

## **The Development of the Legislation on Co-operative Banks in Finland** (for the workshop on legislation on co-operative banking)

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### **Abstract:**

Co-operative banks in Finland held in 2009 over one-third of market share in retail loans and deposits. They are structured in two groups, of which the especially the larger, OP-Pohjola Group (that consists of over 200 banks and alone commands around one-third of the market share), is marked with a substantial degree of integration and produces the full range of banking services in-house. These banks have travelled a long distance from their humble origins as Raiffeisen-type village banks as they were initially formed in the early 20<sup>th</sup> Century.

One aspect of their development that has attracted little notice in academic research has been the role of development of the legislation. The co-operative banks and their central organizations should not be viewed as passive by-standers that adapted to the legislation, but rather as active participants who influenced the legislative process. Thus the legislation of co-operative banks has been influenced both by the internal organizational developments and general changes in public policy towards banks. Due to their significant degree of federation even from their very inception, internal ordering mechanisms have been especially important in the regulation of Finnish co-operative banks. Over time, there have been significant changes in the respective roles of public law and private ordering mechanisms of the group.

The aim of this paper is to briefly review the most important developments within the Finnish co-operative banks and their regulations. In future research, it would be interesting to compare these developments to financial co-operative systems elsewhere.

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## **1. Introduction**

Finnish co-operative banks have developed from the humble beginnings as Raiffeisen-style village banks into fully-blown banking institution that, as a group, is the largest banking group in the Finnish retail market. The legislative process has often lagged significantly behind this process. In the more recent years, the most important piece of legislation concerning Finnish co-operative banks has been the European-wide legislation that has in turn been influenced by the Basel processes.

This paper is a mainly a descriptive exercise outlining the development of Finnish co-operative banks in three different stages. For each stage, I explain the most important internal developments in Finnish co-operative banks, the influence of legislation, and of external environment. It is clear that the relationship between the legislative process and development of co-operative banks goes both ways: not only have co-operative banks been influenced by the legislative developments, but also legislation has followed internal developments of co-operative banks. This is also due to the fact that the representatives of co-operative organizations have been involved in drafting the legislation. One interesting issue requiring further research is what are the benefits and costs of having the industry representatives involved in the legislative process. I'll return to that in the discussion.

Another important issue is to understand to what degree external regulation (public law) and internal regulation of co-operative network (private ordering mechanism) are substitutes or complements. In Finland the co-operative network organizations have played an immensely important role from the very inception of credit co-operatives. In times when legislation has been deficient, the governance of co-operatives have relied heavily on internal governance mechanisms.

The presentation here draws heavily on other sources, especially the centenary history of the OP-group by Kuusterä (2002). I have not included footnotes in the text below for the simple reason that the references would become too numerous. Concerning the development on legislation, I utilize Rousi (1979), in addition to the original legislation.

## **2. The early stage of Finnish financial co-operatives (1902 – 1945)**

One peculiarity of Finnish co-operative development was that it was very much a top down – phenomenon. Even though there was some experimentation with consumer co-operatives since the 1880s, co-operative development started in Finland in large scale only after 1899 when the first co-operative law was enacted. The legislation was promoted by a small number of influential citizens, first and foremost by Hannes Gebhard, who was a Professor of the University of Helsinki. Gebhard became familiar with co-operatives in his study tours in Germany and was interested in improving the living conditions of the rural population. In 1899 Gebhard became the first president of the Pellervo Society, which was established to promote the cause of co-operatives.

Rural credit co-operatives were especially close to Gebhard's heart. In 1902 he was instrumental in establishing the OKO, which was to become the central bank for credit co-operatives. Gebhard also became the first president of OKO. For technical reasons OKO was not initially registered as a bank but rather as an ordinary joint-stock

company; this was because state involvement in banks was not allowed at the time. It should also be noted that it was formed as a joint-stock company, initially owned by wealthy individuals who were supportive to the cause of co-operatives. Later on the shares were bought by member co-operatives.

