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The impact of financial regulation on policy and risk management in financial cooperatives

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Executive summary

How do financial cooperatives manage risk? In organisations usually based on decentralisation and the closeness of colleagues is it not the case that risk management necessarily makes for centralisation and the weakening of the position of financial cooperatives? Does this not call into question their capacity to make decisions locally? Can they combine the implementation of centralised steering and risk management with the preservation of their cooperative character? Many investigations arising from the development of regulatory frameworks and the implementation of supervision and resolution seem inappropriate for cooperative DNA. This preliminary investigation seeks to assess, by way of analysing representative cases from three European countries, and from Quebec, ways of implementing this regulatory framework associated with the Supervisory Review and Evaluation Process (SREP) corresponding to tenet 2 of Basel 3.

The case studies reveal different factors explaining the effects on the organisation and governance of cooperatives, but also that there are arrangements and practices, existing or conceivable, that ensure the maintenance of cooperative particularity without detracting from regulatory principles.

One very salient centralisation seemed inevitable owing to certain regulatory requirements (appropriate oversight on a consolidated basis, the role of the central organisation) and our analysis seeks to reveal the response of various concerns (methodological integrity, synergies). There is no arrangement in this area that can henceforth be deemed totally decentralised.

However, we do not see a convergence towards a single model of direction and risk control. There are major differences in arrangements. At this point we have identified three risk management models: (1) a centralised model grounded in risk strategy and responsibility for day-to-day management at the centre; (2) a decentralised model whereby responsibility and decision-making operate at a local level – in this case there is nonetheless supervision and coordination of the IPS type in place; (3) a third integrated model that also emerges from our analyses. This model makes it clear that a strategy determined at group level is compatible with more decentralised day-to-day management (without a hierarchical or shareholder link to the central entity), with varying degrees of intensity. Various advantages are associated with each model.

Despite these differences it appears that cooperative groups all benefit from a participatory approach to risk management. Directly or indirectly, local entities concur in the definition of a group risk strategy, as they are represented in the management organisation of the central

entity (board of directors) or of an IPS. Similarly, what we call ‘centralised’ local entities are stakeholders in determining the framework applied and the authority eventually conferred on the central entity.

Even if regulation imposes or prompts centralisation it is incumbent on cooperative groups to organise themselves so as to maintain a certain level of participation and/or decentralisation of responsibility. The combination of top-down and bottom-up approaches ensures not only an appropriate management framework (and involvement) at the group level but also double-checking, as local entities also monitor the central entity. However, such arrangements must be complemented by solidarity mechanisms allowing the implementation of provisions for remedy and resolution in case of financial trouble, and equally to ensure a mutual control of risk policy and the effects of risk on results.

We would like to thank very warmly the cooperative groups that participated in this first phase of our investigation: BPCE (France), BVR (Germany), GCC (Spain) and the Mouvement Desjardins (Canada), and those that have already agreed to be associated with the continuation of our research. Our thanks go also to the European Association of Cooperative Banks (EACB), which helped greatly in the establishment of our project. Finally, we acknowledge the accessibility and valuable advice of various national banking authorities.

Main acronyms

CLI	Consolidated leading (risk) indicator
ECB	European Central Bank
ICAAP	Internal capital adequacy assessment process
ILAAP	Internal liquidity adequacy assessment process
IPS	Institutional protection scheme
LI	Leading (risk) indicator
RWA	Risk-weighted asset (Pillar 1 of Basel for the calculation of own funds)

Note

Passages in quotation marks and italics are quotations from our interviewees: for instance *"Following up and monitoring different risks is a responsibility common to the organisation."*

1 Introduction

For many bankers, Basel 3 represents a change of era, a change of model, and some would even say a change of job. These views are inspired by the bearing of Basel principles on two great indicators of a bank's stability: its solvency in respect of its capital, and its liquidity in respect of its assets. The major public economic periodicals and bankers themselves have mainly dwelt on the consequences it would have on the financial sector and the broader economy. It is true that the measures taken do have significant consequences for banks' activities and their financing capacities, but Basel 3 also treats other subjects in respect of the organisation and governance of financial institutions. While they have been less publicised than financial questions, they affect the day-to-day running of the institutions and how people work in them as much or even more.

Basel 3 is a system built on three pillars. Pillar 1, elaborated throughout directive 4 (Capital Requirement Directive, European Union), determines the level of capital required to cover credit, market and operational risks. This is assessed by the risk-weighted asset (RWA or APR) and the capital required by regulation is subject to a different definition from that of accountancy. The second pillar is devoted to establishing a control mechanism for this level of capital, exposure to risk and the measures to be taken to respond to it. Lastly pillar 3, which relates to market discipline, details the information that must be communicated in respect of risk.

The motives of the regulators in holding out for the Basel 3 mechanism are evidently contingent with the banking crisis of September 2008: ensuring that governments are not obliged to intervene to protect banks from bankruptcy. The aim of the regulator is thus to reinforce the financial security and stability of institutions and ensure and strengthen the quality of internal control measures and those of national and European supervisors, irrespective of the status of institutions or whether they are joint stock companies or cooperatives.

Directive CRD 4 is a text of almost 340 pages covering all three pillars and seeking to offer very precise recommendations on how to protect against risks to solvency with a sufficient level of capital, and risks to liquidity to avoid a sudden bankruptcy. While these two kinds of risks are certainly central to its regulatory preoccupations, the directive also addresses the issue of the conditions under which banks are controlled, circumstances that can interfere with control and the corrective mechanisms they put in place. Basel 3 thus impinges as

much on risk management and financial management criteria as on organisational and strategic criteria. The first part of this study summarises the results observed in respect of the general influence of these regulations on retail banks. Within this framework we have assessed the specific consequences for financial cooperatives[1]. The second part of this study is dedicated to our analyses in the field of the governance of risk management in several cooperative financial groups.

2 Aims of the investigation

Our study seeks to present aspects of the response to the specific impact of new regulations on risk management in cooperative financial groups. Do the requirements in terms of capital and liquidity raise doubts about the position of cooperative banks, their risk policy and the conditions of their access to financial resources?

How do financial cooperatives organise their risk management? In organisations commonly founded on decentralisation and the closeness of members, does not risk management regulation necessarily make for centralisation and a weakening of the position of financial cooperatives? Does it call into doubt their capability for decision-making at the local level? Can they combine the implementation of centralised steering and risk control with the preservation of their cooperative character?

Many of the examinations arising from the development of the regulatory framework and the implementation of supervision and resolution mechanisms seem little adapted to cooperative structures. Thus our study also aims to assess, by way of analysis of representative cases in three European countries and Quebec, the modalities of the implementation of the Supervisory Review and Evaluation Process (SREP), which corresponds to Pillar 2 of Basel 3[2].

[1] The first part of this study was conducted in the context of the research of Labex Refi Régulation Financière (in press) and Lamarque, "The Impact of Basel III on the Operations of Retail Banks" in Labex Refi for European Finance Forum, Palgrave MacMillan (forthcoming).

[2] The second part of our study was made possible thanks to the support of the International Summit of Cooperatives, where it was presented during the conference.

3. The effects of the development of regulation

3.1 Capital and liquidity requirements

The issue of improving bank security is at the core of the existence of the Basel Committee, which has been addressing the problem for nearly 30 years. The solvency risk can be defined as the risk of seeing an institution unable to meet the losses associated with its activities (credits, markets or operational). Hence, capital must be sufficient to ensure these losses can be met. As with any business, the liquidity risk lies in the inability to meet short-term payments.

The progressive increase in the required levels of capital and liquidity

At the end of the 1980s, Basel 1 introduced the requirement to cover credit risk with sufficient capital, representing 8% of credits exposed to risk. The Basel 2 accords, which were initiated in 2004, came into force in January 2007. They widened the spectrum of risks covered to include market and operational risks. They retained the 8% level. However, their effects were not really felt because of the sudden spate of bank failures in that year. The Basel 3 accord was adopted in 2010 and it will remain in force until at least 2019. It does not revise the risks covered, but it does increase the requirements in terms of capital, exceeding 15% in some cases. It also adds new requirements in respect of liquidity.

The general principle is that prudential capital should represent a minimum percentage of the exposure to risk, calculated according to banking regulation principles. In the Basel 3 framework all actors expect a rise in the need for capital, in respect of their portfolio of current activity and balance-sheet assets, even before the thresholds are raised. Furthermore, if the requirements continue to increase, as in the case of banks, then palpable effects in terms of strategic and commercial positioning are clearly envisaged, to the point of refusing or reducing financing for certain categories of client.

