

Methodology

*Rating Canadian Provincial Credit Union
Centrals, Credit Unions and Desjardins
Group and Related Entities*

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Insight beyond the rating.

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Introduction to DBRS Methodologies

- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.
- DBRS rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

Scope of the Credit Union Methodology

This methodology is intended to encompass the large provincial credit union centrals, Desjardins Group and large individual credit unions.

INDUSTRY STRUCTURE AND DEFINITIONS

- The rating approach to Canadian credit unions and credit union centrals largely mirrors DBRS's *Global Methodology for Rating Banks and Banking Organisations*, but it also reflects the unusual organizational, financial and legal structure of the credit union centrals and the individual credit unions, which is very different from the structure of stock-based companies.
- Within the credit union movement, there are three tiers: local, provincial and national. At the local level, customers become credit union members by paying a nominal fee in return for equity shares. Although members may own more than one equity share, credit union governance is based on one vote per member.
- Individual credit unions come together to form a provincial credit union system. Each provincial system shares in the ownership of its respective central, which provides a central banking or liquidity management function for the individual credit unions. Centrals also provide numerous other products and services, including trade association-related activities.
- Note that Credit Union Central of British Columbia merged with Credit Union Central of Ontario to form Central 1 Credit Union (Central 1), which now acts as the central for credit unions in both provinces. Credit unions are usually required to be a member of their respective provincial centrals, although this is not the case in Ontario, where participation is optional.

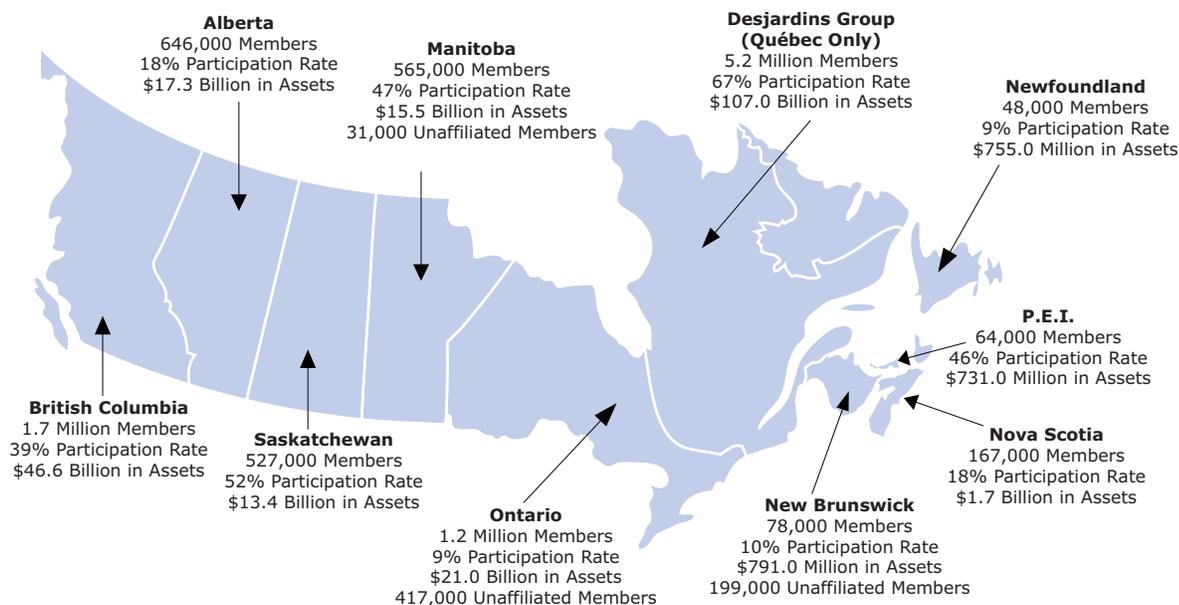


- The provincial centrals together own the Credit Union Central of Canada, which functions as a national liquidity manager and provides trade association services at a national level.
- The Québec credit union system (Desjardins Group) is structured and regulated differently; it operates independently of the credit union movement. As a result, there are differences in the application of the rating methodology from that used in other provinces (see Appendix A for more details).

