Deloitte.

Funding the future

Emerging strategies in cooperative financing and capitalization

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Funding the future: Evolving strategies in cooperative financing and capitalization was commissioned for the 2012 International Summit of Cooperatives, held in Quebec City from October 8-11. The study also demonstrates Deloitte's commitment to recognizing 2012 as the International Year of Cooperatives.

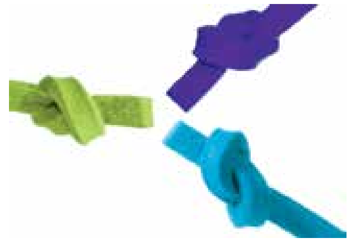
Executive summary

The post-2008 economic crisis has negatively impacted the ability of all commercial organizations to achieve adequate funding. The unique structure of cooperatives further complicates this reality, and requires a customized approach to overcome financing challenges.

To understand whether cooperatives are facing the same issues as the larger market; how their unique structure makes it easier or more difficult to achieve adequate funding and what they can learn from their peers, CFOs and senior executives from the world's largest cooperatives were asked how their organizations had fared during the crisis, and how their financing and capitalization strategies were evolving to respond to new market realities.

The survey provided clear evidence that financing and capitalization are becoming increasingly important for cooperatives, and demonstrated that the cooperative structure places additional constraints on the types of instruments and strategies that can be employed. Despite this, the study found that large cooperatives are gaining experience with external funding sources and innovative funding instruments, and view these as critical to achieving their strategic objectives.

This report focuses on two major areas – the need for funds and sources of funds – with each providing data on participants' responses to questions and placing the information in a larger context.



The need for funds

- **The impact of the crisis is real:** 65% of respondents identified the global financial crisis as having a negative impact on access to financing and capital, and 92% expressed concern about their ability to withstand another financial crisis.

- **Financing priorities are changing:** Survey respondents forecast a distinct shift towards inorganic growth (from 22% to 53%) and operational efficiency (from 17% to 43%) as major drivers of funding needs.

- **Regulatory pressure is intensifying:** 75% of financial services respondents reported that Basel III/Solvency II will have a major impact on their business model, and 58% cited a high level of uncertainty around regulatory change.

- **Access to funding is a priority:** 68% of respondents listed access to funding as one of the top three strategic priorities facing their organizations today.

- **Challenges related to the cooperative structure will continue:** The top three challenges to the cooperative funding model were identified as:
  - i Significant dependence on surplus and earnings (65%)
  - ii Balancing the interests of an increasingly diverse stakeholder group (65%)
  - iii Limited ability to raise capital within the member base (59%)

Sources of funds

- **A more diversified array of financing options has emerged:** 50% of respondents forecast using non-traditional instruments to meet their financing and capitalization needs.
- **There is increased use of external funding sources:** Only 35% of respondents are planning to use obligatory member shares as an equity lever compared to 50% today. To compensate, cooperatives are expanding the use of other types of equity instruments. 53% are planning to issue equity instruments to external investors compared to 38% today.
- **Debt is being diversified internationally:** Funding via international debt markets is forecast to grow from 24% to 53%.
- **Consolidation is being employed as a capitalization strategy:** More than one-third of all respondents expect to use mergers and acquisitions as a tool for meeting their funding needs.
- **Cooperative principles are being used to improve access to funding:** Recommitting to cooperative principles such as a longer-term strategic and operational focus, member economic participation; and collaboration among cooperatives were identified as value-added approaches to solving a cooperative's capitalization needs.

Successfully funding the future

To improve their access to capital, enhance risk management practices, and increase stakeholder engagement, cooperatives are encouraged to:

- **Review** capital needs to ensure that sufficient funding is being raised in response to the evolving economic environment.
- **Assess** historical financing and capitalization strategies to determine their suitability for meeting future capitalization needs.
- **Update** funding plans to ensure that the right mix of debt and equity; the right classes of equity; and the right mix of internal and external investors are being pursued to satisfy capital needs and manage risk.
- **Expand** the range of financing tools to diversify sources of capital and accomplish capitalization plans.
- **Educate** members and investors on the implications of internal versus external funding strategies, and help external investors better understand and appreciate the unique elements of investing in a cooperative.
- **Engage** regulators to ensure that the unique structures of cooperatives are reflected in new legislation and regulations.
- **Strengthen** governance processes by ensuring that the board offers the required competencies, experiences and perspectives with respect to cooperative strategy, risk profile and operations.

Background

The crisis of capital

One of the most significant casualties of the economic crisis that has gripped the world's markets for the last five years has been ready access to sufficient capital and financing. Organizations of all sizes, all industries and all geographies have been impacted. In a recent survey of North American CEOs, for example, nearly half mentioned either U.S. or global economic conditions as their most concerning risk, particularly in the Eurozone.

Capital scarcity is the result of reduced availability from conventional sources and increased need due to a challenging business climate and new regulatory requirements. Cooperative organizations have not been immune to these issues, and face competition from aggressive organizations with increasingly sophisticated social agendas. They must build scale and invest in their businesses to compete, but their unique structure requires a customized approach to meeting funding needs.

When facing the need for increased capital in a competitive and uncertain economic environment, the cooperative business model has emerged as both a strategic advantage and a challenge.

A significant amount of research has been conducted in recent years examining cooperative funding from a theoretical standpoint, with limited feedback from cooperatives themselves.

- Are cooperatives facing the **same financing and capitalization challenges** as the wider market?
- How does the unique structure of a cooperative make it **easier or more difficult** to achieve adequate capitalization?
- How can cooperatives **learn from their peers** in order to optimize their strategies for securing capital?

Taking the cooperative pulse

To answer these questions, Deloitte conducted a global cooperative financing and capitalization survey in the summer of 2012, the first of its kind since the 2008 crisis. CFOs or delegates from 36 cooperatives, including some of the world's largest, were asked how their organizations had fared during the financial crisis, and how their financing and capitalization strategies are evolving to respond to new market realities. Responses were received from four continents and four main industry sectors: agriculture/forestry, banking, insurance and consumer/retail.

Survey findings were supplemented with experience gained serving clients in the cooperative and non-cooperative sectors; interviews of cooperative leaders from around the world; and with complementary peer research. The findings are consolidated in a series of recommendations for cooperatives to optimize their funding strategies.

What cooperatives told us

68%
listed access to funding as a priority today

87%
anticipate difficulty in accessing financing and capital in the future

75%
report Basel III/Solvency II will have a major impact on their business model

53%
forecast shift towards inorganic growth in driving the need for capital

43%
forecast shift towards operational efficiency in driving the need for capital

50%
expect to use non-traditional instruments to meet their financing needs

63%
expect collaboration to be an important funding strategy for the future

The need for funds

With over a billion members worldwide, cooperatives play an important role in the global economy. Driven largely by the needs of their membership, they are different from investor-owned corporations in many regards. However, cooperatives increasingly compete with investor-owned corporations in terms of both operations and access to sources of funding. The cooperative business model, while offering the advantages of access to member financing and often impressive customer loyalty, introduces a number of challenges in an uncertain, highly-regulated economic environment. Cooperatives must be true to their mission as they seek to achieve the greater financial flexibility needed to drive growth and compete successfully.

The global survey confirmed that the financial crisis has affected cooperative organizations around the world, and provides valuable insight into how regulatory and competitive pressures are increasing the need for adequate funding while complicating its acquisition.

