

Methodology

*Analytical Background  
and Methodology for European  
Co-Operative Banks, Second Edition*

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*Insight beyond the rating.*

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# Analytical Background and Methodology for European Co-Operative Banks, Second Edition

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## Introduction

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This methodology details DBRS's approach to analyzing co-operative banking groups in Europe. DBRS aims to assign (1) a group rating or (2) a rating at or above a rating floor to respective member banks<sup>1</sup> within the group. To enable DBRS to assign a group rating, the co-operative group has to (1) display significant economic, strategic, franchise-driven and management cohesiveness and (2) be underpinned by a form of support mechanism; the combination of both transfers any credit risk for the individual member bank to the group. DBRS believes such cohesiveness, strong business integration and unified risk management could offset uncertainties over the timeliness or the enforceability of shared support mechanisms. For less cohesive banking groups, characterised by less material integration among group members and by weaker support mechanisms, DBRS's analysis will indicate a rating floor. A rating floor provides each individual member of the group with a minimum rating level, as opposed to full credit substitution.

This report is divided into three sections. The first two sections describe the major European co-operative banking groups, the concept of a rating floor and group ratings, and outline which factors DBRS considers instrumental in determining either a group or a floor rating. The third section addresses certain fundamental characteristics that differentiate co-operative banking groups from publicly quoted banks or from savings banks and that could have a bearing on their fundamental credit assessment.

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## 1. European Co-Operative Banking Groups and the Meaning of DBRS Ratings

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The DBRS rating methodology for European co-operatives applies to banks belonging to a group of local, mutually owned banks, which in turn own (directly/indirectly) all or part of a central institution, and share, in essence, the following organisational and business principles:

- The group's overall strategy is determined by an electoral process, based on consensual or democratic principles<sup>2</sup>, which also form the intrinsic business culture of these groups.
- Local banks have outsourced some of their operations and functions, especially liquidity management, but in most cases also product development, to a central unit and/or their subsidiaries.

Such criteria, for example, excludes British and Irish building societies, which, although they are mutually owned, have undivided corporate structures involving a single head office and branches, or institutions such as the Dutch SNS Reaal Group, which is owned by a trust (Stichting) rather than having public shareholders, and also has an undivided corporate structure. Equally, DBRS does not consider in its analysis Italy's banche popolari, which, although originally closer to a co-operative structure, and now far evolved away from it, are acting mostly as traditional commercial and retail banks. Finally, our methodology does not refer to co-operative banks in Central and Eastern Europe, some of which have a less clear status and may not even be directly supervised by their countries' banking authorities.

DBRS distinguishes roughly two categories of co-operative banking groups in Europe:

- European co-operatives that have a central authority, combining treasury management and product development with group strategic planning, as well as joint overseeing of regulatory issues for individual member

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1. Throughout this methodology, DBRS uses the terms co-operative, co-operative banks and member banks with the same meaning.

2. European co-operative banking groups are organised according to democratic principles; most co-operatives have a "one man – one vote" principle (some co-operatives have pro-rata voting rights, however, with capped levels). See "Corporate Governance Principles in Co-operative Banks", the European Association of Co-operative Banks (EACB) 2006; assemblies of representatives of local bank are usually the highest authority in regard to the group's policies, group structure and strategy. In some groups the assemblies make their decisions by majority voting or qualified majorities, for example in Germany (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, BVR), whereas other groups demand a consensual decision-making process (for example Rabobank Group).



banks with the national regulator. These groups have, as a result, a strong form of legal or contractual guarantee arrangements and are viewed as a consolidated group for financial and regulatory purposes.

Examples of groups that conform to this organisational structure include: the Rabobank Group in the Netherlands; the OP Group in Finland; and the Crédit Agricole Group, Banque Populaire Group and Caisse d'Épargne in France. DBRS also considers the Swiss Raiffeisen Group (Schweizer Verband der Raiffeisenbanken, SVR) as being within this category, as the nature of the support system, the amalgamation of central authorities in one body and the partial transfer of regulatory obligations to the central body in the group resemble material characteristics of the co-operative groups mentioned above.

In these cases, DBRS would normally expect to rate both the central bank of a particular group or a significant subsidiary and the regional banks of the group at the same level (group rating). In general, ratings assigned to the entities of a co-operative banking group refer to the ability of that particular legal entity to discharge its debt obligations. However, a rating for member banks of highly integrated groups will reflect the strength of the group as a whole and result in a full credit substitution. This is to be expected because for a well-integrated, and in essence consolidated, group, it is hard to separate the attributes of the single entity from those of the group as a whole. For example, risk management will be a seamless process pervading all areas of the group. In addition, the shared support mechanisms provide a solid link between the financial resources of each member of these co-operative banking groups with the financial health of the entire group<sup>3</sup>.

- A European co-operative group where the authority within the group is less centralised and is divided between central banks and powerful associations that claim responsibility in strategic planning, auditing and the administration of support funds. In addition, the national regulator oversees each individual member bank, and the groups' support mechanisms do not amount to legally binding cross-guarantees<sup>4</sup>.

Examples of groups conforming to this organisational structure model include the co-operative banks in Germany (members of the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, BVR), the Crédit Mutuel group in France, the Volksbanken (ÖGV), as well as the Raiffeisenbanken Group in Austria, the Banche di Credito Cooperativo Group in Italy and the Cooperativas de Crédito in Spain.

For this segment of co-operative banking groups, the degree of solidarity and cohesiveness can vary more in comparison to the first group. Consequently, DBRS's analysis for this second group of co-operative banks may conclude that these groups should not be considered as single entities. However, DBRS believes that a group rating can be assigned to some of these co-operative groups despite the absence of cross-guarantees. Section 3 specifies the criteria DBRS utilizes to determine the appropriate level of cohesiveness for a co-operative banking group to be considered as a fully integrated banking group and, in particular, which criteria are considered instrumental to any prediction of future solidarity between individual group members.