OVERVIEW OF CREDIT UNION CENTRALS

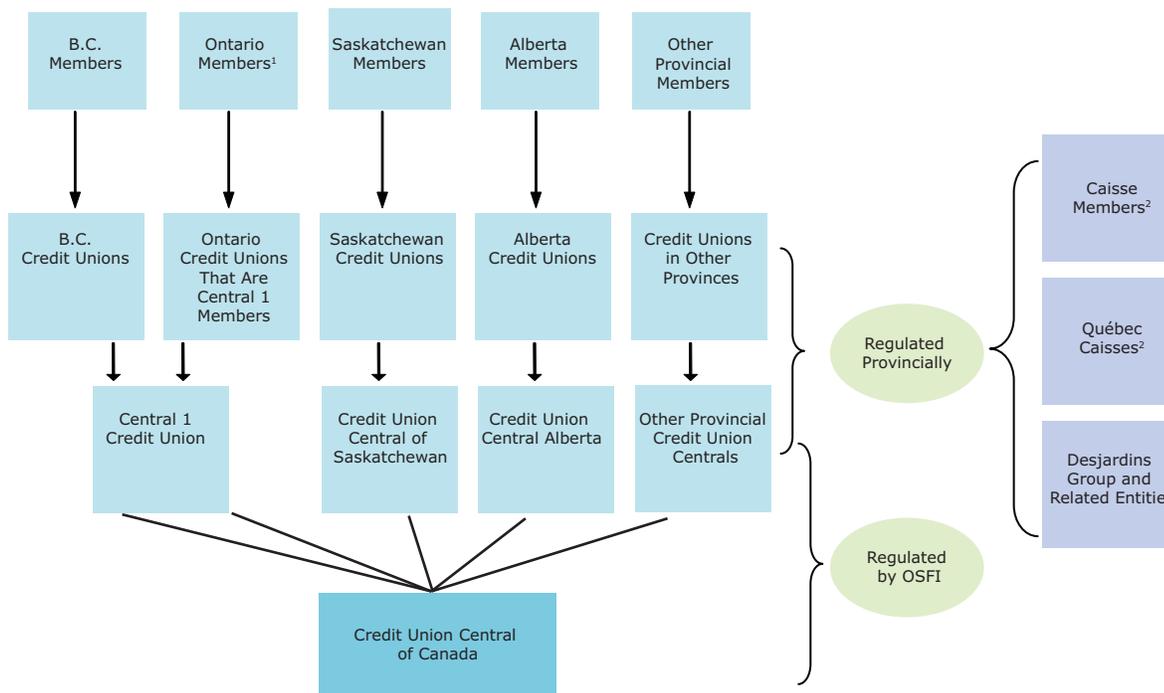
- Credit union centrals exist to serve the needs of their members (i.e., the credit unions of the province or, in Central 1's case, two provinces). A central is a financial co-operative that supplies services to its network of credit unions, particularly statutory liquidity management, clearing and settlement. The central also acts as a trade association, monitors trends and issues in the industry, offers management training and expertise to credit unions and participates in national organizations to represent the interests of the system.
- Either directly or indirectly, centrals also take deposits (in excess of statutory liquidity) from and make loans to their members, moving funding and liquidity from credit unions that have excess to those that need it.
- Centrals can provide a variety of other services to members, although the type and scale vary from province to province. Some centrals provide programs that allow credit unions access to securitization programs, which help with funding. One other program that is used by some centrals is a loan syndication program, which allows credit unions to make larger loans while maintaining single-entity exposure at appropriate levels, as well as improving their ability to diversify their loan portfolios.
- The centrals may have a number of other investments in organizations that offer services to their credit union members, including Credit Union Payment Services (CUPS), which is aimed at reducing payment-processing costs; Celero Solutions Inc. (information technology); The Co-operators Group (insurance); and Credit Union Central of Canada.

Credit Unions and Caisses Populaires in Canada, Q3 2010



Members = members associated with the provincial central.
 Assets = provincial system assets.
 Unaffiliated Members = members not associated with the provincial central.
 Source: DBRS.

Credit Union Centrals and Caisses Populaires in Canada



1. Members of credit unions that are affiliated with Central 1 Credit Union.
 2. Simplified – there are caisse members and caisses in other provinces.
 Source: DBRS.

Assessing Credit Union Systems and Rating Individual Credit Unions

- DBRS assesses the strength of the provincial credit union systems using identical criteria as those used in rating individual credit unions, which largely reflect DBRS's *Global Methodology for Rating Banks and Banking Organisations*. The building blocks for the assessment of a credit union or a system are franchise strength, earnings power, funding and liquidity, risk profile and capitalization, although earnings and growth rates are treated somewhat differently for financial co-operatives than other financial institutions because of the different goals of the organization.
- Typically, the analysis of the system is based on the combined financial statements of the credit unions in their respective provincial systems. These statements are not audited, but they are typically provided by the provincial regulator or the central. (Note: In Ontario, this analysis is based only on the credit unions that are members of Central 1.)
- DBRS recognizes that each system is composed of a group of credit unions with substantial differences in size, complexity, markets, market share, customer demographics, geographic focus, economic drivers, financial risk profiles and asset quality metrics. As such, there are limitations on the ability to generalize about a system's strength using combined statements. However, the rationale justifying the use of combined statements in the analysis is supported by the fact that the systems and their respective centrals traditionally provide mutual support in times of need. DBRS views the cohesiveness of the various system members as an important rating consideration, albeit one that is difficult to quantify.
- The Ontario and British Columbia members of Central 1 are assessed separately because of their different competitive positions and conditions, economic outlooks and regulatory regimes.



DESJARDINS GROUP

- Desjardins Group can be viewed as a more integrated version of a system and a provincial central. The approach DBRS uses for rating Desjardins Group is similar to the methodology used for rating banks, which is outlined under DBRS's Global Methodology for Rating Banks and Banking Organisations.
- The most significant difference is that, although managed as an integrated financial services organization, Desjardins Group is not a legal entity. Its financial statements are the combined financial statements of all the components of Desjardins Group. The issuer ratings for Desjardins Group reflect DBRS's opinion of the overall strength of Desjardins Group from a theoretical perspective; the issuer ratings provide the basis for ratings on Caisse centrale Desjardins and Capital Desjardins inc., which are the issuing entities.

EXTERNAL SUPPORT

Centrals, systems and individual credit unions are in a unique position of supporting each other.

