SUBMISSION TO THE CENTRAL BANK OF IRELAND ON CONSULTATION PAPER 76

COMMUNITY CREDIT UNION

This submission reflects the views of the Board of Directors of Community Credit Union on Consultation paper 76 issued by the Central Bank in December 2013 in relation to the proposed introduction of a tiered regulatory approach to Credit Unions.

CONTENTS

EXECUTIVE SUMMARY

An enhanced regulatory framework including the Credit Union and Co-operation with Overseas Regulators Act 2012 (CUCORA 2012) and Fitness & Probity standards came into effect during 2013.

To build on this the Central Bank of Ireland (CBI), issued Consultation Paper 76 (CP 76) in December 2013, setting out their views on a range of specific areas of the regulatory process and the management of credit unions.

It is proposed that regulatory requirements would vary in the above areas subject to a credit union being classified as Category 1 or Category 2. The classification criteria include the nature, scale and complexity of each credit union.

- **General Comments**

  Our Credit Union is concerned with the general tone and thrust of CP76. Whilst it is generally accepted that failings in our financial system over the past 15 years were due, in part, to inadequate regulation, the proposals in this document appear to be excessive and overly prescriptive. They could also be deemed to be restrictive to credit union operations and development with the rationale behind many them being unclear.

  There also appears to be a conflict of approach insofar that a strong emphasis is placed on strengthening the governance and management of credit unions, which one would presume would lead to prudent management of the organisation, yet the level of detail in the limits proposed in various areas suggest that the CBI does not have confidence in properly managed credit unions to manage risk appropriately.

  Whilst acknowledging that this is an initial consultation document, there are gaps which would need to be clarified in order to assess the impact of the proposed regulatory approach. For example, credit unions will be classified as category 1 or 2 in accordance with three criteria (the nature, scale and complexity of the credit union) but only one, asset size, is clear. Further detail would need to be provided as to how the CBI would interpret "nature" and "complexity".

  Finally, the proposed timelines could be problematic to introduce new systems and amend the structure of savings, loans and investment portfolios.

The views of the Board in the specific areas raised for discussion are

- **The Principle of a Tiered Regulatory Approach**

  The principle has merit but the categories proposed are too broad and the proposed regulatory structure is onerous, restrictive and brings the CBI to the level of micro-managing credit unions.

  The methodology proposed assumes that the credit unions within each category are essentially homogenous and, by extension, precise limits and guidelines can be applied across the group. In fact, however, the savings, lending and other operational drivers within say, a large urban, rural or industrial credit union could be quite different and a limit appropriate in one case may be quite unsuitable in another.

- **Lending**

  In the current economic environment of a general reduction of loan demand, and a regulatory environment which has applied specific lending restrictions on many credit unions, the overall current impact on lending of these proposals will be minimal. As the economy recovers however, and opportunities to lend productively increase, they could inhibit growth in this key area of credit union activity.

  A secondary point is that the on-going monitoring of the loan book to ensure compliance with the myriad of limits, within which it is expected to operate, will add a significant level of complexity to this area.

- **Investments**

  Investment income is a key element of credit unions income structure and must be managed to maximum advantage, particularly in the current period of poor loan demand. The proposals outlined will severely impact on the earning potential of every credit union's portfolio and, in a properly functioning and regulated, banking system, it is arguable that the restrictions are not required.

- **Savings**

  There are two broad elements to the proposals, both which appear to be inappropriate. Firstly, the imposition of a maximum share limit is designed to address savings concentration and potential liquidity issues, but it is a crude mechanism and a higher degree of sophistication is required.

  Secondly, the focus on ensuring that the majority of member's savings are held in shares appears to be at odds with other regulatory objectives of lengthening the loan book maturity profile and maintaining sufficient liquidity as shares are, in the main, demand savings accounts.

- **Borrowing**

  As currently most credit unions have no borrowings, this could be considered to a be a moot point but, to avoid restricting development potential in the future, arbitrary values should be dropped in favour of seeking approval for specific proposals based upon business plans.

- **Additional Services**

  It is noted that this is left open for submissions which is appropriate at this time. If a list of approved services is agreed following receipt of submissions a mechanism for regular review should be established.

- **Governance**

  The constant improvement of standards is of benefit to both regulators and members so it should be welcomed. The range of committee and roles outlined however for credit unions in Category 2 would be excessively onerous for those at the lower end of the scale, i.e. just above the €100m benchmark.