Finally, for a less integrated group, it would be incorrect to attribute the full strengths and financial resources of the wider group to a single particular local or central co-operative bank, since those strengths and resources are not fully available to the said entities. DBRS believes that the rating for a co-operative bank of a less integrated group will be driven more by the credit quality of that entity itself. However, even for this type of co-operative bank, the rating will reflect both the co-operative bank's own strengths and its ability to draw on the resources of all other entities within the group through a support system which in most cases exists, should the need arise. As a result, when assigning issuer ratings to local co-operative banks, as well as to the central bank of less integrated groups, DBRS will establish a rating floor. But unlike fully integrated groups, DBRS's ratings for these co-operative banks do not need to match. In setting such a floor, DBRS makes two assumptions:

- That the level of business integration is such that all local banks receive a degree of benefit from being part of the group as a whole.
- That if one local bank were to suffer difficulties, it would be supported by the group.

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3. For the definition of DBRS's rating scale and further details on group ratings as well as ratings floors see also [DBRS's Analytical Background and Methodology for European Bank Ratings](#), January 2007.

4. Throughout this methodology, DBRS uses the terms support mechanism, support agreement and support system with the same meaning.

The value of such integration and support determines the level at which the rating floor is set. In this sense, the rating floor can be interpreted as the tolerated downward deviation from the average creditworthiness of the co-operative banks within that group. It is possible for strong member banks to be rated higher than the floor (which is not possible with a group rating).

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## 2. Analytical Criteria for Group Ratings and Rating Floors

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A crucial element of DBRS's analysis for co-operative banks is to determine the extent to which the group is integrated, both in terms of formal solidarity agreements and its actual operating practices. DBRS assesses current and future solidarity among group members based on the degree of integration and consolidation within the group.

In this context, when the European Parliament and the Council signed the Capital Requirement Directive for Credit Institutions and Investment Firms (CRD or the Directive)<sup>5</sup> in June 2006, the Directive reflected several changes to the framework the European Commission proposed in July 2004. One of these changes was amending the way the risk weight for intra-group exposures would be calculated. While the first proposal only allowed a 0% risk weight for specific exposures between a parent and its subsidiaries, the final version of CRD also included the possibility of applying a 0% risk weighting to counterparties that are members of the same institutional protection scheme (that is, support system) as the lending credit institution, provided that following conditions are met<sup>6</sup>:

(1) The counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary service undertaking company and is subject to appropriate prudential requirements.

(2) The counterparty is established in the same Member State as the credit institution.

(3) There is no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the credit institution. The credit institution and the counterparty have entered into a contractual or statutory liability arrangement that protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary (referred to below as an institutional protection scheme).

(4) The arrangements ensure that the institutional protection scheme will be able to grant support necessary under its commitment from funds readily available to it.

(5) The institutional protection scheme disposes of suitable and uniformly stipulated systems for the monitoring and classification of risk with corresponding possibilities to take influence.

(6) The institutional protection scheme conducts its own risk review which is communicated to the individual members.

(7) The institutional protection scheme draws up and publishes once in a year either (a) a consolidated report comprising the balance sheet, the profit-and-loss account, the situation report and the risk report, concerning the institutional protection scheme as a whole or (b) a report comprising the aggregated balance sheet, the aggregated profit-and-loss account, the situation report and the risk report concerning the institutional protection scheme as a whole.

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5. Legislation that will allow EU countries to transpose the new capital rules for banks (Basel II) into national law.

6. DBRS's summary; for more details see Article 80, Section 3.2. of the Directive 2006/48/EC as well as the Directive 2006/49/EC of the European Parliament and of the Council, relating to the taking up and pursuit of the business of credit institutions (recast), 14 June 2006.



(8) Members of the institutional protection scheme are obliged to give advance notice of at least 24 months if they wish to end the arrangements.

(9) The multiple use of elements eligible for the calculation of own funds (multiple gearing) as well as any inappropriate creation of own funds between the members of the scheme referred to in (3) shall be eliminated.

(10) The institutional protection scheme is based on a broad membership of credit institutions of a predominantly homogeneous business profile.

(11) The adequacy of the systems referred to in (5) has to be approved and monitored at regular intervals by the relevant competent authorities.

The inclusion of a 0% risk weighting for counterparty risks within banking groups that are not consolidated based on a parent/subsidiary relationship was the result of strong lobbying from decentralised banking groups in Europe, especially co-operatives and savings banks. DBRS believes that most of the European co-operative groups (including those in the second group – see above) will qualify in order to achieve the 0% risk weighting, especially in view of the somewhat general guidelines and the fact that the national legislative and regulatory powers still have room for interpretations when CRD is transposed into national law.<sup>7</sup>

In order to decide on a group or floor rating, DBRS believes Article 80 of the CRD is a useful starting point and specifically underpins the assessment of the support mechanism of co-operative groups. Therefore, DBRS will mention or expand in Section 2 of this report on most of the points listed above. However, in the case of a group rating, a checklist can give a first and necessary, but more often not sufficient, base of the analysis. Therefore, DBRS believes it is important to understand the economic rationale and willingness of co-operative groups to act as one cohesive unit, which includes, but goes beyond, the structure of the support mechanism. DBRS's analysis is focusing to a considerable degree on qualitative factors, such as group strategies, reputation risks, corporate governance and risk management.

## 2.1 SOLIDARITY AGREEMENTS

All co-operative banks in Europe have some form of “solidarity agreement” in place, in which members of the group are forced to commit to support other members of the group, should the need arise.<sup>8</sup> What varies is the extent, nature, depth and coverage of these solidarity agreements.