Centrals

- Credit union centrals have typically been assigned a support assessment rating of SA2, reflecting anticipated support from the provincial government for the system through the central. Although this support assessment is strengthened if there is a higher participation rate (i.e., individual members divided by provincial population), it has also been assigned to centrals with lower participation rates, usually because their respective systems often provide critical financial services for rural and smaller population centres that are not adequately served by banks.
- As a result, some form of government support would be anticipated. Additionally, under a stressed scenario, some form of support would be expected from the other provincial systems.
- The support assessment of Desjardins Group is somewhat unusual in that it reflects anticipated support from the federal government in line with that expected for the large banks.

Systems and Individual Credit Unions

- Credit unions and systems occupy a unique place in the support assessment area in that support goes both ways: the expectation of very strong likelihood and predictability of timely external support from the provincial credit union central to the system or credit union warrants an SA1 assessment and the expectation of support from the system to the central also warrants an SA1 assessment. This is different from DBRS's support assessment methodology, Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments, in which a support assessment rating of SA1 would be notched down from the supporting organization.
- Given this relationship, DBRS has chosen to assign support assessment ratings of SA2 to individual credit unions and systems. Under DBRS's support assessment methodology, an SA2 support assessment is notched up from the organization's intrinsic assessment. However, it should be noted that a credit union's or system's intrinsic assessment will have elements of support from the central and the other system members that cannot be separated from its assessment because of the way systems are organized.
- The anticipated support from the central and the other system members was taken into account in the ratings even prior to the adoption of DBRS's support assessment scale in 2006.



Credit Union, Central and System Rating Considerations

PROFITABILITY

- Profitability is not the primary focus of a central and consequently a high level of income at the central level is not a critical aspect of DBRS's rating methodology.
- Profitability at the underlying system level is more important. While profitability at the system and individual credit union levels is considered an important rating criteria, the level of profitability, as measured by return on equity (ROE), is expected to be lower than a pure for-profit financial institution as the profit is not the only goal of the organization.
- While the provincial systems and individual credit unions usually do not view high levels of profitability as the overriding goal of their organizations, DBRS believes that a reasonable level of profitability is a key component of a credit union's credit profile in order to generate positive internal capital generation.
- The analysis of earnings also takes into consideration the tax regime governing credit unions, which typically results in their paying lower tax rates. This beneficial tax position is offset by the generally lower pre-tax earnings of these institutions.

COMPETITIVE LANDSCAPE

- In Canada, banks are the major competitors of credit unions and they tend to dominate most businesses (other than insurance) in the retail financial services market. However, banks are not uniformly strong regionally. Québec and British Columbia, as well as rural regions across Canada, are areas where credit union systems have strongholds and may hold some competitive advantages relative to banks. However, the relatively large size of banks means that any major shift to target areas of traditional credit union strength could have a negative effect on the systems.
- The participation rate (i.e., members of credit unions in the province divided by the provincial population) provides some insight into how successful a system has been in market penetration. However, it is used with caution. The numbers are prone to inconsistency because they are gathered from a large number of credit unions that may have customers in common.
- Additionally, it is not a proxy for market share as members may also be customers of other financial services organizations. Moreover, credit union market share varies substantially, with more rural and small-town credit unions usually enjoying stronger market share and larger city credit unions usually operating under more competitive conditions.

STABILITY

- Since systems operate like retail banks, their profitability and strength is highly affected by local economic conditions. Although sometimes difficult to quantify, the diversification of the provincial economy has a bearing on the underlying strength of the system, particularly in terms of asset quality and earnings stability. The underlying economic drivers of some provinces can be very concentrated.
- This issue is usually even more pronounced for individual credit unions, which typically have a high level of geographic concentration, particularly if the local economy is disproportionately exposed to a cyclical industry. Furthermore, with their material exposure to real estate, credit unions can be affected by local housing prices, although in Canada, real estate prices would have to decline materially to affect ratings.



REGULATION

- The individual credit unions are provincially regulated as deposit-taking financial institutions, while the provincial centrals are regulated at the federal level by the Office of the Superintendent of Financial Institutions (OSFI) and also by the provinces.
- In its analysis of provincial systems, DBRS assesses the risks related to credit unions that come under scrutiny of the provincial regulator or of the central with respect to asset quality, leverage, management or other issues. In recent years, these credit unions have tended to be smaller, with limited implications for the provincial system should they become insolvent. Typically, a weaker credit union will merge with a stronger credit union long before it becomes insolvent, in part due to reputational risks to the other system members.

OTHER INHERENT INDUSTRY CONSIDERATIONS

Credit Union Concentration

- The number of credit union mergers (i.e., of healthy credit unions) has been substantial over the past several years, contributing to the emergence of larger, more complex credit unions, which overall provide additional strength to a system.
- When a credit union grows to become a significant proportion of total system assets, DBRS assesses the individual credit union as a component of overall system strength. Weakness at a single large credit union has significantly more impact on the entire system than at a smaller one.

Deposit Guarantees

- The provinces of British Columbia, Alberta and Saskatchewan provide an unlimited guarantee on deposits at credit unions, which is advantageous compared with federally regulated deposit-taking financial institutions, which have a \$100,000 cap on insured deposits. The guarantee materially strengthens the funding profile of the centrals and individual credit unions in assisting in deposit gathering and reducing the risk of a run on the individual credit unions and the system, with resulting implications for the central.



