CENTRAL BANK & FINANCIAL SERVICES AUTHORITY OF IRELAND

EUROSYSTEM

CONSULTATION PAPER

CP 44

STABILISATION SUPPORT FOR CREDIT UNIONS

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1.0 INTRODUCTION

1.1 Prior to September 2008 the Savings Protection Scheme ("SPS"), owned and operated by the Irish League of Credit Unions ("ILCU"), was the only protection afforded to members of credit unions for their savings. However, since 20 September 2008 credit unions have been included in the Statutory Deposit Guarantee Scheme ("DGS") under which 100 per cent of each member's savings is covered up to a maximum of €100,000. For this reason, the purpose and relevance of the current SPS is in doubt.

1.2 While the DGS provides protection for members' savings there is no statutory external support mechanism to provide support to a credit union that experiences solvency difficulties. The current SPS does provide some degree of stability support. In this regard, the ILCU has played an important role in maintaining the SPS and providing support to credit unions in difficulty and this has provided a degree of helpful stability to the credit union sector. However, the SPS is not itself regulated, nor under any degree of regulatory control, and therefore the Central Bank of Ireland ("the Bank") is unable to place any formal reliance on it as a support mechanism.

1.3 In addition to being unregulated, there are further important questions about the value and liquidity of the existing SPS fund. There are also questions about governance and accountability arrangements, which reflect the fact that it is a discretionary arrangement operated by the board of the ILCU, and is not a scheme open to all credit unions. This discretion inevitably introduces uncertainty about the circumstances when the SPS could be utilised. This is, of itself, problematic from a regulatory standpoint as it calls into question its utility. The exclusion of non-ILCU members further complicates this issue.

1.4 The balance between the benefits of the SPS and the possible incentives it creates must also be weighed. A scheme able to provide short term stabilisation support to a credit union is valuable for confidence in the sector. However, there is some risk that credit unions might behave less responsibly given the availability of such a 'bail out' mechanism. There are a number of ways in which this moral hazard can be reduced, but we would question whether the current structure of the SPS is optimal in this regard.

1.5 A further risk is that the fund merely postpones the resolution of problems at a credit union, for example through a winding-up or merger process. There is some evidence that this is a practical rather than a theoretical risk. This, in turn, probably creates additional moral hazard.

1.6 We explore this issue in more detail later in this paper.

THE PURPOSE OF THIS CONSULTATION

1.7 In recent years, the Bank has sought to modernise the prudential regime for credit unions in Ireland. We consider it important that we review the role of the SPS within this programme of work.

1.8 We also consider it important to do so in the light of the increased financial pressures being experienced by credit unions and their members. The SPS has played a role in addressing such problems in the past and any decision on the future of the SPS fund is a matter for the ILCU. However, given the scale of challenges the sector now faces, we consider it prudent to evaluate the various options available for the provision of solvency support to credit unions, of which the SPS is one option.

1.9 This Consultation Paper sets out the current position with regard to the stabilisation arrangements in place (the SPS); the key issues / principles for stabilisation arrangements; and the models that could be considered for stabilisation schemes for the credit union sector. The paper contains questions on which we wish to receive the views of interested parties. Comments received from the consultation will inform our future policy work on this matter and provide input to the Strategic Review of the Credit Union Sector.

1.10 The Consultation Paper is divided into the following sections:

- 2.0 Overview of the Credit Union Sector in Ireland
- 3.0 History and Role of current SPS
- 4.0 Key Issues / Principles
- 5.0 Models / Options for consultation
- 6.0 Consultation Process

2.0 OVERVIEW OF THE CREDIT UNION SECTOR IN IRELAND

2.1 Credit unions are cooperative financial institutions owned and controlled by their members which offer services to members within their common bond. The primary legislation under which credit unions are registered and regulated is the Credit Union Act, 1997 ("the Act"). Since May 2003 the Bank, through the Registrar of Credit Unions, is responsible for administering the system of regulation and supervision of credit unions with a view to the:

- Protection by each credit union of the funds of its members, and
- Maintenance of the financial stability and well-being of credit unions generally.

2.2 The primary focus of our work as regulator is the maintenance of the safety and security of members' savings. The announcement by the Government in September 2008 of the extension of the DGS to credit unions (which covers 100 per cent of each member's savings up to a maximum of €100,000) provided members of credit unions with the same level of deposit protection as depositors in other deposit-taking institutions.