- **Reserves**

  More detail is required on the extent of the proposed operational reserve and the basis of calculation.

- **Liquidity**

  The proposed requirements appear to be excessive as traditionally credit union savings have been stable. In an extreme situation, however, where there was a run on a credit union, liquidity even at this level is unlikely to be sufficient but the event could be managed within the existing provisions of S32 (1) of the Credit Union Act 1997 (whereby a credit union can apply up to 60 day notice period before honouring a share withdrawal request) to allow for time for other remedial action to be taken.

- **Other Prudential Requirements**

  The range of additional requirements suggested have merit in themselves but will be difficult to implement in the current environment where credit unions are working to implement many regulatory changes simultaneously.

- **Provisioning**

  The concept of a standardised approach to this area has intrinsic merit but there is a strong belief, and some evidence, that methodologies being recommended by external advisors do not fully reflect the credit union model as it currently operates in Ireland. Significant discussion therefore is required on the detail of such an approach.

In summary, Community Credit union welcomes initiatives that will facilitate the regulation and orderly development of the credit union movement in the coming years and look forward to the continued engagement with the CBI on this topic.

THE TWO-TIERED REGULATORY APPROACH

Notwithstanding that this idea has been around for some time now, and has gained some traction within the CBI and the movement, the question must be conclusively decided as to whether it is appropriate or not to have a tiered approach to regulation or, should all credit unions be regulated to the same degree. If the first question is agreed in the affirmative, the second question is how many tiers should be set and what criteria should be applied to how credit unions are placed in each tier.

The broad argument that, if a credit union is operating a simple, low complexity and low risk model, then a high level of regulation is not required makes intuitive sense and correspondingly, as complexity and risk increases, then so should the regulatory approach and this is reflected in the application of PRISM.

The suggested approach, however, that credit unions would be divided into two categories with an arbitrary set of limits and restrictions applied to all in that group is debateable in two respects.

Categories

Two categories, principally segmenting organisation's as being either above or below €100m, is a crude delineation of complexity, nature and risk exposure, principally at the lower end of the scale. Credit Unions of, say, up to €40m in assets tend to have single office environments, limited management resources and simple product ranges. Above €70m the more common experience is multiple offices, more developed management structures and complex product ranges reflecting a higher level of risk.

If regulatory categories are to be established it should include at least three groupings – a) up to €50m, b) €50m to €150m and c) over €150m, with the proviso that a credit union may apply, or be directed, to a different category following a review of the nature and complexity of its business against pre-defined criteria.

Application of Two-Tiered Approach

The proposed application strategy principally revolves around setting arbitrary limits in key areas. This presupposes that all credit unions in the group are homogenous, which is not the case. For example a large highly lent industrial credit union will have little exposure to investments but have a significant exposure to its (specific) common bond. By contrast a large rural community credit union with a lower level of lending is likely to have very different considerations. Its investment portfolio is likely to contribute a high percentage of its income and member borrowing needs may include larger value and shorter term loans related to an agricultural business cycle.

Whilst, it is useful to set out broad guidelines / values in key areas, recognition should be given to important differences between organisations that may fall within generic groupings.

LENDING

Lending in credit unions is at low point as demand is low and strong repayments coupled with write-offs continue to drive down loan books. This is having a detrimental effect on the economy as it restricts cash in circulation and consumer demand and on credit unions as loan interest income falls.

The challenge therefore is for credit unions to implement strategies to grow their loan books in manner which does not take on unacceptable levels of risk and, from a regulatory perspective, the CBI must ensure that this is the case.

The proposed methodology is complex, crude, and likely to penalise classes of members unfairly by virtue of their connection with an officer of the credit union and not achieve the desired regulatory effect.

- **Large Single Exposures**
  CP76 proposes a generic maximum single exposure of 10% of Regulatory Reserves. While this may reasonable in the context of fully secured lending it would be considered high risk in the normal sphere of typical unsecured credit union lending.

- **Maximum Loan Durations**
  The proposal that 40% of the loan book may be lent over 5 years and 15% over 10 years is reasonable, if the lending is secured. Unsecured loans over these durations would carry a higher default risk.