Business Risk Factors Specific to Systems, Centrals and Credit Unions

With respect to specific system, central and credit union risk assessments, DBRS has identified the following more specific business risk factors that, we believe, capture the essential strengths and challenges in an accurate fashion, providing transparency for outside readers. Ultimately, the specific drivers and the subsequent review of key financial metrics encompass the five overall rating considerations noted above.

Company-Specific Business Risks – Critical Factors

Rating	AA Exceptional	A Superior	BBB Adequate	BB Weak
System Assessment				
Economic Footprint	<ul style="list-style-type: none"> Wide geographic footprint within province or multiple provinces. Province(s) is (are) economically diversified. 	<ul style="list-style-type: none"> Good geographic footprint within province. Province may have less economic diversification. Potentially more cyclical economy. 	<ul style="list-style-type: none"> Geographic footprint within province is adequate. May rely too heavily on rural areas or areas with limited economic diversification. 	<ul style="list-style-type: none"> Concentrated geographic or economic footprint within province. Cyclical provincial economy.
Franchise Strength	<ul style="list-style-type: none"> Very high proportion of provincial population are members (> 50%). 	<ul style="list-style-type: none"> High proportion of provincial population are members (20% to 50%). 	<ul style="list-style-type: none"> Modest proportion of provincial population are members (10% to 20%). Entrenched bank competitors. 	<ul style="list-style-type: none"> Small proportion of provincial population are members (< 10%). Entrenched bank competitors.
Degree of Integration	<ul style="list-style-type: none"> Central, system and credit unions are highly integrated from a capital and risk management perspective. Central has ability to force a capital call. A few small credit unions may be under supervision. 	<ul style="list-style-type: none"> Central, system and credit unions are less integrated, although highly coordinated. Central usually has ability to force a capital call. Usually flexible dividend policy at the central level. A few small credit unions may be under supervision. 	<ul style="list-style-type: none"> Credit unions are more independent from the rest of the system and central. Central may have the ability to force a capital call. Less dividend flexibility under normal conditions. Several small credit unions may be under supervision. 	<ul style="list-style-type: none"> Credit unions are independent from the rest of the system and central and have the ability to exit the relationship with central. Central has no ability to force a capital call. Less dividend flexibility under normal conditions. A medium-sized or larger credit union may be under supervision.



ECONOMIC FOOTPRINT

- The health of retail bank-like financial institutions usually tends to mimic the health of the economic conditions within their footprint; individual credit unions, systems and centrals are all affected by this reality.
- Individual credit unions often operate in a concentrated geographic area, which can expose the institution to material risks, particularly if the local economy is disproportionately exposed to a cyclical industry. Furthermore, with their material exposure to real estate, credit unions can be affected by local housing prices, although in Canada, real estate prices would have to decline materially to affect ratings.
- Provincial systems are less concentrated geographically than individual credit unions, although provincial economies can still be materially exposed to cyclical industries. Systems can also be more exposed to volatile pricing in agricultural commodities (both directly and indirectly) as a result of their success outside of major urban centres.
- Centrals are directly affected by the underlying health of the system, although in one case (Central 1), there is a diversification benefit to being the central for credit unions in two different provinces with materially different economies.

FRANCHISE STRENGTH

Centrals

- The strategic focus of all centrals is to serve the needs of its member credit unions. At its most basic level, this primarily involves the liquidity management, clearing and settlement functions, although centrals are involved in a wide variety of other operations that support their credit union owners, primarily in areas where the central's larger scale and ability to aggregate spending reduce costs.
- While the centrals provide operational support to credit unions through various means, they themselves are owned and supported by their systems. Larger systems generally are better able to support a stronger central as a result of a higher level of resources.
- In most provinces, credit unions are required to be members of the provincial central; DBRS views this mandatory membership in the central as a positive factor.

Systems and Individual Credit Unions

- The traditional strategic focus of most credit unions has been in the retail sector, with lending activities usually concentrated in residential mortgage lending funded by core retail deposits. Further supplemental activities include lending to small and medium-sized enterprises (SMEs) and smaller commercial accounts.
- Some credit unions, particularly larger ones, have expanded into larger commercial lending and looked to the wholesale markets for additional funding. Non-lending activities typically account for a smaller proportion of revenues, although wealth management has been an increasing focus in recent years.
- Like the banks, the level of critical mass and market share that a credit union has in its chosen market is a key rating consideration, although in the case of credit unions, the target market tends to be more concentrated.
- One key strength that credit unions share is that their customers are also their owners, which can provide relationship advantages over competing banks and non-banks. Mutual ownership also allows fee structures to be more attractive for customers as profitability is not the only goal. This, combined with the ability to return a portion of the profits to their members/owners either as dividends or patronage rebates can result in a more loyal customer base.
- Credit unions generally tend to focus on retail branch banking, serving fewer customers per branch compared with banks. While this contributes to a comparatively high cost structure, it allows them to provide good-quality and personal service. Banks' high ROE targets make branches in smaller centres economically unattractive, allowing credit unions to flourish in this key market.
- Many credit unions have a high degree of local commitment, particularly in rural areas and smaller centres, which provides additional ties to the community. Donations to local charitable organizations are common.