Considering the extent of solidarity agreements, DBRS will determine which legal entities are covered by the agreement. This is important as there are cases in which some legal entities of a group are excluded from solidarity agreements; for example, the former French Natexis Banques Populaires was not part of the solidarity agreement that covers the rest of the co-operative banks comprising the Banque Populaire Group.<sup>9</sup> In contrast, the support agreement of the BVR (association for co-operative banks in Germany) extends its coverage to even a relatively small banking subsidiary of the DZ Bank AG Deutsche Zentral-Genossenschaftsbank (DZ Bank) or to other members with non-core businesses such as DVB Bank – a specialised transport finance provider with limited strategic alignment to the rest of the group.

An entity's rating will still benefit from a group rating or a rating floor, even if an agreement did not provide for any support to it specifically, if this entity is economically and strategically important to the group – for example, well entrenched product providers like insurance companies, asset managers

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7. In any case, if co-operatives of the second group achieve 0% risk weighting this does not automatically result in a regulatory consolidation, meaning that the regulator will allocate the responsibility for capital and liquidity oversight to the central authorities of this group.

8. In several countries, co-operative groups have actually more than “just” one support mechanism in place; for example, in Germany the BVR commands over the Garantieverbund (Guarantee Network; the possibility to guarantee non-performing loans at member banks) and Garantiefond (Guarantee Fund; liquid funds in order to be prepared to inject capital into problematic banks). In our analysis we would look at each mechanism alone as well as in their combined force.

9. Natexis Banque Populaire no longer exists. Natexis was officially merged with Ixis CIB (Groupe Caisse d'Epargne) in November 2006 to form Natixis. Banque Populaire and Groupe Caisse d'Epargne each owns 34.4% of Natixis, which is publicly quoted. Natixis is either not part of the solidarity agreement.

or mortgage banks. The fact that local co-operatives would be supported by their peers is likely to strengthen the franchise value of all co-operatives, as it is evident that client relationships and pricing power benefit, with the result that the earnings of the group as a whole can be higher and more predictable. Consequently, it also follows that the financial flexibility of this entity – during normal operating conditions – is likely to be stronger as it is part of the group. In addition, in most cases these strategically important entities are owned by member banks that are included in the shared support agreement, and, as such, are likely to benefit through parental support from an existing support agreement.

When considering the **nature** of the solidarity agreement, DBRS assesses its strengths, and the likelihood that the support it envisages will indeed be provided. Questions to consider include the following:

- Are members of the agreement legally bound to provide support to other members (in essence legally forced to provide support), or is there merely an agreement in principle to provide support (voluntary commitment)?
- Is the support qualified in any way? For example, may member banks decline to provide support if the problem has arisen due to fraud?
- Is the support fund already paid-up, or is it based on a call-up of funds? (Funds are more reliable if they have already been contributed, rather than being merely “committed”.)
- Does the solidarity mechanism allow creditors of the troubled entity to make a direct claim against all other members of the solidarity fund (effectively providing “credit substitution”)?
- Can investors make claims against the fund or group of members if monies owed by the individual co-operative bank are not forthcoming or are claims only enforceable after the troubled entity has been declared bankrupt or has been taken over by an administrator (“timeliness of payment”)?

Furthermore, DBRS refers to recent examples of how solidarity agreements are exercised in practice. However, historical evidence illustrates quite clearly that structural differences in support mechanisms in Europe do not play such a big role in the rescue of troubled co-operative banks. For instance, co-operative banks in Germany or Austria (Volksbanken) – both examples of banks with support systems in place, but which do not amount to a legally binding guarantee – were always supported if needed and their creditors never incurred losses. Therefore, despite the fact that, in essence, evidence of historical support is good to have, it is not *sine non qua* for a rating floor as well as a group rating.

When considering the **depth** of a solidarity agreement, DBRS attempts to estimate how much money is available to support its ailing members. In the case of a paid-up fund, the amount is evident, although it may be supplemented by provisions for further money to be called upon once the fund is depleted. But in many cases, such agreements provide for unspecified amounts to be called upon from local banks as the need arises. This has led to the belief that the entire resources of a co-operative group may be deployed to aid a member in distress. However, unless the group is being liquidated (an eventuality DBRS thinks is highly unlikely for any west European co-operative), banks participating in a solidarity agreement will continue to have their own capital needs. DBRS believes that the depth of a solidarity fund is therefore constrained by the extent to which participating banks can contribute prior to breaching their own individual regulatory capital ratios.

Furthermore, the depth of a solidarity fund needs to be considered in relation to the feasible size of claims it would have to meet. It is likely that a fund’s resources would be sufficiently large to meet the needs of a troubled local co-operative bank, but they may be insufficient in relation to the potential needs of the central organisation. Determining the relative size of a local co-operative network and its central organisation is an integral part of the analysis, as is ascertaining the group’s ability to raise potential funds from its member bank in times of need. In this context, a by-product of such depth of solidarity agreement analysis sometimes leads to the question of meltdown scenarios. However, such discussions add little value in determining the depth of the solidarity agreement, simply because there would always be a meltdown scenario where available funds – with the constraints mentioned above and assuming the group is cohesive – would be insufficient<sup>10</sup>. DBRS believes that plausible stress scenarios, rather than unrealistic meltdown scenarios, are the most useful exercise to determine the depth of a solidarity fund.<sup>11</sup>

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10. The deep recession that hit Finland in the early 1990s undermined profitability across the entire financial sector and led to a banking crisis in autumn 1991. The authorities were forced to take exceptional measures (takeovers, government assistance and temporary blanket guarantees to banks) to secure the stability of the financial system, including support for the co-operatives.

11. In this context, please see our comments on the risk profile of European co-operatives below.



When considering the **coverage** of a solidarity agreement, essentially DBRS wants to know whether the agreement in place covers off-balance liabilities as well as those on the balance sheet. There may also be certain exclusions to the type of losses the solidarity agreement is able to cover. Therefore, DBRS examines a whole range of different scenarios that could possibly pre-empt a bank to make a call on the solidarity agreement, and asks whether, under such circumstances, it would be covered by the agreement.

