St Anthony's & Claddagh CREDIT UNION

Response of

St Anthony's & Claddagh Credit Union

To

Consultation paper CP76

Introduction of a Tiered Regulatory Approach for Credit Unions

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St. Anthony's & Claddagh Credit Union is regulated by the Central Bank

General Comments

St Anthony's & Claddagh Credit Union welcome the opportunity to contribute to the debate on "A Tiered Regulatory Approach for Credit Unions". We recognise the new approach of this consultation process which precedes a regulatory impact analysis. Therefore we have not conducted an in depth analysis on the impact of the proposals contained in this paper. Rather we have sought to comment on the proposals and where appropriate to offer alternatives.

We support the principle of a tiered regulatory approach which recognises the diversity in the Credit Union sector. In particular we appreciate the transparency which we hope such a tiered approach will bring. This transparency will enable greater understanding between Credit Unions and their supervisors in the Central Bank.

However there are specific areas discussed later in this document which in isolation may simply be an attempt to eliminate specific risks but when taken in totality could fundamentally damage the business model of the Credit Union. The business of the Credit Union is about risk. We must seek to manage this risk, we cannot eliminate it. The controls required to eliminate risk would be prohibitive and in such circumstances the greatest risk is not to do business at all.

The overriding consideration when examining Tiered Regulation must be to develop a regulatory system which will support a vibrant Credit Union Sector in the 21st century. Tiered Regulation must support not simply what Credit Unions are doing today but what they aspire to do tomorrow.

It is expected that the restructuring of the Credit Union Sector facilitated by Rebo will see the development of the Credit Union Sector as a niche player in the Financial Services Industry. As such it will provide a wide range of financial products and services to individuals and groups. The experience in other jurisdictions such as Canada would support this view.

In such circumstances regulation must account for clusters of credit unions, these clusters could be defined by the business models of the Credit Unions e.g.

> **Cluster A**- traditional credit unions with a simple business model run mainly by volunteers serving personal customers in a local market (common bond).
> **Cluster B** - the status quo for many credit unions which have a professional staff, a limited range of product serving personal customers and community groups' in a market limited by the common bond.
> **Cluster C** - a sophisticated credit union run by a professional staff and board with a wide range of products serving personal, corporate and community groups in a broad, possibly national market.

These clusters could broadly map the three tier system proposed by the Credit Union Commission and the PRISM Categories of the Central Bank as applied to Credit Unions – Medium High, Medium Low and Low.

Section 4 Overview of Tiered Regulation

The benefit from a flexible approach such as Tiered Regulation may be lost if the thinking governing it becomes rigid. There are some comments in this section which would raise a concern that this may happen. This would include:

- Initially all Credit Unions will be Category 1 and must apply to be category2.
- Credit Unions can change from Category 1 to 2 but it is not expected from Category 2 to 1.
- The linking of Category 2 to a specific asset size.

Furthermore the current wording is vague and effectively defines the application process associated with moving from Category 1 to Category 2 as being on a "case by case" basis. This approach would seem to contradict the spirit of Tiered Regulation which seeks to cluster Credit Unions and to regulate the cluster in a clear and objective manner.

This approach is surprising following the development of PRISM as a regulatory tool. Based on St Anthony's & Claddagh Credit Union's experience of PRISM it would appear to be an effective tool used by the supervisor to understand the business model of the Credit Unions

In such circumstances it is difficult to understand why the data gathered to date under PRISM is not used to cluster Credit Unions based on their business model. The clusters could equate to the three tiers previously discussed in the general comments section previously.

Cluster A is likely to refer to very small credit unions that provide the traditional core services of savings and loans to a very limited common bond; given their simple business model reduced regulation is now appropriate. This reduced regulation may be technology based where the input of a supervisor is only required when the Credit Union does not meet the standard metrics.

Cluster B is likely to be the largest cluster and will include the majority of Credit Unions in what the Commission referred to as Tier 2 and 3. It will effectively be the status quo. The introduction of Tiered Regulation should not mean that any Credit Union loses any of its current business operations.