- **Home Loan Lending**
  The prospect of entering into this market on a limited basis is a useful niche that credit unions could consider. In the interest of prudence, however, it would need to be backed by matching term savings and the thrust of the consultation paper with regard to savings would appear to contradict this.

- **Restricted Persons**
  This new classification, which includes all family members of members of the Board of Directors and senior management, is fraught with potential difficulties particularly given the definition of “family” as set out in S2(1) of the 1997 Credit Union Act 1997[1]

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1. ‘‘member of the family’’, in relation to any person, means that person’s parent, grandfather, grandmother, father-in-law, mother-in law, husband, wife, son, daughter, grandson, granddaughter, brother, sister, half-brother, half-sister, uncle, aunt, nephew, niece, first cousin, son-in-law, daughter-in-law, brother-in-law or sister-in-law;

In many credit unions, particularly in small communities, there may be a great deal of familial interconnectedness between members which could cause that family grouping to reach the maximum permitted limits without any excess concentration of borrowing or lending risk.

Whilst the reasons for it are apparent, the risk of abuse of position is surely reduced in the current and developing regulatory environment and the reporting of loans to family members of officers in governance roles as part of the Prudential Return could equally address this concern.

INVESTMENTS

Presently the range of permissible investments by credit unions is set out in the 1997 Act which draws on the TAIO (Trustee Authorised Investment Order). We also have guidance notes from the CBI giving direction on the management of investments. Some variance currently exists between the terms of the TAIO and the CBI Guidance notes in certain areas and clear direction in this area would be helpful.

In recent years many credit unions suffered significant losses which some observers have attributed to poor management of their portfolios. In some cases this may have been true but, the majority of the losses occurred when professional advice had been taken which did not hold good through the collapse of the banking sector and the recession.

- **Minimum Counterparty Rating of A**
  This is reasonable benchmark to be considered when considering an investment but all Irish banks, which currently form the backbone of credit union portfolios, do not meet this standard. If any of the Irish banks do not receive an upgrade before the implementation of this requirement the implications for both them and credit unions could be considerable.

- **Permitted range of investments**
  The restriction, as applied to category 1 credit unions, would have a materially adverse impact on investment income with questionable advantages on risk management.

- **Counterparty Exposures**
  The current basis of relating counterparty exposures to a percentage of the investment portfolio more fairly recognizes risk across all credit unions. Relating it to regulatory reserves could seriously impact on credit unions with high investments to assets ratios and drive considerable amounts of money out of Ireland.

- **Liquidity**
  The proposed levels are excessive and would greatly impact on credit union income.

As a general package of measures the proposals are overly complex providing plenty of scope for inadvertent breaches by individual credit unions.

SAVINGS

It appears that the CBI's preference, from a risk perspective, is that credit unions hold the majority of member savings as shares as this allows flexibility at year end in terms of the cost of those funds and limits the obligation arising to other members who may hold savings in deposit accounts.

Against this there is also recognition that deposits offer much more flexibility to tailor a product to suit different needs that a member may have so deposit accounts, as a product offering, cannot be ignored.

- **Shares Vs deposits**
  The thrust of the proposal in CP76 is that share savings should remain the predominant vehicle for members to invest in their credit union. Undoubtedly this is the current preference with most members seeking also to avail of life savings insurance benefits provided by their credit union in relation to share savings, but there is also an imperative to develop complementary deposit based savings options to a) enable credit unions to offer an option to members who may wish to have a defined level of earnings on their savings or b) may wish to earn a higher return by locking their savings in for a defined period of time. In addition term savings facilitate matching funding with longer term lending.

- **Maximum limit**
  The principle of a maximum limit is simple to understand and implement but does not address the underlying risk that it attempts to mitigate. For example, a member of a family could place €500k in a credit union by utilising a partner and three children's accounts. A more sophisticated approach is required in this area.

BORROWING

Borrowing (by a credit union) has not been a feature within credit unions for some time and it is now unusual to find one requiring non-member funding. It is important to address it however to avoid any future risks of a credit union taking on debt imprudently.

- **Borrowing Limits**
  While the Credit Union Act 1997 provided for a borrowing limit of 50%, CBI approval is required if a credit union proposes taking on borrowing of more than 25% of its assets. This would appear to adequately deal with the risk.

