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IRELAND

Introduction of a Tiered Regulatory Approach for Credit Unions

Submission by St. Francis Credit Union of Consultation Paper CP76

Thursday, 27 March 2014

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.

No we do not agree with the two tier approach as set out in CP76.

1. The tiered regulatory approach is seen as a method to micro manage credit unions, limit their ability to service membership, restrict levels of dividends and interest rebates payable to our members and will squeeze the life out of smaller credit unions who are already feeling the pressure due to increased costs, falling income and increased regulation.

2. The two tiered approach has not been proven to any great degree in any jurisdiction to date. The three tiered breakdown suggested by the Commission report was flawed in that treating a credit union with asset values of €11m the same as a credit union with assets of €90m was always going to be problematic as the nature, scale and complexity of both entities would not be in any way related. The two tiered approach set out in CP76 is going to exacerbate this situation and smaller more vulnerable credit unions will find the regulatory approach much too difficult to manage.

3. The application by a CU to move from category 1 to category 2 is very open to interpretation and very short on detail regarding time-lines and rights of appeal.

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.

We are of the opinion that the operation of the two category approach will cause irreparable damage to the credit union movement in all aspects of the proposal as set out.

1. **Lending.** There is no mention in CP76 regarding lending restriction currently in place for a large proportion of CU's with little or no means of appeal to the Central Bank. Our experience is that there is little or no interaction when an appeal is made on restrictions and nothing in CP76 counter acts this. Can a CU who currently has lending restriction in place undertake commercial lending up to a total amount of 100% of Regulatory Reserves even with a restriction in place?
   The proposal that a category 2 credit union may carry out limited lending to home loans within lending limits. This we assume refers to Section 35. Given the Section 35 limits it will not be possible for a CU to advance significant amount s under this heading. The other issue is that there are greater risks involved in this type of lending given their terms and the probability that a CU will not enforce security on this type of loan given our community links.

2. **The restricted Person Limits** is a further attack on the volunteer base of the CU. The definition of family is so broad that the proposal would be unworkable. This proposal is discriminatory on the credit worthiness of members of the CU who would/may not be aware of this restriction prior to applying for credit. This proposal will also make it more difficult to attract new volunteers to the CU movement.

3. **Investments -** A category 1 CU will only be able to invest in bank deposits, Irish and EEA state securities with a maximum duration of 5 years. This will result in a significant loss of investment income for CU's as they will be unable to invest in bank bonds. Bank bonds currently rank pari passau with deposits and allow for CU's to add additional investment income for the same counterparty risk. Irish bonds with a duration of < 5 years trade at a significant premium which will have a severe negative impact if written down in the year of purchase. We estimate the effect on a category 1 credit union with investments of €30m will be a reduction in investment return from circa 2.03% to circa 1.20% or a loss in income of €250k per annum. We estimate the effect on a category 2 credit union with investments of €30m will be a reduction in investment return from circa 2.03% to circa 1.60% or a loss in income of €300k per annum.

4. **Investments** - Category 2 credit union (this CU). Current investment portfolio is €73m. The counterparty limits related to Regulatory Reserve will result in a significant outflow from the Irish domestic banking sector. Over 30% of our portfolio will be moved and if we extrapolate this to the CU sector this will result in an outflow from the Irish banking sector of €2.1bn. At a time when the ECB is looking to reduce its funding commitments to peripheral banks this seems to disadvantage both domestic banks and the credit unions that have supported the domestic banks through the crisis.

5. **Bank Bond limit cap of 50% of Regulatory Reserves** will have a severe impact on this credit union. This would require us to move €29.8m from bank bonds to either Irish government bonds / deposits. Currently Bank bonds are delivering a coupon return of 3.56% per annum. Worst case scenario is that we move the funds to deposits where the average return would be between .5% & 1%. This would reduce income by €750k per annum. Best case scenario is that the funds are moved to 5 year Irish Government bonds @ circa 2% which would reduce annual investment income by €450k. Bank bonds currently rank pari passau with deposits and allow for CU's to add additional investment income for the same counterparty risk.

6. **Savings –** Restricting the level of savings @ €100,000 will restrict the credit unions in the aspect of growth. Level is not proportionate across size of credit union.

7. **Additional Governance Requirements –** the requirement for a category 2 credit union to have a dedicated risk management officer, compliance officer and internal audit function will add significant overheads on credit unions. Currently we are outsourcing compliance & internal audit. Having dedicated risk, compliance & internal audit officers will add a further €240,000 in management expense to our Cu and given falling loan interest, proposed changes to the investment regime which will lead to reduced investment income the additional governance requirements will make it uneconomic to apply for category 2 status.

