Tiered Regulation

The Central bank issued a “Consultation Paper” (CP 76) on proposed system of Tiered Regulation for credit unions in December 2013. They have invited submissions and have set a date of March 31st for acceptance of those submissions. This paper is the first part of a series of steps to the introduction of a proposal.

Tralee Credit Union has examined this consultation paper and welcomes the opportunity to respond. Tralee Credit Union is a large rural credit union with a broad community base, in excess of 30,000 members and currently with €130m in assets. Like all financial institutions we have suffered during the economic “melt down”. Our members have experienced a much changed environment resulting in loan demand dropped off and our income levels have levelled out due to this reduction in income from lending and further pressure with reducing rates of return on our growing investment portfolio.

Having said that; Tralee Credit Union has survived the recession very well. We managed our costs, without any loss of employment. We continued to pay a dividend on our savings to members and continued to offer them a safe place for their savings. Our assets have increased year on year. In the last 18 months our loan book has stabilised and we are beginning to see growth again. We continued to support our local organisations and communities. We provide all the normal credit union services as well as incoming and outgoing direct debit and payment facilities, EFT and we provide local ATMs and online access so that members can access their accounts at all times. We are part of a group of eleven credit unions that are currently developing a debit card solution for our members. We see Tralee Credit Union playing a more prominent role in the financial and economic future of our membership.

Economic Assessment

Credit Unions in Ireland hold a very important place in local economies. As at December 2013, the total assets of the sector were €13.9 billion. Loans to members have decreased by almost 13 per cent from December 2012 and currently stand at €4.3 billion, with the sector average loan-to-asset ratio being approximately 32 per cent and it is notable that 190 credit unions now have a loan-to-asset ratio of less than 30 per cent. To date our development has been hampered by our average asset size and resources, our governance model and a lack of real leadership in the movement. Of the almost 400 credit unions in the republic of Ireland just over 20 credit unions would qualify by size for the new proposed Category 2 credit union. 197 credit unions have less than 20m in assets and 309 have less than €50m in assets. During our development we have become fixated with being “local” organisations serving local communities rather than member service organisations where service to members is the priority. For that reason credit unions have developed slowly and with very a very limited service model. We have created this “niche” for ourselves and we are finding hard to visualise ourselves as being any different.

Similarly, regulation proposes to keep the same model for credit unions going forward and “impose” regulation as opposed to support the development of credit unions.

We believe that credit unions hold a very important space in our economy. Without credit unions over the last five years in particular, many families would not have been able to survive. Our members trust us to give them the services that they require for their economic well being.

Building on this base we think that credit unions can have a hugely positive impact and help our economy to prosper. Because of our ethos and our “not for profit” principles we believe that there is a great opportunity for credit unions to grow their services, create sustainable communities and indeed provide much needed stimulus and to provide employment opportunities.

The Commission on Credit Unions introduced the idea of Tiered Regulation for credit unions that would allow the Central bank to regulate the credit unions in accordance with their size and risk to the economy. The Commission envisaged 3 tiers of

- Assets < €10m
- Assets between €10m and €100m
- Assets greater than €100m

This tiered system has caused some discussion among credit unions because of the variance between size of the tiers. A credit union with 15m in assets (which would have a different governance model and less management resources) has completely different issues and potential problems and risks to a credit union with €90m in assets. Credit Unions with €100m in assets probably have the same issues as credit unions with €200m or €300m in assets

The consultation paper suggests a two tiered model with a line at €100m being used as the differentiating line with credit unions having close to or above €100m having **to individually apply** to be a Category 2 credit union. I will address this issue of the value of the tiers later.

Tralee Credit Union would contend that in framing a regulatory environment for credit unions that we should not confine ourselves to the current model. History suggests that once regulation is introduced it will not be changed again in the short or medium term. It is important therefore that regulations do not have the effect of limiting the development of credit unions but should be seen as a promoter of what is so good in our organisation.