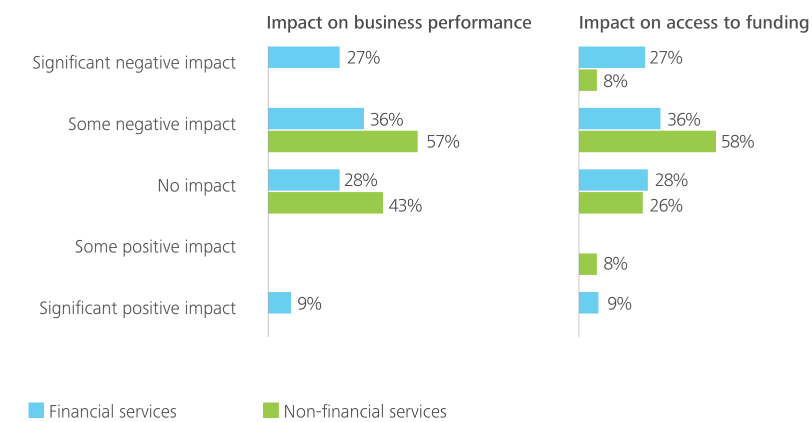
The impact of the financial crisis

The 2008 economic crisis has had a profound impact on cooperatives. As expected, the effect was most pronounced in the financial services (FS) sector, with 63% in this group reporting "significant or some" negative impact on business performance. In the non-financial sector (non-FS), although no cooperatives reported a significant negative impact, 57% did report that it had "some" negative impact on their business performance.

In the financial services sector, 27% also reported that the financial crisis had a significant negative impact on availability and access to capital. Only 8% of non-financial services cooperatives felt this way, with many (58%) citing "some" negative impact on the availability and access to financing and capital.

Survey respondents indicated anxiety about their ability to manage another financial crisis. The concern is especially prevalent in the capital-intensive agriculture sector and the financial markets-dependent banking and insurance sectors, where 100% of financial services cooperatives indicated they are "somewhat to very" concerned. Similarly, 93% of agricultural cooperatives surveyed indicated this level of concern about their organization's ability to withstand a situation similar to 2008.

2008 Global financial crisis



57%

report negative impact of the 2008 financial crisis on business performance

66%

report negative impact of the 2008 financial crisis on access to funding

Shifting funding priorities

The global financial crisis experience is impacting the way cooperatives deploy funding. As with the broader economy, cooperatives reported that their pre-crisis funding activities were conducted primarily to satisfy organic growth and infrastructure needs. Looking forward, there is a distinct shift towards inorganic growth (from 22% to 53%) and operational efficiency (from 17% to 43%).

Within the financial services sector, growth and efficiency are also important considerations, but these organizations forecast a greater need than the "all cooperatives" group to respond to capital-related regulatory requirements and external rating and market expectations.

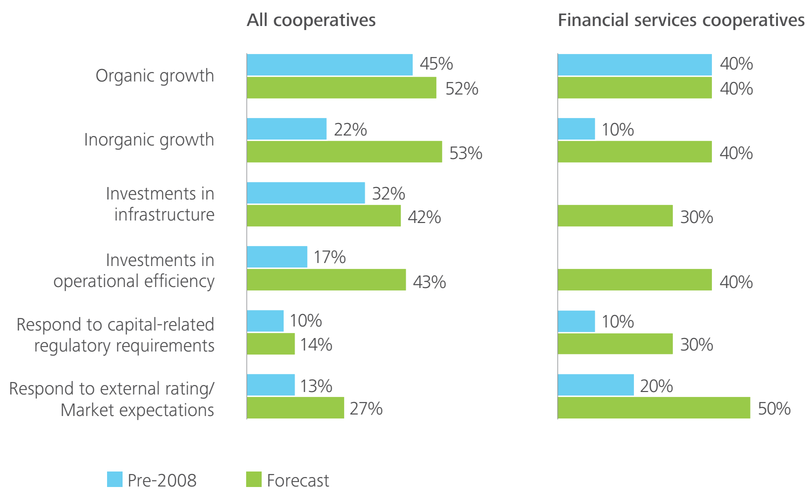
Increased focus on inorganic growth

Among the cooperatives surveyed, organic growth and inorganic growth are cited as the top factors driving the need for funding. The cooperative sector focus on growth is consistent with the larger market; it is generally accepted that creating and maintaining economies of scale is of renewed importance to cost competitiveness. As cooperatives compete with non-cooperatives in most markets, they are consequently feeling pressured to remain competitive by acquiring scale.

External research and survey responses confirm that growth presents unique challenges for cooperatives. Cooperatives often operate in mature industries with defined geographies and specific mandates; many have formal or informal restrictions on entering neighbouring territories. A growth strategy can also be difficult to communicate and implement in the cooperative context, particularly where the benefits to existing members are not clear or where members perceive the strategy as diverting resources available for distributions or reinvestment in other priority activities. In certain circumstances, democratic decision-making process may engender a level of risk-aversion that makes a growth strategy less attractive.

Further complicating the pursuit of inorganic growth is the fact that many cooperatives are structurally unable to issue additional common equity,[1] and must therefore fund acquisitions and other expansion projects through debt and/or liquid assets. The success of a cooperative in managing this and other challenges will impact its growth strategies.

Key factors driving the need for capital



Investing to improve operational efficiency
Investing in technology and infrastructure to improve efficiency and meet member and customer expectations has been identified as another important driver of the increased need for funding. 66% of all cooperatives surveyed rated investment in technology and 61% rated investments in infrastructure as having a medium to high degree of importance today.

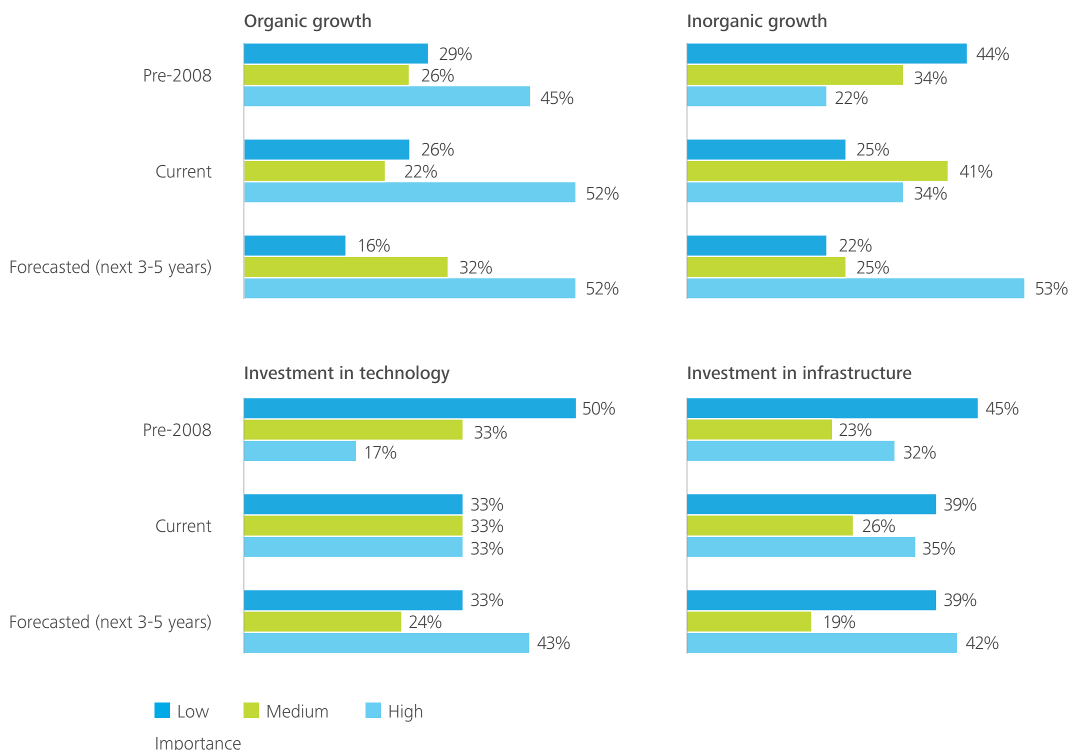
While cooperatives and non-cooperatives both view investments in technology and infrastructure as critical to improving productivity, remaining competitive and growing operating margins, the nature of cooperatives can translate to additional pressure in this regard. Financial cooperatives, for example, have historically maintained extensive branch networks to support strong links to their members and communities. In our survey, a European financial services cooperative reported the need to explore opportunities for increased efficiency in these networks. This need will likely escalate as mobile banking, contactless payments and integrated cash management become table stakes, prompting credit unions to invest significantly if they are to remain competitive with the leading banks.[2]

Intensifying regulatory pressure

One of the most far-reaching responses to the global financial crisis has been the move by multiple jurisdictions to increase regulatory oversight of market activities, particularly in the financial services sector.