On viewing solidarity agreements within the context of these four parameters, it is evident that considerable differences do exist. Thus, the fact of knowing that a solidarity agreement is in place tells us little about any credit enhancement it bestows on rated entities within the group, and pure formalistic analysis of support systems does not ultimately deliver a verdict in favour or against that for a full group rating or a floor rating.

For example, **legally binding cross-guarantee systems** at Rabobank Group, Credit Agricole, the OP Group, Banque Populaire and Raiffeisen in Switzerland constitute strong forms of solidarity agreements due to the fact that they ensure that all the financial resources available to the group – with the constraints mentioned above – can be ultimately utilized to service the debt of a group’s member banks.<sup>12</sup> However, most of these cross-guarantees are commitments from one co-operative bank to the other participating co-operatives banks in its group and vice versa. Therefore, an investor in any particular co-operative bank has no immediate and direct claim upon the group’s fund or banking group as a whole. Moreover, in some cases, the language of these cross-guarantees is more akin to deficiency guarantees, like in Finland (OP Group)<sup>13</sup>. In conclusion, if DBRS were to base its judgment on the likelihood of support coming from the group only on cross-guarantees, DBRS would have to acknowledge that the timeliness of payment is not ensured. As a result, DBRS does not automatically view European co-operative banking groups – with a legally binding cross-guarantee system in place – as a single economic entity if regulatory, business or organisational forces do not render a high level of cohesiveness and inherent solidarity (which in practice holds true for all of the co-operative banking groups mentioned above) whether they have cross-guarantees or not.

At the same time, DBRS believes that co-operative banking groups with support agreements in place – although they are structurally weaker than those with legally binding cross guarantee mechanisms, specifically where participating co-operative banks have no legal claim to support from funds or other members of the group – can still achieve a group rating. Such support systems, which in effect fall short of a legally binding cross-guarantee, exist, for example, at co-operative banking groups in Germany and Austria (Volksbanken and Raiffeisenbanken). Ultimately, a solidarity agreement, sufficient in depth, coverage and track record, combined with a strong level of “willingness”, could possibly offset any structural weaknesses inherent in the solidarity agreement’s nature. Obviously, this kind of de facto obligation presupposes a high level of strategic and managerial cohesiveness, strong business integration and unified risk management.

## 2.2 MANAGERIAL AND STRATEGIC COHESIVENESS

DBRS believes that in order to achieve cohesiveness and solidarity within a group of legally independent banks and to justify a group rating, the group requires a transparent and accepted process for making strategic decisions. In this context, DBRS believes it is less relevant whether strategic decisions are made based on a formalized framework or on consistent and internally accepted practices.

However, DBRS also believes that the level of strategic cohesion achieved is correlated to the willingness of local banks to forward strategic issues to the group organisational bodies. In most of the European co-operative banking groups, questions like partial demutualization, selection of core products, customer groups and distribution channels (e.g., direct banking, consumer lending) or international expansion and group-wide financial target ratios are decided upon within a group context.

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12. We excluded Raiffeisen Austria from the list of co-operative banking groups with cross-guarantees because Raiffeisen’s “Kundengaratiefonds” is qualifying its support in regard to coverage (no off-balance-sheet payment obligations are covered) and nature (fraudulent behaviour is not covered).

13. For this matter, also the “Kundengaratiefonds” of the Austrian Raiffeisenbanken is worded as a deficiency guarantee.

There are some key areas of consideration, including the following:

- Which centre “leads” the groups in strategic decisions, not so much in reference to the initiative but to the ultimate decision taken and implementation? If group-relevant strategic decisions are taken by various bodies and institutions within the group, how are they linked with each other, how is a timely decision process ensured and how is it ensured that the group overall follows a coherent strategy?
- Equally important is whether accepted strategic decisions can be executed effectively. Can a group authority sanction strategically accepted behaviour and constrain material deviation from the agreed strategic goals?

In this context, DBRS believes that it is important to have a monitoring process in place to review the implementation of these strategies. As a bare minimum, DBRS looks for a group’s ability to assemble consolidated financial accounts. A better scenario would be some level of internal reporting – a group-wide financial controlling on activities with the purpose of ultimately reviewing financial ratios achieved by the combined group. In co-operative banking groups with cross-guarantees, managerial cohesiveness does not come automatically. It comes about as the result of organisational structure and “co-operative culture”, which, for example, in the case of Rabobank, includes a decision-making procedure based on a consensus model. At Rabobank, the group seeks to decide group-wide strategies unanimously, and institutions like regional representations – a so-called “Rabo Parliament” and a national assembly – ensure that the local banks are adequately represented.

In general, DBRS believes co-operative banking groups with a democratic decision process – a majority voting system – where the outcome for the group members is not binding and no central body has the power to execute strategy for the overall group is more likely to lower the level of strategic coherence when compared to more centralised or consensus-based models. DBRS believes that different strategies could in fact lead to a group with heterogeneous risk profiles, which is not beneficial in predicting future solidarity.

Again, historical evidence shows this conclusion is unlikely to be either black or white because strategically less homogeneous co-operative banking groups have not necessarily exhibited less solidarity. For example, in the German group of co-operative banks, co-operatives exist –so-called Group der Sparda-Banken<sup>14</sup> – which compete with other member banks in some products, carry a different brand and pursue more discriminating customer selections which in their turn have historically shown a considerable impact on banks’ business profiles and contributed to reduced risk costs. Given the nature of these kinds of deviating strategies, it might be assumed that solidarity within the cooperative banking group in Germany may weaken; however, historic evidence has shown that the opposite is true.