- The centrals provide operational support to credit unions through various means, including providing pooled services, which can help offset the costs of operating a smaller financial institution, including systems and technology solutions.
- DBRS's ratings are based on the analysis of qualitative and quantitative factors that may or may not be affected by size. However, smaller credit unions are more likely to exhibit higher levels of geographic, product and distribution concentration, as well as higher expense ratios, which may limit ratings. Larger credit unions benefit from scale economies. Additionally, a larger equity base can provide a level of financial flexibility under trying conditions.
- As a result of mergers and other factors, large credit unions have emerged in recent years. In Alberta, one credit union currently accounts for 58% of the provincial system's assets. Although DBRS does not currently rate this credit union, the capacity of the provincial central to provide support for such a large credit union would be a relevant factor in the rating assessment of the credit union. The creation of Central 1 reduced (but did not eliminate) this concentration risk in British Columbia and Ontario.

DEGREE OF INTEGRATION

- The degree of integration between centrals and credit unions can be materially different. Desjardins Group is the most integrated. Even though members elect the boards of the individual caisses and the boards of the caisses elect the boards further up the chain, the organization is largely managed from top to bottom.
- Individual credit unions tend to be more independent, although the degree of independence varies from province to province. At the extreme end, credit unions in Ontario are the most independent and do not have to be members of Central 1 (although the credit unions that are members of Central 1 have voluntarily given up this independence by signing ten-year lock-in agreements).
- The more integrated systems tend to have agreements with their respective centrals that will allow the central to force the system to increase its capital, if required (a capital call). However, even without the ability to force a capital call, provincial systems have historically agreed to increasing the capital of the central in times of need. As a result, DBRS views the ability to force a capital call as a positive feature, although it is not necessarily essential for a strong credit rating.

COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

Country/Province Risk

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.
- Systems and centrals are also exposed to risk at the provincial level as a result of their footprint and regulation.



Corporate Governance

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria Evaluating Corporate Governance.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles can also be considerations.
- At the level of the local credit union, the members are always customers, and it is from this pool that the board of directors is elected. Given the growing complexity of financial services products and the credit unions themselves, there exists the possibility of weak governance at the individual credit union level. That said, the risk is partially mitigated by supervision at the central level and the provincial government regulator, as well as pressure from peer credit unions.
- A central's board is composed of elected or appointed representatives from the central's credit union members, with members often representing either the larger, more sophisticated credit unions in the province or representing regional areas.



Financial Risk Factors Specific to Centrals, Systems and Credit Unions

KEY METRICS

- While financial risk measures play a role in fine-tuning a central's rating relative to its system assessment, particularly liquidity, stand-alone central metrics are not always an appropriate measure given the support mechanisms involved.
- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the Canadian credit union industry.

Credit Union Financial Metrics

Key System Ratios	AA	A	BBB	BB
Liquid assets-to-total assets	> 10%	> 10%	< 10%	< 8%
Gross non-performing loans-to-gross loans	< 0.5%	< 1.0%	1.0% to 1.5%	> 1.5%
Leverage (equity-to-assets)	> 7.0%	> 5.0%	5.0% to 4.5%	< 4.5%
Internal capital generation	> 7.0%	> 7.0%	< 7.0%	< 5.0%
Return on equity	> 12%	> 8%	< 8%	< 6%

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.
- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.



Overall Considerations in Evaluating the Financial Risk Profile of a Central, System or Credit Union

In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the Canadian credit union industry. Note that the risks and/or attributes of subsidiaries that are large relative to the central may affect a central's rating.

EARNINGS

- DBRS earnings analysis focuses on core earnings (i.e., earnings before non-recurring items) and in doing so considers issues such as the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., is the company a low-cost producer?); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations.
- DBRS generally reviews company budgets and forecasts. Segmented breakdowns by division are also typically part of DBRS analysis. Notwithstanding the focus on core earnings, note that actual net earnings is also a consideration in our analysis given the direct impact that this has on the capital structure.

Centrals

- Profitability is not the primary focus of a central and consequently a high level of income at the central level is not a critical aspect of DBRS's rating methodology; any excess earnings are typically passed on to the credit union owners by way of patronage and/or dividend payments.
- The central's large, high-quality liquid asset portfolio typically generates a low return; commercial lending generates a higher return; and loans to credit unions may vary depending on the individual central's policy. On the funding side, mandatory system deposits may be at lower-than-market rates, although deposits in excess of this amount are usually at market rates. Spreads tend to be low.
- The proportion of non-interest income tends to be high in the revenue mix, partially as a result of the low spreads. The high level also reflects the central's purpose of being an aggregator of certain services, charging the system fees for expense outlays – virtually a pass-through of costs to the system. DBRS views fees earned outside the system (which are not very common) as being a positive factor, subject to the degree of risk.

Systems and Individual Credit Unions

- Credit unions usually do not view high levels of profitability as the overriding goal of the organization. However, DBRS believes that a reasonable level of profitability is a key component of a credit union's credit profile in order to generate positive internal capital generation and provide evidence of a successful business model.
- Even though credit unions exist to serve their members and are not as focused on growth as banks, a reasonable level of growth is considered healthy and necessary for a credit union to maintain its franchise value, competitive position and cost competitiveness (particularly in the environment of rising compliance and information technology costs).
- Credit unions typically generate a high proportion of their revenues from net interest income. As DBRS expects competition-driven pressure on margins to remain a long-term trend in the financial services industry, higher levels of revenue diversification are considered a positive rating consideration. Given the retail focus of credit unions, ideally these revenues would be recurring fee income from investment or insurance brokerage operations.
- Credit unions tend to have high cost structures for a variety of reasons, including limited economies of scale, additional costs related to the democratic process, the high proportion of costly retail branch banking within the business mix and, in some cases, operating in less densely populated areas than banks. While the activities of the central can assist in reducing high costs, typically, they have remained higher than their large bank competitors.