Many new regulations do not take into account the unique structure of cooperatives, creating additional and often unnecessary burdens on these organizations. At best, these regulations fail to improve a cooperative's risk profile; at worst, they serve to limit its strategic flexibility.

Drivers of capital needs



Basel III and Solvency II
75% of financial services cooperatives surveyed for the study are working towards Basel III (global capital adequacy standards) and Solvency II (EU insurance regulation) compliance. In this subset, 75% identified the impact of these regulations on business model and strategy as a key concern, with 58% citing uncertainty related to the application of the final regulatory frameworks to cooperatives. Cooperatives surveyed indicated the need for additional guidance or a cooperative-specific set of regulations, with 55% saying that it is "required or strongly required" and a further 18% responded that it is "somewhat required."

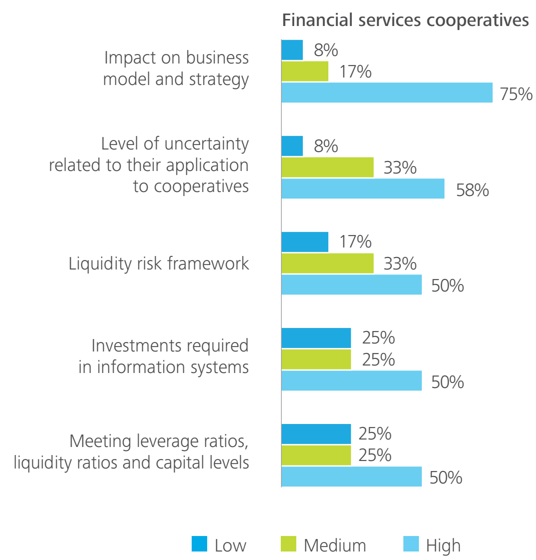
IFRS
While the move to IFRS (International Financial Reporting Standards) potentially impacts all cooperatives, compliance is a particularly critical issue for the financial services sector. Among cooperatives surveyed for the study, 68% are working towards IFRS compliance. Major concerns include increased volatility in results, and additional cost, effort and risk associated with models required to derive fair value information. Cooperatives are also concerned that the classification of cooperative member shares as liabilities rather than equity due to their share redemption features will impact external investor perception of their capital strength and negatively impact the treatment of these instruments for regulatory capital purposes. Adding to this concern is a lack of clarity on how cooperative-specific accounting treatments will be managed under IFRS. 70% of respondents indicated a "somewhat to strong" need for additional guidance and clarification on the implementation and impact of IFRS.

Access to funding now a cooperative priority

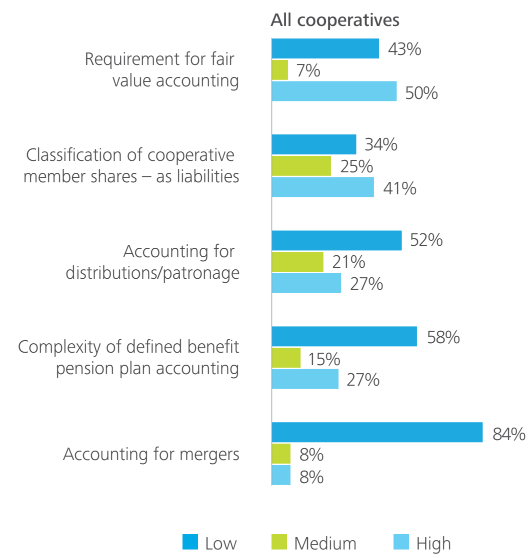
Survey respondents confirmed that access to funding has become more complicated in the aftermath of the 2008 global financial crisis. Consequently, survey respondents reported an increased level of vigilance relating to maintaining sufficient access to liquidity and capital. For many cooperatives, access to funding is expected to be an increasingly high-priority issue, moving from 50% pre-crisis to 68% today and 77% in the future.

The financial services cooperatives surveyed are already placing greater importance on access to funding. While a slightly larger percentage of this group (56%) ranked access to capital before the financial crisis as a high priority, 78% identify it as such in the current environment.

Key concerns with Basel III/Solvency II regulations



Key concerns with IFRS standards



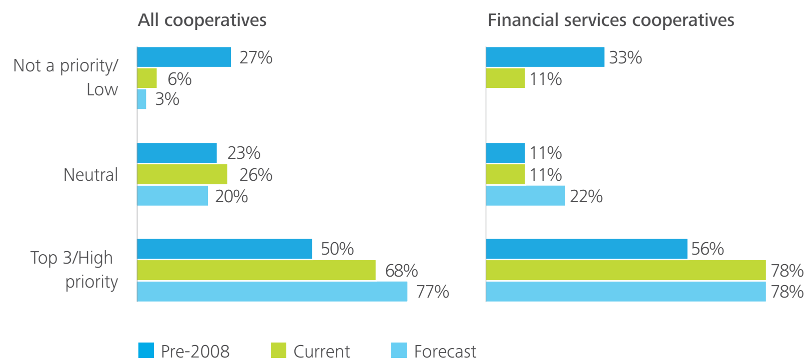
Not only is accumulation of funding a high priority for cooperatives, it is a difficult process, made so by the general issues of economic uncertainty and increased regulations as well as the restrictions imposed by the cooperative model on the issuance of equity. Of all cooperatives surveyed, 87% expect that accessing sources of capital other than retained earnings will become "somewhat to very difficult." This is significantly higher than the 45% calling it "somewhat to very difficult" pre-crisis, and the 68% citing it as such today.

Liquidity concerns affect lending decisions

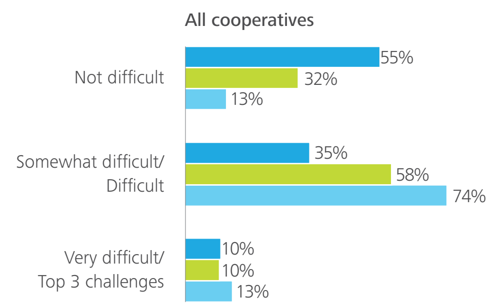
Since the global financial crisis, fluctuations in global liquidity have had a major impact on financial stability and economic growth. As the sovereign debt crisis spreads from Portugal, Italy, Ireland, Greece and Spain to core Eurozone countries, the possibility of a second credit crunch continues to temper equity markets and impact market liquidity and credit spreads. European banks' risk aversion in such an environment, coupled with increased capital requirements owing to Basel III reforms, created tight liquidity conditions in the last quarter of 2011. Since then, Moody's decision to put 114 European banks and eight non-European banks on negative watch in 2012 is expected to affect interbank lending, and eventually increase the cost of funding for borrowers.[3] This decision will also constrain the availability of funding for a number of organizations as banks become increasingly selective about the recipients of their financing.