Cluster C will for many be aspirational at this time but its inclusion in the structure will allow the sector to develop in line with the experience in other jurisdictions such as Canada. It is anticipated that Credit Unions would offer a full suite of financial services and products and as such be subject to substantive regulation. This development of the sector could be assisted by Rebo.

To facilitate Credit Unions who would wish to move from their assigned cluster, transitional arrangements must be in place. These transitional arrangements should provide clarity on the standards required of each cluster and the regulatory practices governing those clusters.

When defining the standards required for each cluster the focus should not simply be on predefined Key Performance Indicators rather it should include the judgement of supervisors as developed during the PRISM process.

Section 5 Overview of Categories

While the Celtic Tiger era has taught us that there must be limits to ensure that risk is correctly managed, we must ensure that the limits are not such that they prohibit the sector from thriving and in a worst case scenario from actually doing business and surviving. Sometimes the greatest risk is not to do business at all.

Lending

Traditionally this is the core business of the Credit Union sector and it must be the foundation on which the future growth of the sector will be based.

The limits for the loan book should seek to manage the residual risk associated with the loan therefore the limits should be based on the value of the loan after accounting for

- Shares and/or Deposits held by the Credit Union as security against the loan
- Value of the specific bad debt provision held against the loan

We note in particular the following in relation to specific issues:

- Commercial Lending - Differentiation is necessary between sole traders requiring low risk finance for tools, transport etc. and SME lending for capital projects and on-going working capital purposes. The nature and risk associated with each of these sectors is very different and should be treated differently.
- Section 35 restrictions have been used to manage the risk associated with the lending excesses of the Celtic Tiger era but if Credit Unions are to adopt a more sophisticated business model then a more complex Asset Liability Management system will be required.
- Community Loans – Registered charities and religious organisations should be included in this category. There is potential for strategic development between the charity sector and the Credit Union sector, care must be taken that arbitrary limits do not inhibit this potential. Rather than simply looking at an individual level for the Credit Union and for the charity, a fund could be developed from which the Credit Union could gain income and the charity could secure funding. The detail of such a fund is beyond the scope of this paper but care should be taken that restrictions included in this consultation document do not prohibit such opportunities.
- Concentration Limits –If as expected the strategic direction is to grow the loan book the suggested percentages will inhibit growth. On a practical level we must recognise that it is the residual risk in the loan book which much be managed therefore the limits should be based on the value of the loan book after taking account of savings held as security and any specific bad debt provision. Furthermore the use of the regulatory reserve is limiting as for the majority of credit unions it refers to only 10% of the Total Assets. As an alternative the limits could be applied to the value of total assets or the net loan book after bad debt provision.
- Home Loans – specification of maximum maturity is arbitrary and limiting, rather it should be linked to income earning potential of the individual applying for the loan.

Lending cond.

- Restricted Persons Limit – a defining feature of Credit Unions is the common bond. This means that the members are intrinsically linked by area and often by personal relationship. This is what gives the Credit Union its greatest strength, the loyalty of the membership. However the limitation of the common bond does mean that the rate of interrelationship between the board, management and membership is high. To impose the restriction as envisaged will mean that a significant part of the common bond can no longer do business with the credit union. This will be particularly true in relation to mortgage lending. It would seem that the objective of this restriction is to limit the risk of undue influence in the loan underwriting process. This risk is already dealt with through:
    - Legislation and guidelines in relation to governance and fitness and probity of credit union officers
    - Policies and procedures within the Credit Unions in relation to conflict of interests.

  Furthermore this suggestion is discriminating against individuals who are related to Credit Union officers. While favourable treatment should not be conferred on such individuals, nor should they be actively discriminated against.

- Large Exposure Limit - as discussed above in relation to concentration limits the regulatory reserve is not appropriate as a limiting factor on the loan book.