Typical Earnings Ratios

Central – Profitability Ratios

- Net interest margin.
- Net interest spread.
- Net interest income-to-operating revenue.
- Other income-to-operating revenue.
- Operating expenses-to-operating revenue.
- Operating expenses-to-average assets.
- Tax rate.
- Dividend payout.
- Adjusted return on equity.
- Adjusted return on assets.

Credit Union and System – Profitability Ratios

- Net interest margin.
- Net interest spread.
- Net interest income-to-operating revenue.
- Other income-to-operating revenue.
- Operating expenses-to-operating revenue.
- Operating expenses-to-average assets.
- Loan loss provision-to-operating profit.
- Tax rate.
- Return on equity.
- Return on assets.
- Member distribution payout ratio.

FUNDING AND LIQUIDITY

Centrals

Funding and liquidity are core functions for a central.

- **Mandatory Deposits:** The primary source of funding at the central level is through a requirement that the credit unions maintain a certain level of deposits (mandatory deposits) at their respective centrals. The level of mandatory deposits that each credit union must maintain in the central varies from 8% to 10% of liabilities. Higher mandatory deposit requirements are viewed positively by DBRS as it increases the stability of the central's funding base.
- **Excess Deposits:** Typically, a large proportion of most credit unions' excess liquidity has tended to be deposited with the central as well. While centrals may have some flexibility with respect to funding costs with mandatory deposits, excess deposits typically command market rates of return. Excess deposits, which rise and fall with system demand, are not viewed as being as stable as mandatory deposits.
- **Debt Markets:** The three large centrals rated by DBRS (and Desjardins Group) have short-term commercial paper or deposit note programs in place to access external short-term wholesale funding (as well as liquidity) and one has a medium-term note program. DBRS views positively the flexibility these programs offer, although access to the wholesale markets at a reasonable price was limited during the recent global financial crisis.
- The core purpose of a provincial central revolves around providing liquidity to its members. DBRS places a substantial emphasis on the central's ability to meet the liquidity needs of itself and its system through on-balance-sheet unencumbered liquid assets.
- This on-balance-sheet liquidity is usually supplemented with short-term deposit notes and third-party lines of credit. DBRS views strong levels of unutilized committed credit lines positively in the liquidity assessment.
- The provincial centrals also have access to liquidity from other provincial centrals.



Systems and Individual Credit Unions

- Core retail deposits remain the dominant form of credit union funding. Credit unions also have access to funding through their respective provincial credit union centrals, which typically take excess credit union deposits and make credit union loans. The arrangement provides funding to those credit unions that need it from ones that have excess liquidity. Some of the centrals have also set up other funding programs, including programs that help credit union funding through securitizations and loan syndications. Some of the larger credit unions have also pursued external funding options.
- All credit unions that are members of provincial centrals are required to maintain mandatory liquidity deposits with the provincial central. The specific requirements vary from province to province. Credit unions have access to a portion of this liquidity through borrowing arrangements with their provincial credit union central.
- Credit unions generally also have excess liquidity, which is often also on deposit with the provincial central.

Typical Liquidity and Funding Ratios

Central – Liquidity and Funding Ratios

- Liquid assets-to-assets.
- Loans-to-assets.
- Liquid assets-to-total debt and deposits.
- Central liquid assets-to-system assets.

Credit Union and System – Liquidity and Funding Ratios

- Liquid assets-to-assets.
- Loans-to-assets.
- Loans-to-deposits.
- Liquid assets-to-total debt and deposits.
- Deposits-to-assets.

ASSET QUALITY

Centrals

- Provincial centrals are first and foremost liquidity providers and the liquidity portfolio is usually a large proportion of total assets. Although asset quality within this portfolio is typically held at quite conservative levels, DBRS monitors changes in the composition of the portfolio over time.
- The lending policies of different provincial centrals vary widely. The largest portion of the loan book is usually loans to credit unions within the system. Typically, these are secured by a general security agreement with the borrowing credit union's assets. These loans are considered relatively low risk and, historically, they have seldom, if ever, defaulted.
- Some but not all centrals also make commercial loans directly; these loans are often made in conjunction with the lending activities of one or more of the credit unions within the system. Typically, this is the area of the highest level of asset quality risk for a central, although the absolute level of commercial lending is typically not a large component of the central's asset base. DBRS analyzes the credit risk of these portfolios with an emphasis on underwriting criteria, as well as industry and single-name concentration exposures.
- Other loans, which typically make up a small portion of the lending portfolio, are often in the form of lending to other co-operative ventures and low-risk employee residential mortgages.

Special Situations

Credit union centrals may have unique situations that DBRS assesses based on the specific risks and rewards that these situations offer.



