



**Credit Union**

Irish League of Credit Unions

# Submission to Central Bank of Ireland in Response to CP 62

Fitness & Probity Regime for Credit Unions

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## 1. Introduction

*“I would pinpoint the location of the flaw in the policy approach to regulation as lying in the presumption that the instinct for self-preservation of well-governed firms would be sufficient to protect the system, thereby allowing light-touch regulation. (The presumption was mistaken: the banks were not well-managed from the risk point of view).”*

*“Obtrusive and intrusive as opposed to light-touch (regulation)... This dimension also relates to a more challenging fitness and probity regime – recently extended to cover not only new entrants, but existing directors, senior management and relevant staff. When the whole system has failed, it should not be a surprise to find that, one way or another, very few of those who were the very top decision makers in Irish banks before the crisis are still acting as bank directors today.”*

**Extracts from the closing remarks by Governor Honohan, at the Central Bank of Ireland Stakeholder Conference, 27 April 2012**

The ILCU would like to recognise the work of the Central Bank since 2010 on reforming the banking and insurance sectors in Ireland. Often the language in the financial services sector can be applied loosely and “the banking sector” is incorrectly applied to what is a much more diverse “financial services sector”. It is vital that more prudent and straightforward financial service entities such as credit unions receive adequately differentiated and appropriate treatment. The ILCU would ask those in the Registry of Credit Unions to be mindful of this when devising regulation for credit unions which should be differentiated from the Central Bank’s efforts to obtrusively and intrusively regulate the banking and insurance sectors.

*“I want to tell you very clearly here today that our new risk based model means that we will not have a one size fits all approach. Regulation will be balanced and proportionate depending on the risk of the sector or the firm in question. While we will improve our level of engagement across the board, a systemically important bank should expect a more intrusive profile than, for example, a credit union with a lower risk profile. Our approach will allow us to differentiate between the firms that we regulate. This means that the rules for credit unions will not be the same as those applied to big systemically important banks. Our approach will allow us to recognise the distinct and important role that credit unions play in Irish society. I understand and appreciate that credit unions are different. They have close links to the local community and play a vital role thanks to you, the dedicated volunteers, today in this hall. I know we need to have a bespoke and differentiated approach to the regulation of credit unions, as we have had in the past.”*

**Extract from a speech by Matthew Elderfield, Head of Financial Regulation (currently Deputy Governor of the Central Bank) to the Irish League of Credit Unions AGM, 24<sup>th</sup> April 2010.**

Due to its co-operative and autonomous nature, a single credit union does not present a high risk to the overall stability of the financial service sector nor to the interests of its members. As it does not have an underlying motivation to maximise profits, a credit union does not engage in financial activities which are deemed to be either of high risk or of high complexity. When combined with their relatively small asset sizes, credit unions are categorised as low risk under the Central Bank’s own PRISM classification system for financial institutions. However, the knock-on effect is that credit unions are reliant on a relatively modest level of income compared with, for example, the banking

sector which do engage in these more complex and riskier activities. The more modest and arguably robust business model of credit unions presents a unique challenge for regulators. This challenge is to avoid inhibiting the necessary growth and development envisaged by the Commission on Credit Unions for this sector through the imposition of disproportionate and unsustainable costs of compliance.

The ILCU is of the view that if the long-term impact of new regulation is that it creates unsustainable compliance costs, this would go against the intentions of the Commission on Credit Unions to *“reform how credit unions are structured, governed and regulated. A strengthened and re-vitalised sector can be in a position to play an increasing role in the retail financial landscape.”*<sup>1</sup> As such, the ILCU recommends that the Registry of Credit Unions remains mindful of escalating compliance costs for credit unions during its post implementation review of the proposed Fitness and Probity Regime.

The ILCU also believes that when implemented, this F&P regime should remain the F&P regime for all credit unions, as it is tailored to suit their organisational structure. It would be a mistake for the Central Bank to consider transferring credit unions into the existing F&P regime, either post 2016 or for those acting as insurance intermediaries. This is because, as highlighted in the quote from Governor Honohan, the purpose of the existing F&P regime is to regulate key decision-makers of financial institutions that are similar in structure and type to those that played a central role in the banking crisis of Ireland.

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<sup>1</sup> The Commission on Credit Unions (2012); the Report of the Commission on Credit Unions; Executive Summary, P.v.