Effect 1: Management of risk exposure

Banks continually monitor the use of capital associated with each of their activities, particularly with their credit policy. The credit risk amounts to at least 70% of total exposure, and among cooperative groups in particular sometimes more than 80%. The mechanism for calculating the capital requirement that emerges from Basel 2 is relatively simple. The more a bank finances a client at risk the more capital it must hold to meet a bankruptcy. The more a bank is exposed to a sector of activity sensitive to the economic situation, the more it has to cover itself in this way. The risk-taking policy thus directly determines capital requirements.

This matter is particularly sensitive on the companies' market (and for SMEs in particular), which is traditionally more risky than the private market. Some sectors of activity are subject to economic circumstance and they risk finding themselves rationed because the risk of defaulting is too high. Table 1 shows that exposure to credit risk does not correlate only with amounts granted, but with quality as well. In the case of the bank in Table 1, the reduction in credit holdings on the balance sheet between 2012 and 2013 did not reduce its exposure (measured by RWA), but the reverse. And conversely, a rise in credits between 2013 and 2014 was not matched by a reduction in RWA.

Table 1: Changes in RWA credit and capital requirement (Groupe Crédit Agricole, billions of €)

€ billions	**2015 Basel 3**	**2014 Basel 3**	**2013 Basel 3**	**2012 Basel 2.5**	**2011 Basel 2**
Total of credits on balance-sheet	331	314	301	330	399
Total RWA credit	267.9	257.3	265.8	257.1	277.8
Including retail bank credit	48.6	42.7	38.5	38.5	NA
Capital required for the credit risk	21.4	20.6	21.2	20.6	22.3

Source: Groupe Crédit Agricole

Three factors explain these changes:

1. The quality of the borrowers: the more a bank lends to borrowers with a good credit rating (1–3 on a 10- or 12-point scale) the more the RWA will be minimal or even nil. Lending to a customer deemed risk-free does not require any capital. So the best clients will have no difficulty in satisfying their requests for credit while the most at risk will experience much more difficulty, SMEs in particular.
2. The economic situation: in a period of weak or even negative economic growth the number of borrowers in difficulty goes up. When sectors of activity are in a precarious situation the actors' risks increase. Hence for the same amount of credit the risk exposure goes up, and with it the level of capital required. Consequently, certain sectors confronted with a more unstable economic situation risk having less access to bank finance

3. The amount of credit granted: the amount of credit granted has a direct impact on raising or lowering RWA. In a period of economic slowdown retail clients borrow less, and *vice versa*.

It is difficult to say which of these three effects has been the most significant in recent years. Only listed banks supply such information on a consolidated basis. Nevertheless we can see a real difficulty emerging for actors with average ratings, or those at the limit of what banks are prepared to finance at the present time. It is evident that the institutions set themselves limits that must not be exceeded in the context of what is nowadays called "the appetite for risk".

The customer's credit rating is more vital than ever, not just as supplying the basis for acceptance or rejection, and for determining and negotiating a rate of interest, but also in terms of the capital required. This requirement can be eased by a guarantee arrangement, but this tends to reinforce the criteria for credit authorisation, and a requirement of profit for the banks. In fact the rise in capital must in principle be sourced from profit margins. The interest rates proposed have to allow for profit to be realised, which is not often the case in a highly competitive context like the present, with very low interest rates. This appears to be a difficult equation to solve.

Consideration of the appetite for risk – credit in this case – is central to the approach, and so institutions have to determine clearly the positions they agree to take in terms of volume and profit margin. For a cooperative bank this brings several challenges in respect of the historically posted loan strategy. In the context of their geographical involvement with local businesses, are some cooperative actors more inclined to agree to finance customers with more risky credit ratings? While such a policy may be in accordance with their cooperative orientation, it creates a problem in respect of mechanical demands for greater capital. It is only possible for them to increase their share of this type of client by disposing of largely redundant capital and taking on a greater cost of risk.

This gives rise to a phenomenon where regulatory principles run broadly counter to the natural orientation of cooperative banks and tend to trivialise policy in every sort of institution. This very often leads cooperative banks to behave like traditional banks by themselves favouring the least risky customers.

Be that as it may, the question of the general balance between the business model – the cooperative model founded on proximity, geographical commitment, solidarity with and support for local development, and their profit and pricing policies – and the establishment of capital in conformity with regulations is a serious challenge. There is a real risk that financial cooperatives have to endow themselves with much more capital than conventional banks if they want to sustain their orientation in terms of social responsibility and adherence to their own values.

Effect 2: Increasing capital and the ability to bear loss

The preceding examples all point to the conclusion that more capital is required. Table 2 shows this sensitive development for classical (share capital) banks. Overall, the capital holdings of European banks increased by nearly 50% between 2009 and 2014, and are expected to increase by another 25% by 2018.

Table 2: Capital change according to balance-sheets[3]
Billions of €

Banks	Book value of capital 2007	Total assets 2007	Book value of capital 2015	Total assets 2015
Société Générale	31	1071	62.6	1334
BNPP	59	1694	100	1994
BPCE	47.8 (2009)	1029 (2009)	57.6	1166
CA SA	46	1414	59.4	1529

Sources: Bank reference documents

Beyond what we have suggested about the need to develop the business model to adjust the level of capital holdings, regulatory changes prompt changed management of capital in retail banks, in two respects:

Further improving performance and results: The best way to bring about this improvement is to improve operational performance and have the capability to improve net results. It is clear from the situation of retail banks today that this is a difficult aim to attain and suggests an acceleration of redundancy plans on a global scale. The first reason is the lowering of interest margins (the difference between the levels paid by customers and the level at which the bank repays itself). This has prompted a wave of renegotiation of credit conditions on the part of

[3] For BPCE consolidated accounts are available only since 2009.

clients. With the banks favouring the least risky customers, the interest margin is reduced still further. This lowering of interest margins is not balanced by a rise in commissions linked to the pricing of products and services, which most clients take badly, or by greater returns for market products. On this last point, the effects of the new regulations about market risk prompt investors to turn towards safe but less remunerative products, such as government bonds.

As a result, net banking income in France has stagnated for the past two years and the forecasts are not very optimistic. Therefore, the only possibility to make any profit is to limit operating costs (60% of which consist of personnel costs) and the cost of risk (see Lamarque, 2014). Which brings us back to a minimum risk credit policy that in turn leads to limiting increase in income…

French cooperative banks have not yet launched themselves into major reorganisation because of this, unlike the Dutch Rabobank.[4] Not having shareholders they are doubtless under less pressure to aggregate financial performance ratios as return on equity (ROE), which investors consider the main thing. Thus they enjoy a margin for manœuvre, but one that may not last if pressure on profits goes on for too long.

Having the capacity to raise capital rapidly: The other solution for increasing holdings is to have ready access to investors so that they can bring other capital. And this introduces a new problem for cooperative banks. However, maintaining net results with the organisation's capital is the essence of the cooperative system, which is not obliged to remunerate shareholders. One might suppose that the cooperative model is privileged because of this. However, the regulator and supervisor are fairly circumspect when it comes to the stability of capital and the ability to raise funds rapidly. On the first point it is true that members who bring monies that might be considered capital can ask to be reimbursed by the cooperative (at the nominal value) and this has to be done. If a large number of members decided to do the same thing the bank would be in danger. The regulator is thus inclined to consider members' shares more as debts, especially as they are often sold as an investment to customers of a cooperative bank.

[4] Cooperative banks, some of which are listed, might also find themselves obliged to distribute less in dividends and so diminish the value of their shares.

In situations of financial strain another difficulty arises from the rate at which this kind of bank can raise new members' shares. With the implementation of Basel regulations financial cooperatives have embarked on ambitious plans to raise members' shares. Without getting too technical, there are various types of these shares, some of which have features that reinforce their stability. Capital-raising and reinforcing activity like this does reveal a measure of success, but over the longer term it is not compatible with a short-term lack of liquidity. It really is a matter of having the ability to respond rapidly when events put the bank's liquidity in jeopardy. It is of paramount importance to be able to access sources of liquidity as quickly as possible. Whatever happens, it seems that rightly or wrongly the reactivity of a shareholder is greater than that of a member.

As for establishing a new total loss absorbance capacity (TLAC) ratio and the minimum requirement for eligible liabilities (MREL): apart from the technical aspects, the basis of these ratios is the "bail-in" mechanism, or the capacity of banks to mobilise liability resources other than capital to absorb losses that put the survival of the institution in danger. These mechanisms are still under discussion. Once again this will impact on cooperatives and their system of social shares reimbursable at members' request. Holders of social shares will be contacted through the resolution mechanisms, just as shareholders in conventional banks are. This risk, which is taken into account in the remuneration expected by shareholders, is currently not paid, or paid very little, to members of cooperatives.