2.3 There are currently 414 credit unions registered in the Republic of Ireland with total members reported to be in the region of 2.9 million. Total assets of the sector amount to €14.5 billion, of which €7.3 billion relates to investments and €6.8 billion represents loans to members. Total members' savings amount to €12.6 billion and total realised reserves amount to €1.7 billion.[1]

2.4 The credit union movement has grown rapidly over the last ten years. Over the last couple of years financial pressure on credit unions has resulted in them experiencing significant stresses on their two main assets – investments and loans. This has had consequent impacts on other financial aspects of their business, in particular liquidity, solvency / reserves and dividends. In recognition that these stresses are increasing steadily due to the current economic environment our main regulatory focus at this time is on the levels of provisions and reserves held by credit unions. Stabilisation support also has an important role in this context.

3.0 HISTORY AND ROLE OF THE CURRENT SPS

3.1 Since 1989, when the current SPS was established by the ILCU, member credit unions have been contributing to the SPS fund, which we understand now amounts to c.€119 million. The SPS has two elements – stabilisation and compensation.

3.2 ***Stabilisation*** involves providing financial and other assistance to a credit union in difficulty in order to give them time to trade out of difficulty, enabling the credit union to maintain member confidence while doing so. The financial support provided typically takes the form of a financial guarantee against certain loans which is accompanied by a series of conditions made to ensure that the credit union complies with certain policies and procedures.

3.3 ***Compensation*** involves protecting members' savings in the event of the failure of a credit union. As noted earlier, since 2008 the savings of credit union members are protected by the statutory DGS up to a maximum of €100,000 per member per credit

[1] Based on Prudential Returns from credit unions as at 31 December 2009.

union. Accordingly, the SPS as a compensation mechanism would appear to be no longer relevant.[2]

3.4 ***Section 46*** of the Act states that a credit union may incur expenditure in participating in a SPS[3] approved by the Bank. However, we have been unwilling to approve the current ILCU SPS due to the questions we have about its operational platform, governance issues and lack of consensus in the movement about the scheme.

3.5 The SPS is not an insurance vehicle but a fund which is controlled on a purely discretionary basis by the board of the ILCU. Participation by credit unions in the SPS does not confer any legal right to assistance – assistance may be provided at the discretion of the ILCU board and / or its Administration Committee.

3.6 All credit unions do not contribute to the SPS – those which do not contribute are primarily, but not exclusively, members of the Credit Union Development Association (CUDA). The operation of the SPS has been the subject of open disagreement between the ILCU and CUDA over many years and it is unclear what support, if any, would be afforded by the SPS to non-contributing credit unions, or CUDA credit unions, in the event of solvency problems in these credit unions.

3.7 The SPS is accounted for in the ILCU consolidated financial statements. Accordingly, the nature of the assets of the ILCU SPS is unclear and its exact liquidity position is unknown. Consequently, the adequacy or appropriateness of the SPS in dealing with the increased financial risks now being experienced by credit unions individually and for the sector overall is questionable.

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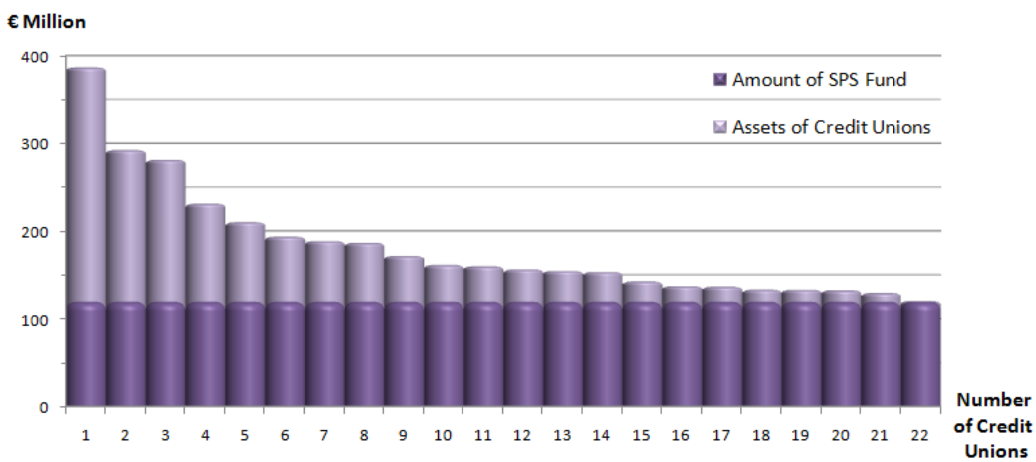
[2] It should be noted that ILCU credit unions in Northern Ireland also contribute to the SPS. At this time we understand that credit unions in Northern Ireland have no statutory deposit protection for members and accordingly, the compensation element of the SPS is relevant to those credit unions.