The Credit Union developed in response to a need for credit which was not catered for by the high street banks. Very often it was the need of people on the margins of society who are vulnerable to the tyranny of unlicensed moneylenders. This need still exists in society. In other jurisdictions including the UK it is government policy to develop the infrastructure of the Credit Union Sector to deal with the issue of Financial Inclusion. This infrastructure is in place in Ireland through the Credit Union sector and should be used to take a lead on financial inclusion as a policy priority

This does not mean that the Credit Union take on undue risk but rather that it uses the risk mitigating infrastructure developed in response to the financial crisis so that it can become

- A niche player in the broader financial services market

And

- A policy leader for financial inclusion

Investments

The most immediate challenges facing Credit Unions in relation to Investments are

- Reduction in rate of return available
- Reduction in number of suitable counterparties available

The obvious risk associated with these challenges is

- The use of unsuitable counterparties
- The extension of the overall term with a consequent impact on liquidity

If general limits are to be used they could be based on the size of Investment Portfolio rather than on the Regulatory Reserve. The suggested limit based on regulatory reserve would require a greater number of counterparties than currently available in Irish market. This will lead to an exit of capital from Irish deposit holders and the assumption of greater political risk for Credit Unions.

The danger of political risk should not be underestimated in a democratic organisation such as the Credit Union which for trade relies on member confidence. Members at AGM may understand that a Credit Union made a loss because of the failure of an Irish financial institution, they may not understand if the same loss occurs due to the failure of a non-Irish institution.

An alternative to the suggested restriction is:

- Retain current regulations as set out in the 2006 Guidance Note
- To use the value of Total Assets or the Investment Portfolio as the basis of the restriction.
- For EU Government bonds to be excluded from the restrictions applied to investments. If it accepted that EU Government bonds are the most secure investments, then no direct restriction need apply.
- The introduction of a Credit Union Government bond. This is beyond the scope of this paper but there is strategic potential for such a bond. The restriction on the use of a Collective Investment Scheme may prohibit such a strategic opportunity.

Savings

This is a limited financial risk. As at March 2014 in St Anthony's & Claddagh Credit Union there are 51 accounts with more than €100,000; the total value of these accounts is €7.8m, this means that only €2.7m of member's money is at risk representing only 1.7% of total savings.

The issues associated with the restriction of savings to €100,000 are;

- Reputational risk for the Credit Union
- Restriction of choice for member

Given the shrinking of the Financial Services Industry and the increased automation of the pillar banks for many personal customers the Credit Union is the provider of choice.

This choice is particularly important in the Credit Union as a democratic organisation.

Furthermore the restriction of deposits as a percentage of shares will limit

- The development of savings products within the Credit Union sector.
- The use of more sophisticated Asset Liability Management techniques.

This is contrary to the trends seen in other jurisdictions such as Canada and Ghana where shares in the credit union are only a small proportion of savings, with the greater part being held in a variety of deposit accounts. This enables better Asset Liability Management.

Such restrictions will ensure that the Credit Unions will be unable to become niche players in the financial services market. This is anti-competitive.

Again the point must be made that the regulation should support the development of the sector not inhibit it.

Additional Services

It is envisioned that Credit Unions will be a niche player in the personal financial services market. Its unique selling point will be based on its connection with the member as owners, therefore the products offered should cater for the financial needs of members from the cradle to the grave and would include additional services such as Mortgages, Mobile Banking, Credit Cards and so on.

Furthermore as a community based financial institution the Credit Union is in a position to provide a full financial service to community groups this would include working capital loans, long term loans for infrastructure projects and operational accounts with EFT facilities.

To develop this business model to its greatest potential the Credit Union sector must have the freedom to grow. This does not mean taking undue risk which may endanger the savings of members but it does mean that the Credit Union is not constrained by absolute limits which can become the drivers of the business rather than the indicators of it.

Therefore it is not appropriate at this time to limit the services of Credit Unions to a "menu" based on current services. Innovation in financial services is on going, Credit Unions and their regulators must be flexible enough to respond it.

This development will be organic; to ensure it is efficient good communication between the credit unions and their supervisors in the Central Bank will be necessary. This communication will include:

- The Credit union keeping their supervisors informed on an on-going basis of business developments
- The supervisors giving clear feedback on the reasons for decision such as the approval/refusal of new products and the imposing/lifting of restrictions.

Such communication should mean that a Credit Union can be confident of being granted approval for a business development if they know that the supervisor has already examined and tested the business case for same.