Effect 3: Increasing the level of high-quality assets to ensure a sufficient level of liquidity

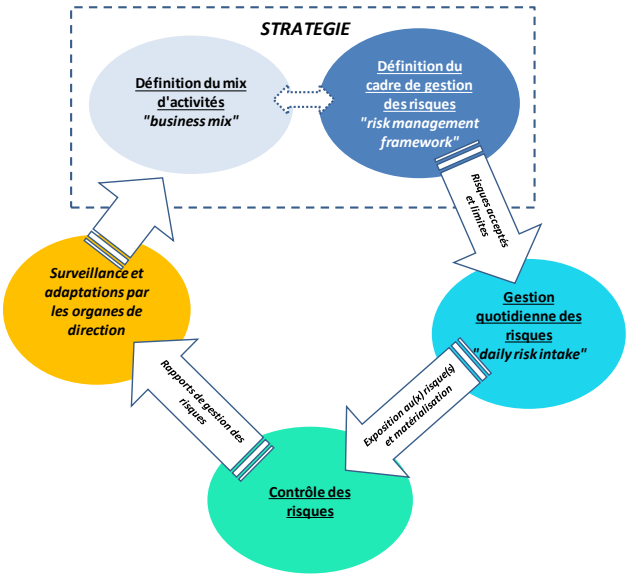
The question of capital was the main issue in the period 2010–15. Many banks have been obliged to anticipate demands linked to new Basel 3 thresholds principally under pressure from ratings agencies. The issue in the period just starting, and until 2019 (at the earliest), is liquidity. We will not go into detail here about the measures that are currently under consideration to satisfy new demands, because they are not really specific to cooperative banks in comparison with conventional banks.[5] They mainly concern the need for high-quality available assets that can quickly be transformed into liquidity without risk to their value to meet debts that fall due in less than a month, in the case of the liquidity coverage ratio (LCR), and less than a year in the case of the net stable funding ratio (NSFR). These obligations have led many banks to increase their deposits in the central bank.

[5] See Lamarque, forthcoming.

The consequences of these effects on banks' business models

To understand the consequences of these effects we have to go back to the banks' cycle of risk management that arose from the regulatory framework of the supervisory review and evaluation process (SREP), which interprets the thinking behind Pillar 2 of the Basel regulations. Figure 1 depicts this management cycle. It shows clearly that the definition of the activity mix, or business model, must be constructed or reviewed according to the risk management framework and, as we shall see later on, according to the appetite for risk authorised by decision-making authorities. As a consequence, each bank must have the ability to sustain its business model and its risk policy in terms of capital and liquidity. Adjustment will be made either by adapting the business model to the scarce available resources or by finding enough scare resources to maintain it. It is more likely that a balance will be found between both solutions.

Figure 1: Description of the SREP management cycle



The second striking fact lies in the importance of the input of governance, not only management in general, in defining the appetite for risk and, beyond that, in deciding on the implementation of resolution in case of financial stress. This new mission has led to the creation of risk committees, distinct from audit committees, within boards of directors or oversight. They will inevitably lead to a strengthening of the authority of those administrators who are members of these committees on questions of risk.

These two effects are potentially problematic for banks. The business model of these banks is intimately associated with solidarity values to do with geographical commitment, which may involve somewhat greater risk-taking with particular sectors of activity or kinds of client. In terms of governance, administrators elected to bodies in charge of risk control are nowadays not elected by virtue of their experience or expertise in the field. These two subjects are central to the preoccupations of financial cooperatives and our initial results indicate that consideration must be given to this matter.

3.2 Matching resources and risk control

Prudential regulations coming from the Basel committee are not just about quantitative ratios; with the implementation of surveillance arrangements they also have a qualitative dimension. SREP supposes the establishment of mechanisms controlling capital levels: the process of evaluating the sufficiency of internal capital (internal capital adequacy assessment process, or ICAAP) and the process of evaluating the sufficiency of internal liquidity (internal liquidity adequacy assessment process, or ILAAP). Concerning the management of liquidity risk, and consequently ensuring that depositors will be able to recover their assets in case of bankruptcy, the chief question lies in the organisation of arrangements put in place to anticipate liquidity risk, and, in relation to cooperative groups, the solidarity mechanisms existing to ensure the liquidity of entities within the group.

However, the question of supervising liquidity risk presents itself differently between decentralised entities with strong local bodies, like many financial cooperatives, and conventional banks. For example, regulation relative to the operation of financial groups, which arises today from principles enunciated by the Basel committee CRD4, clearly expresses the desire to see a clear definition of the mission and responsibility of the central organisation, particularly in respect of governing risk. The directive states that:

- in respect of the control of credit risk, it is necessary to have a global measure for the consolidated group, a common rating and specification of the entity responsible for the rating;
- the solvency and liquidity of the central organisation and all the affiliated establishments are traceable in their entirety in the consolidated accounts of the establishments;
- the management of the central organisation is empowered to give instructions to the management of affiliated establishments.

On the first point especially, the implementation of the note of instruction better known as BCNS 239 of January 2013, on the aggregation of risks in financial groups and the reporting of such risks, illustrates well the necessary development of institutions and their governance. This note particularly stresses the need to strengthen and improve infrastructure (in the sense of information organisation and systems) to transmit the best information in the context of reporting to governance bodies and to senior management so that they can identify, assess and manage risk.[6]

The regulation confers a number of powers on the central organisation that flow directly from what the directive indicates and is expressed in each national legislation.

- To take all measures necessary to ensure the liquidity of the group as well as that of each of its networks and affiliates and to that effect to determine the group's rules of liquidity management, notably in defining the principles and modalities of the situation and direction of the financial management of its constituent entities, and the conditions in which the establishments may carry out operations with other credit institutions or investment companies, conduct securitisation operations, issue financial instruments, or conduct any operation necessary for the management of liquidity.
- Take all measures necessary to ensure the solvency of the group, especially in implementing mechanisms for the internal solidarity of the group, and in creating a common guarantee fund and determining its rules of operation, modalities of intervening in supplementary funds, and the contributions of affiliated institutions for its provision and reconstitution, in the context of each national legislation.
- To determine the principles and organisational conditions of a mechanism of internal control of the group and each of its networks to ensure the control of the organisation, the management and quality of the financial situation of affiliated establishments, notably by way of controls on site, for example, a general inspection.
- To determine the policy and principles for risk management as well as the limits for the group and each of its networks and to ensure permanent oversight on a consolidated basis.

In the cases we have studied we find the same type of situation with the central organisation taking a strong role; this predominance has a marked effect on risk policy and management.

[6]BCBS 239, Principles for effective risk data aggregation and risk reporting, January 2013.http://www.bis.org/publ/bcbs239.pdf

In general, risk management skills can be expected to be strengthened with a view to improving the decision-making process and to ensuring effective control over all parts of the group to obtain an accurate picture of exposure to risk at the group level.[7] The regulator also expects arrangements for internal solidarity to be put in place to ensure a proper resolution if one component entity undergoes financial stress. Establishing such mechanisms also has the effect of reinforcing risk governance. Two principal types of arrangement are currently observable:

Simple systems of guarantee and solidarity

This system has been put in place in the case of two cooperative groups in our sample. It is broadly described in their reference documents. Its aim is to guarantee the liquidity and solvency of the group and affiliated institutions so as, if need be, to organise the financial solidarity within different groups of entities or brands[8] before looking to the overall solidarity between the entities. In the group BPCE the central organisation is responsible for taking all necessary measures to organise the guarantee of solvency for the group as well as of each of the entities or brands, particularly in implementing the appropriate internal solidarity mechanisms of the group and in creating a guarantee fund common to all the brands, whose operation rules it determines, and the modalities for releasing supplementary funds from two existing networks, as well as the contributions of affiliated institutions for its provision and reconstitution. Box 1 illustrates this arrangement.

[7] Several studies link the existence of a risk-management arrangement with a reduced exposure to risk. See, e.g., Aebi et al. (2012), Ellul et al. (2013).

[8] In many cooperative groups there are several different brands. The entities belonging to the same brand are first solid among themselves before looking for solidarity between the brands and other affiliated entities.