Gebhard was influenced primarily by the Raiffeisen model of financial co-operatives. This was evident in the model rules he drafted for financial co-operatives and which were distributed by the Pellervo Society. These model rules from 1902 directed co-operatives to work in ways that were compatible with the Raiffeisen principles of credit co-operatives (for the Raiffeisen model of financial co-operatives, see Prinz 2002)<sup>1</sup>:

- 1) Credit co-operatives were established in order to benefit the farmers;
- 2) The members should share a common bond by their place of living; initially credit co-operatives were mostly village-based and typically had less than 100 members;
- 3) The members have a joint and unlimited liability of the debts of the co-operative;
- 4) Volunteer work was important and the elected officers were unpaid; the credit co-operatives paid a small compensation to the treasurer, who worked part-time for the co-operative;
- 5) Subsidiary role of profits; profits were allocated to build up the equity capital of the co-operative.
- 6) Democratic self-governance of co-operative by the members;
- 7) Focus on poor borrowers and their liberation from usury;
- 8) All borrowers and depositors were members; only individuals could be members.

The instrument to pursue these policies was OKO, which distributed low-cost agricultural loans originally issued by the state.<sup>2</sup> The first credit co-operatives were formed only after the formation of OKO and were closely supervised by OKO. While practically all credit co-operatives were established in order to access the low-cost agricultural credit, OKO could easily ensure compliance by threatening to terminate access if the rules were not followed. This also explains why for a long time the only relevant public law for credit co-operatives was the co-operative law from 1901. The model rules from 1902 were not publicly enforced legislation but instead private ordering mechanism within the network, backed by OKO's role as a funding intermediary.

The period between 1902 – 1920 was the early stage of the co-operative development, when the focus was in the establishment of co-operatives. The 1910s were a relatively quiet period in the co-operative development, partly due to the adverse external developments, such as intensification of the Russian rule in Finland, the First World War, the tragic and bloody Civil War in Finland 1918, and the general turmoil following the Russian revolution and Finnish independence.

Instead, the 1920s turned out to be a successful decade for the Finnish credit co-operatives. Their number more than doubled from 602 in 1920 to 1416 in 1930; this last

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<sup>1</sup> I use the term 'credit co-operative' to describe the proto-banking type of Finnish financial co-operatives. The equivalent Finnish term is *osuuskassa*, where 'kassa' is the same word as the French *caisse* or German *Kasse*; however, no equivalent English term exists. After the financial co-operatives were given the full banking license in the banking legislation from 1970, Finnish financial co-operatives have been called *osuuspankki*, or co-operative bank.

<sup>2</sup> Finland belong to the Russian empire from 1809 until 1917, but had a considerable autonomy. Thus the "state" refers here to the Finnish government, rather than to the imperial government.

figure has been the all time record for Finnish financial co-operatives. Membership increased even more rapidly, from 31 000 in 1920 to 144 000 in 1930. At the same time when new co-operative banks were established, many existing ones grew significantly. By the end of 1920s, the network of co-operative banks covered almost the entire country.

There were also important legislative and organizational developments. In 1920, credit co-operatives were entitled the right to receive deposits also from non-members. This also prompted public supervision of banks, though the supervision authority were delegated to OKO, which had already before supervised co-operatives. However, now OKO had a public mandate for supervision, whereas previously the supervision was based on the fact that OKO was the primarily lender to credit co-operatives. The division between member and non-member customers within co-operative banks also comes from this period.

An important organizational development within the network of credit co-operatives happened when the Central Association for Credit Co-operatives (in Finnish *Osuuskassojen keskusliitto*, or OKL) was established in 1928. OKL took into its responsibilities the supervision of credit co-operatives, collection of statistics on the movement, advisory services, promotion of new co-operatives, and external relations, whereas OKO focused more on its operations as central bank for the group. A guarantee fund, to which the co-operatives had to make mandatory contributions, was established in 1932. Credit co-operatives were granted the right to open checking accounts in 1932.