## 2. Executive Summary

The ILCU welcomes the introduction of a Fitness & Probity (F&P) regime specifically tailored to the credit union sector as recommended in the Final Report of the Commission on Credit Unions (published April 2012).

The ILCU has evaluated the suitability of the proposed regime detailed in Consultation Paper (CP) 62 for its affiliated credit unions under two broad criteria:

- (i) **Does the proposed regime enhance the interests of credit union members?** As regards this criterion the ILCU believes that, on balance, the proposed F&P Regime does enhance the interests of credit union members.
- (ii) **Does the proposed regime protect the co-operative ethos and democratic nature of credit unions?** As regards this criterion the ILCU believes that, on balance, the proposed F&P regime does not protect the co-operative ethos and democratic nature of credit unions. However, the ILCU has highlighted a small number of issues with the proposed regime, which if addressed would rectify this.

These issues can be summarised as follows:

1. The proposed regime will require credit unions acting as restricted retail intermediaries to transfer into the existing fitness and probity regime. Credit unions currently acting as retail intermediaries, provide a limited range of insurance services as prescribed by the Credit Union Act, 1997 (exemption from additional services requirements) Regulations 2004 (as amended) which represent only a small fraction of credit union income but are valued services for their members. These credit unions, or credit unions wishing to act as retail intermediaries in the future, will be required to comply with regulations which are unworkable for an organisation reliant on a voluntary board and committee structure.
2. The Central Bank will be applying a policy of withholding specific guidance around tangible minimum standards of fitness and probity for the CUCF – 1, CUCF-2, CUPCF-1 & CUPCF-2. Due to the level of uniformity of organisational structure, business model and services amongst credit unions, the application of this policy is not justified for the proposed F&P regime. The ILCU believes that it is within the ability of the Central Bank to provide prescriptive guidance around minimum standards (particularly in relation to section three – Conduct to be Competent and Capable) for CUCF-1, CUPCF-1 and CUPCF-2. This clarity will aid compliance with the proposed regime, while also assisting nomination committees in carrying out adequate due diligence on candidates.
3. In practice, subsection 3.2 of the Draft Standards of Fitness and Probity for Credit Unions would prohibit the vast majority of members within a credit union's common bond from being considered for election to any voluntary position deemed to be a control function. The majority of the membership within the common bond will not have suitable experience which will enable them to meet the standards of F&P. This is in direct conflict with the democratic right of members to elect their own board.

The ILCU believes that the nomination committee should be afforded the discretion to nominate capable members who may not meet all eight components of subsection 2.2 (a) prior to election, but commit to addressing any competency shortcomings within a defined timeframe.

4. CP62 contains a number of compliance issues; terms requiring clarification and inconsistencies with existing legislation. The ILCU has highlighted these for amendment or clarification.

In this submission, each of the four issues will be highlighted in the proceeding four sections. In each section a solution to each of these will be outlined. The final section will respond to the six consultation questions from CP62.

### 3. Credit Unions Acting as Restricted Retail Intermediaries

As prescribed in the Credit Union Act 1997 (Exemption from Additional Services Requirements) Regulations 2004 (as amended), credit unions may act as a restricted retail intermediary with regard to five basic general insurance products - (i) loan protection and life savings insurance (including related riders); (ii) travel insurance; (iii) home insurance; (iv) motor insurance; (v) repayment protection insurance. It is estimated that approximately 248 credit unions in the Republic of Ireland are authorised as a restricted retail intermediary.

Section seven of CP62 proposes that in 2015 all credit unions acting as retail intermediaries will be required to transfer into the existing fitness and probity regime. It is the view of the ILCU that this will result in the majority of staff and volunteers within the credit union becoming either CFs or PCFs. In addition, it will require these officers to meet standards which are geared towards highly specialised professionals. In short, compliance with the existing F&P regime will be so difficult and costly, it is very unlikely that a credit union could justify continued authorisation as a restricted insurance intermediary, therefore reducing the services offered to members which, in turn, is reducing the choice of provider that the consumer currently has.

We would suggest that for credit unions offering the aforementioned restricted insurance products that they would comply with the MCC requirements in addition to the proposed tailored F&P regime outlined in CP 62.