Box 1: Solidarity mechanisms within the BPCE group

As a central organisation BPCE manages the Banque Populaire network fund, the Caisse d'Epargne network fund and has set up the mutual guarantee fund, the Fonds de Garantie Mutuel:

- The Banque Populaire network fund consists of a deposit of €450 million made by banks into BPCE accounts in the form of a 10-year deposit, indefinitely renewable.
- The Caisse d'Epargne network fund has received a deposit of €450 million made by savings banks into BPCE accounts in the form of a 10-year deposit, indefinitely renewable.
- Le Fonds de Garantie Mutuel is made up of deposits from the Banques Populaires and the Caisses d'Epargne into BPCE accounts in the form of a 10-year deposit, indefinitely renewable. The amount of these network deposits was €18 million on 31 December 2014 and the fund will be supplemented each year by 5% through contributions from the Banques Populaires, the Caisses d'Epargne and their affiliates according to the consolidated results of the group.

The total amount of deposits made into the BPCE in the name of the Banque Populaire network fund, the Caisse d'Epargne network fund and the Fonds de Garantie Mutuel cannot be under 0.15% and cannot exceed 0.3% of the sum of the group's weighted assets.

In the establishments' individual accounts, the constitution of a deposit under the guarantee and solidarity system is relayed by the identification of an equivalent amount under the heading of a section devoted to equity. Mutual guarantee associations that statutorily grant their exclusive guarantee to a Banque Populaire benefit from the latter's guarantee of liquidity and solvency, the associations being collectively registered with it, according to article R. 515-1 of the monetary and financial code.

The managing board of BPCE has every power to mobilise the resources from different contributors without delay and in an agreed order on the basis of earlier authorisations granted to BPCE by the contributors.

Source : BPCE reference document

All the establishments in a group will come to the aid of beneficiaries in the case of a temporary liquidity situation (guarantee of liquidity) or to avoid or manage situations of financial defaulting (guarantee of solvency). The solidarity mechanism is inbuilt in the BPCE Group and does not constitute a guarantee that can be triggered by a third party, although French supervisory banking authorities might demand that the mechanism be brought into action if circumstances demand it.

The main limit to this kind of device is that it cannot benefit from a reduction in prudential demands, unlike mechanisms of the IPS kind described below. For the regulator, the question lies in his governance with consequences in terms of reactivity and decision-making in a crisis situation (the organisation holding authority).

The institutional protection scheme (IPS)

Capital requirements regulation (CRR) defines an IPS as an arrangement, contracted or as framed by law, that protects the establishments that compose it and, in particular, guarantees their liquidity and their solvency to avoid bankruptcy, should the case arise (article 113, paragraph 7 of the CRR, first phrase). The competent authorities can, in accordance with the conditions laid down in the CRR, exempt the members of an IPS from some of the prudential requirements or grant them exemptions. Currently, IPSs are recognised for the purposes of a CRR in three countries that are participating in the single supervisory mechanism (SSM/MSU): Germany, Austria and Spain. Two cases in our study are concerned here.

According to the ECB, in absolute terms, the importance of the IPS is considerable, given that 50% of credit establishments in the eurozone belong to an IPS, which represents about 10% of the total financial assets of the zone. In most cases, big and not so big establishments that are subject to surveillance by the ECB are members of the same IPS. Because of the high degree of autonomy and independence of establishments, in certain cases the ECB considers that although this mechanism guarantees the liquidity and solvency of its members, it is not the same as a consolidated banking group. We will return to the effects on governance of this hierarchy in section 5.2.

The basic interest of this mechanism lies in the possibility for the ECB to authorise a credit establishment to apply a risk weight of 0% to these exposures towards a counterparty that is a member of the same IPS, except for exposures that give rise to category 1 capital elements, to additional category 1 capital elements or category 2 capital elements. This is the main decision relative to the eligibility of an IPS with a view to prudential surveillance. Moreover, the application of the CRR's article 113 is one of the conditions preliminary to the granting of extra exemptions to members of an IPS, namely:

- the exemption of the deduction in participation in the capital instruments;
- the granting of an exemption relative to liquidity demands;
- the application of a percentage of lesser cash outflows and a percentage of higher cash inflows for the calculation of the requirement concerning coverage in liquidity needs.

Without going into the technical details too much, it is quite clear that these mechanisms affect the main regulatory solvency ratios. That is why, in July 2016, the ECB began a

consultation on the evaluation criteria of the IPSs it uses.[9] Before carrying out a detailed prudential evaluation it first of all determined whether an IPS was in a position to apply sufficient support in a case where one or other of its members was facing strong financial constraints concerning liquidity and/or solvency. As the ECB states in its document, we can see clearly that questions of organisation and governance are at least as important as the financial capacities of its members. An IPS should ensure that its member institutions abide by the regulatory requirements for own funds and liquidity. If such preventive measures are not sufficient the IPS needs to decide on material or financial support. Intervention by the IPS is deemed to be triggered, at the latest, where there is no reasonable prospect that any alternative measures, including those provided for in the recovery plan, would prevent the failure of that institution. As part of its contractual or statutory arrangements, the IPS should have in place a broad range of measures, processes and mechanisms that make up the framework within which it operates. This framework should comprise a suite of available actions ranging from less intrusive measures, such as closer monitoring of the member institutions on the basis of relevant indicators and additional reporting requirements, to more substantial measures that are proportionate to the riskiness of the beneficiary IPS member institution and the severity of its financial constraints, including direct capital and liquidity support.

In such a framework the characteristics of IPS evaluated by the ECB will mainly affect:

- the absence of obstacles to the transfer of funds between units;
- the rapidity of transfers;
- the absence of serious difficulties in management matters;
- the absence of serious problems in corporate governance in connection with members; of the IPS with a potential unfavourable effect on the rapid transfer of capital or on the rapid reimbursement of liabilities;
- the decision-making process relative to the support measures will allow a solution to be found in due course.

The topic of governance is therefore central and concrete situations need to be evaluated, within the cooperative groups concerned, which may not depend on ECB criteria.

[9] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/institutional_protection_guide.fr.pdf

After governance, the other lever of control is that of credit risk management policy. An IPS is responsible for the implementation of proactive instruments in the monitoring of risks and their follow up. This ranges from the choice of indicators to follow and fixing their limits to the realisation of stress tests at regular intervals to quantify the potential support measures to be taken concerning capital and liquidities. Finally, the IPS evaluates the risks and vulnerabilities of the sector to which its members belong at regular intervals.

The functioning of cooperative financial groups is questioned and the establishments develop their organisation and governance more or less rapidly. At one point the Crédit Agricole considered a reorganisation of its central body (ROC) where the functions mentioned above would be transferred from the listed structure via a holding company that owned most of the CASA capital. This project, which was not implemented, demonstrates the complexity of the structures of governance in the cooperative and friendly society context in general and the difficulty faced by the regulator and the banking supervisor in deciphering them. The bank nevertheless carried out some adjustments in governance matters with the presence of political authorities on the CASA board. Above all it clarified the financial structure of the group by ceding the cooperative preference shares that it held in the regional funds of the same banks.

Smilarly, during 2013 the BPCE group simplified its capital structure by buying up Natixis cooperative investment certificates through its regional banks, a structure with a certain number of affiliates. Thus the distribution of roles between BPCE, the central body and Natixis, which is listed, is clear and has been reinforced by a strict separation in capitalistic relations between the regional units of the groups (Caisses d'Epargne and Banques Populaires) and BPCE and then between BPCE and Natixis.

These examples of the largest French cooperative groups illustrate well the need for clarification of their organisation and governance to increase their efficiency but also their transparency from the outside. However, it is difficult to describe the consequences of relations between regional units and the central institution.

The object of our case studies is in fact to evaluate the devices set up by cooperative banks today to define their appetite for risk and the day-to-day management of risk, and especially the sharing of responsibilities between the central and the local levels.

4. What framework and steering for risk management? The governance of four major financial cooperative groups

4.1 Investigation settings

To answer this question four cooperative groups agreed to take part in our study: BPCE (France), Mouvement Desjardins (Canada), BVR (Germany) and Grupo Cooperativo Cajamar (Spain). These four groups are major actors in their national banking sectors, on the international scene and in the cooperative sector. Moreover, the three European groups are totally or partly supervised by the Central European Bank, which is a reflection of their importance. The Mouvement Desjardins is also considered as a banking group of systemic size by its supervising authority, the Canadian Autorité des Marchés Financiers (AMF). This number of groups, voluntarily restricted in the first phase, allowed interviews to be conducted on site and based on questionnaires covering many aspects of the governance of risk management. Our results are not attributed to one group or another for reasons of confidentiality. Some groups under review have an organisation that includes intermediary bodies, such as regional units, between local structures and the central institution. This study does not distinguish formally between these units and assimilates them at the local level.