In the 1920s-1930s also witnessed a drift from the original Raiffeisenian principles, at least for the larger credit co-operatives. From the late 1920s on it became possible for companies to become members (though without voting rights), which made possible to extend loans to companies. The broadening of operations and the impact of the world-wide economic depression in the 1930s caused mergers among the co-operatives, and they started to serve larger territories. The death of Gebhard (who was a staunch defender of the original Raiffeisen vision of credit co-operatives) in 1933 also contributed to the surrender of Raiffesenian policies. In 1938 the market share of credit co-operatives in loans was 11%, against 30% of savings banks and 45% of commercial banks (the rest being divided between mortgage banks and the national bank). However, commercial banks were not active in rural markets, so the main competitors for credit co-operatives were the savings banks.

### **3. From credit co-operatives to co-operative banks in a highly regulated environment (1945-1985)**

In the late 1930s credit co-operatives had an established position in the Finnish financial markets, although they were at the time clearly smaller compared to savings banks and commercial banks. The tragic war with Soviet Union produced unexpected side effects that strengthened the market position of credit co-operatives. Finland had to cede significant territory from Eastern Finland to Soviet Union. This meant that 450 000 people had to be relocated (around 12% of total Finnish population). In addition to that, during the war the government had promised that landless crofters could purchase land in favourable terms. The government gave loans to immigrants and crofters after the war, and most of these loans were handled through credit co-operatives. As a consequence of

this programme, the market share of credit co-operatives of loans increased from 10% in 1944 to 25% in 1948 (though decreasing to 20% by 1954); at the same time, the number of members grew from 164 000 in 1944 to 223 000 in 1949, after which the growth slowed down. Even though the influence of the land purchase programme was partly a temporary boost, it elevated co-operative bank to a level where they became significant competitors to savings and commercial banks.

The postwar-period until the mid-1980s was a period of heavy regulation for the Finnish banking sector. Both the loan and deposit rates were regulated by the Bank of Finland. The access to capital markets was restricted, which allowed the central bank to control for the money supply. There was a constant shortage of loanable funds, and the role of price competition was eliminated. The main way to compete was by setting up new branches.

The operations of credit co-operatives came ever closer to commercial or savings banks. Volunteerism in management was replaced by professionalism at the latest during the 1950s, though for larger credit co-operatives this development had started already during the 1930s. The co-operatives had regular opening hours and own premises. In addition to the deposit services, credit co-operatives engaged with payment services and holding securities.

The new development was also reflected in the legislative development. The Co-operative Law was renewed in 1954, and it obliged the credit co-operatives to revise their rules according to the instruction given by the Ministry of Finance. However, the requirements of the Ministry were not included to the Law on Co-operatives, but to the new model rules for credit co-operatives by OKL from 1955. They included provisions e.g. on guarantees for loans, liquidity management of co-operatives, and increased required capitalization. The rights of OKL to conduct supervision were increased. Interestingly, these requirements were done through the private ordering mechanism of the network and not through the public law. The model rules were ultimately subject to OKL's approval, not to the Ministry of Finance. This indicates a strong trust on the behalf of the government to the private ordering mechanism of the co-operative network. On the other hand, in the highly regulated financial environment government had also excellent means of sanctioning, if the co-operative network had chosen to ignore the instructions given by the government.

The increased demands on credit co-operatives with respect to opening hours, liquidity, capitalization and complexity of organizations caused mergers between co-operatives. The number of credit co-operatives had been steadily following since the peak of 1930 (1416 co-ops) to 1079 in 1940, 684 in 1950, and 537 in 1960. The decline was especially rapid in the war year and the years immediately after the war, partly reflecting the fact that the credit co-operatives in the seceded territory (where credit co-operatives were especially strong) were liquidated. At the same time membership kept increasing, despite of the demographic changed caused by the war: in 1940 the number of members in the network was 156 000, in 1950 230 000, and in 1960 302 000.

In the highly regulated environment banking crises were a rare occurrence, but the co-operative network experienced a severe one in the second half of the 1960s. This was related by the lending by OKO to small and medium-sized enterprises in the metal industry. The lending was organized through the association of SMEs in the metal industry, called Mekes. The heavy commitments OKO had towards lending to Mekes

violated the prudential standards of bank lending and explicit instructions by the national central bank. To the top of it, the amount of bad loans among the Mekes loans was extraordinarily high. The loans could have bankrupted OKO and severely damaged the entire credit co-operative network. The situation was not entirely due to mismanagement on the part of OKO, but there was also political pressure from the highest quarters to give these loans. The situation was solved by central bank intervention, change of management, and bond issue to finance the losses. The Mekes crisis was the most severe crisis the Finnish financial co-operatives have experienced so far, and it was a useful reminder of the fact that the worst crisis in financial co-operative networks often start from the center, rather than from the field.