[3] SPS is defined under Section 46 as a scheme ***established to protect in whole or in part the savings of members of a credit union in the event of insolvency or other financial default on the part of the credit union***. This definition pre-dates the inclusion by credit unions in the statutory deposit guarantee scheme.

3.8 To date the SPS has been called upon to provide solvency support to credit unions in only a small number of cases, and for relatively small amounts. Although this has been helpful in some cases, and has provided a degree of stability to the credit union sector as a whole, we consider it prudent to question the SPS's ability to meet the potential difficulties that may arise in this new and challenging economic environment. In this regard the current SPS fund of c.€119 million represents less than one per cent of the total assets of the credit union sector at 31 December 2009 of €14.5 billion. Furthermore, as set out in the chart below, at that date there were 22 credit unions that each had total assets in excess of the SPS fund.

Credit Unions whose Total Assets Exceed level of Savings Protection Scheme



3.9 The question also arises as to whether the current SPS model, which purports to support credit unions that may not be viable in the long term, is still appropriate for the future wellbeing of the sector. We doubt whether the current arrangements would be able to cope with a widespread problem, or indeed a series of individual problems over a sustained period of time, in the sector.

4.0 KEY ISSUES / PRINCIPLES

4.1 On balance, we would favour the existence of an external stabilisation solvency support mechanism for the credit union sector designed to provide **short term, time**

limited support to a credit union. Such a scheme should also not be in lieu of other actions, including winding-up or merger. Stabilisation is therefore, in our view, a first condition for resolution.

4.2 A range of options could be considered for such support, including:

- A statutory scheme with or without credit union movement involvement;
- A remodelled voluntary SPS;
- A continuation of the existing SPS; or
- The wind-up of the existing SPS and its non-replacement.

These options are set out in detail in paragraphs 5.2 – 5.7 below.

4.3 While best practice internationally is that where a deposit guarantee scheme is in place for credit unions this is on a statutory basis, there is no standard international practice for statutory stabilisation schemes in the credit union sector. In certain states in Canada, the deposit guarantee fund also serves as a stabilisation fund. In Spain, which has recently faced financial viability issues amongst its savings bank (cajas) sector, the Fund for Orderly Bank Restructuring (FROB) was established to provide support for the orderly transfer of weakened / non-viable institutions by facilitating access to capital for institutions engaged in restructuring[4]. Paragraph 5.2 of this paper sets out an option in this regard.

4.4 There are a number of key principles which need to be addressed. These are set out in more detail in paragraphs 4.5 – 4.13 below.

MORAL HAZARD

4.5 The existence of stabilisation arrangements can create 'moral hazard' in that credit unions may take less care and take on more risk in managing and operating their business in the expectation that, in the event of severe financial difficulties / crisis

[4] The FROB gives the authorities powers to dispose of an ailing institution or break it up. The European Commission (the Commission) approved until 30 June 2010 the Spanish recapitalisation scheme for banks aimed at enhancing the strength and solvency of credit institutions.

situation, the stabilisation fund would be available to provide them with the financial assistance to continue in operation. Accordingly, it is important that under any stabilisation scheme, the provision of solvency support would only be considered on a case by case basis, with each case considered on its merits. There would need to be a clear process in place setting out the conditions for provision of support which would apply including appropriate disciplinary processes for boards and management of credit unions having to seek formal support.

Resolution

4.6 A stabilisation regime might also be counterproductive in circumstances where it ceases to be a short term, emergency support mechanism, and instead becomes a longer term means of keeping a credit union in operation.

4.7 There are many reasons why credit unions get into financial difficulties, but a major one is poor governance and management. We consider it important that stabilisation support is a route to resolving such problems, not perpetuating them.