ADDITIONAL SERVICES

The 1997 Credit Union Act contains, in addition to Savings and Loans, a list of core services that were considered to be pre-existing at that time. Since then other services have been developed and, if a credit union wishes to offer them, they must first obtain CBI approval. Many credit unions have sought to develop additional services for the benefit of members since then.

Given the complexity, and risk, associated with some of the newer services being considered, e.g. debit cards, it is appropriate that there should be some consideration of the organisations ability to provide this service competently and safely.

We suggest that, outside of the designated core services, permission should be considered on a case by case basis containing a full risk assessment, by the credit union, of the proposed activity.

GOVERNANCE

CUCORA 2012 and the Fitness & Probity regulations are very prescriptive in terms of what is expected from Boards and senior staff of credit unions and have placed increased demands on both groupings.

- **New Committees**
  With the current committees structure the commitment expected of volunteers is significant. The addition of further committees, with full or partial mandatory board participation, would put additional on volunteer resources and act as a disincentive to potential new volunteers.

- **New Roles**
  Dedicated in-house risk, compliance and internal audit is desirable but is unaffordable for most credit unions unless they are significantly in excess of €100m in assets.

- **External Board Evaluation**
  Regular external review of any individual group can maintain standards but further clarification is required on who the reviewer is and what criteria would be applied.

  It could also be argued that such an external review undermines certain responsibilities and functions of the Chairperson, the Board Oversight Committee and the Internal Auditor.

RESERVES

The case for maintaining adequate reserves as a buffer against potential (usually unforeseen) losses is established, however, the current minimum value of 10% is somewhat arbitrary. Notwithstanding this there appears to be an imperative to build this to a higher, unspecified level.

Whilst reserves are necessary they also represent “Shareholder Wealth” that members cannot access thereby disadvantaging individual members. *(When this situation was allowed to develop in agricultural co-operatives it was one of the drivers towards demutualisation.)*

- **Operational Risk Reserve**
  Further detail would need to be provided as to how this would be assessed.

LIQUIDITY

A credit union must have access to sufficient liquid funds to meet it on-going cash obligations. Currently liquidity is expressed as the amount of cash that can be accessed within a 3 month window as a percentage of the unattached savings.

Determining the “correct” level to hold is quite difficult. As credit union savings and loans are reasonably predictable it is possible to forecast future requirements in a normal environment. The difficulty arises in providing for unexpected events. For example if a rumour started that a credit union was on the verge of collapse, 100% liquidity would not be sufficient.

- **Minimum Liquidity**
  Most credit unions’ liquidity position is predictable and controllable. Share movements tend to follow established trends and loan issues can be matched to repayments if necessary until invested funds are available. Consequently, this absence of volatility allows liquidity to be safely maintained at lower levels that might otherwise apply to other financial institutions.

  The current requirement for 20% access to unattached savings within 3 months appears to be adequate.

- **Basis of calculation**
  The current methodology correctly links liquidity to the underlying risk, i.e. the funds that could be called upon. The proposed method of linking this to assets breaks this link and does not appear to be a valid basis to assess liquidity needs.

OTHER PRUDENTIAL REQUIREMENTS

Credit unions are currently working under the not insignificant burden of meeting the current prudential requirements and specific requirements (e.g. lending restrictions and liquidity reporting) applied on case by case basis. The impact and benefit of additional requirements must be fully assessed before further tasks and cost are added to the sector.

PROVISIONING

Provisioning for loans in arrears has been a serious issue for credit unions since 2008. The extent, depth and duration of the recession created a problem of a scale never before witnessed and it has been extremely difficult to establish the “correct” provision for likely bad debts over this time.

- **Standardised Approach**
  The benefits of a standardised approach to this key area would have obvious benefits both from a regulatory perspective and from the position of a compliant credit union. The devil, however, is in the detail as to what this approach should be and what factors should be taken into account.

  The “roll rate” method is currently favoured by many credit unions on the advice of external advisors but visibility of the calculations is not present. Against this other methods seem fraught with subjectivity and would lend themselves to generating a standard result.

  Equally CBI directives in relation to multiple loans within specified periods have been taken up as indicating a requirement for higher provisioning and, whilst this may be indicative of a risk (that should be adequately assessed at underwriting stage) it does not reflect the reality that many credit union members borrow frequently within modest overall limits.

  In essence there would be need to be full clarity, discussion and agreement about the methodology to be applied.