### 2.3 ALIGNMENT OF RISK-MANAGEMENT PRACTISES

Over the past five years, the general trend amongst European co-operative banks has been to standardize their risk management processes. Furthermore, within these organisations, it is apparent that it is the central management of the particular co-operative groups that are most familiar with an advanced risk-control methodology. DBRS believes that the standardisation of processes and limits need not necessarily compromise local know-how. An example of one of the most ambitious efforts to standardise risk management to date is that being undertaken by Germany’s DZ Bank and the BVR. The central authorities, DZ Bank and the BVR, have devised and implemented an internal rating system for its local co-operative banks, based on a “bonus and malus” system – local banks deemed to be “more risky” would need to pay higher fees to the group solidarity funds. The “bonus and malus” system is accompanied by other risk management enhancing tools that were also introduced at the individual co-operative bank level at the same time as the “bonus and malus” system. Some of these tools included the unified rating framework for corporate loans (BVR II Rating), the VR Control and the first initiatives of risk transfers through securitisation (the VR Circle), which ultimately should help to create a group-wide risk management culture. However, it should be added that co-operative banks cannot be forced to implement the VR Control, the rating system or to participate in the VR Circle.

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14. The German group of Sparda Banken had a combined balance sheet of EUR50.5 billion in 2006 and is focused on retail banking, especially with a lean product range and in combination with attractive pricing.



In this context, DBRS specifically focuses its attention on the management of credit risk within the groups. There have been cases in the past in which European co-operative banks suffered major losses by taking undue market risks; but such risks do not constitute structural challenges for a group of co-operative banks, whereas credit risks are more likely, if ever, to fulfil this characteristic.

Moreover, if a co-operative banking group is to qualify for a group rating, DBRS would certainly expect a unified risk management culture, where the measurement and evaluation of risks (specifically credit risk) and level of risk appetite – despite varying from bank to bank as a result of the inherent model of decentralised decision-making – is limited by a range of boundaries. These boundaries can be the result of a transparent, formalised and accepted group-wide set of rules, or they can devolve from a continuing trend of best practises on a voluntary basis.

## 2.4 HIGH LEVEL OF BUSINESS INTEGRATION

In recent years, there has been an overall trend among European co-operative banking groups towards greater integration of policies and procedures in order to realize cost savings and partly to ensure maximum leverage of the group's resources (for example, by standardising products). As mentioned above, there is also often a desire, on the part of the central organisation, to ensure that local co-operatives operate within pre-defined bounds and do not unilaterally increase the group's overall risk profile.

Business integration tends to be driven from the centre but *de jure* must be approved and implemented by local co-operatives. Managers at the centre, with a more global view of the group, tend to be the first to recognise the possibilities to cut costs and staff, and to standardise products. Local co-operatives naturally will see the value in retaining small branches, even if they are only marginally profitable, and in maintaining strong staffing levels. This is not to say that managers at the centre do not recognise the importance of a strong local presence nor that local managers are indifferent to costs and efficiency. Nevertheless, the perspective of these two groups in prioritising their own agendas can vary greatly. However, in practice, DBRS is aware that European co-operatives have been successful in resolving just about all the differences they may have had, even if takes a long time in some cases. For example, in 2003 local Rabobanks approved measures, calling for a loss of 1,921 full-time equivalent jobs at branch level through the "Rabo Parliament".

Examples of business integration include the following:

- Treasury functions, including the management of excess liquidity, are usually managed by the central organisation. So, for example, local co-operatives deposit excess liquidity with their central organisation, which re-deploys it to other co-operative group members finding themselves short of funds. Market risk, such as interest rate risk, is assumed by the central organisation.
- DBRS also includes here the risk management practises mentioned above. Credit approval procedures may be defined centrally, with the central organisation (central bank or association) becoming involved in the approval of credits over a certain amount. Acceptance criteria and credit scoring may also be standardised.
- The group branding, product range and product design may be handled centrally. That is not to say that the central organisation is necessarily setting sales targets for particular products but simply that local co-operatives take products manufactured centrally, and do not undertake any activities inconsistent with the overall strategy and risk profile of the rest of the group.
- IT systems may be centralised across the group and the Basel II Capital Accord is leading, in some cases, to centralised capital allocation methodologies.

Again, a particular point of interest, similar to the strategic decision-making above, is the aspect of business integration with regard to the extent to which the central organisation may intervene in local co-operatives or other group members, if they depart from group policy in their day-to-day business. In simple terms, the question is whether the central organisation has the ability, *de jure* or *de facto*, to remove local executives who deviate from group policy.

In some co-operative banking groups, local banks have an obligation to receive services and products from their central bank and the group's product providers. In other groups, where no such formal obligation exists, it is evident that not all business for this kind of local bank is conducted through the central bank or the centralised product provider. If these kinds of local co-operative banks take a short-term view, it seems

rational to take the best offer available on the market in order to maximise its profits, which, according to the nature of its business, cannot always be expected to come from the group. DBRS believes cases where crossovers in the day-to-day business activities between local co-operative banks and their centralised product providers are few and/or are seen to be declining could not only lead to their central product providers becoming less efficient but also indicates a less cohesive structure within the group.

DBRS believes that increasing integration enhances the strength of a co-operative group. The benefits are likely to be most visible in improving efficiency. Less easy to discern, but equally important, is a stronger group-wide risk culture, a greater leverage of the financial resources and the brand. DBRS thinks that the benefits of such integration for a group, as a whole, far outweigh any loss of local specificity which may have been displayed by particular local banks. One of the greatest strengths of co-operative banks is their local presence, but this strength should not be compromised by the standardisation of product design or back-office and IT functions.

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### 3. The Analysis of Some Credit Fundamentals that Characterise Co-Operative Groups

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A rating for a cohesive co-operative group is driven primarily by the group's fundamental credit strengths, in the same way as a rating for any other financial institution. These attributes may have arisen as a result of the co-operative structure and origins of the bank (i.e., large number of branches, retail rather than corporate focus, desire to serve all sections of the local community) but a (hypothetical) non co-operative bank with completely different origins and displaying the same attributes could be treated in the same way and would receive a similar rating, if analysed by DBRS.