Our work concentrates on the risks particularly linked to those of the banks' activities that are followed by the supervisory authorities. Some of the risks are the object of a requirement concerning "basic" coverage of the bank's own capital (capital ratio of Pillar 1 of the Basel regulations, see above): credit risk, market risk and operational risks. Others are subject to distinct regulatory requirements (e.g. liquidity risk, rate risk). The banking supervisor pays particular attention not only to different ratios but also to the management framework and the control of different risks.

The dimensions of governance and methodology play an important role in the ICAAP and ILAAP analyses carried out by the supervisor in the SREP framework. If any weaknesses are noted they could lead to an add-on requirement of equity or balance sheet liquidity. Table 3 describes the underlying elements of the main specific risks discussed in this study. Other risks, more particular to certain models of activity, were also mentioned by the cooperative groups during our interviews.

Table 3: Principal specific risks examined in the study

Credit risk	Provisions and losses on loans to clients
Liquidity risk	Risk that the dates of incoming cash flows (or the availability of assets) will not cover future cash pay outs
Interest rate risk (banking books)	Risk on interest margins resulting from a lag between the dates of refixing rates (duration) of assets, liabilities and derivatives
Operational risk	Risk of losses linked to the failure of internal processes and/or information systems, frauds, etc.
Market risk (and exchange)	Risk resulting from the revaluation of carrying values according to the marketing value (trading accounts or fair value under IFRS) or exchange value

Table 4 summarizes the main characteristics of each of these groups. In particular it shows that they pretty widely share the same types of risks that can affect their results. The liquidity risk has not been included in this table as it does not have a direct effect on the volatility of the result. Three of the groups are the subject of prudential requirements and supervision on a consolidated basis. All the groups haves set up a mechanism of solidarity and guarantee between the units of each organisation. Two of these are standard mechanisms (such as those just commented on) while the two others have an IPS-type solidarity function.

Table 4: Profile of the four groups studied

	Group A	Group B	Group C	Group D
5 main risks for the group *				
Credit risk		■	■	■
Rate risk (bank's accounts)	■	■	■	■
Operational risk	■	■		
Business risk	■	■	■	■
Market and exchange risk	■		■	
Investment risk	■	■	■	■
Other risk(s)				■
Risk weighted assets (RWA), % of the total on 31/12/2015 **				
Credit risk	87%	93%	89%	83%
Operational risks	10%	7%	9%	15%
Market risks	3%	0%	3%	2%
Financial solidarity mechanism between units in the group				
Standard type mechanism	■			■
Extended type mechanism (IPS***)		■	■	
Level of prudential requirements and supervision by banking authorities				
(Banking) units in the group on an individual basis	■		■	
Consolidated situation	■	■		■

* Effect on the volatility of the total or consolidated financial result of the group, measured or perceived. NB: does not include the liquidity risk.

** Leading to a demand for equity (ratio of equity in Pillar 1 of the Basel requirements): only concerns these three types of risk.

*** Institutional Protection Scheme

In our case studies we emphasised management responsibilities and we tried to identify the actors and structures behind decisions, as well as those involved in internal supervision.

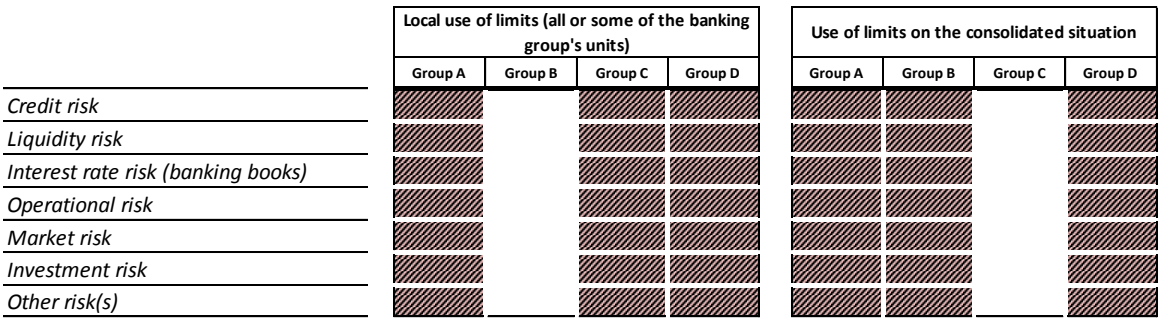
4.2 The analysis of management responsibilities

This section presents the results of our analysis of the management tools put in place for the different elements of the management cycle, the possible differences between the groups when it is a question of local and central responsibilities and the motivation behind certain tools. We are interested in analysing the current governance of the groups studied. Later, we will examine recent, ongoing or potential developments of these tools, adopting a prospective dimension.

Definition of the appetite for risk

In conformity with prudential regulation the different groups studied have set up methodologies that allow them to frame their overall appetite for risk. These methodologies have been applied on a large scale (the units making up these groups) and/or on a consolidated basis. This definition of the appetite for risk is stated according to several leading indicators (LI) covering the capitalisation and liquidity risk but also, for three of them, profitability risk (earnings volatility). As shown in Table 5, these LI are then translated into management limits and policies on a wide variety of specific risks, such as credit risk or rate risk, and this holds for each of the groups.

Table 5: Translation of LI according to different specific risks
(besides regulatory limits)



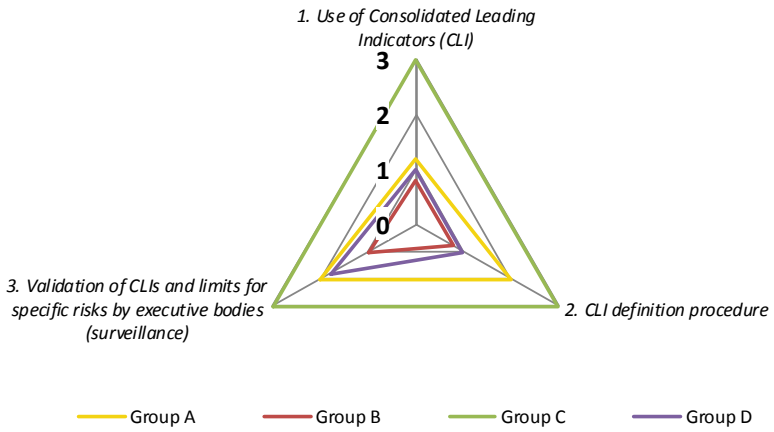
The appetite for risk is thus spread in a granular configuration according to the different risks. These limits ensure consistency between day-to-day management (decisions) and management aims. The LI and specific limits constitute the risk management strategy. These specific limits apply right up to the consolidated level for three of the four groups, which leads us to suppose that they are themselves derived from consolidated leading indicators (CLI). This is in fact the case and three of the groups have defined their appetite for risk on a consolidated basis (Figure 2, item 1). This supposes a certain degree of centralisation or at least of coordination when the consolidated levels are fixed.

When considering the "historic" decentralisation of the governance of cooperative groups we were interested in the procedure selected for fixing the CLI levels (Figure 2, item 2). Among the three groups using CLIs, two define them in a centralised way, according to a top-down approach. The CLIs result from an appetite for risk defined for the whole group and not from the rise of a "local" LI (local LIs are also determined, in a second phase, by the central unit). In the case of one of the groups, local LIs were subsequently adopted by local executive bodies (boards of directors who have the possibility to reduce this risk allocation but not increase it). In the case of the second group, which had adopted a top-down approach, only the central executive bodies were involved in approval. A third group also fixing CLIs distinguished itself by a mixed approach: the central unit established a first LCI proposition and a translation into local LIs. This proposal was then discussed with local units. The approach is thus both top-down and bottom-up. The LIs are approved twice by the executive bodies, at central and local level. For the fourth group that did not make use of LCIs, local LIs are prepared locally and only require the approval of local executive bodies.

We thus observe a convergence between the degree to which the local unit is implicated in the preparation of (C)LIs and the local executive body in approval of them. What emerges is a desire to centralise (or not) the definition of appetite for risk.

These early observations also tend to reveal different models of governance and centralisation. The existence of LCIs and the degree of centralisation of their definition both seem to be linked to the level of prudential requirements (and to supervision by banking authorities): local, dual (local/consolidated) and just consolidated.

Figure 2: Centralisation of the definition of the appetite for risk



Interpretation of the scale

The measures take entire values from 1 (centralisation) to 3 (decentralisation). To make the diagram easier to read, some markers have been slightly moved, for example, a marker close to 1 corresponds to an effective value of 1.