Governance

A substantial amount of work in the area of governance has been carried out in Credit Unions in recent years but ultimately the Credit Union is a democratic organisation. This means that the Board and Management are held to account by the membership at the Annual General Meeting. Democracy is not an efficient means of oversight but it is effective. In these circumstances an external review is not necessary. There is already a high level of oversight in the Credit Union Sector including:

- The Board Oversight Committee who report directly to the members
- The External Auditor who report directly to the members and the Central Bank
- Supervisors from the Central Bank

The requirements for a category 2 Credit Union to have a "dedicated" risk management office, compliance officer and internal audit function is inappropriate. It does not take account of the organisation structure of the individual Credit Union or the competence of these officers. Surely the important issue is that these functions are carried out correctly not that they are "dedicated".

Fitness & Probity

The Fitness & Probity requirements as implemented by the Central Bank were "copied" from those for commercial banks and do not fully account for the volunteer nature of the board of Directors of Credit Unions. In particular

- The requirement to give access to Revenue Records. A tax clearance certificate should suffice.
- The focus on employment\volunteer history. This approach will examine the experience gained over the defined period as opposed to the transferable skills developed.

Liquidity

Rather than specifying liquidity as a percentage of unattached savings consideration should be given to other more sophisticated methods of Asset Liability Management. For example

- Encouraging members to invest in deposits rather than shares
- Classifying some shares as longer term shares
- Managing cashflow

This should be developed in cognisance of the regulation surrounding investments in particular the development of a Credit Union bond.

Other Prudential Requirements

Rather than adding the additional cost of an interim audit the internal audit function could furnish a report to the Central Bank and which could cover specified areas.

Section 6 Provisioning

St Anthony's & Claddagh Credit Union is of the view that this section is beyond the scope of a paper on Tiered Regulation.

Furthermore there is a risk that the Central Bank will become involved in the micro management of credit Unions in relation to bad debt provisioning.

The specifics are vague but the emphasis seems to be on required percentages. Credit Unions should be encouraged to develop a culture of prudent Bad Debt Provisioning using good judgement.

Key to this will be encouraging Credit Unions to carry out loan book reviews in house rather than using external consultants. The advantage of this is that the Credit Union Management will better understand the profile of the loan book and the consequent inherent risk. This should improve not only bad debt provisioning but also loan underwriting. An added benefit will be to reduce the costs of such reviews.

Section 8 Summary of Views

(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.

St Anthony's & Claddagh Credit Union welcomes the concept of tiered regulation but would suggest that the proposed categories are too restrictive and rigid. Three categories based on the business model of the credit unions should be developed; the intelligence for such categories should be available following the PRISM reviews of 2012 and 2013.

(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.

The category approach suggested is too restrictive and does not take into account the development of the Credit Union Sector as a niche player in the broader Financial Services Industry. A more sophisticated approach based on the business model of the Credit Unions is required.

(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.

If the Credit Union Sector is to develop as envisioned by the Credit Union Commission the regulatory environment must be future proofed. It is not appropriate to simply list a "menu" of services from which categories of Credit Unions can choose. Rather the regulation should be based on the business model of the Credit Unions.

(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.

There is a risk that the Central Bank will become over involved in the micro management of Credit Unions in relation to bad debt provisioning. Credit Unions should be allowed to develop a culture of prudent Bad Debt Provisioning. The emphasis should be on developing good judgement rather than on required percentages. Key to this will be encouraging Credit Unions to carry out loan book reviews in house rather than using external consultants.

(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.

Yes, following the work of the Credit Union commission and the initial review of the majority of Credit Unions under the RRISM regime now is the most opportune time to introduce Tired Regulation. However the approach as currently conceived does not take advantage of the significant work done to date which would assist with the clustering of credit unions.

(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.

While the time for tiered regulation is opportune the approach as set out in this document is rigid and could mean the advantages of Tiered Regulation will be lost. As a starting point all Credit Unions should maintain the status quo in relation to the current business model. Furthermore the revised timetable should take account of the change in consultation date by one month.