While credit co-operatives started to function increasingly like banks, regulation through the co-operative law and by private by-laws became increasingly problematic. OKL strived already from late 1950s on to change the legal status into banks and it made a proposal on the change of banking laws in 1960. To implement this change took almost ten years, because in early 1960s there started a general revision of banking laws and a committee was set up for this task in 1961. The law eventually came into effect only in 1970. Among the most important features of this legislation was that unlimited liability was replaced by limited liability, the required ratio of equity capital of liabilities was set to 2% (whereas for commercial banks it was 4% and for saving banks also 2%), and there were requirements concerning the loan insurance fund of the network. The supervision of co-operative banks continued to be delegated to the group internally, and the group reported to the national bank. Co-operative banks received practically the same banking rights as commercial and savings banks.

The economic structure transformed rapidly during the 1960s and the 1970s from agriculture to industry and services. This caused a movement from the rural areas to towns. From the perspective of co-operative banks, this was a problem because the movement had profiled itself as 'rural banks'. In Finland there never was a urban co-operative banks of the 'popular bank' (*Volksbanken, banques populaires*) – type, probably because of the strong position of savings banks also in the urban areas. The co-operative banks took a strategy to become the banks of 'ordinary people', and not any longer be confined to a particular social group. On the whole this transformation was successful. The market share of loans and deposits increased from around 20% in 1970 to the vicinity of 25% in 1980.

#### **4. From credit market liberalization to crisis and beyond (1985-2010)**

The system where the central bank regulated interest rates became increasingly obsolete in the 1980s. The banks developed financial innovations that enabled them to circumvent the interest rate regulations, especially in commercial lending. The harmonization of European financial markets, ongoing liberalization in other countries, and technological innovation all put pressure to liberalize the financial markets. During the late 1980s interest rate regulation was stopped, central bank launched its open market operations, and borrowing from foreign markets was liberalized. The liberalization of financial markets led to huge increases in the supply of loans, both to enterprises and individuals.

Unfortunately, the regulation of the financial market did not keep pace with the developments in the sector. The need to update the requirements for minimum capital,

risk taking and liquidity was widely recognized and committee work to modernize the legislation was started in 1982. Again, the work to update the legislation took several years, and the new legislation came into effect in the beginning of 1991. In the legislation the scope of banks' operations was broadened, but the requirements for equity capital were tightened and there were new regulations concerning the risk positions the banks could take.

However, these measures came both too late and were probably insufficient even during the time of the enacting of the law (Halme, 1996). The huge increase in lending generated an economic bubble in the late 1980s, which was reflected in rapid increases in corporate stock prices, as well as housing prices. The bubble burst in 1991, when Finland entered into a severe depression, where the GDP dropped by 14% in two years and unemployment increased to 20%. This was accompanied with a banking crisis, which culminated when the national central bank took over the central bank for savings banks (SKOP). Savings banks, and especially SKOP, was in the forefront of lending expansion and investment into corporate stock. In September 1991 SKOP became insolvent and was taken over by the central bank. Many local savings banks became insolvent in the crisis as well and most of the local savings banks were forced to be taken over by largest commercial banks and co-operative banks in 1993.

Co-operative banks fared better during the crisis than many of their competitors, possibly because of their lower exposure in the stock and real estate market and due to the more conservative policies of their central bank (OKO). However, many of the large co-operative banks took significant risk. At the time OKO did not have sufficient means to discipline individual banks that had in the new situation gained independence in their fund raising. The co-operative banking network as a whole got out of the crisis without state subsidies, but some of the largest co-operative banks had to be bailed out by the group. This was especially the case with the co-operative bank in Helsinki, which actually had to be liquidated and reopened.<sup>3</sup>

The overall performance of co-operative banks during years of boom and bust was such that it gained foothold compared to its competitors. The market share in lending increased from 25% in 1985 to almost 30% in 1992. The liquidation of most savings banks in 1993 increased the market share to 34% in 1993. The increased capital requirements had already prompted bank mergers and the number of co-operative banks dropped from 372 in 1980 to 310 in 1992.