4.8 Similarly, we do not consider it in the long term well-being of the sector that weak credit unions should exist in perpetuity, and certainly not without corrective prudential measures being taken. We do not favour a stabilisation scheme which stands in the way of the timely resolution of prudential problems – particularly any actions which might, through example, have the overall effect of *improving* prudential standards elsewhere in the sector.

Governance

4.9 Any stabilisation arrangements should have an acceptable degree of independence from any representative body or any other credit union sector interest group. There should be independent non-executive directors. Directors and management should be subject to fitness, probity and competency requirements.

FINANCIAL ADEQUACY

4.10 The issues that must be satisfied in relation to the financial adequacy of stabilisation arrangements include the following:

- ***Adequacy of the fund***: This must be determined by means of financial review to establish if it can meet potential obligations to provide financial support to credit unions in difficulty, particularly if one or more larger credit unions and / or several credit unions required assistance at the same time.

- ***Investments of the fund:*** There must be clear investment policies on the classes and maturities of assets in which the fund can invest, ensuring that the capital is guaranteed and that no undue risk is taken.

- ***Liquidity of the fund:*** Details of the maturity of the assets would be required to determine the ability of the fund to meet expected demand based on best, medium and worst case scenarios. There must be arrangements for access to stand-by borrowing should liquidity be required at short notice.

- ***Contributions to the fund:*** How should these be set and should they be voluntary or mandatory?

- ***Reconstituting the fund:*** Should a substantial drawdown be sought in respect of credit unions in financial difficulty the stabilisation arrangements must include appropriate mechanisms to restore its financial position to enable it to fulfil its stabilisation obligations in respect of other credit unions should the need arise.

- ***Auditing of the fund:*** The accounts of the fund must be subject to external audit.

Timeliness of Access

4.11 It is important that credit unions should be able to access any stabilisation fund quickly and without hindrance. In order for this to occur there should be clear and transparent rules on drawdown of support and conditions attaching to stabilisation support. There should be agreements, standardised in so far as possible given the variety of situations that may arise in individual credit unions, which can be tailored as necessary for individual credit unions. There should be controls in place to ensure that any request for stabilisation assistance will go through a formal assessment and decision-making process.

Universality of Access

4.12 The structure and operation of the SPS has in the past been divisive within the credit union movement. Unless any proposed stabilisation arrangements have transparent mechanisms, with an appropriate level of statutory backing and are clearly distanced from any one representative body or credit union sector interest group, there is likely to be opposition from other sector stakeholders. There should be an acceptable level of consensus within the movement about any stabilisation arrangements and there must be universality of access.

Regulation

4.13 Any statutory scheme must be supported by appropriate legislation which provides for regulation by the Bank. Under any scheme, whether statutory or voluntary, it must be clear that the powers of the scheme should not duplicate or conflict with those of the Bank and any conditions attaching to financial support must be agreed with the Bank.

5.0 MODELS / OPTIONS FOR CONSULTATION

5.1 We have identified six models for stabilisation on which we wish to consult and receive views from the credit union sector stakeholders. These models cover three broad categories, namely (i) statutory models, (ii) voluntary models and (iii) options relating to the current SPS.

STATUTORY STABILISATION MODEL (1) – CENTRAL BANK CONTROL

5.2 A statutory stabilisation scheme would set out obligations covering a number of key areas relating to the scheme which would be given effect through specific legislation.

These obligations would include provisions on matters such as:

1. The establishment of the scheme, the form of company to be used, its objects, powers and rules;
2. Directors and management (including appointment, functions / responsibilities, fitness, probity and competency requirements, terms of office and removal);
3. Contributions by credit unions (basis and calculation of level of contribution, provisions for dealing with failure by credit unions to contribute, provisions to reconstitute the fund in the case of substantial draw down);
4. Designation of the Bank as the competent authority to regulate the stabilisation fund with powers to carry out its functions in this regard including imposition of conditions, requirements and directions and to impose sanctions for non-compliance;
5. The basis on which the fund could provide stabilisation to a credit union including the maximum level of support to be provided, type of conditions or requirements that could be attached in relation to payments to a credit union (subject to the approval of the Bank);
6. The type of investments which the stabilisation fund may invest its surplus funds;
7. Internal audit and risk management committees; and

8. Annual accounts and auditing of the stabilisation fund.

Alternatively, as a variant to the above model, the Deposit Guarantee Scheme (DGS) or some alternative arrangements similar to the FROB arrangements in place in Spain could be the vehicle used to provide for statutory stabilisation support and the orderly transfer of non-viable credit unions. If the DGS were the vehicle it may be possible that credit unions could maintain a single deposit in the DGS that could cover both compensation and stabilisation support.