- *Item 1:* 1 if CLI used, if not then 3
- *Item 2:* 1 if CLIs are defined according to a top-down approach; 2 if a mixed approach; 3 if CLIs are defined according to a bottom-up approach
- *Item 3*: 1 if only validation by the central body; 2 if double validation; 3 if only local validation

The management of specific risks

In this section we examine the second phase of the risk management cycle: the responsibilities of day-to-day decision making regarding specific risks, within the framework of fixed limits. Figure 3 shows our different measures of central and local responsibilities.

For all the groups, the decision about *credit* (granting it to clients) is shared with the central body[10] (Figure 3, item 1). The decision remains local when it is a question of loans of usual amounts and risks but it is referred to the central body in more important cases. Similarly, for all the groups, the local decision is based on scoring models developed by or with the central body (Figure 2, item 2) with a view to greater consistency and synergy.

The incentives for maintaining a partly decentralised credit decision converge. It is well known that local knowledge of clients, aided by the roots of local units and the latters' capacity for decision making (granted by management executives) are put forward. The local decisious constitutes "an important comparative advantage

[10] For one of the groups, certain units are not included in the solidarity mechanism. Decisions remain completely local.

regarding other banks" and, quoting another group, "the Group provides a framework and potential alerts (counterpart, sector ...) but the knowledge of the client is local". These observations are confirmed by the fact that this decentralisation of the credit decision is also observed for group B, which had anyway opted for a strong centralisation of risk management.

Concerning *liquidity* management, it must first of all be noted that the local units do not refinance themselves directly on the markets (inter-bank or bond) except for a few units in one of the groups. The refinancing is managed by the central unit. Besides this, loans/borrowings between units are most often effected through the intermediary of the *central* unit (Figure 3, item 3). The central body thus assumes the role of group "banker". Day-to-day decisions about liquidity (management of liquidity gaps, choice of non-commercial transaction maturities) are also centralised for two groups (Figure 3, item 4). In another case analyses enabling day-to-day decision making are carried out locally but the transactions are done within the framework of envelopes defined by the central unit. Day-to-day management is thus qualified by the group as "relatively centralised". The last case presents a decentralised decision, while the units still have to refinance themselves from the central body.

For all the groups under study, the role of banker, which is assumed by the central body, is motivated by a desire to manage globally the capacities/needs for the financing of different units and to rationalise refinancing on the markets (monetary and bond). The sole presence of the central body or of just a few units means the number of operations (and the recourse to ratings agencies) can be limited and a consistent calendar can be managed. Regarding day-to-day management, centralisation is also motivated by a need for efficiency for some groups and the wish to limit the number of management reports. However, another group puts forward the need to analyse the local deposit of stocks and loans (better control of commercial liquidity).

With the exception of one group, the day-to-day management of *rate risk* (Figure 3, item 5) is wholly or partly decentralised down to local units. Even if this is still carried out within a definite framework it still seems less centralised than liquidity. However, the intensity of this decentralisation is in correlation with that observed for liquidity. So group D, which has opted for centralisation of the day-to-day management of liquidity, only delegates part of the decision making on the rate risk and, notably, the central unit only intervenes in hedging operations. Group A, whose liquidity management is less centralised, decentralises more of its rate risk management. Consistent with liquidity, the central body in group C does not take part in local day-to-day management.

This link between the (de)centralisation of the day-to-day management of rate risks and liquidity can be explained by the fact that they call on data that are partly shared. Decentralisation is notably more marked for the rate risk and could be explained by (i) a longer management horizon, (ii) the generation of supplementary local revenues linked to the transformation of maturities, or even (iii) a source of risk diversification.

When it is a question of *operational risks*, greater decentralisation is observed (Figure 3, item 6). With the exception of group B, the central unit does not intervene in most of the everyday decisions to rectify and mitigate risk. However, this does not exclude the central body from playing a role as it is a question of resolving transverse problems and being alert to events that happen in the group.

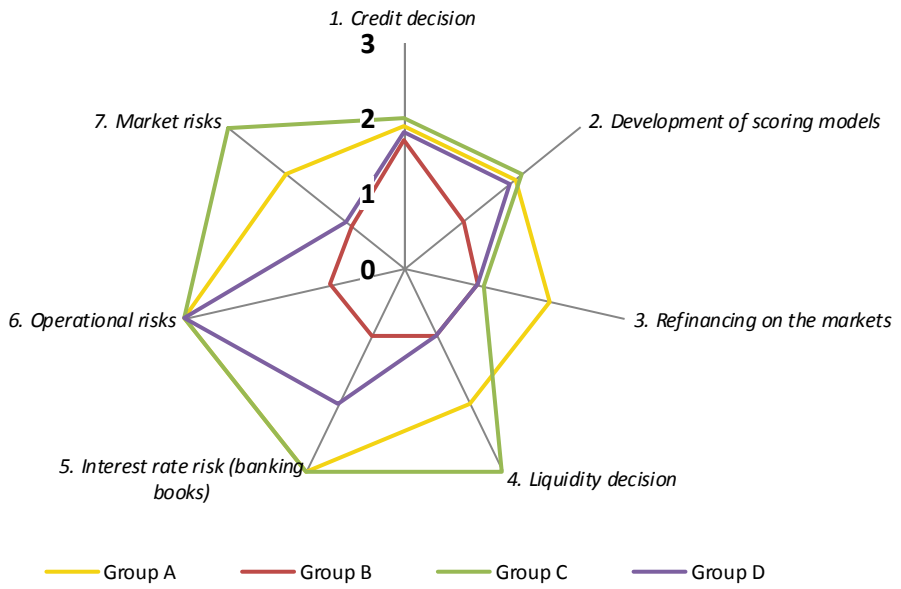
Like credit risk, but in a more pronounced fashion, this decentralisation of the day-to-day management of operational risks is motivated by knowledge of local incidents. These require things to be taken in charge and for there to be responsibility at the unit level.

As represented by the RWA in Table 4, the groups studied are less exposed to *market risks* than to credit risks. The management of market risks is centralised for two groups

(Figure 3, item 7). For group A the market risk is managed locally but few units are involved in activities that generate market risks and equity market exposure goes up to the central unit on a daily basis. Like the choices made for other risks, the market risks of group C are handled locally.

Specific risk management appears less centralised than the definition of the strategy might encourage us think. The analysis reveals that a relatively centralised strategic decision in not incompatible with more local management of specific risks on a daily basis. Besides, rate risks and operational risks are the subject of a fairly clear decentralisation. The credit decision and the management of liquidity risk also capitalise on the knowledge and experience of local units but the involvement of the central body is more marked. There is therefore a point of balance (variable) between the consideration of local competences and responsibilities and the importance of certain risks or even the synergies found in the centralisation (e.g. scoring methods). However, the refinancing that can affect the "survival" of a group is systematically placed under the authority of the central body. The level of (de)centralisation of specific risk management is linked to that observed for the strategy, and this is a wider reflection of the choice of models of governance.

Figure 3: Centralisation of (day-to-day) specific risk management



Interpretation of the scale

The measures take entire values from 1 (centralisation) to 3 (decentralisation). To make the diagram easier to read, some markers have been slightly moved, for example, a marker close to 1 corresponds to an effective value of 1.