It is therefore not surprising that cooperatives today are especially concerned about their ability to meet liquidity needs. 26% noted that before the 2008 crisis, it was "somewhat to very difficult" to meet liquidity needs. Today, 32% of cooperatives feel this way, and 74% expect to experience difficulty in the future.

Access to capital as a priority



Difficulty in accessing capital



Cooperative structure challenges continue

Opinion was divided on how the cooperative business model impacts its ability to raise capital. Although almost half (48%) of all respondents felt that a cooperative's capital structure and restrictions are not a competitive disadvantage, 59% felt they had limited ability to raise funds within their membership base.

As cooperatives are often funded primarily through obligatory member capital (on which members do not expect a rate of return), and debt (where interest payments can be tax deductible), they typically enjoy a lower cost of capital. Not surprisingly, only 30% of all respondents felt they had an intrinsically higher cost of funds than their non-cooperative competitors.

Ownership structure limits access to equity

The ownership structure of a cooperative results in limited sources of traditional equity capital. Cooperatives do not typically issue common equity shares to external investors, as ownership and control must reside within the membership base. As a result, cooperatives have historically relied significantly on retained earnings to fund growth, which limits the rate of capital accumulation and the ability to grow.[4]

Although 62% of respondents in the non-financial services sector felt they had limited ability to raise capital within the member base, ranking it the top challenge, financial services cooperatives did not identify this particular factor as a challenge. Differing perceptions may be due to the global financial crisis, but could also be structural – a large agri-foods respondent indicated that the preference of agricultural cooperative members is to limit investment in the cooperative to their trade commitment.

Balancing funding requirements with stakeholder interests

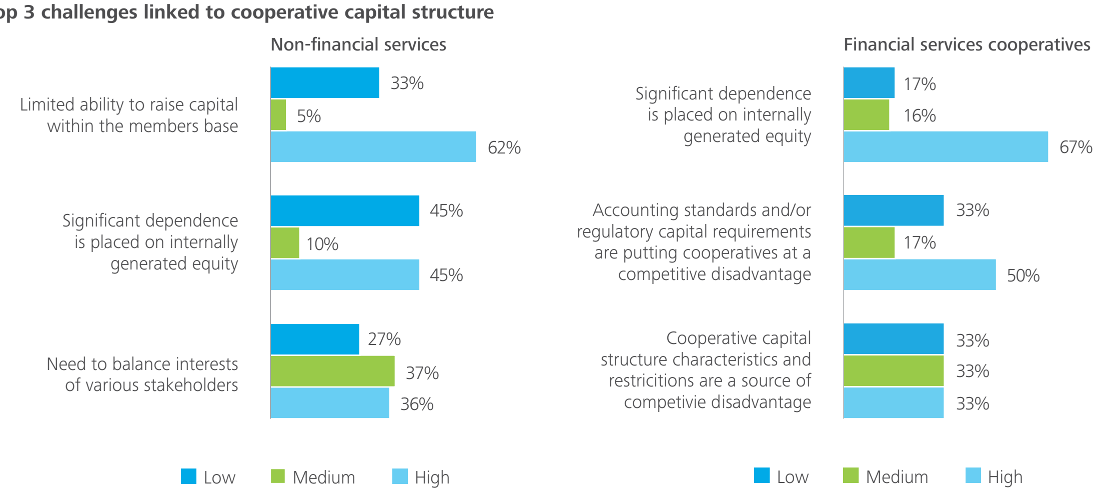
73% of the survey's non-financial services respondents agreed that balancing a cooperative's financing and capitalization requirements with interests of various stakeholders is a challenge. One of the cooperatives interviewed mentioned that achieving alignment between management and members on strategic priorities can be an issue, especially as it relates to inorganic growth. Members may see expansion as a risky endeavour and hesitate to support related investments, while management could view growth as a necessary response to a competitive marketplace.

Although the overlap between the constituencies in a cooperative – with members being owners, but also clients, suppliers and employees – could serve to simplify decision-making when interests align, it can complicate issues when they do not. The balancing act becomes further complicated when external investors with differing investment objectives are introduced to the mix.

Robust governance required

The decision to pursue innovative financing options requires added oversight and risk management capabilities. However, external research on the topic concludes that cooperatives vary widely in the robustness of their governance structures. While the one member/one vote principle enabled cooperatives to better withstand the financial crisis through risk aversion, consideration should be taken to prevent an overly conservative and/or insufficiently rigorous approach to risk management.[5, 6]

Top 3 challenges linked to cooperative capital structure



Top 10 shifts in attitude pre-crisis versus forecast

The table below presents the "Top 10" issues where the cooperative perspective, as provided by survey responses, has shifted most significantly before and after the global financial crisis (GFC).

Topic	Change from pre-crisis to forecast	Details
Meeting liquidity needs	+ 48%	26% of the cooperatives noted that it was "somewhat difficult" to meet their liquidity needs pre-GFC. This number shot up to 74% for the future.
Difficulty accessing sources of capital	+ 39%	Only 35% of the cooperatives felt it was "somewhat difficult" to access sources of capital pre-GFC, while 74% expect this to be "somewhat difficult" in the future.
Inorganic growth	+ 31%	Organizations placing high importance on inorganic growth grew from 22% pre-GFC to 53% in the future.
Prioritization of access to capital	+ 27%	The prioritization of access to capital as "high" increased from 50% pre-GFC to 77% for the future.
Operational efficiency	+ 26%	Importance of investing in operational efficiency grew from 17% pre-GFC to 43% in the future.
New financing markets	+ 30%	The perceived importance of developing new financing markets grew from 23% pre-GFC to 53% in the future.
International debt markets	+ 30%	Employment of international debt markets grew from 23% pre-GFC, to 53% in the future.
New types of financing & capitalization instruments	+ 24%	"High" support for issuing new types of financing and capitalization instruments grew from 26% pre-GFC to 50% in the future.
External, non-member investors	+ 20%	Perceived importance of issuing equity to external, non-member investors grew from 20% to 40%.
Collaboration with other organizations	+ 16%	Support for collaboration with other organizations (including cooperatives and non-cooperatives) grew from 47% to 63%.

Although the overlap between the constituencies in a cooperative – with members being owners, but also clients, suppliers and employees – could serve to simplify decision-making when interests align, it can complicate issues when they do not. The balancing act becomes further complicated when external investors with differing investment objectives are introduced to the mix.

Sources of funds

As cooperative organizations seek to satisfy their increased need for capital, they are exploring a variety of new options. This section highlights some of the advantages of the cooperative model as it relates to financing and capitalization; outlines conventional and emerging options available to cooperatives; and presents examples of how cooperatives are finding innovative solutions to their funding needs.

A diverse array of financing options

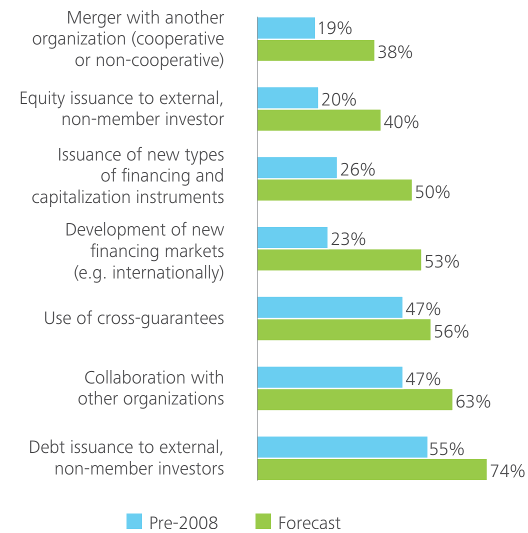
Organizations generally have four options for financing new growth and operational investments: operating capital (e.g. retained earnings); debt (e.g. bank loans, issuance of debt instruments, securitization); equity; and hybrid debt/equity instruments (e.g. convertible bond offerings). Cooperatives have historically focused on funds from operations and debt or equity from their member base. However, as the survey responses indicate, cooperatives are now looking beyond traditional financing approaches to improve their capital positions and enable growth.