#### 3.1 ASSESSING THE RISK PROFILE OF CO-OPERATIVES

European co-operative banks are generally seen as having low-risk and highly predictable profiles. Historically, their core business – retail banking and servicing the needs of small- and medium-sized local companies and entrepreneurs – has produced stable earnings. Moreover, a strong local presence and the market shares of local co-operatives are sufficient to ensure healthy long-term earnings.

However, there are two ways in which the business mix of European co-operatives has been evolving, potentially leading to higher risk profiles: (a) more wholesale and treasury business and (b) foreign acquisitions.

DBRS thinks it is important to monitor the relative size of central organisations and the local co-operative bank networks. Since the central organisation tends to undertake wholesale and treasury activity, its risk profile is generally higher than that of the local network. Although one intuitively thinks of co-operative banks in terms of their retail deposits and loans, the central organisation often constitutes a large proportion of the consolidated group balance sheet. To illustrate this point, consider the case of a hypothetical co-operative group, which, at a certain time, had 90% of its balance sheet located within the local co-operatives and 10% at the central entity. Such an organisation would likely have a low risk profile, based on retail lending and retail funding. Suppose this hypothetical group evolved over time so that 90% of its balance sheet was located within the central entity, and only 10% within the local co-operative banks. The organisation would almost certainly now have a higher risk profile, due to greater reliance on wholesale lending and market funding.

Just looking at the relative size of assets gives only a shallow impression of the risk profile of the group. More important measures to follow are the extent to which the group is being funded by retail deposits raised at the local level, as opposed to wholesale funds raised by the central entity, and the extent to which revenues are generated by local banking, as opposed to wholesale and treasury activities, which may be more volatile.

The second way in which the business mix of European co-operative banks has been evolving is in the areas of foreign acquisitions. Two Austrian co-operative groups, Raiffeisen Zentralbank Österreichische



AG (RZB) and Österreichische Volksbanken AG (OeVAG), provide examples. RZB started building its operations in Central and Eastern Europe in the late 1980s, and investments in this region and in Russia now account for about one-third of the group balance sheet and more than half of pre-tax earnings. In the case of OeVAG, Central and Eastern Europe accounts for close to a quarter of assets and about one-third of pre-tax profits. These developments have clearly changed the nature of the group's franchises. In practice, DBRS's conclusion has been that these investments have not led to deterioration in their risk profile, since the greater potential risks of Central and Eastern Europe have been offset by the diversification that they bring, and also the growth opportunities that they offer.

Crédit Agricole provides another example of a co-operative whose business profile has been materially changed through acquisition. Although the bank's franchise already extended well beyond retail banking – to include wholesale banking, asset management and insurance – the acquisitions of Crédit Lyonnais and Banque Indosuez opened the way to further diversify earnings and strengthen the group's financial condition.

### 3.2 GOVERNANCE

According to DBRS's analytical framework for bank assessment, DBRS considers the relationship between officers and directors on one hand and all constituencies of stakeholders on the other hand – such as depositors, creditors, fixed income investors, regulators, customers and evidently shareholders – to be essential in our bank governance analysis. DBRS includes in the stakeholder category the overall ecosystem in which a bank operates, since reckless behaviour by its management and board can endanger the safety of a large segment of a country's banking sector.<sup>15</sup> In view of this broad definition of governance, DBRS analyzes some specific characteristics of co-operatives' structures at the various levels of a co-operative banking group, which might have an impact on the banking group's risk profile<sup>16</sup>.

- At the level of the local co-operatives, the members (similar to shareholders in a listed bank) are always bank customers, which does not mean all customers have to be members. In addition, members of the supervisory board are always members and, by default, customers. At the same time, co-operatives play a vital role in the local economy – often being the only provider of loans to small local companies in some rural areas. Consequently, members of supervisory boards of these smaller banks are less likely to be familiar with the growing complexity of financial products (a local co-operative bank is also using derivatives to hedge its market risks or is buying structured securities for its own portfolio). Based on these characteristics, there exists the real possibility of poor governance at local co-operatives. Such scenarios might happen from time to time, but the formal as well as informal supervision of the local co-operatives by its associations, by the national regulators (or by the central bank depending on the organisational structure) and last but not least by its peers are already well developed so that these hypothetical examples do not pose a structural challenge to co-operative banking groups in Western Europe. Some of the co-operative banking groups have a group-wide integrated risk management, like Rabobank Group, Crédit Agricole, OP Group or Banque Populaire. Also, co-operative groups with less centralised powers have developed processes that minimize the risk of such hazardous behaviour. For example, Raiffeisenbanks in Upper Austria voluntarily agreed to submit all loans above a certain amount (defined in relation to the bank's capital) to a fund<sup>17</sup> where each co-operative bank holds a share in proportion of its contribution to the fund's loan volume. This way the fund managers, represented by the co-operatives' representatives, function as the group's gatekeeper for large credit exposures.
- At the level of the central bank, the majority owners of the central banks, namely the local co-operatives, are also core customers of the bank. Sometimes central banks might be challenged to find a balance between offering their local banks the best services and best products for the best price (normally a

15. For more details on DBRS Governance analysis please see [Analytical Background and Methodology for European Bank Ratings](#), January 2007.

16. The relationship between the stakeholders of a co-operative entity is also referred to as “co-operatives governance”, whereas the interaction of the various co-operatives in the network of a co-operative group is referred to as “net governance”. See “Governance Strukturen in genossenschaftlichen Finanzverbund: Anforderungen und Konsequenzen ihrer Ausgestaltung”, Theresia Theurl and Thorn King in *Arbeitspapiere des Instituts für Genossenschaftswesen der Westfälischen Wilhelms-Universität Münster*, October 2002, or “Verantwortungsvolle Unternehmensführung und -kontrolle (Corporate Governance) im österreichischen Volksbanken-Finanzverbund”, Dr H. Hofinger, *Brussel December 2005*, 1st convention of European co-operative banks.

