staff to better execute such an agenda? These are the kinds of questions we need to address if we want to align capital's interests more closely with capitalism's.

Serve stakeholders, enrich shareholders

The second imperative for renewing capitalism is disseminating the idea that serving stakeholders is essential to maximizing corporate value. Too often these aims are presented as being in tension: you're either a champion of shareholder value or you're a fan of the stakeholders. This is a false choice.

The inspiration for shareholder-value maximization, an idea that took hold in the 1970s and 1980s, was reasonable: without some overarching financial goal with which to guide and gauge a firm's performance, critics feared, managers could divert corporate resources to serve their own interests rather than the owners'. In fact, in the absence of concrete targets, management might become an exercise in politics and stakeholder engagement an excuse for inefficiency.



Although this thinking was quickly caricatured in popular culture as the doctrine of “greed is good,” and was further tarnished by some companies’ destructive practices in its name, in truth there was never any inherent tension between creating value and serving the interests of employees, suppliers, customers, creditors, and communities, and proponents of value maximization have always insisted that it is long-term value that has to be maximized.

Capitalism’s founding philosopher voiced an even bolder aspiration. “All the members of human society stand in need of each others assistance, and are likewise exposed to mutual injuries,” Adam Smith wrote in his 1759 work, *The Theory of Moral Sentiments*. “The wise and virtuous man,” he added, “is at all times willing that his own private interest should be sacrificed to the public interest,” should circumstances so demand.

Smith’s insight into the profound interdependence between business and society, and how that interdependence relates to long-term value creation, still reverberates. In 2008 and again in 2010, McKinsey surveyed nearly 2,000 executives and investors; more than 75 percent said that environmental, social, and governance initiatives create corporate value in the long term. Companies that bring a real stakeholder perspective into corporate strategy can generate tangible value even sooner.

Creating direct business value, however, is not the only or even the strongest argument for taking a societal perspective. Capitalism depends on

public trust for its legitimacy and its very survival. According to the Edelman public-relations agency’s 2011 Trust Barometer, trust in business in the United States and the United Kingdom (although up from midcrisis record lows) is only in the vicinity of 45 percent. This stands in stark contrast to developing countries: for example, the figure is 61 percent in China, 70 percent in India, and 81 percent in Brazil. The picture is equally bleak for individual corporations in the Anglo-American world, “which saw their trust rankings drop again last year to near-crisis lows,” says Richard Edelman.

How can business leaders restore the public’s trust? Many Western executives find that nothing in their careers has prepared them for this new challenge. Lee Scott, Wal-Mart Stores’ former CEO, has been refreshingly candid about arriving in the top job with a serious blind spot. He was plenty busy minding the store, he says, and had little feel for the need to engage as a statesman with groups that expected something more from the world’s largest company. Fortunately, Scott was a fast learner, and Wal-Mart has become a leader in environmental and health care issues.

Tomorrow’s CEOs will have to be, in Joseph Nye’s apt phrase, “tri-sector athletes”: able and experienced in business, government, and the social sector. But the pervading mind-set gets in the way of building those leadership and management muscles. “Analysts and investors are focused on the short term,” one executive told me recently. “They believe social initiatives

don't create value in the near term." In other words, although a large majority of executives believe that social initiatives create value in the long term, they don't act on this belief, out of fear that financial markets might frown. Getting capital more aligned with capitalism should help businesses enrich shareholders by better serving stakeholders.

Act like you own the place

As the financial sector's troubles vividly exposed, when ownership is broadly fragmented, no one acts like he's in charge. Boards, as they currently operate, don't begin to serve as a sufficient proxy. *All the Devils Are Here*, by Bethany McLean and Joe Nocera, describes how little awareness Merrill Lynch's board had of the firm's soaring exposure to subprime mortgage instruments until it was too late. "I actually don't think risk management failed," Larry Fink, the CEO of the investment firm BlackRock, said during a 2009 debate about the future of capitalism, sponsored by the *Financial Times*. "I think corporate governance failed, because . . . the boards didn't ask the right questions."

What McKinsey has learned from studying successful family-owned companies suggests a way forward: the most effective ownership structure tends to combine some exposure in the public markets (for the discipline and capital access that exposure helps provide) with a significant, committed, long-term owner. Most large public companies, however, have extremely dispersed ownership, and boards rarely perform the single-owner-proxy role. As a result, CEOs too often listen to the investors (and members of the media) who make the most noise. Unfortunately, those parties tend to be the most nearsighted ones. And so the tyranny of the short term is reinforced.

The answer is to renew corporate governance by rooting it in committed owners and by giving those owners effective mechanisms with which to influence management. We call this *ownership-based governance*, and it requires three things.