Many are identifying new financing markets and issuing new types of financing instruments. They are evaluating the issuance of equity to external, non-member investors, and collaborating with other organizations – both cooperative and non-cooperative – at higher rates. Rather than relying solely on bank debt, the percentage of cooperatives seeking to issue debt to external, non-member investors jumped from 55% pre-crisis to a forecast level of 74%.

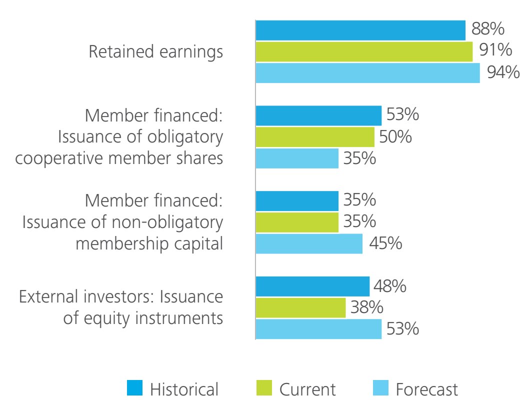
Expanded equity options

Many cooperatives depend on retained earnings as the primary source of equity financing. Obligatory member shares are another key source, particularly when the minimum investment is greater than a nominal amount. However, survey respondents indicated that obligatory member shares, historically the most common source of capital after retained earnings, will decline in significance. Only 35% expect to use these as a top equity lever compared to 53% before the crisis. Cooperatives decreasing their reliance on obligatory membership capital are expanding the use of non-obligatory member capital and capital from external investors.

New funding options



Comparison: Utilization of top equity levers



Cooperative equity and debt instrument options (non-exhaustive)

The table below identifies potential cooperative debt and equity instruments for quick reference.

Instrument name	Description
Conventional (obligatory) cooperative membership shares	• Acquired by members as condition of membership • Issued and redeemed at nominal value • Typically adheres to one member-one vote principal • Earns return in the form of patronage and other dividends • Generally considered Tier 1 capital as long as redeemable under limited circumstances
Preferred shares and certificates – members	• Issued exclusively to members • Redeemed at nominal or market value • Typically non-voting • Earn priority interest • Perpetual, non-cumulative type generally categorized as Tier 1
Preferred shares – non-members	• Acquired by third-party investors that are not members of the cooperative and may not use its services • Redeemed at nominal or market value • Could include voting rights • Priority right to earnings • Perpetual, non-cumulative type generally categorized as Tier 1
Tradable cooperative shares and investment certificates	• Transfer of assets to an investor-owned firm in exchange for stock • Listing of minority portion of cooperative shares or shares of some entities on a regulated market • Traded at market value • Could be voting or non-voting • Earn return through dividends • Generally constitutes Tier 1 capital
Senior debt issuance	• Could be issued to members and non-members • Redeemed at nominal or market value • Non-voting, unless hybrid • Earn return through interest which could be floating or fixed
Subordinated debt issuance	• Loans (or securities) that rank below other loans (or securities) with regards to claims on assets or earnings • Typically issued to outside investors by large organizations • Non-voting • Fixed or floating interest rate
Covered bonds (FS)	• Debt instruments secured by a pool of assets, such as mortgages or loans, held by special purpose vehicle (SPV) that guarantees repayment of the covered bonds in case of default by the issuer
Securitization (FS)	• Process through which an issuer creates a financial instrument by pooling other financial assets (e.g. mortgages) and then markets different tiers of cash flows relating to the repackaged instruments to investors

% of respondents				
Currently issuing		Forecast		Remarks
50% FS and non-FS		**20%** FS	**43%** non-FS	• Primary motive of the acquirer is to conduct business with the cooperative rather than get financial returns
70% FS	**19%** non-FS	**40%** FS	**48%** non-FS	• Enable cooperatives to raise discretionary equity • Could be issued directly by the cooperative or by a separate legal entity
40% FS	**36%** non-FS	**60%** FS	**50%** non-FS	• Enables the cooperative to bolster its equity position
80% FS	**60%** non-FS	**89%** FS	**70%** non-FS	
50% FS up from 17% pre GFC		**34%** FS		• Could help with bank's liquidity position but does not reduce leverage ratios
33% FS down from 50% pre-GFC		**33%** FS		• Drop in usage mainly due to significant contraction in securitization markets following the global financial crisis rather than the cooperatives choosing not to access this market

Outlined below are some examples of how cooperatives have diversified their funding sources by using non-traditional types of financing instruments.

Issuance of conventional cooperative membership shares

Membership equity shares, typically issued to establish the ownership interest of members, are usually one of the cheapest sources of financing as members do not expect a market rate of return. Membership equity shares generally enforce a one member/one vote ownership structure. In some jurisdictions, legislation allows cooperatives, when required, to make mandatory assessments for long-term membership shares that do not give additional voting rights but pay small dividends.[7] As noted above, surveyed cooperatives are decreasing their reliance on obligatory cooperative member shares and increasing the use of other types of equity levers.

Membership equity shares in a financial services cooperative have been generally considered Tier 1 capital for Basel requirements as long as they are redeemable under limited circumstances, and the redemption does not reduce capital below a fixed level. Redemption of membership equity shares usually requires board approval.

Another closely aligned category is patronage equity shares. These are investment shares issued in lieu of patronage dividends, and are themselves eligible for dividends. The individual caisses (credit unions) of Canada's Desjardins Group give their members the option to receive surplus dividends as membership certificates instead of cash. The membership certificates are non-voting, but give the holder the right to an interest rate voted on by the members and conditional on the caisse generating a surplus. Another example is a North American dairy cooperative that grew to over $3B in revenues relying significantly on member capital; its current capital structure includes over $500M in investment shares.[8] The cooperative's patronage shares are eligible for dividends and can be transferred among members.

Issuance of preferred shares/certificates to members

Member certificates are non-obligatory instruments that allow members to increase their investment in the cooperative. The certificates can have a fixed maturity date or can be perpetual in nature. They earn a set percent annual dividend that is discretionary, but must be paid before surplus payments to members. Certificates can be cumulative, meaning that if the dividend is not declared one year, it will accumulate with the following year's dividend, or they can be non-cumulative.