17. Treuhandkreditfonds.



better price than the market price) and reaching their own financial needs, especially those mirrored by bond investors, for example, generating sufficient profits to provide adequate risk coverage and to build up capital reserves. At listed banks, the shareholders might force the bank's management into a riskier strategy in order to achieve the required return on their investment. At co-operative central banks it might be the growing demands of the local co-operatives – which could use their combined power as shareholders and customers to force the central bank to generate the needed profits in riskier businesses because the central bank role generates small losses at best. The growing demands of the local banks are driven by their natural desire to safeguard their local franchises first and a potential lack of consideration for the financial fundamentals of the overall group. DBRS believes the level of cohesion within the co-operative group and the central bank's governance are correlated. Cohesive groups are less likely to experience conflicts of interests.

- At the level of the relationships and interactions between central bank, local co-operative and other entities of the co-operative organisation – for example, product and service providers, IT companies and co-operative associations – DBRS analyses the balance of power between the various bodies. In theory, the group of local co-operative banks or their elected delegates is at the top of the organizational hierarchy in a co-operative banking group which replicates an inverse pyramid (at the bottom is the central bank). At the same time, the central banks or the associations monitor (in their role as regulators), review (in their role as the group's risk managers or administrators of the support funds) and sometimes audit<sup>18</sup> the individual co-operative banks. Through this reversal of powers within the organizational structure, co-operative banking groups' interactions gain a greater level of complexity and DBRS has to extend its analysis beyond a pure formalistic collection of statutes and regulations in order to understand which party might use his or her power to the potential disadvantage of the group. In this context, DBRS puts a great weight on soft facts; for example, how does the group present itself in the press, during its decision-making processes, and in the discussions between each other (i.e., in their assemblies, conferences)?

### 3.3 FRANCHISE VALUE

DBRS's bank ratings attach importance to franchise value. The concept of franchise can be defined in many ways, but DBRS defines franchise value as a bank's capacity to preserve and grow a stable and predictable risk-adjusted earnings base in activities and markets in which it maintains an important presence.<sup>19</sup> Co-operative banks typically have strong retail banking franchises based on a dense branch network, strong branding and in-depth local knowledge. Typically, as they move away from retail financial services and become more involved with wholesale products, where client relationships and branch power are less well entrenched, their overall franchise value may decline. In practice, DBRS has noticed that the expansion of non retail activity has usually been balanced by the positive effects of diversification and enhanced risk control.<sup>20</sup>

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18. In Germany and Austria, co-operative banks are audited by the associations of co-operative banks, not by external auditors.

19. For more on DBRS's views on a bank's franchise please see [Analytical Background and Methodology for European Bank Ratings](#), January 2007.

20. For example, Credit Mutuel with CIC and Banque Populaires with former Natexis; more slowly but also diversifying is Rabobank.

## Market shares of larger Western European co-operative banking groups:<sup>21</sup>

Co-Operative Group	Members	Clients	Market Share in Deposits %	Market Share in Credits %
BVR (Germany)	16,000,000	30,000,000	18	12
Union Nacional de Cooperativas de Credito (Spain)	1,669,676	9,592,625	5	6
Crédit Agricole (France)	5,700,000	31,000,000	28	27
Credit Mutuel (France)*	6,900,000	14,500,000	12	17
Banques Populaires (France)	2,800,000	7,000,000	8	10
Caisse d' Epargne (France)**	3,076,000	10,000,000	13	15
Banche di Credito Cooperativo (Italy)	744,000	4,000,000	14	7
Rabobank (Netherlands)	1,641,000	9,000,000	39	26
Raiffeisen (Austria)	1,657,186	3,600,000	27	23
ÖGV (Austria)	673,158	1,500,000	6	6
Swiss Union of Raiffeisen Banks Group	1,371,107	3,000,000	18	13
OP Bank Group (Finland)	1,160,000	4,000,000	32	31

\*Without Livret Bleu (EUR18 billion).

\*\*Without Livret A (EUR67 billion).

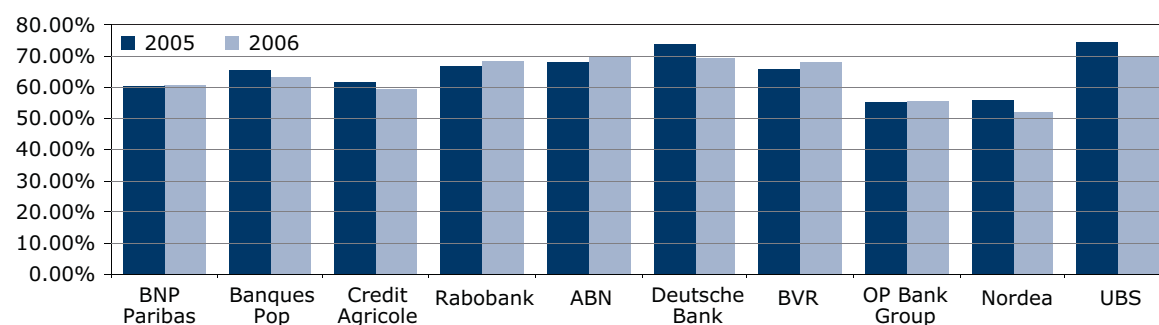
European co-operative banking groups have identified various opportunities and challenges for their franchises, including the following:

- In Germany, the BVR confronted the aggressive direct banking activities of foreign players like ING DiBa or specialised niche players such as banks that specialised in financing cars, which target the traditional core products of local co-operative banks, especially in the case of savings and term deposits. In contrast, co-operative banking groups like Rabobank view their direct banking model as an opportunity to grow their franchise internationally, by exporting their direct banking model to other European countries (i.e., RaboDirect in Ireland).
- A co-operative bank's retail banking franchise is to a large extent based on how its customers identify themselves with their local bank and is often enhanced by their membership (essentially a shareholder with democratic voting rights and, in some cases, obligations to provide financial resources if the bank runs into trouble). Co-operative banks have realised that the customers' membership needs enhancement to maintain any discernable advantage when compared to private banks and further enhance the loyalty of customers. That is to say, European co-operative banking groups are beginning to realise that while presenting them with opportunities and having acknowledged that they have failed to address this issue in the past, to continue to do so could have long-term negative impacts on their business models.