Systems and Individual Credit Unions

- With (usually) a high proportion of low-risk residential mortgages in the loan portfolio, asset quality generally tends to be strong for the largest asset class in the credit unions' loan portfolio.
- Commercial lending has been growing at a measured pace for some time. Although the size of these portfolios is limited by the regulators, this area of lending typically has the largest asset quality implications for a credit union.
- Among other aspects, DBRS focuses on large individual name exposures relative to the size of the institution's equity base and earnings before loan loss provisions. Some provincial centrals have set up commercial syndication programs that allow credit unions to reduce exposure to these large loans, which is a positive factor.
- One significant challenge for all credit unions is loan diversification; typically, a credit union will operate in a narrow regional area (geographic concentration), and it may prove difficult for a credit union to appropriately diversify its commercial loan portfolio if its region is highly focused in a single industry.
- DBRS assesses trends in loan mix, non-performing loans, watchlist loans and reserve adequacy.
- DBRS also assesses the asset quality of the liquidity and investment portfolio, although asset quality is usually quite high in this area.

Typical Asset Quality Ratios

Central – Asset Quality Ratios

- Loss provision-to-average assets.
- Reserves-to-average assets.
- Loan loss provision-to-average assets.
- Gross non-performing-to-loans.
- Gross non-performing loans-to-(equity + loss reserves).
- Member loans-to-assets.
- Other loans-to-assets.

Credit Union and System – Asset Quality Ratios

- Reserves-to-loans.
- Provision for loans-to-average loans.
- Gross non-performing loans-to-gross loans.
- Net non-performing loans-to-net loans.
- Gross non-performing loans-to-(equity + loss reserves).
- Reserves-to-non-performing loans.

CAPITAL STRUCTURE AND ADEQUACY

Centrals

- Equity funding at the provincial central level is accomplished through a requirement that the credit unions maintain a certain level of equity invested in the central, usually based on a percentage of liabilities (such as the mandatory deposit requirement).
- Earnings retention is not necessarily significant since much of the profit or potential profit is returned to the system through pricing, patronage rebates and distributions.
- A central has the ability to ask its members for additional capital when required. In its analysis, DBRS assesses the ability of the system to provide additional capital if required. In some (but not all) cases, a central has the ability to require the system to make an additional capital contribution (a capital call) if necessary; DBRS views this as a positive rating consideration. As a result of the ability to recapitalize the central by the system, equity funding at the system level is more critical to funding growth than internal capital generation at the central level.



Systems and Individual Credit Unions

- Credit unions' capital structures vary from those of publicly traded companies because of their co-operative ownership. Equity is typically a combination of retained earnings, equity shares and sometimes investment shares (which DBRS views as similar to preferred equity). While equity shares and investment shares can have a wide variety of attributes, they typically can be redeemed at the option of the holder, which is not usually the case for consideration as permanent capital.
- Usually, a credit union's rules will limit redemptions of any type of share to a maximum level for a year, such as a maximum of 10% of the issue per year, which provides an important level of permanence under a stressed scenario to this form of capital. DBRS places an emphasis on capital permanence in its assessment of the quality of capital. As a result, DBRS views retained earnings as the strongest form of capital, with equity and investment shares assessed based on their individual attributes related to permanence.
- DBRS assesses capital ratios, including regulatory ratios such as Bank for International Settlements (BIS) risk-weighted ratios, over time. However, since credit unions are regulated provincially and the provinces do not necessarily conform to OSFI standards in the measurement of the risk weighting of assets and capital eligibility, direct comparisons with credit unions in different provinces or federally regulated financial institutions are sometimes difficult. As a result, in some cases, a greater consideration may be placed on non-risk-weighted leverage ratios combined with both qualitative and quantitative analysis of the business risk profile of the credit union.

Other Risk Management Considerations

- Management's appetite for assuming market risk is a consideration in the rating process, particularly trading exposure and asset-liability mismatching. Subsidiaries engaged in these activities are assessed as well. Although difficult to quantify, operational risk is another consideration in the rating process.

Typical Capital Structure and Adequacy Ratios

Central – Capital Structure and Adequacy Ratios

- Debt-to-equity.
- Equity-to-assets.
- Borrowing multiple (a regulatory ratio).
- BIS capital ratio (a regulatory ratio).
- Internal capital generation.

Credit Union and System – Capital Structure and Adequacy Ratios

- Leverage (equity-to-assets).
- BIS capital ratio (a regulatory ratio).
- Internal capital generation.



Appendix A: Desjardins Group and Related Entities

OVERVIEW

Desjardins Group

Desjardins Group is the largest financial services organization in Québec; it is composed of the co-operative (caisse) network and a subsidiary/corporate sector, which is owned by the co-operative network. As a co-operative, Desjardins Group is ultimately owned by its 5.4 million members. The co-operative segment includes the following:

- Approximately 450 caisses (credit unions) in Québec and Ontario.
- Auxiliary members from approximately 29 caisses in New Brunswick and Manitoba and Desjardins Credit Union in Ontario.
- The Fédération des caisses Desjardins du Québec (the Federation), which provides common services to their caisses, including training, communications, technical support and sales efforts.
- Caisse centrale Desjardins, which provides liquidity and access to wholesale funding for Desjardins Group.
- Capital Desjardins inc., which provides additional capital funding for the caisses.
- Desjardins Security Fund (Fonds de sécurité Desjardins), set up to meet the needs of caisses experiencing temporary difficulties.

The corporate sector includes operating units that offer trust services, general insurance, securities brokerage, asset management, venture capital and, through Desjardins Financial Security, life and health insurance. The financial statements of Desjardins Group represent the combined financial statements of all related entities (similar to consolidated financial statements). Desjardins Group is regulated by the Autorité des marchés financiers.