Issuance of preferred shares/certificates to non-members

Similar to certificates issued to members, those issued to non-members are uninsured, perpetual, non-cumulative and carry no voting rights. Rabobank issues hybrid capital (similar to certificates) via a trust to outside, non-member investors in exchange for a defined rate of return based on prevailing government bond rates. Investors in this type of instrument do not have the right to convert their securities to ownership shares in Rabobank, and hold no voting rights. Another example is CHS, a leading U.S. cooperative owned by farmers, ranchers and other coops. Since 2003, CHS has issued non-voting preferred shares to outside investors that can be traded on NASDAQ. The shares entitle the owner to receive an 8% dividend on the par value of the shares.[9]

For smaller cooperatives, an investment pool is a useful approach. As part of an experiment in 2006, twenty-one Australian credit unions created a purpose-built entity to issue preferred shares to institutional investors and offered returns based on a spread over BBSW (Australian financial markets reference rate). The credit unions provided the entity with a loan reserve equal to 10% of the aggregate face value of the issuance. Given that the credit unions had no history in this type of instrument and therefore no track record of payment, the reserve provided additional comfort to the market with respect to the preferred shares.[10]

Issuance of tradable cooperative shares and investment certificates

Tradable cooperative shares and investment certificates require the cooperative to transfer all assets to an investor-owned firm in exchange for stock. A minority portion of the stock is then sold on the stock exchange to raise capital directly from outside investors. Cooperatives retain control of the organization by holding the majority of outstanding stock while accessing outside capital. As an example, Crédit Agricole S.A, listed on the Euronext (Paris) was created to represent all of the Group's business lines and components. As of December 2011, 56.2% of Crédit Agricole S.A was owned by the regional banks that make up the Federation of Crédit Agricole, and 38.7% was owned by institutional and individual investors.[11] Danish Crown, a Danish food processing company and Europe's largest pork producer, voted in October 2010 to form a limited company wholly owned by the cooperative for the purpose of opening up external investor financing options over the long term.[12]

Deployment of secondary markets to enable trading of cooperative instruments

Secondary markets, such as a regulated stock exchange, allow investors to purchase cooperative securities from other investors rather than directly from the issuing company. Secondary markets enable the trading of cooperative capital, thus providing liquidity to members and investors. A secondary market for cooperative capital instruments such as preferred shares/member certificates would make these instruments more attractive to both members and external investors. While only 9% of non-financial services respondents provide secondary markets for their investors, 25% of financial services firms currently do so. This is partly driven by regulatory requirements for Tier 1 capital. One European financial services respondent noted that they established a secondary market to enable trading of membership certificates, which were required to be non-redeemable in order to qualify as Tier 1 capital. To allow holders of these certificates to opt out and to eliminate the need for a liquidity premium, the cooperative trades membership certificates quarterly at a market value derived from bids and offers received through the quarter.

Setting up a secondary market requires a significant effort and ongoing administration. Cooperatives must determine eligible instruments (e.g. membership shares, preferred shares or common shares); establish a system to process orders; decide on the frequency; set up a clearing house to match buyers and sellers and update records (often outsourced); and determine the share valuation.

35%

expect to rely on obligatory cooperative member share, declining from 53% pre-crisis

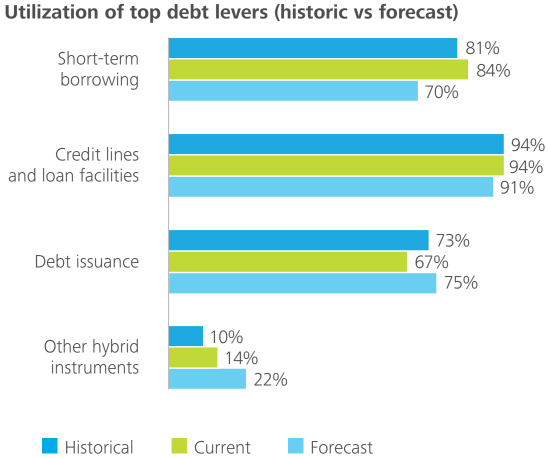
74%

Forecast to issue debt to external non-member investors, a jump from 55% pre-crisis

Expanded use of debt instruments

Credit lines and loan facilities are expected to remain the top debt lever used by the cooperative sector. Among cooperatives surveyed, 94% currently use these instruments, and 91% expect to use them in the upcoming three to five years. However, over-reliance on bank loans can be problematic in light of regulations such as Dodd Frank and Basel III. These regulations decrease leverage ratios and increase reserve requirements for banks, reducing the amount of capital that they are willing to put at risk and increasing the cost of debt for borrowers. This de-leveraging threatens to decrease the availability of loans for non-cooperatives and cooperatives alike, and further bolsters the case for increased debt diversification.[13] Surveyed cooperatives are considering issuing more non-loan debt and hybrid instruments in the future – 75% and 22% respectively compared to 67% and 14% today.

Utilization of top debt levers (historic vs forecast)



Issuance of senior debt to members

Senior debt issued to members typically has a defined long-term maturity and a fixed or a floating interest rate. Rabobank has successfully issued senior debt to its members who value both the attractive rate of return and the opportunity to contribute to the financing of their cooperative.

Issuance of subordinated debt to non-members

Subordinated debt is typically issued to outside investors with a defined long-term maturity. It is non-voting with a fixed or floating interest rate. In most cases, only large organizations are able to generate sufficient scale to issue stand-alone subordinated debt. However, similar to trust preferred shares, an investment pool approach can be used for smaller organizations.

Of the cooperatives surveyed, 74% are expecting to issue debt to external, non-member investors. This is especially true in the agricultural sector and in North America. The benefits of issuing long-term debt include longer maturities than bank loans, which increases flexibility for CFOs, and an opportunity to diversify the investor base. For example, Canada's Desjardin Group issued a significant amount of subordinate debentures on the American capital markets via Capital Desjardins,[14] a wholly-owned purpose-built subsidiary. The proceeds were then invested in subordinated notes issued by Desjardin's member caisses, effectively allowing them to raise financing when needed. Rather than going through the process individually, the member caisses deal with Desjardins Capital which issues on a consolidated basis. Desjardins Capital's short form base prospectus allows it to issue senior notes and Class C preferred shares.[15] Similarly, some of the agricultural cooperatives in France that previously relied solely on bank debt have started accessing bond markets, and many are analyzing this option.

Expanded use of cross guarantees

Cooperatives are projected to increase the deployment of legally-binding cross guarantees to connect different entities of the group as a risk management tool. In a cross guarantee arrangement, individual entities are liable for each other's obligations. Rating agencies tend to view this type of arrangement as less risky since the entire organization is viewed as a single consolidated risk unit. Liquidity management is performed by a central function for the collective. Survey respondents forecast an increase in cross guarantee arrangements from 47% pre-crisis to 56% in the future.

Increased use of external funding sources

An underlying theme of the move to more innovative financing instruments is the employment of external funding sources. This trend is expected to continue as cooperatives grow in size and the complexity of their capital needs increase. Cooperatives who embrace this strategy must also ensure that their debt and equity issuances are presented in a market-friendly manner – particularly to investors unfamiliar with the cooperative model – or they risk creating tension between internal and external stakeholders with different strategic priorities.

International diversification of debt

There is a clear trend towards cooperatives crossing national borders in search of capital. Large cooperatives in particular are becoming comfortable issuing debt in foreign-denominated currencies. While this may reflect the emergence of multinational cooperatives and customers, international debt issuance is increasingly being used to support funding strategies such as currency hedging, diversification of the investor base, interest rate exposure and access to lending markets. Prior to 2008, only 23% of respondents reported accessing international debt markets. That number is forecast to be 53% of all surveyed cooperatives and 65% of those in the non-financial services sector.