STATUTORY STABILISATION MODEL (2) – CENTRAL BANK APPOINTED EXECUTIVE

5.3 As with the previous statutory stabilisation model outlined above, obligations covering a number of key areas relating to the scheme would be given effect through specific legislation. These obligations would be similar to those outlined at 5.2 above. The main difference would be in relation to the governance arrangements whereby the board would comprise non-executive directors from the credit union sector, while the Bank would appoint the executive.

VOLUNTARY STABILISATION - SINGLE SPS MODEL

5.4 Under this model only one group of credit unions could establish a stabilisation fund. This stabilisation fund **would not be approved by the Bank** under legislation. The reason that a voluntary stabilisation model would not be approved is that membership by credit unions of such a scheme would be on a voluntary basis and would not be under Bank control. Accordingly, the Bank could not place full reliance on this model as a support mechanism. However, notwithstanding the voluntary nature of such a scheme, there would need to be certain minimum *non-statutory requirements* for the establishment and operation of such a fund so that credit unions that wished to contribute to such a scheme would have some degree of assurance about its governance and transparency of its operations. These requirements would be set by the Bank in consultation with credit union sector stakeholders and included in a memorandum of understanding.

The type of requirements would cover areas such as:

1. Management and administration;
2. Probity and competence of directors and management;
3. Conditions and procedures on provisions of assistance;
4. Access to ensure scheme open to all credit unions subject to their ability and commitment to comply with the requirements of the scheme;
5. Contributions by credit unions;
6. Procedures for auditing of accounts; and
7. The arrangements for periodic reporting to the Bank.

VOLUNTARY STABILISATION – MULTI-SPS MODEL

5.5 Under this model any credit union or group of credit unions could establish a stabilisation fund. As with the previous voluntary model set out at 5.4 above, this stabilisation fund **would not be approved by the Bank** for the reasons outlined above, although there would be certain minimum *non-statutory requirements* for the establishment and operation of such a fund which would be set by the Bank in consultation with credit union sector stakeholders.

MAINTAIN CURRENT SPS – AS IS

5.6 This option would involve the current ILCU SPS model continuing in its current form "as is". Accordingly it would continue to operate as a discretionary fund managed, controlled and operated by the ILCU. **It would not be approved by the Bank**.

Wind-up and Transfer of current SPS

5.7 The future of the current SPS would of course be a matter for the ILCU. However, if a statutory stabilisation scheme was established along the lines set out under paragraphs 5.2 or 5.3, then the ILCU may wish to consider some form of wind-up of its current SPS. In such a case, while it would be a matter for the ILCU to decide on what it would wish to do with the assets of its SPS fund, one option would be for it to voluntarily transfer the assets to the statutory stabilisation scheme or DGS and in that case ILCU credit union members could in turn receive a corresponding offset against the amount that they would be required to contribute under the statutory stabilisation scheme or DGS.

6.0 CONSULTATION PROCESS

6.1 We are seeking views and comments from credit union sector stakeholders on the stabilisation models set out in paragraphs 5.2 – 5.7 of this Consultation Paper. Matters that should be addressed in submissions by interested parties include indicating the preferred stabilisation option or options for the credit union sector and the reasons. Where more than one option is favoured these should be ranked in order of preference.

6.2 In addition views are sought on the following questions:

1. Should there be stabilisation arrangements in place for the credit union sector?

2. Should stabilisation arrangements be on a statutory or voluntary basis?

3. Should there be one stabilisation scheme for all credit unions or multiple schemes?

4. What should happen to the existing SPS fund?

5. How should the ethos of the credit union movement be protected under any arrangements?

6.3 The closing date for submissions is 16 August 2010. We welcome submissions from all interested parties. Please make your submission in writing or, if possible, by email. We intend to make all submission available on our website. We will not publish any material that we deem to be potentially libellous or defamatory.

Please clearly mark your submission "Stabilisation Support Schemes" and send it to:

Registry of Credit Unions
Financial Regulator
PO Box 9138
College Green
Dublin 2

Email: RCUConsultation@centralbank.ie

Registry of Credit Unions

23 June 2010