Executive Summary

The proposed two tiered regulatory model as suggested by the Central bank is not suitable for Irish credit unions. Having looked at the model we feel that the regulations proposed are too prescriptive, do not reflect the current development model and needs of Irish Credit Unions and will do nothing to support the growth of our credit unions and could, in fact, hinder the development of our credit unions because they are so prescriptive and too restrictive.

Main points:

- The comparison with the Canadian credit union structure has little relevance due to the fact that our relative sizes and business models bear no resemblance.
- There is no reasonable purpose behind the proposal for a restriction on the level of individual savings,
- The restriction on individual borrowings takes no account of the value of security being taken to back up the loan which means that our current lending restrictions remain in place and

- The restrictive nature of the investment proposal means that credit unions will not be able to compete in the market place for business under any heading.
- The model proposed does not offer any incentive for credit unions to look beyond their current model and be a more powerful force in our local and national economies

Section 1 of the paper consists of the introduction and the purpose behind the paper and references the legislation and reports that back up the logic of the proposed system.

Section 2 gives some more background to the proposal. Section 2.2.1 refers to complexity and scale and quotes from the report of The Credit Union Commission that suggests that "the regulatory requirements in place for credit unions should be proportionate in nature". We will reflect on this issue as we go through the Consultation paper.

Section 2.3 refers to a two tiered regulation in place in UK and Ontario Credit Unions in Canada. I think it is important to point out that Ontario is home to 26 of the 100 largest Credit Unions in Canada with the largest Meridian having $8.7bn in assets and number 26 having $229m in assets (based on figures from CU Central Canada Dec 2012.) **Class 2 credit unions in Ontario are credit unions with assets exceeding $1bn.**

It is important to point out that the balance sheets and business activities of Canadian credit unions differ hugely from our model. For instance East Kootenay CU in Ontario which is the smallest Ontario CU in the Top 100 CUs at $229m has a loan book of $209m of which only $19m are personal loans with $106m in residential mortgages and the balance of loans in commercial secured and revolving credit loans. A similar sized credit union in Ireland, of which there are only a handful, would probably have 95% of their loan book in personal lending. Tralee Credit Union has just over 7% of its current loans with terms longer than ten years.

I would think therefore that it would be difficult to use Canadian Credit Unions as a "Yards stick" when looking at our proposed model.

Section 3 Covers the purpose of the consultation and I believe that the approach is correct providing that the Central bank are not already decided on the route that they want to travel. It would be important that the Impact analysis would be rigorous and take into account future models for our credit unions and not just the model in place at present. As credit unions grow in size and the expected amalgamations take place so too our business model needs to change. Any regulation now being put in place should not hamper that necessary change.

Section 4: Proposed Tiered Regulatory Approach for Credit Unions

In reality section 4 and section 5 need to be read together to get a proper feel for the range of activities that a credit union in each category can hope to get involved in.
While we understand that regulation is there to ensure the soundness of credit unions it must also support credit unions to grow their business model safely and allow them to pursue their goals to offer their members a better and more relevant level of services. This document does not in any

way reflect the needs of the credit union member. The purpose of a credit union should be to provide a full range of financial services for its member in a safe, cooperative and not for profit manner.

Savings:
Currently our savings "model" of holding the majority of our savings in "shares" with very limited deposits restricts our business model, costs us in dividend and places too much of a burden on our income. Credit Unions in Ireland hold about 98% of their savings in member share accounts. This removes any flexibility as to how these savings can be employed. We are driven to producing a dividend of the shares for members rather than what level of service we can offer. Our legislation supports this ideal with new services having to be self financing whereas it would be hard to argue that our current "services" are self financing. We should be looking towards a model where only a certain percentage of our savings are held in shares and attract a dividend. The greater part of our savings should be held as deposits or in "current" accounts. This would allow for more flexibility for credit unions to "manage" their business better. This would, of course, need to be backed up by an appropriate ALM Policy. The new proposal does not seem to support such a change.