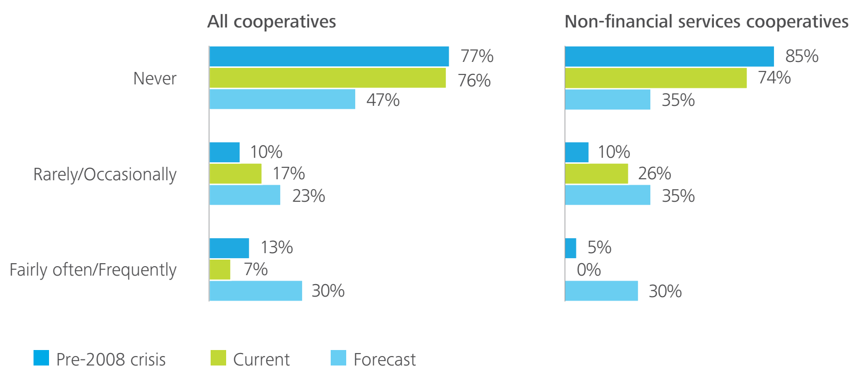
Making the cooperative attractive to member and non-member investors

As cooperatives move away from obligatory membership capital towards non-obligatory sources, they must strive to make the cooperative an attractive investment for member and non-member investors. As an executive of a **European food cooperative** noted, the usual debate within the cooperative sector is whether external investors should be allowed to invest in a cooperative, but another important question is whether investors would want to invest. This respondent's cooperative has actively engaged external investors by building a track record of performance and investing in branding and technology to stay competitive with non-cooperatives.

Engaging with investors and rating agencies

Building relationships with investors and lenders will support a cooperative's ability to access financing at competitive rates. The relationship with rating agencies is especially important for cooperatives primarily financing themselves through debt, or for those seeking to issue debt in the future. Keeping investors and rating agencies educated and updated through regular communication and discussions in the form of meetings, presentations, roadshows and results calls can enhance this relationship.

Use of international debt markets



Consolidation as a capitalization strategy

Consolidation is not a new concept for the cooperative sector. Scale is a strategic imperative for many industries, and inorganic growth can be an effective tool. As an example, the number of credit unions in Canada dropped from 3,700 to 370 between 1966 and 2012, while at the same time, the percentage of Canadians who were members of a cooperative more than doubled. As economies of scale can improve access to funding and lower the cost of funds, financing and capitalization pressures are projected to accelerate the consolidation process.

As noted previously, inorganic growth was cited by survey respondents as a major driver of capital requirements. While some level of consolidation will be achieved through the purchase of non-cooperative entities, unleveraged mergers of cooperatives is a more obvious method of strengthening a balance sheet and building a platform for growth. The ongoing merger of cooperative banks in the Philippines into a single viable entity is one example of how capitalization needs are driving consolidation in the cooperative sector.[16]

Application of cooperative principles to improve access to funding

Adherence to cooperative principles among the cooperatives surveyed remains strong. The huge range in operating models, industries and geographies make broad generalizations difficult, but elements of the cooperative model can be seen as assisting an organization's funding efforts. Survey respondents confirmed the importance of the International Cooperative Alliance's (ICA) cooperative principles[17] to their organizations, with 69% reporting that adherence was formally tracked and only 6% reporting that these principles were not considered.

Long-term strategic and operational focus

Cooperative management is expected to act as an intergenerational steward of a healthy business, and prioritize the long-term viability of the organization over short-term market/investor pressures. Cooperatives often exhibit or emphasize a stronger sense of purpose and a firmer focus on their longer-term strategy than non-cooperative businesses. This can prevent over-reacting to short-term issues and opportunities. For example, while European cooperative banks have a 21% market share, they only accounted for 7% of all the European banking industry's write-downs and losses between the third quarter of 2007 and the first quarter of 2011.[18]

The longer-term focus may translate to less volatile earnings and greater risk aversion, as member-owners generally rank quality of service over return on investment. While not specifically asked in the survey, multiple studies have found that the risk-averse nature of cooperatives was a factor in their ability to better withstand the 2008 global financial crisis.[19, 20] However, as discussed earlier, a focus on risk aversion can be more successful when balanced with exploration of innovative funding strategies.

Member economic participation

Member economic participation is one of the defining features of cooperative societies. Members have the responsibility to contribute equitably to their cooperative, and to exercise democratic control. Members often receive limited compensation on capital subscribed as a condition of membership. However, by exploring innovative instruments such as non-obligatory member equity, cooperatives are providing opportunities for members to strengthen their cooperatives while offering a market rate of return. These strategies can revitalize the membership base as an enabler of growth and stability.

Cooperation among cooperatives

The principle of "cooperation among cooperatives" can be an important financing tool. For example, cross guarantees between vertically-aligned cooperatives can be used to reduce trade finance capital requirements and free up capital for other uses. Pooling of assets and liquidity programs via structures such as credit union centrals is another example of how cooperatives are working together to manage their capital requirements.

Successfully funding the future

As the 2008 financial crisis and aftershocks including the Eurozone debt crisis continue to disrupt global markets, cooperatives around the world are being forced to re-work their approaches to financing and capitalization. This study has reviewed the factors behind the increased need for capital, and explored the innovative ways that leading cooperatives are addressing the problem.

How can cooperatives use this information to enhance their organization's financing and capitalization capabilities?

Evidence suggests they should examine their current strategies and methods, and identify opportunities to integrate innovative approaches.

Provided below are series of questions cooperatives should ask about their current capitalization strategies. The questions have been grouped into a seven-step review process, which progresses from high-level strategy to tactical implementation. Many also apply to non-cooperatives, but in aggregate the questions are customized for the unique needs of cooperative organizations.

1 Review capital needs

Survey respondents clearly indicated that their capital needs are increasing due to greater competition, regulatory pressures and complexity of operations. To reduce the risk of inadequate capitalization, it is important that these new conditions be considered in an organization's capitalization plans. Cooperatives should ask themselves:

- Do we have the **liquidity necessary** to meet our normal operational and financial commitments? What **contingencies** have we built into our plan?
- Are we considering **inorganic as well as organic** growth?
- If inorganic growth is being considered, do we have **sufficient capital to fund the purchase**, or will it be a non-cash merger?
- How will the funding of future acquisitions affect our **credit rating and access to capital** in the future?
- Will our **planned investments in operational efficiency** be sufficient to maintain our competitive position?
- Have we adequately projected the **capital impact of proposed regulatory changes**?
- Have we adequately planned for both **short-term and long-term capital needs**?

2 Assess historical financing and capitalization approach

A solid understanding of historical capitalization approaches is an important step in the strategy process, particular to identify why a particular mix of debit/hybrid/equity and internal/external funding approaches has been used in the past. Given that the range of instruments also varies by the complexity of each cooperative, it is important to understand the track record of these approaches. Cooperatives need to look into their recent past and consider:

- How difficult has it been for us to **access sufficient capital**? Has the perception of lenders, investors and rating agencies changed?
- What are the **key factors** affecting our credit rating?
- Do we have any important credit facilities coming to term? What **impact would renegotiation have on availability of capital**? On cost of capital?
- Are sources of capital **diversified enough** to allow for changes in financing conditions?
- Is our **cost of capital competitive with our peers**, given our risk and operating profile?

3 Update funding plans

With an understanding of your historical capitalization approaches and projected capital needs, cooperatives need to review their funding plans and assess their suitability for meeting future capital needs. Cooperatives should ask:

- Do we understand the **key performance metrics** and disclosures of relevance to our internal and external investors?
- Do we know how we **compare to other coops and non-coops** in our industry?
- Do we have access to **adequate stable financing** based on our capital plan?
- Do we have the **right mix** of retained earnings, debt, equity, and hybrid instruments?
- How must this investment mix **change to match** our capital needs?
- Do we have **the right classes** of financing and capitalization to meet our regulatory needs?
- Are we overly dependent on **internal or external investors** for our capital needs?
- How well positioned are we to **withstand another financial crisis**? Do we have sufficient liquidity and contingency provisions?
- Does our membership **understand and support** the financing and capitalization strategy?

