Registry of Credit Unions

Central Bank of Ireland,

PO Box 559

Dame Street,

Dublin 2.

20 March 2014

Dear Sir /Madam,

Tiered Regulatory Approach for Credit Unions

I refer to the public consultation with respect to the above proposal.

Thank you for the opportunity to contribute to public policy on this matter.

Attached is a submission for consideration in advancing policy and practice development in this domain.

Please contact me if you wish to discuss the submission further as you proceed to the next phase of this process.

Yours sincerely

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Introduction of A tiered Regulatory Approach for Credit Unions

Consultation Paper CP 76

Consultations Questions – Section 8

(i) Do you agree with the proposed tiered regulatory approach for credit unions? If you have other suggestions please provide them along with the supporting rationale.

<u>Response (i)</u>

The tiered approach does not appear to enjoy widespread international adoption and the UK experience is hardly very relevant given the scale of individual credit unions there, their number and the population penetration they enjoy. The absence of plentiful international benchmarks is not an absolute barrier to adopting a policy: it does however command that the design and implementation has to be very robust and thorough as it will inevitably involve encounters with unanticipated phenomena in terms of systems, governance, public administration, personnel, information, exchanges, goal congruence, moral hazard, agency, public value, and monetary flows and balances.

Notwithstanding the limited empirical evidence of operation, it has conceptual appeal insofar as it represents an effort to strengthen a *risk based regulatory orientation*. Previous reports by the Comptroller and Auditor General, Regling & Watson, Nyborg, and Honohan have all stressed the importance of this concept to regulatory effectiveness. Internationally reports from the US, Iceland, Denmark, the European Union and UK have echoed this message. Yet risk receives relatively little express reference in the consultation document.

Credit Union Members are subject to a number of types of regulatory risk:

- their individual credit union crystallises a regulatory exposure,
- the regulator of their credit union crystallises a regulatory exposure with respect to their credit union,
- a counterparty of their credit union crystallises a regulatory exposure which affects the financial and trading position of the said credit union, and,
- a regulator of the counterparty crystallises a regulatory exposure which affects the financial and trading position of the said credit union.

The tiered approach addresses some of these exposures. It is critical however that all Credit Union Stakeholders appreciate this wider exposure of individual credit unions and the role that regulators, domestic and international, play in the risks universe affecting Credit Union Members. Irish Members are affected by the actions of all counterparties, whether Irish or overseas, that deal with their Credit Union, and by the actions of the regulators of each of those counterparties within the financial services sector.

It is significant that counterparties operating in Ireland under the single passport scheme are allowed advertise as being subject to Irish regulation for conduct of business activities alone while an overseas regulator is mentioned only in the context of licensing. In a retail context, licences are what individuals buy for phenomena like dogs, televisions, fishing and driving. The issuers of licences in most cases have very limited roles if any post issue. Credit Union Members should be assured that counterparties trading in Ireland under the single passport are appropriately subject to prudential regulation by a responsible agency in the home country. Credit Union Members rely on the Central Bank, Department of Finance and their political representatives in the Oireachtas and the European parliament to secure such assurance and to amend the retail communication accordingly.

The proposals are silent on the capacity within the Central Bank to make the assessments involved in reclassification of Credit Unions and how it will develop its regulatory mechanisms for this task. Credit Union Members and taxpayers generally will wish to know the degree to which the Central Bank will carry out reviews and inspections itself and the degree to which this work will be subcontracted to third parties. Third party subcontracting while offering particular access to expertise also denies the Central Bank the opportunity to develop that expertise itself and dilutes responsibility for the work undertaken. The concrete proposals for tiered regulation will need to address this matter explicitly.

There is good consideration of the purely financial issues associated with lending, liquidity and reserves and the views of individual credit unions should carry due weight in the evaluative process being undertaken by policy makers.

The capacity and process dimensions need to be spelled out further in the next phase of policy development before the tiered based approach could be wholly endorsed. Validated performance metrics and process maps on current regulatory interactions, interventions, and procedures would help inspire confidence in the proposals which envisage greater powers and discretion accorded to the Central Bank in this domain. There needs to be a more holistic expression of the envisaged change.

(ii) Do you agree with the proposals for the operation of the two category approach for credit unions set out in sections 5.1 - 5.11? If you have other suggestions, please provide them along with the supporting rationale. It should be noted that tiering is possible where regulation making powers are available to the Central Bank. Where requirements are set out in the 1997 Act they apply to all credit unions and cannot be tiered.

Response (ii)

The proposed design is not nuanced or gradated sufficiently in reducing the number of tiers from three to two. Credit Unions' capacity to expand the range and depth of services is both enabled and limited by its people, its capital, its systems and its surplus generation pattern. It is worth considering whether the transition between tiers should be gradual rather than absolute as envisaged in the current proposals. It is in the interest of Members that credit unions should be facilitated in making such transition in a manner that does not lead ambition to overstretch the resources and nor does it lead the Central Bank to inhibit normal positive development by excessive prudence.

The Central Bank by its own public admission maintain a watch list of credit unions that have faced financial challenges so it is not a fair description to say that credit unions cannot be tiered in regulatory practice under the 1997 Act.