The Commission on Credit Unions Report supports credit unions providing a full range of financial services. The imposition of the existing F&P regime will frustrate credit unions in achieving these goals. As stated in the Final Report of the Commission on credit unions “...,the following section describes the Fitness and Probity Regime that has been introduced for all regulated financial services providers other than credit unions and sets out the Commission’s recommendation on the introduction of an appropriate Fitness and Probity Regime for credit unions.” At no stage did the Commission recommend the application of the existing F&P regime to credit unions. In fact, as quoted above, it specifies the need for an F&P regime which is suited to credit unions.

Any suggestion that it is legally necessary to credit unions into the existing F&P is disputed by the ILCU. The ILCU believes that this transfer would not be in the interests of credit union members and also the Central Bank, for the following reasons:

- a) Credit unions are unique in that they are restricted to offering a limited range of insurance products as prescribed by the CBI whereas other insurance intermediaries have the option to provide a full suite of insurance products. This is a differentiating feature of credit unions which justifies application of different regulations around F&P.
- b) From July 2013, credit unions acting as retail intermediaries will be subject to an F&P regime. In the unlikely event of an unrestricted retail intermediary raising an issue with this to the Central Bank, it is difficult to see how they can argue unequal treatment. Both regulated entities are subject to F&P regimes. Both regimes require key officers to meet Standards of Fitness and Probity. The differences between the two regimes are due to differences in the primary legislation governing the structure and services of each.

- c) The division of credit unions amongst two F&P regimes will have practical implications for the Central Bank in terms of the additional resources required to monitor and administer the existing (and unsuitable) F&P regime for an extra 248 regulated entities. The Central Bank should consider whether the remote risk of any arguments being raised by an unrestricted retail intermediary outweighs the additional expenditure of public money that will be incurred annually.



## 4. Prescriptive Guidance in Minimum Standards

The ILCU is of the view that credit unions will continue to act in a responsible and compliant manner following the introduction of the proposed F&P regime in July 2013. As recommended in their submission on the F&P RIA, the ILCU welcomes the commitment to provide guidance to credit unions as detailed in section six of CP62.

One of the main anticipated issues of compliance regarding the proposed F&P regime will relate to the subjectivity around the standards of F&P. The responsibility is on the credit union to internally verify that an individual meets the standards through a process of due diligence. This creates a potential compliance headache for credit unions. If we take the example of the standard of Competence and Capability – (b) *has obtained the competence and skills appropriate to the relevant function, whether through training or experience gained in an employment or voluntary context; what is a sufficient level of experience – 1, 2, 3 years? What other professional / voluntary functions could be deemed relevant? The interpretation of this standard by the credit union will may be at variance with the Central Bank’s interpretation.*

In practice, it is very likely that compliance issues will arise where a credit union has in good faith approved officers, through a process of due diligence, as having met the standards. The Central Bank subsequently either when reviewing an IQ for a PCF or through an inspection of the credit union’s due diligence process, deem these officers as having not met the standard. This probable issue will arise due to the lack of clarity around the standards.

It is unfortunate that the Registry of Credit Unions has not availed of an opportunity to increase the rate of compliance and thus reduce the likelihood of having to engage in corrective and enforcement action, through leveraging one of the unique features of the credit union movement. Unlike the wider financial services sector, there is much less diversity in credit unions. In the wider financial services sector, there is a wide variance in organisational structure. In credit unions there is minimal variance in organisational structures due to very prescriptive legislation (the Credit Union Acts 1997 to 2012). Similarly, the variance in services offered in the financial services sector is great. However, there are a limited number of financial services offered by credit unions which do not vary across the sector. While the credit union sector as a whole may be unique, the uniformity within the sector is very high. These factors combined result in the responsibilities and capabilities required for roles such as a director, chairperson and supervisor having minimal variance across credit unions.

The ILCU assumes that as part of the proposed F&P regime, an internal policy will exist within the Central Bank and / or Registry of Credit Unions regarding prescriptive minimum levels of experience, skills and knowledge for highly standardised roles that fall under CUCF-1<sup>2</sup> {i.e. director and board oversight committee members (supervisors)}, CUPCF-1 (Chairman) and CUPCF-2 (Manager).

The ILCU recommends that guidance on these minimum standards be made available to credit unions as part of the guidance issued by the Central Bank for the following:

- Prior experience
- Prior training / qualifications

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<sup>2</sup> The ILCU would be of the view that CUCF-2 roles would have a higher degree of variance.