- *Item 1*: 1 if granting of credit decision is systematically central; 2 if the decision is central according to the amount and the risk; 3 if the decision is systematically local
- *Item 2*: 1 if development is central; 2 if central/local partnership; 3 if local development
- *Item 3*: 1 if access to the market (monetary or bond) is exclusive to the central body; 2 if access is only for a limited number of units; 3 if access is for most units
- *Item 4*: 1 if day-to-day decision making (e.g. choice of maturity for a debt) depends solely or principally on the central unit; 2 if decision shared with local units; 3 if local decision
- *Item 5*: 1 if day-to-day decision (e.g. refinancing at a fixed or variable rate, covers) depends exclusively or principally on the central unit; 2 if decision shared with local units; 3 if local decision
- *Item 6*: 1 if decision (remediation) is central; 2 if decision is usually shared; 3 if decision is local
- *Item 7*: 1 if risk is only present at the level of the central body or its exclusive authority; 2 partial decision by local units or limited number of local units with authority; 3 if local decision

These observations meet the propositions put forward by the academic literature on the (de)centralisation of risk management. Therefore a common decision (e.g. the granting of a standard loan) gains by being decentralised to capitalise on local

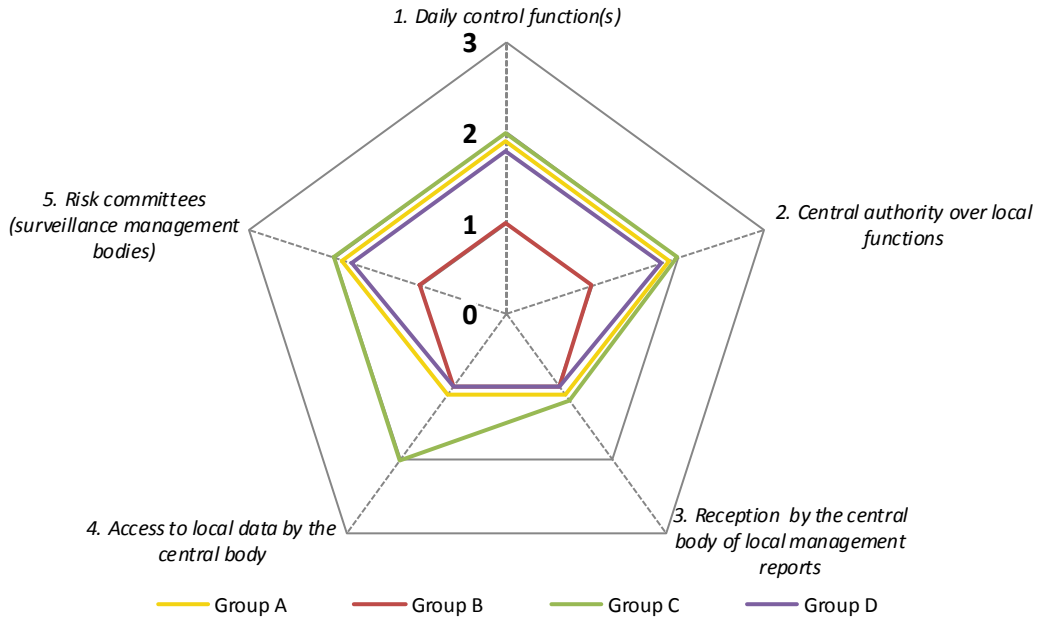
knowledge and makes the unit in question more responsible (appropriation).[11] However, as it is a question of "survival" or global strategy (appetite and breakdown of the risks) the decision gains by being coordinated centrally.[12] We will return to these aspects in section 6 where we propose an analysis of assets and challenges for cooperative groups.

Control and analysis of risks, monitoring by executive bodies

At this point we turn our attention to the control and analysis of risks (Figure 4). As item 1 shows, most of the groups have introduced shared responsibilities. However, Group B is an exception since the monitoring of risks is carried out by the central unit, which is consistent with its choice of centralising the day-to-day management of risk. Apart from this case, we can note that there is dual surveillance, at local and central levels, although those responsible at the local level are not placed under the hierarchical authority of the central body (Figure 4, item 2). This absence of hierarchical authority is notable because the cooperative structure means that the central body does not exercise any authority via local executive bodies. As one of the groups pointed out, the lack of central hierarchical authority means that local control functions can be positioned as a first line of defence. Initial responsibility for control and analysis therefore falls to local units, at least in those cases where they have to handle day-to-day decision making. For two of the groups, however, it should be noted that the central body has a functional and/or normative authority over local control and analyses. For all the groups, the central body receives all the management reports prepared by the local units and they generally have access to local information systems (Figure 4, item 4).

[11] See, for example, Stein (2002) and Ozbas et al. (2005) in the selective bibliography.
[12] See also Stein (2002).

Figure 4: Centralisation of control and risk analysis



Interpretation of the scale

The measures take entire values from 1 (centralisation) to 3 (decentralisation). To make the diagram easier to read, some markers have been slightly moved, for example, a marker close to 1 corresponds to an effective value of 1.

- *Item 1*: 1 if the monitoring function is carried out exclusively by the central unit; 2 if control function responsibilites are local and central; 3 if control is local
- *Item 2*: 1 if hierarchical authority; 2 if functional or normative authority; 3 if absence of authority
- *Item 3*: 1 if reception by central unit or IPS; 3 if not
- *Item 4*: 1 if direct access; 2 if partial access; 3 if no access
- *Item 5*: 1 if single central committee; 2 if committees at local and central levels; 3 if only local committees

Figure 4 also shows that the management of risks is subject to regular monitoring by executive bodies with a view to surveillance (item 5). Except for group B, where only the central unit is in charge of risk management, the responsibility for monitoring risks is shared, similar to locally exercised control functions: a first line of defence (which is in any case formally required by the regulations). In itself this local responsibility is not specific to cooperative groups since the executive board of the subsidiary of a commercial banking groups is tasked with the same responsibility. However, the number of units in cooperative groups is generally more important when related to the consolidated balance sheet or the total (especially at a domestic level). A more

fundamental difference, as we shall see when we come to section 6, is the representation (direct or indirect) of local units in the central executive bodies. Thus, even if the group adopts a top-down approach, for example, when the CLIs are fixed, this is validated by the local units. Equally, each unit can monitor the exposure to risk of the group and the central unit[13] (if the latter is leading the activities).

4.3 Developing arrangements

The instruments described above are a snapshot taken in mid-2016. Our interviews show that they have been subject to adaptations over the last few years and continue to evolve. The most notable development without doubt has been the decision by group B to centralise its management tool (excepting for granting certain loans) following the mutualisation of earnings and risks between units. The "risk" responsibilities and teams have been transferred to the central body, for both strategy and day-to-day management. Its IPS is still in place yet seems to play a less decisive role than in the past since the solvency risk for all of the units is now managed by the central body (consolidated supervision). For the other groups, and despite their differences, the day-to-day allocation of management responsibilities does not seem to have been fundamentally revised. Nevertheless, the central unit's implication in everyday management is increasing as it is a question of methodological developments and of norms as well as of information systems.

The different groups have underpinned their management strategy through the definition of their appetite for risk, with consolidated and/or local LIs (CLIs). Most groups using a CLI have increased their range (number) as well as extending the perimeter of units included ("roll out"). Group C currently has no use for a CLI for its central body (which is an IPS) and is developing analyses that will allow an even more global and granular view of risks. The group is thus capitalising on the presence of teams that monitor risks and an executive committee within the IPS, an advantage regarding the standard solidarity mechanisms.

[13] Or even to be informed about the exposure of other local units (we have not analysed this aspect in the present study).

Another common denominator among recent or current developments is the articulation between appetite for risk, such as the economic capital mobilised,[14] and the activity model. In quoting different groups, we can for example note "*the practice of fixing LIs that is integrated in the annual budget process*" or "*the deployment of LIs at the level of the line that concerns jobs and professions*" or even "*the development of the use of appetite at the level of the strategic planning process, the reinforcement of the prospective dimensions of some LIs*."

These mechanisms and their deployment to different units (allocation, implication of the central body, etc.) will be particularly interesting to study. The activities of financial cooperatives are in fact mainly situated at a local level, as is the group's equity.

5. Supervision by banking authorities

5.1 The particular case of cooperative groups

With the exception of the eligibility of shares in equity capital, international prudential regulations (linked to the work of the Basel committee) make little reference to cooperative financial groups. As far as the structure of banking groups is concerned, the rules are based on the notion of a parent unit and subsidiaries and so they refer to classic structures that are subject to "natural" consolidated supervision. However, European and some national legal regulations affect the ways in which cooperative groups are supervised.

Article 10 of European regulation CRR 575/2013 states that the national supervisor can waive prudential requirements for a group on an individual basis. These units must be permanently affiliated to a central organisation (not necessarily the parent company) and the following conditions must be met: (i) solidarity in the commitments of the units and the central organisation; (ii) monitoring of the solvency and liquidity of the central body and all affiliated establishments on the basis of consolidated

[14] All the risks together, taking into account the effects of diversification, so the view is in fact greater than that of Basel Pillar 1.

accounts; and (iii) formal authority of the board of the central organisation (i.e. the capacity to issue direct instructions) over the management of the affiliated units. In this case, the affiliated units are considered as subsidiaries and the group conforms to prudential requirements (equity, liquidity ratios, management framework, etc.) exclusively on a consolidated basis. The supervisor therefore overturns the shareholding structure. This is the case for group B in our sample.