Caisse centrale Desjardins

Caisse centrale Desjardins, a wholly owned financial agent of Desjardins Group, provides a variety of services to related entities as well as government institutions and medium-sized and large businesses. It is a direct clearer of the Canadian Payments Association and the Canadian Depository for Securities Limited and provides cash management activities for the entire Desjardins Group caisse network.

Capital Desjardins inc.

Capital Desjardins inc. is a wholly owned subsidiary of the Federation. As a single-purpose vehicle, Capital Desjardins inc. was created exclusively for the purpose of offering its securities in the financial markets and using the proceeds to acquire subordinated notes (Tier 2 capital) of the caisses.

RATING DESJARDINS GROUP AND ITS RELATED ENTITIES

Desjardins Group

- The approach DBRS uses for rating Desjardins Group is similar to the methodology used for rating banks, which is outlined in DBRS's *Global Methodology for Rating Banks and Banking Organisations*.
- The most significant difference is that, although managed as an integrated financial services organization, Desjardins Group is not a legal entity. The financial statements are combined financial statements including all the components of Desjardins Group. Issuer ratings on Desjardins Group reflect DBRS's opinion on its overall strength from a theoretical perspective; these issuer ratings provide the basis for ratings on Caisse centrale Desjardins and Capital Desjardins inc., which are the issuing entities.
- Like banks, the building blocks for Desjardins Group's intrinsic assessment are franchise strength, earnings power, funding and liquidity, risk profile and capitalization, although earnings and growth rates are treated somewhat differently for financial co-operatives because of the different goals of the organization.



Intrinsic and Support Assessments of Desjardins Group

Desjardins Group has been assigned an SA2 support assessment rating, reflecting anticipated support from the federal government through the provincial government.

Franchise Strength

- **Strategic Focus:** The traditional strategic focus of Desjardins Group has been to maintain its leading market position in the province of Québec, where it has leading or near-leading market positions in mortgages, other consumer credit, personal savings, agricultural lending and SME lending. In the Canadian market, Desjardins Group is unique in that it is a regulated deposit-taking institution with significant operations in the life, health and general insurance industry, which DBRS views positively. Desjardins Group was able to develop this business more fully than banks because it is regulated provincially, which allows the sale of insurance in caisse branches, whereas federal legislation prohibits insurance sales from bank branches.
- **Governance:** Like credit union systems, the customers are the owners of individual caisses and they elect the board of the caisses (one vote per member, no matter how many shares are held). Representatives from the caisses elect the board of the Federation, which controls Desjardins Group's operations. From a governance perspective, the largest difference between a credit union system and the Desjardins Group model is that Desjardins Group is managed as an integrated organization, while credit unions operate more independently of the central structure.
- **Earnings Power:** While Desjardins Group does not view high levels of profitability as the overriding goal of the organization, it has targeted modest ROE and growth goals. DBRS believes that a reasonable level of profitability is a key component of its credit profile.

Funding and Liquidity

- **Funding:** Desjardins Group's dominant form of funding is core retail deposits; the high level of individual deposits is considered a strength. Desjardins Group has access to wholesale funding through Caisse centrale Desjardins and Capital Desjardins inc., which provides an important level of flexibility.
- **Liquidity:** DBRS assesses the on-balance-sheet liquidity of Desjardins Group, with a particular emphasis on Caisse centrale Desjardins because of its position as treasurer of Desjardins Group. In addition, a review is conducted of other sources of liquidity, including securitization programs.

Risk Profile and Risk Management

- **Asset Quality:** While the economy of Québec is reasonably diverse, Desjardins Group's concentration in the province remains an asset quality issue, albeit one that is slowly being addressed through expansion outside the province.

Capitalization: Structure and Adequacy

- **Capital Strength:** Desjardins Group's capital structure is composed of qualifying, capital, permanent, dividend and preferred shares, as well as general, stabilization and future patronage dividend reserves and undistributed surplus earnings. The undistributed surplus earnings and general reserve together are similar to retained earnings held by various components of Desjardins Group. The general reserve, which is by far the largest component of equity, can only be used to cover a deficit and cannot be shared among the members or used for a dividend payment. DBRS views this as an adequately robust structure as most of the equity is permanent in nature.



Appendix B: DBRS Ratings

DEFINITION OF ISSUER RATING

- DBRS Corporate rating analysis begins with an evaluation of the fundamental creditworthiness of the issuer, which is reflected in an “issuer rating”. Issuer ratings address the overall credit strength of the issuer. Unlike ratings on individual securities or classes of securities, issuer ratings are based on the entity itself and do not include consideration for security or ranking. Ratings that apply to actual securities (secured or unsecured) may be higher, lower or equal to the issuer rating for a given entity.
- Given the lack of impact from security or ranking considerations, issuer ratings generally provide an opinion of default risk for all industry sectors. As such, issuer ratings in the banking sector relate to the final credit opinion on a bank that incorporates both the intrinsic rating and support considerations, if any.
- DBRS typically assigns issuer ratings on a long-term basis using its **Long Term Obligations** Rating Scale; however, on occasion, DBRS may assign a “short-term issuer rating” using its **Commercial Paper and Short Term Debt** Rating Scale to reflect the issuer’s overall creditworthiness over a short-term time horizon.

SHORT-TERM AND LONG-TERM RATINGS

- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled “**Short-Term and Long-Term Rating Relationships**” and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

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