4 Expand the range of financing tools

When choosing the method of raising capital, cooperatives can no longer expect to rely on what has worked in the past. They should consider various alternatives to generate opportunities, lower cost of funds and mitigate operational risk including:

- **Non-traditional debt** instruments
  - **Senior debt** to members and non-member investors
  - **Subordinate debt** to members and non-member investors
- **Non-traditional equity** instruments
  - **Preferred shares/certificates** to members and non-members
  - **Tradable cooperative shares** and investment certificates
- Exploring **new financing sources** (e.g. external investors)
- Issuing debt in **foreign geographies/currencies**
- Establishing **purpose-built entities** to enable external fundraising
- Formal and informal **collaboration with other organizations** (e.g. joint ventures, cross guarantees, supply chain financing)
- **Mergers** with other cooperative organizations
- **Acquisition** of non-cooperatives

5 Educate members, investors and rating agencies

While all commercial ventures require the support of their investors, it is particularly important in the case of cooperatives. A strategy that embraces obligatory and non-obligatory member capital, for example, relies on explicit member support for success. In many cases, this will involve convincing members to accept a wider strategy than the one they originally endorsed. External investors, in contrast, require a certain amount of hand-holding to be educated on the unique structure of cooperatives and appreciate their value. To review the success of current engagement strategies, cooperatives should consider the following questions:

- Do our members understand the **implications of internal versus external** funding?
- Do our members understand that **retained earnings may be insufficient** to meet capital needs?
- Do external investors understand what **makes our organization different/unique**?
- What is our **investor reporting strategy** (annual reports, quarterly reports, relevant metrics, etc)?
- What is our **engagement strategy** for rating agencies?

6 Engage regulators

As the survey confirmed, adverse regulations are among the most significant challenges facing cooperatives today. Concerted and coordinated lobbying efforts have succeeded in the past in modifying regulations in a cooperative-friendly manner. Simply allowing the regulators to implement new strategies will not be sufficient. If applicable, develop and implement an active engagement strategy for market regulators that includes the following activities:

- Participate in **cooperative industry efforts** to identify key regulatory issues and develop a **common influencer approach**.
- **Structure your regulatory** (e.g. IFRS, Basel III, Solvency II) technical arguments and suggested solutions in a **cohesive and persuasive format**.
- Reach out to your **regulatory bodies** to educate them on the unique nature of your organization.

7 Strengthen governance processes

Increasingly complex financing and capitalization strategies will significantly change the way cooperatives raise funds. To manage these strategies and ensure that the right types of funds are being raised for the right reasons in a manner that mitigates risk, cooperatives need a robust governance structure. Organizations should assess the impact of capital structure changes on their governance processes by asking:

- How do our **governance processes impact our ability** to change capital structures?
- Does our board **collectively offer the required competencies**, experiences and perspectives with respect to cooperative strategy, risk profile and operations?
  - If gaps are identified in the above assessment, consider **recruiting external board members** with appropriate expertise.
  - **Expand the role of audit**, risk and compensation board committees to increase transparency and improve risk management.

The domino effects of the 2008 financial crisis have hit the cooperative sector. While these organizations traditionally relied on retained earnings and member financing to fund business plans, like all organizations today, they are operating in a very different business environment. They need more money to grow and compete, and funds are less available than ever before.

For cooperatives, accessing new sources of funding is made more complex by a unique business model – one that presents opportunities as well as challenges. Cooperative organizations able to navigate new options and raise sufficient funds for inorganic growth and operating efficiencies can capitalize on these opportunities. By reviewing their funding strategies, embracing innovative financing options, and actively engaging their investors and regulators, they will be in a stronger position.

The increased complexity of *funding the future* is a challenging issue for cooperatives, as are the broader issues of achieving scale and market differentiation. All cooperatives must take steps to solidify their value proposition in an intensely competitive environment.

To succeed in both funding and assuring their futures, it is imperative that cooperatives focus on their core business and value proposition to create a distinct and sustainable advantage.

Are you ready?

Appendix: About the survey

Overview

The objective of the study was to understand how the largest cooperatives – with a focus on the financial services and agricultural sub-sectors – manage their financing and capitalization needs. The study set out to capture the “voice of the cooperative sector” through a global survey of CFOs and senior executives. The survey itself was conducted in April-June 2012, and was distributed to large (Global Top 300) cooperatives in four industry sectors: agriculture/forestry, banking, insurance and consumer/retail. The survey results were augmented with secondary research and in-depth interviews with cooperatives.

Key questions asked

Sources of funds

- How does the capital structure need to evolve in response to changes in drivers for capital and the need for added flexibility?
- What are some of the specific considerations for cooperatives in the financial services sector?
- How can membership contribute to improving the solidity of capital structure

Key stakeholders

- Why is it important to get membership buy-in of cooperative priorities and funding strategy?
- What considerations are required to improve access to external, non-member investments?
- What can be done to ensure that cooperative model particularities are considered in regulation?

Capital management

- What is the impact on governance processes of capital structure changes?
- How will you execute this strategy?

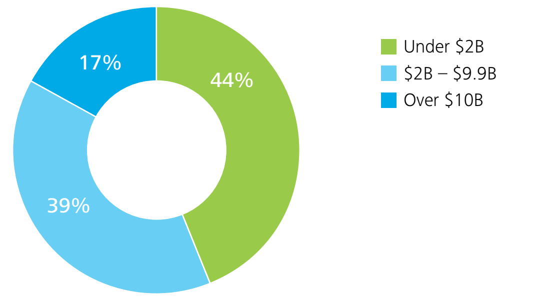
Where warranted, respondents were asked to provide responses for three distinct time periods: Pre-2008 crisis, current, and a 3-5 year forecast.

Responses

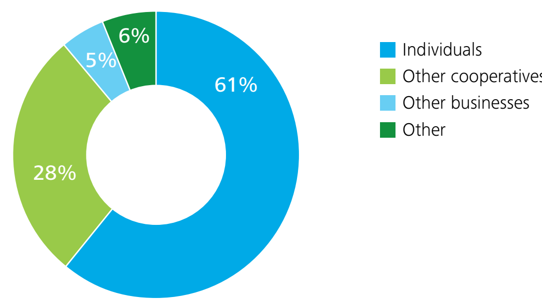
The survey received a total of 36 responses from cooperatives. Interviews were conducted with five cooperatives to gain additional details and insights.

The focus of the survey was large cooperatives. Over half of all respondents had annual revenues in excess of $2 billion USD.

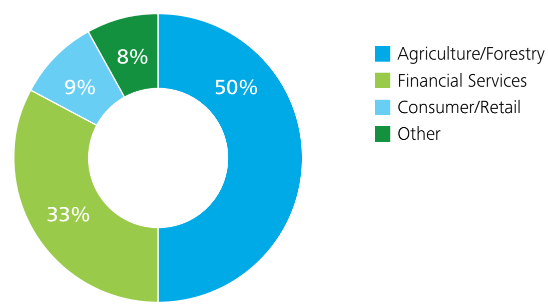
Survey sample: Revenue (USD) breakdown



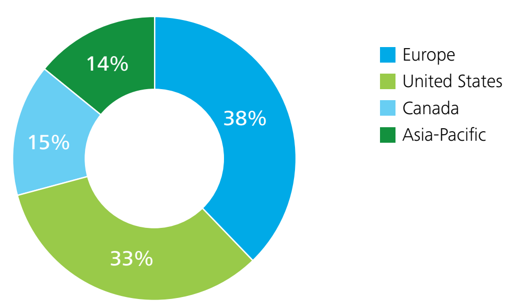
Membership structure of surveyed cooperatives



Industry distribution



Geographic distribution



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