However, even though co-operative banks survived in the crisis comparatively well, there were clear needs to reform the relationship between the central organizations and local banks. The bank supervision within the group lacked means to discipline deviating banks, and this was one point to which a change was wanted. A carrot for co-operative banks in tighter federation was the possibility that the capital requirements, established by the Basel processes, could be counted at consolidated level, provided that certain conditions in the group structure would be met. The developments within the savings banks had shown that the supervision of banking groups had to be tightened. The model of delegated monitoring, where the national banking supervisor is monitoring the group and the group monitors the member banks, was to be continued, although the

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<sup>3</sup> This has led to the somewhat ironic situation that the OP-bank in Helsinki, which is the largest and in many ways the flagship bank for the group, is not a co-operative, but a joint-stock company owned by the group.

representatives of national banking supervisor would have favoured a system where there would have been only one national co-operative bank, thus obviating the need to have two-tiered supervision. However, this structure was not acceptable to local banks. A compromise solution was a model where the position of the center and its possibilities to intervene were enhanced, and where the joint liability of banks toward each other was strengthened. The two-tiered central organization, where there was the central bank (OKO) and central group organization was maintained, but the latter was renamed from OKL to *Osuuspankkikeskus* (OPK). OPK now became the central co-ordinating organization within the co-operative banking group with authority to give directions to local banks, even though the latter remained as judicially independent entities are retained independent authority in most decisions. The new group structure was introduced in 1997 and it was codified into the law in 2001. A significant part of this most recent co-operative law is actually devoted to the group structure.

The move into the tighter federation was a controversial one, as it meant a reduction of the authority of banks, and the increased cross-insurance might lead into transfers from prudently managed banks to reckless banks. This latter interpretation was particularly relevant in the aftermath of the banking crisis. Although most critical banks ended up accepting the new group structure, 44 co-operative banks did not and they formed their own co-operative banking group, *Paikallisosuuspankkiryhmä* or “Local Co-operative Banks”, or the POP-group.<sup>4</sup> The main co-operative banking group has been called OP-group (where OP stands for *osuuspankki*, or co-operative bank). It is also noteworthy that the POP group is actually not a group in the sense of the co-operative banking law, but rather a fairly loose affiliation of co-operative banks (in the terminology of Cuevas and Fischer 2006, a consensual network).

Among the most recent relevant developments within the co-operative banking sector has been the purchase of Pohjola insurance company by OKO in 2005. OKO, which was listed in 1989 but has remained majority owned by co-operative banks, financed the operations by issuing new shares. This operation made the OP Group one of the largest player in the Finnish insurance market as well. The purchase also led into some changes in the group structure. OKO was renamed as Pohjola Bank in 2008, and the group is now called OP-Pohjola Group.

In economic terms, both of the co-operative banking groups have been doing very well. In 2009, the OP-Pohjola group was the largest retail bank in Finland. Its market share in customer deposits was 32.7%, whereas the closest competitor, Nordea Finland, stood at 31.2%. In deposits, the market share of OP-Pohjola was 33.2% and for Nordea 32.0%. The market shares of POP group were 2.0% in loans and 3.1% in deposits. The market shares of co-operative banks are now at a higher level than they have ever been. Both groups of co-operative banks are at the moment very profitable and extremely well capitalized, which is in stark contrast to most of their prior history where had been undercapitalized. Both groups have capitalization well in excess of the 8% that is usually interpreted as the required minimum level. Currently, the minimum equity capital for banks in Finland is 5 million euro, although this is not required from banks that already possessed their banking license. Many co-operative banks have their equity capital below euro 5 million.

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<sup>4</sup> In some ways this may be misleading, because banks belonging to the OP-Group are just as local as those in the POP group.