8. **Board Evaluation** – requirement that category 2 CU's BOD be subject to external evaluation will put additional pressures to fill voluntary positions on the Board of Directors. We understood that powers given BOC were to complete oversight on the BOD so not sure what role of BOC is?

9. **Liquidity** - Requirement for CU's to hold 10% liquidity < 7days, 5% <30 days and balance 5% in the 90 day bucket. Unrealistic requirement both from administrative point of view and from a return point where the initial 15% will earn circa .23%.

10. **Operational Risk Reserve** – possibility of having additional operational risk reserves based on nature, scale & complexity. CU's are generally well reserved and having further onus to carry additional reserves will effect CU ability to a) meet the reserve and b) making it more difficult to make dividend payment.

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

We have no comments to make on this.

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.

We are of the opinion that the details outlined in CP 76 are much too vague to interpret and make an educated comment on. There is currently a standardised provisioning methodology in place and operating effectively.

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.

Credit unions are in a process of change both with the introduction of new legislation and amalgamations / transfer of engagements in process. Given the nature, scale and complexity of these changes we believe that a more prudent approach should be taken and that the changes as set out in CP 76 be delayed. We also feel that given the low interest rate environment, the position of the credit cycle and our slow growing economy a hurried introduction of these measures would have a detrimental effect on the credit union movement.

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.

We think the timeline for implementation of the proposed tiered regulatory approach is too short given all of the other changes that credit unions have to deal with as a result of the implementation of the Credit Union and Co-operation with Overseas Regulators Act. A suitable period of time should be allowed for credit unions to bed in these changes before having to understand and prepare for a tiered regulatory system.

Appendix

The following is our financial analysis of a typical Credit Union with asset values of €100m. The analysis is based on pre implementation of CP 76 and post implementation. Our assumptions are set out below.

Typical Category 2 Credit Union with €100m in Assets

	Pre CP76	**Post Implementation CP76**
Assets:		
Loans	€25,000,000	€25,000,000
Investments	€70,000,000	€70,000,000
Fixed Assets	€5,000,000	€5,000,000
Total Assets	€100,000,000	€100,000,000
Liabilities:		
Statutory Res	€10,000,000	€10,000,000
Other Reserves	€5,000,000	€5,000,000
Savings	€85,000,000	€85,000,000
Total Liabilities	€100,000,000	€100,000,000
Income & Expenditure		
Loan interest[1]	€2,500,000(10%)	€2,500,000(10%)
Investment Income[2]	€1,421,000(2.03%)	€1,120,000(1.60%)
Total Income	€3,921,000	€3,620,000
Expenditure:		
Salaries	€685,000	€685,000
Additional Salaries + PRSI + Pension[3]	-	€240,000
Regulatory Fees[4]	€65,000	€100,000
Other Mgt Expenses	€1,900,000	€1,900,000
Total Mgt Expenses	€2,650,000	€2,925,000
Surplus	€1,271,000	€695,000
Transfer to:		
Statutory	€130,000	€70,000
Provision for BD	€300,000	€300,000
Operational Risk Reserve[5]		€400,000
Total Transfer	€430,000	€770,000
Available for Distribution	€841,000	€-75,000

The effect of the full introduction of CP76 will have a very serious impact on the finances of credit unions as set out in the figures presented in the Appendix:

- Income would drop by 7.67%
- Expenditure would increase by over 10%
- Transfer to reserves would increase by 79%
- There would be no funds for distribution to members.

Assumptions:

1. **Loan Interest**. We believe that changes set out in CP76 in regard to lending will have little or no effect on levels of lending.
2. **Investment Income**. From out analysis the effect of concentration and counterparty limits plus the liquidity restrictions will reduce the level of investment return from 2.03% to 1.60%.
3. **Additional Salaries.** As a category 2 credit union there is a requirement to have dedicated Risk, Compliance and Internal Audit functions within the CU and the associated costs set out are in respect of this.
4. **Regulatory Fees.** We are aware of additional regulatory levies to be imposed on credit unions in the future on top of the credit institutions resolution fund levy.
5. **Operational Risk Reserve.** We are treating the requirement as set out for an operation reserve of 2% in the same manner as the requirement to have Regulatory Reserves in place. We are anticipating that this reserve will have to be in place within a period of 5 years.