A member whose credit union falls into Category 1 can save only a maximum of 1% of the assets of a credit union or a maximum of €100k whichever is the lower. The 1% rule has been part of credit union legislation since the original credit union act of 1966. At that stage credit unions were a very small but important part of our economy. We have managed to grow our business and our reputation since then but the 1% rule remains intact. That makes little sense and we suggest that this level should be revised upwards to a realistic figure to allow credit unions take larger deposits from members.

Where credit unions fall into Category 2 and can offer more "complex services" the proposed regulation suggests that it can only take a maximum of €100k in savings from members, which is the same limit as for smaller less complex credit unions. This means that as a credit union grows the percentage that an individual member may hold in savings reduces. It makes no sense that a Category 2 credit union must restrict its service to members at this level. Many members would have savings, redundancy payments, lump sum pension payments or inheritances that would exceed this amount. As credit unions grow in size they will have requirement to be able to service all its member's needs. We would suggest that a percentage of 3% would be more relevant but we see little value in having such a cap on savings and suggest that each credit union should be able to make its own determination on the level of savings that it would take from its members. Each credit union should then have an appropriate Asset Liability Management Policy that would reflect the level of savings and how these savings are invested and the liquidity levels that such savings would require. We are not aware of any other financial institution that has a similar cap on savings from their clients/members.

Credit unions are currently "top heavy" with savings and this is seen as a negative by many. We see this as proof that members are happy to use their credit union for savings purposes. They are happy that their credit union is a secure place to save and even when other larger financial institutions were struggling most credit unions have been a stabilising and positive influence. Regulations should allow for other models to develop and placing a cap on savings would restrict this. We have voluntarily put a “cap” on savings at €100k for members but we are regularly asked to allow greater levels for members. The Board would not like to be confined by regulation in this way and would feel confident that we could manage greater levels of individual savings as we progress. We feel that including this level of detail in regulation is too restrictive.

Loans:
Problems facing credit unions at present include the lack of demand for our lending products, restrictions on our lending limits and a lack of variety in our lending. We are almost totally tied to the personal lending area and this means that as the majority of our loans are for short terms. This loan profile poses a risk to the sustainability of credit unions because it means that we need to keep “churning out loans” in an effort to maintain our loan books to an acceptable level. Central bank figures for Q4 2013 suggests that personal lending was down by 8.8% for the full year compared to the previous year and that total personal lending has almost halved from 2009 to 2013 (€28.9bn to €15.4bn)
As far as lending is concerned credit unions have become a “one trick pony”. We are almost totally tied to personal lending. Credit Unions in Canada have a very different model with even the smallest credit unions involved in the secured lending market.

The Lending Framework suggested in the paper suggests very little change from the current situation, a situation that has evolved rather than been planned. The definitions of the various loan types seem overly prescriptive and limit lending rather than support and/or encourage lending.
The regulations suggest that the current Section 35 limits are set in stone and that loans are categorised by term rather than by any security that a credit union might hold. In Canada credit union loans are largely secured on member’s property and goods. It seems strange that we seem to be fixated by the term of the loan rather than the purpose and the possible security available and the value of that security. The proposal suggests that you can give an unsecured loan out for 15 years but that you cannot allow any security held to add any value to the loans. For Category 1 credit unions, holding in the region of €50m to €100m, should have the facility to offer “secured” loans to members, with a term of up to 20 years subject to having a proper ALM Policy in place to back up their service. Restricting these credit unions to having no more than 10% of their loans longer than ten years is not conducive to the development of these credit unions.
Credit Unions should, alternatively, be allowed to “invest” in a cooperative company that would then have funds available for types of specialist lending. The company would provide the necessary underwriting and legal skills and services with the credit union benefitting from the enhanced member relationship and the income from the various loan products.