If there is failure to apply Article 10, the units in the group remain individually subject to prudential requirements. However, in the case of groups that have an IPS, intra-group loans may not be subject to a weighting risk in the calculation of the demand for local units' equity (Article 113 of the same CRR, section 3.2). The classic mechanisms of solidarity, which do not correspond to the criteria defined in 7-c of the article, are not eligible. In the following section we show that IPS seem to be the first level of integration according to the regulator. Beyond this, supervision on a dual basis (individual units and consolidated situation) comes either under legal provisions that designate certain cooperative groups individually or under the judgement of the supervisory authority. The systemic profile of some groups that took part in our study is certainly not unrelated to a requirement for a regulator/supervisor where consolidated monitoring is concerned.

5.2 The consequences for governance

Our analyses have revealed a growing role for the central body but its responsibilities vary enormously from one group to another. Supervision on a consolidated basis is more than just a starting point for the management cycle and the use of a CLI places this supervision at the heart of a risk management cycle. This management of risk up to group level does not necessarily result in authority over the day-to-day management of local risks. We observed such authority in group B whose governance is resolutely centralised and whose local units are no longer subject to prudential requirements. This model is totally centralised. Despite the existence of a CLI, a lesser degree of day-to-day authority is observed in groups A and D (according to different intensities).

This is also manifested by an absence of a hierarchical link between the central unit and the monitoring (and analysis) functions of local risks. However, the central unit does have a functional and/or normative authority. We propose that the model operated by these two groups is "integrated".

Group C maintains clearly more decentralised day-to-day management. Its IPS-type solidarity mechanism nevertheless has teams monitoring the capitalisation of all the units and a group risk committee. The IPS also ensures the deployment of consistent methodologies at group level. The units are autonomous when it comes to day-to-day strategy and management. This model is "decentralised" but not totally because it is also "monitored". The role of the IPS can be compared to that of the supervisory authorities. We see the existence of an IPS with a defined authority (a capacity for preventive intervention) as constituting an initial level of centralisation, at least for the integration of the management of risks.

Finally, we raise the question of the role of governance, executive directors and executive boards in the internal control system that establishments set up (Lamarque and Karfoul, 2009). This preoccupation with the quality of governance does not concern monitoring but it does reinforce its significance and the contribution it makes to strategic decision making and fixing risk-taking levels. This movement is the logical consequence of criticisms made by the authorities about the passivity of governance bodies (boards of directors and supervisory boards) when it comes to controlling the risk taking of the establishments they supervise. In July 2015 the BCBS published its latest recommendations on the principles of business governance for the banking sector.

Here again, we find concerns about the composition and qualifications of board members. Everything therefore converges to increase the level of expertise of governance bodies so that they will be able to assume their function of controlling management decisions, will be able to challenge them and will also be able to assume their responsibilities in matters of strategic choices and risk policy.

These evolutions also result in stricter control by supervisors of the quality of governance and the possible reconsideration of certain administrative appointees. We arrive at a kind of certification of members of governing bodies to verify whether they really have the ability to carry out their functions.

The profiling and selection of administrators are directly affected by this new regulatory context. This poses several challenges to the way that administrators are recruited. Even using the term "recruitment" may seem incongruous, seeing that administrators are elected at the shareholders' general meeting (for a bank with share capital) or by members or their representatives (in the case of cooperative banks). Changing the way board members are appointed is not envisaged. So-called independent administrators must also be elected by the general assembly. However, what appears clearly from these "fit and proper" principles, which are gradually being adopted, is that candidates who are proposed for election must respect these expectations.

For cooperative banks, the election of financially experienced administrators is still problematical. As cooperatives with customers, these banks have a governance system that means clients can be elected to governing bodies. In this system financial expertise comes second to members' interests. The implementation of these principles has already had consequences in that certain elected heads of executive boards on cooperative banks have had to stand down from their post as executive director. In October 2014 the Crédit Agricole even brought proceedings against the Council of State arguing against this device. But the most difficult task will be to find candidates who have the required skills to conform to the new principles. For these actors it is a question of reflecting upon new devices that maintain both the specificity of the model and the capacity to constitute a board that brings together all the skills needed for it to be considered as collectively efficient.

Moreover, all the banks are going to implement training programmes for their administrators to maintain and increase the skills base. However, seeing how complex

the principles of banking management and associated regulations are, it is not obvious that the training currently being put together will be sufficient to attain the level desired. Besides this attempt at conformity, which seems to worry those concerned, the efficiency of governing bodies and the quality of decision making is now recognised as a real competitive advantage. Many companies have embarked on programmes to increase their efficiency and the quality of their contribution.

6. Summary of forces and challenges for cooperative groups

As we noted in Section 4.2, one of the assets put forward in our interviews is proximity to clients, thanks to knowledge of the client and "*the client's identification with his or her local institution*". All or part of everyday decision making arises totally or partly from this knowledge. This "*decision-making capacity*" is increased by the presence of local executive bodies and, as the group highlighted, "*during the first financial crisis our cooperative structure with local decision-making capacity proved its efficiency*". The materialisation of risk is directly measured for each unit in the income statement, which reinforces the efficiency of local responsibility: "*This decentralisation is based on the accountability of each of the local units in terms of the quality of their results and their balance sheet*." In this sense, the cooperative structure is clearly distinguishable from a commercial bank operating at a national level because its balance sheet is shared by different branches and a single income statement is issued.

The everyday responsibility of local units is not contrary to a management strategy (appetite for risk and limits on specific risks) nor to coordinated monitoring of the group. As we noted earlier, decentralisation can be linked to "integrated" management and can intervene in a management framework, ensuring a shared vision of risk. However, this integration is less natural than in the case of a commercial banking group because of the absence of a shareholder/hierarchical authority at the central body. It does, however, have the advantage mentioned by our interviewees: its participative dimension. The absence of a hierarchical authority at the central body and a greater coordinating role ensure a consistent framework alongside activities

developed locally and acceptance by local management. Thus, "*the monitoring and surveillance of different risks constitute a responsibility that is common to the organisation*" and "*this vision is founded on cooperative values that include inter-cooperation and solidarity and allow prudent risk management to be adopted*".

From this point of view it seems important to maintain the clearly marked direct or indirect presence of local units among central management bodies. Beyond the participative dimension, this presence allows local units to decide ultimately on a shared management framework and, beyond any specific legal provision, on the authority conferred on the central body. Where there is no central body in the usual sense (invested with different responsibilities regarding risks, marketing, HR – even conducting certain activities itself) the governance linked to the setting up of an IPS seems to offer an opportunity to develop this participative dimension to risk management.

However, when it comes to implementation, integration mechanisms become complex and can present a kind of inertia. This is the other side of the "participative" coin. The information system is also a more delicate matter for cooperatives than for a commercial bank holding company since the information feedback is less natural. The weight of the "information tools and systems" dimension also emerged clearly from our interviews.

7. Conclusion

Cooperative financial groups have been undergoing important changes since prudential banking regulations were extended to the governance of risk management. The devices that we have been able to analyse are the product of cooperative groups' reactivity and have been clearly established throughout the management cycle as defined by the regulator: definition of strategy, day-to-day management and monitoring. These responsibilities as well as their associated methodologies require increased centralisation if only for reasons of consistency and cost. However, we have not observed any convergence towards a single model.

Monitoring by authorities based on a consolidated situation necessarily requires stronger centralisation. For some of these implementations, the central unit acquires wide decision-making authority over different dimensions of management. Nevertheless, apart from this "centralised" model we have also identified an "integrated" model where the central unit is at the heart of the arrangement, particularly for strategy, but everyday responsibility remains local for a number of decisions (and at different intensities, according to the group). This model highlights that it is possible to deploy instruments at group level without necessarily adopting total centralisation. In our study an IPS-type mechanism nevertheless exerts a surveillance authority over the capitalisation of group units and ensures the consistency of several methodological developments.

Cooperative groups therefore continue, to different degrees, to capitalise on the decision-making capacity of local units and on their local knowledge. Another asset of cooperative groups also stands out clearly in our analyses: the participative dimension of risk management. In effect, whatever model is used, local units are represented on the executive bodies of the central unit and are therefore participants in decisions made at group level and the authority conferred on the central unit. This ensures a framework for risk management as much as it ensures adhesion among all the units. Until now, it has been possible to maintain these advantages and forms of decentralisation. However, the increase in the scope of regulatory requirements poses a challenge to cooperative groups as is concerns, for example, the articulation between risk strategy and activities, methodologies and increasing complexity and information systems.

These challenges are also questions for future research into the governance of risk management in cooperative groups. To these questions may be added those on the opportunity to extend IPS-type devices, if need be, as an alternative to instruments that are more centralising, and the necessary training in risk management for members (stakeholders) elected to executive boards.

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