### 3.4 EFFICIENCY

Efficiency has been a big issue for European co-operative banks. Historically, they have been less efficient than their publicly quoted peers and this has led to suggestions that the co-operative business model is inherently less efficient and more prone to higher costs than that of commercial banks. In answer to this, DBRS would point out that in practice, the efficiency indicators of European co-operatives have been converging with those of quoted banks (see graph below).

#### Cost/Income Ratio of Selected European Banks



21. Data from Unico, EACB and DBRS's own calculations based on annual reports and Rapport de la Commission Bancaire 2006, Banque de France; most numbers refer to the financial year-end 2006; for the Swiss Raiffeisenbanken DBRS refers to 2006 and 2005 numbers; number of clients are banks' or DBRS's estimates.



The arguments on efficiency revolve in part around the de centralised nature of co-operatives and the importance of maintaining a strong and visible local presence. The legal structure of co-operatives vests power at the local level, which flows up to the central organisation with the result that, in principle, executives at the centre are unable to impose staff redundancies or branch closures against the will of local managers. Therefore it is hardly surprising that local managers are typically those most committed to maintaining high levels of local staffing and infrastructure and local procedures and systems, rather than having centralised ones passed down from head office.

Arguments on efficiency also revolve around the belief that co-operative groups are not “profit maximisers” and therefore have little incentive to maximise efficiency. Unlike publicly quoted banks, the co-operatives are not controlled by outside shareholders seeking a high return on their investment. Factors such as service to customers, members and local communities are viewed as key objectives rather than profit per se. However, in practice, those at the centre have been able to implement efficiency drives. As the process is more consensual, it is more gradual than that which would typify a quoted bank, where redundancies and closures are a matter for central management. In addition, such processes also tend to start from a position of greater inefficiency – indicative of a historical lack of focus on this issue in the past – and so have further to go. In this context, the Swiss Raiffeisenbanken have introduced a framework of forward looking “what-if resolutions”, creating binding contingency plans in the case of certain scenarios. For example, what to do in the event of an abrupt drop in interest margins or how to cope with dramatic changes in the financial markets. These plans do not need to go through the democratic decision-making process again before being activated, and allow quick reactions in a changing business environment.

In addition, it should be remembered that branch-based retail banking tends to display relatively high levels of cost, but it also tends to result in more consistent earnings and lower loan loss provisions.

### 3.5 CAPITAL

In principle, co-operatives have no access to outside share capital; their core capital comprises retained earnings. *Prima facie*, this puts co-operative banks at a disadvantage since they have no tradable currency (in the form of their own shares) to use in mergers and acquisitions, nor are they able to raise additional capital. This in turn may constrain the strategic flexibility of co-operative banking groups.

In practice, however, co-operative groups have been able to find ways around these constraints, although in some cases this has meant opening up the capital structure to outside investors. For example, Crédit Agricole implemented a partial demutualization in order to acquire Crédit Lyonnais after already owning the former Indosuez. The group Banque Populaire owns the publicly quoted Natexis Banque Populaire, a wholesale and investment banking enterprise, in sharp contrast to the retail and small business focus of the group and Credit Mutuel Centre Est Europe which owns Crédit Industriel et Commercial (CIC). Similarly, the financial resources of RZB’s partial IPO of RZB International, RZB’s holding company for its banking operations in Central and Eastern Europe, will allow RZB to compete with larger banking groups as a result of its international expansion.

Co-operatives have used different structures to gain access to the equity markets. The precise nature of these structures rarely has any bearing on the rating; what matters is that co-operatives have found a way to mitigate their lack of access to share capital. Consequently, as the frequency and variety of equity market access has increased in recent years, this particular structural aspect of co-operative banks has become much less of a rating concern than in the past.



Further, co-operatives' share capital<sup>22</sup> has shown some specific characteristics that are different to share capital at listed banks, especially the redemption rights of members' shares as well as the treatment of contingent capital as regulatory capital. For example, co-operatives in Germany, Austria or Switzerland could theoretically call on contingent capital from their members if they run into troubles, and this contingent capital is included in Germany, Austria and Switzerland, in the capital calculations for regulatory purposes.<sup>23</sup> These characteristics do not have a bearing on DBRS's assessment of the capitalisation of a co-operative group. Contingent capital represents a minor fraction of the co-operatives capital structure, and redemption rights are already quite restricted<sup>24</sup> or are likely to be watered down or eliminated, especially following stricter International Financial Reporting Standards (IFRS) accounting rules for these capital instruments.<sup>25</sup>

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22. Members' interests in a co-operative are often characterised as members' "shares", "certificates" or "units" and are referred to in this text as members' "shares".

23. In Germany and Austria this contingent capital counts as Tier II capital.

24. For example, in France the general law on co-operatives puts an upper limit on the extent to which capital, measured against the highest level attained, can be reduced by refunds (the proportion is higher for co-operative banks than for other categories of co-operative), see "What are shares in the capital of a co-operative", European Association of Co-operative Banks (EACB), October 2003.

25. Background: On 25 November 2004, the International Financial Reporting Interpretations Committee (IFRIC) issued its Interpretation IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments giving guidance on the classification of members' shares in co-operative entities either as financial liabilities or as equity. IFRIC 2 states that members' shares that would be classified as equity in the absence of the members' right to request redemption are equity if either of the following conditions is met: (a) the entity has an unconditional right to refuse redemption of the members' shares or (b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. However, provisions in local law or regulations or the entity's governing charter that prohibit redemption only if conditions, such as liquidity constraints, are met (or are not met) do not result in members' shares being equity. In July 2005, the European Commission fully adopted IFRIC 2 effective for annual periods beginning on or after 1 January 2005.

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