(iii) Are there any areas where credit unions could provide new additional products or services to their members? Should these be available to category 1 and category 2 credit unions or only category 2 credit unions? If you have suggestions please provide them along with the supporting rationale and the associated additional requirements

Response (iii)

A suggested definition of a credit union business model is as follows:

A Credit Union's business model represents the actual choices, regarding who it serves, with what product/service mix, on what platform, with appropriate margins, pricing and payments *terms in delivering specified benefits to the Member community within a risk range involving a prescribed capital base, with a suitable liquidity profile, framed in its totality by Credit Union principles.*

The thrust of regulation is to support the fulfilment of the aspiration expressed in such a definition. All stakeholders need to have an appreciation of the worthiness of this expression but also of the responsibilities it commands. Tiered regulation has the potential to support the realization of the particular expression by an individual Credit Union of a sustainable business model.

Credit Unions should not be permitted to adopt the *originate and distribute* model that existed in other parts of the financial system and that contributed to the recent financial crisis. Securitisation would not be consistent with the values of the credit union movement.

The Central Bank needs to reflect carefully on the lessons learned from the recent payment protection insurance (PPI) experience. Issues that require attention here are

- Whether the current qualification regime for the sale of such products is adequate
- The role of incentives in distorting advice and sales behaviours
- The adequacy of internal control in the providers of such financial services.
- The culture of financial institutions in which this issue arose.

Credit Union Members will wish that there are appropriate standards and guidance in place that would not expose them to the behaviours and losses that underpinned the PPI phenomenon in whatever additional services might be provided by their Credit Unions.

Currently Credit Unions principal sources of finance are (i) funds from members in the form of shares and deposits and (ii) retained surpluses. The proposed model sees other forms of credit being introduced to the financial structure of credit unions. Public policy would need to proceed with caution in this domain as it may

- alter the distribution of margin between Members and others
- change the risk profile of a credit union
- expand the capital expenditure appetite in credit unions
- expose credit unions to new sets of interactions with large financial institutions,

- distort the governance focus in Boards already under stress from the economic and regulatory environment in which they operate.

(iv) Do you agree that a provisioning framework should be developed for credit unions as proposed in section 6.2? If you have additional proposals please provide them along with the supporting rationale.

Response (iv)

The provisioning approach for Credit Unions for the financial statements should be consistent with the appropriate financial reporting standards. Such standards generally are not prescriptive of particular methods. If the Central Bank wishes to secure an amendment of those standards then it should engage fully with the standard setting process to have them amended.

Auditors report on the financial statements and express opinions by reference to compliance of the financial statements with the relevant accounting standards. Auditors currently receive guidance from the Central Bank in advance of conducting audits and such guidance has not to date prescribed a particular provisioning methodology. The Central Bank has the capacity to interact with the regulatory bodies for auditors where it has evidence of unsatisfactory work with respect to regulated entities.

If the Central Bank wishes to prescribe a particular method for regulatory purposes, it must justify the adoption. Where the prescribed method exceeds that which is required for observation of accounting standards and principles, the Central Bank may request such information be prepared as part of its regulatory returns.

The Central Bank in its approach to provisioning has an obligation to ensure that it does not require Credit Unions to have more onerous and costly approaches to provisioning than it requires of other lenders that it regulates and which compete with Credit Unions. Public policy with respect to competition in both domestic and European contexts clearly would be triggered by such inconsistency were it to occur.

The Central Bank has a pivotal position with respect to the wider social and economic environment in which loan arrears manifest themselves. This means that the signals it sends to the borrowing community regarding the honouring of loan commitments can be supportive or detrimental to the capacity of Credit Unions to recover arrears. It also means that where the process of resolving multiple indebted Members arrears involves prioritising other lenders' claims, this prejudices "non arrears" Members in an affected Credit Union and advances the interests of shareholders in other financial institutions. Again in this domain the institutions of the State, including the Central Bank, should exercise due care and acknowledge properly the potential conflict of interest that exists in the manner in which this process is conducted. This is particularly the cases where the State is a major shareholder in the other lenders of Credit Union Members.

(v) Do you agree that the tiered regulatory approach should be introduced at this time? If you consider that alternative timing is more appropriate, please provide suggestions, along with the supporting rationale.

Response (v)

To the extent that the tiered regulatory approach may in fact represent a formalisation of a process that is already manifest in regulatory practice, then it is fitting that it should be given the requisite legitimacy.

(vi) If it is considered that the tiered regulatory approach should be introduced at this time, do you agree with the proposed timelines for the introduction of the tiered regulatory approach set out in section 7.1, in particular the transitional period proposed between the publication and commencement of the regulations? If you have other suggestions please provide them, along with the supporting rationale.

Response (vi)

The timelines are dependent on:

- both the Central Bank and individual Credit Unions developing resources, processes, procedures and capabilities to underpin the tiered approach
- the extent to which there is substantive engagement with the issues raised during the consultations
- the degree to which there is acceptance of the final proposals

In light of the above considerations, the timelines appear to be ambitious.

Supplementary Observation

Due weight should be given to the requisite cultural change among Credit Union Stakeholders that is necessary to achieve the desired public value from a tiered regulatory process. Credit Union Members would want this as otherwise a lack of evolution could prove an obstacle to securing the desired benefits. All parties should acknowledge the need to demonstrate some such movement.

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February 2014

This submission is made in an academic capacity and the views contained therein are solely those of the author and should not be construed as representing the views of the Business School or any other party.

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