Similarly Category 2 credit unions should be allowed to offer “secured” loans to members to an appropriate level which we would suggest initially would be up to at least 50% of their assets and supported by an appropriate ALM Policy and proper underwriting principles. Having such a secure loan book would give the credit union a better balance between lending and investments would give a greater guarantee of income and would enhance the member/credit union relationship. While currently secured lending is viewed in a poor light because of the recent mortgage problems which relate to over-priced houses and over-zealous lending practices in reality, secured lending is the safest form of lending to be in. While a lot of mileage is being made out of the level of loan arrears in credit unions. This level of arrears is due to the economic climate that exists for members at present, the restrictions that are in place that stop credit unions from lending and the reliance on, essentially, one lending product; a personal loan. Personal lending is a much more problematic lending area and the fact that most credit unions have managed their loan portfolio well over the last number of years is a testament to their underwriting skills, management ability and to the loyalty that members have to their credit unions.

Lending Risk: Under PRISM, credit unions are being assessed according to the various perceived risks in their operations. The measurement of these risks is used as a "tool" in determining their sustainability and strength. Restricting our loan books to largely personal lending is surely adding to our overall risk profile. Canadian credit unions to which the paper refers have the majority of their loans out in secured lending. We feel that Irish credit unions should also be allowed to go in this direction.

In Tralee Credit Union we have loaned out more than €40m in the last two years, yet our overall loan book is just €47m. To maintain the level of our loan book we have to lend aggressively but soundly otherwise we won't have the income to support our structure and pay a dividend to members. We manage our loan book well and although we offer "secured" loans to our members out to 20 years maturity we have not had to apply for an extension to our Section 35 limits. We would like, however, to have the facility to grow this portion of our loan book over time in a safe and structured manner. We would question as to why you would want to include the "Terms and Conditions" of your secured loan type in regulation? Surely including this type of detail in regulation is being overly prescriptive.

Investments: With the demand for loans currently low credit unions need to be able to maximise the returns on their investments. Under current Guidance Notes (2006) credit unions have limited options in relation to investment of excess funds. The options set out in the notes are further restricted by the current proposal. By linking the percentages to the Regulatory Reserve figures rather than the overall Investment Portfolio as is the current situation it restricts the exposure to any one financial institution but spreads the investments so thinly that available financial institutions will get a portion of our investments by right rather than having to compete for them. In TCU's case we can currently place up to €20.75m in any one institution. Under the new proposals we could only invest €13m in any one institution. That would mean that we will be seeking institutions from outside the state to make our investments. This would further restrict our ability to get the best rates for our investments resulting in less income and an increased level of risk to our sustainability.
The introduction of short term liquidity constraints will put further pressure on credit unions to get a return for income purposes. Category one credit unions with have a five year investment limit on their bank deposits and state securities. Limiting the term to 5 years means that these credit unions will have a restricted income potential. State securities are normally issued for ten year duration at least. Having a 5 yaer limit will mean that credit unions will not be able to buy these state securities at issue but only in the secondary market. Currently a 10 year Irish State Bond with a ten year duration will yield in excess of 3% p/a taking into account the purchase price of the bond. A similar 5 year bond is currently yielding between 1.3% and 1.6% which means that category 1 credit unions are losing out on this potential income. The fact that a

government bond can be traded any day and could therefore be listed as a “liquid” investment is not addressed.

For category 2 credit unions again the restrictions make little sense and are too prescriptive. Deposit accounts to a maximum seven years makes little sense, having a maximum investment of the value of the Regulatory Reserve again makes little sense as it will require the credit union to spread their funds too thinly across institutions. Having Corporate Bonds linked to the value of the regulatory reserve again makes little sense. We have not concentrated hugely on the proposals relating to investments as we understand that some of the financial companies are better placed to do that.

Conclusion

There is nothing positive for credit unions in this document. If introduced it will mean that credit unions in Category 1 (less than €100m) have no hope of a future and credit unions in Category 2 will be bound by so many restrictions that it will be almost impossible to develop any meaningful business model. Including so much specific detail in regulation makes them too prescriptive and too restrictive. Making such regulation is relegating credit unions to a much lower tier than other financial institutions and will render them ineffective.

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Tralee Credit Union limited