The success of co-operative banks has also been indicated by the development of membership. Membership increased rapidly in the booming 1980s, when it went up from 362 000 in 1980 to 660 000 in 1990. During the depression membership declined, but started to rise again after mid 1990s. During the organization break-up in 1997, the co-operative banks in the OP Group had 647 000 members. In 2002 (also the centenary of the group), the limit of one million member was surpassed. As of 2009, the group had over 1.25 million members. The POP group had around 100,000 members.

## **5. Conclusions**

This brief survey of the history of co-operative banks in Finland was intended to clarify issues relevant for the legislation of Finnish co-operative banks. I chose to present include a historical description on the development of co-operative banks and also a description of general banking environment. This was to show that the legislation and regulation of in Finland has generally followed the internal developments of the co-operative banks and also the external environment.

There are several interesting leads for further research. One pertinent theme when reading the history of financial co-operatives and legislative development is that co-operatives are themselves active participants in the legislative process. This has advantages and disadvantages. Halme (1996) is critical on the participation of the financial sector in its own regulation which she interprets to have led into lax regulatory standards and slow legislative development, especially in the period of deregulation of the financial market that occurred in the late 1980s and early 1990s. In general, the banking legislation should ensure level playing fields for all market participants and protect the depositors. Currently all banking groups in Finland are treated equally. There are no limitations in operations stemming from organizational structure; co-operative banks have the same rights as commercial or savings banks. Deposit protection has been explicitly in place since 1993 (and prior to that implicitly; the government would not have allowed depositors to lose their money).

On the other hand, Cuevas and Fischer (2006) argue that financial co-operatives should be consulted when relevant legislation is drafted. There are good arguments for that as well. Outside parties seldom are sufficiently knowledgeable about co-operatives to take into account all their special characteristics. The Finnish legislation has partly been rather tailor-made, for instance taking into account the current structure of OP-Pohjola Group. In turn, the structure was jointly determined by the bank management and the regulator.

An interesting issue for further study is also the interplay between the public law and the private ordering mechanisms of co-operative banks. Between 1902 and 1970, financial co-operatives were regulated only by the Law on Co-operatives and by their private ordering mechanisms. The importance of the latter was pronounced in this period, and it has retained its importance also after 1970, when the first Law on Co-operative Banks was enacted. It has also happened that private regulations has become public jurisdiction, e.g. in the regulation between the relations of the central bodies and local banks in the most recent piece of co-operative banking legislation from 2001. Still, there are many issues that are solely arranged by private and mutual agreements between the group and member banks (in the case of OP-Pohjola Group). One important example is

the division of surplus, that is uniform across all banks in the OP-Pohjola Group and is based on bonuses based on the use of services.

Finally, the dominant role of the co-operative network in the legislative process raises the question whether it suppresses, perhaps inadvertently, the dynamics of the co-operative banking sector. The dynamics of the sector have been after the 1920s to the direction of exit through mergers, rather than new entry. The law contains provisions for the establishment of co-operative banks, but in practice there does not emerge new co-operative banks. One reason for this is also the legislative requirements of minimum equity capital, 5 million euro. The typical amount of equity investment in the basic equity is 100 euro per member. Meeting the minimum capital requirement with this sum would require at least 50,000 members. To be clear, this is a requirement imposed by the Basel processes and the European Union. Probably the development of new financial co-operatives would be via credit unions, that are possible under the current regulatory system (although they cannot accept member deposits). The developments with ethical banking may provide a stimulus towards that direction.

Although this paper has only dealt with the Finnish system, the biggest pay-offs for this type of research would be if these issues could be compared with a number of financial co-operative systems, in Europe and elsewhere. My hope is that these presentations in the ICA conference could be used as a starting project for a comparative research project.

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Appendix: The development of number of financial co-operatives, members, and market shares in loans and deposits between 1910-2009

Year	Number of financial co-operatives	Number of members	Market share in loans (%)	Market share in deposits (%)
1910	370	17,000	0.5	0.1
1920	602	31,000	0.3	0.2
1930	1416	144,000	8	4
1940	1079	156,000	10	8
1950	684	230,000	22	16
1960	537	302,000	20	18
1970	445	290,000	21	20
1980	372	362,000	25	24
1995	301	674,000	32	32
2009*	263	1,366,000	35	36

\* Combined for OP-Pohjola Group and POP-group.