More-effective boards. In the absence of a dominant shareholder (and many times when there is one), the board must represent a firm's owners and serve as the agent of long-term value creation. Even among family firms, the executives of the top-performing companies wield their influence through the board. But only 43 percent of the nonexecutive directors of public companies believe they significantly influence strategy. For this to change, board members must devote much more time to their roles. A government-commissioned review of the governance of British banks last year recommended an enormous increase in the time required of nonexecutive directors of banks—from the current average, between 12 and 20 days annually, to between 30 and 36 days annually. What's especially needed is an increase in the informal time board members spend with investors and executives. The non-executive board directors of companies owned by private-equity firms spend 54 days a year, on average, attending to the company's business, and 70 percent of that time consists of informal meetings and conversations. Four to five days a month obviously give a board member much greater understanding and impact than the three days a quarter (of which two may be spent in transit) devoted by the typical board member of a public company.

Boards also need much more relevant experience. Industry knowledge—which four of five non-executive directors of big companies lack—helps boards identify immediate opportunities and reduce risk. Contextual knowledge about the



development path of an industry—for example, whether the industry is facing consolidation, disruption from new technologies, or increased regulation—is highly valuable, too. Such insight is often obtained from experience with other industries that have undergone a similar evolution.

In addition, boards need more-effective committee structures—obtainable through, for example, the establishment of a strategy committee or of dedicated committees for large business units. Directors also need the resources to allow them to form independent views on strategy, risk, and performance (perhaps by having a small analytical staff that reports only to them). This agenda implies a certain professionalization of nonexecutive directorships and a more meaningful strategic partnership between boards and top management. It may not please some executive teams accustomed to boards they can easily “manage.” But given the failures of governance to date, it is a necessary change.

More-sensible CEO pay. An important task of governance is setting executive compensation. Although 70 percent of board directors say that pay should be tied more closely to performance, CEO pay is too often structured to reward a leader simply for having made it to the top, not for what he or she does once there. Meanwhile, polls show that the disconnect between pay and performance is contributing to the decline in public esteem for business.

CEOs and other executives should be paid to act like owners. Once upon a time we thought that stock options would achieve this result, but stock-option-based compensation schemes have largely provided incentives for the wrong

behavior. When short-dated, options lead to a focus on meeting quarterly earnings estimates; even when long-dated (those that vest after three years or more), they can reward managers for simply surfing industry- or economy-wide trends (although reviewing performance against an appropriate peer index can help minimize free rides). Moreover, few compensation schemes carry consequences for failure—something that became clear during the financial crisis, when many of the leaders of failed institutions retired as wealthy people.

There will never be a one-size-fits-all solution to this complex issue, but companies should push for change in three key areas:

- They should link compensation to the fundamental drivers of long-term value, such as innovation and efficiency, not just to share price.
- They should extend the time frame for executive evaluations—for example, using rolling three-year performance evaluations, or requiring five-year plans and tracking performance relative to plan. This would, of course, require an effective board that is engaged in strategy formation.
- They should create real downside risk for executives, perhaps by requiring them to put some skin in the game. Some experts we’ve surveyed have privately suggested mandating that new executives invest a year’s salary in the company.

Redefined shareholder ‘democracy.’ The huge increase in equity churn in recent decades has spawned an anomaly of governance: at any annual meeting, a large number of those voting may soon no longer be shareholders. The



advent of high-frequency trading will only worsen this trend. High churn rates, short holding periods, and vote-buying practices may mean the demise of the “one share, one vote” principle of governance, at least in some circumstances. Indeed, many large, top-performing companies, such as Google, have never adhered to it. Maybe it’s time for new rules that would give greater weight to long-term owners, like the rule in some French companies that gives two votes to shares held longer than a year. Or maybe it would make sense to assign voting rights based on the average turnover of an investor’s portfolio. If we want capitalism to focus on the long term, updating our notions of shareholder democracy in such ways will soon seem less like heresy and more like common sense.



While I remain convinced that capitalism is the economic system best suited to advancing the human condition, I’m equally persuaded that it must be renewed, both to deal with the stresses and volatility ahead and to restore business’s standing as a force for good, worthy of the public’s trust. The deficiencies of the quarterly capitalism of the past

few decades were not deficiencies in capitalism itself—just in that particular variant. By rebuilding capitalism for the long term, we can make it stronger, more resilient, more equitable, and better able to deliver the sustainable growth the world needs. The three imperatives outlined above can be a start along this path and, I hope, a way to launch the conversation; others will have their own ideas to add.

The kind of deep-seated, systemic changes I’m calling for can be achieved only if boards, business executives, and investors around the world take responsibility for bettering the system they lead. Such changes will not be easy; they are bound to encounter resistance, and business leaders today have more than enough to do just to keep their companies running well. We must make the effort regardless. If capitalism emerges from the crisis vibrant and renewed, future generations will thank us. But if we merely paper over the cracks and return to our pre-crisis views, we will not want to read what the historians of the future will write. The time to reflect—and to act—is now. ◯

Dominic Barton (Dominic_Barton@McKinsey.com) is McKinsey’s global managing director and is based in the London office.

Adapted and reprinted with permission from “Capitalism for the long term,” by Dominic Barton, *Harvard Business Review*, March 2011. Copyright © 2011. All rights reserved.