- Capacity to perform the role

These could be used as a baseline for all credit unions, and assist in the formulation of compliant policies, plans and due diligence processes. The Central Bank would retain the right to require higher standards if they deemed the credit union to be larger or operating a more sophisticated business model.

## 5. Nomination and Election of Members for Voluntary Roles

Due to the nature of any F&P regime, it will inevitably conflict with the democratic structure which is a cornerstone of credit unions. In effect the democratic right of eligible credit union members to be considered for election to positions such as director or board oversight committee member (supervisor) is overridden by the requirement to have particular experience, knowledge and skills.

This must be balanced against the requirement for the credit union to have fit and proper people operating in key roles to ensure the prudent and appropriate management of member's assets.

Section 56B of the Credit Union Acts 1997 to 2012 (the Acts) greatly enhances the role of the nomination committee. This committee will have a central role regarding compliance with F&P. All candidates for positions on the board must be proposed by this committee {Section 56B (5)}. As such, the ILCU recommends an amendment to section 2 of the Fitness and Probity Standards in order to reduce the erosion of the democratic right of members to serve their credit union.

Section 56B(4) (i) – (k) of the Acts requires the nomination committee to ensure that newly appointed directors complete an induction training programme as soon as is practicable but no later than 6 months following their appointment.

It is recommended that under the proposed F&P standards section 2.5 is added which states:

*2.5 The chair of the nomination committee will have discretion regarding the nomination of a candidate for the position of director who may not fulfil 2.2(a), but commits to a development plan and will be reassessed no later than six months of the commencement of their term, if elected. If the director does not satisfy the credit union due diligence process at this point, they will provide their resignation to the board.*

The ILCU believes that this amendment improves consistency between the Acts and the proposed F&P regime while also accounting for the democratic nature of credit unions.

## 6. Compliance Issues; Terms Requiring Clarification and Inconsistencies with Existing Legislation

The ILCU has highlighted eight items contained within CP62 for clarification or amendment by the Registry of Credit Unions.

### Term of Office / Appointment for CUPCF-1

Page eight of CP62 refers to the term of appointment of the Chair. The term of office of a chair is one year, at which point he/she is eligible to be re-elected. They can remain in this position up to a maximum of four years. As there is no mention of “term of appointment” in the new Acts, the ILCU would like to clarify that this extends up to a maximum of four years for a Chair, if re-elected. This is to ensure that in-situ CUPCF-1’s can see out their term to a maximum of four years, and new CUPCF-1 are not required to seek approval each year.

### Term of Appointment and Contracted CUPCF-2

The ILCU would like clarification as to whether an in-situ manager (CUPCF-2) who is currently on a fixed-term contract e.g. 3 year contract, would be required to seek approval from the Central Bank if the credit union opts to extend their contract, or make the manager permanent? Similarly would newly appointed CUPCF-2 be required to seek re-approval when their fixed-term contract with the credit union expires? The ILCU assumes that as long as an individual holds the same PCF position regardless of their employment contract status, they do not need to seek re-approval from the Central Bank, as long as due diligence is ongoing.

### Transitional Arrangements versus Section 53(6) (b) of the Credit Union Acts 1997 to 2012

Section Eight of CP 62 lays out transitional arrangements for PCF’s and CF’s. It specifically refers to transitional arrangements for in-situ officers occupying CF roles and PCF roles. Section 53(6)(b) of the Acts require the full board to be re-elected following the commencement of this provision.

The ILCU would like clarification as to whether directors and the chair will continue to be considered in-situ if section 53(6)(b) is commenced during the transitional arrangement period as outlined in section eight of CP62? Should this provision be enacted during the transitional arrangement period, the ILCU believes that it would be appropriate to have these officers considered in-situ post-election for the purpose of ensuring a manageable transition into the proposed F&P regime.

### Break in Term for CUPCF-1 and CUPCF-2

If a CUPCF-1 or CUPCF-2 vacates their position for a period of time, will they be required to seek re-approval from the Central Bank? If so, would exceptions be made for extended absences due to extenuating circumstances e.g. ill health?

### **Subsection 4.1 (l) of the Draft Standards of Fitness and Probity**

Subsection 4.1 (l) appeared as a provision within Section 15 of the Credit Union Bill 2012. This provision was removed as it was deemed appropriate for this matter to be dealt with in the Registered Rules of the Credit Union. The ILCU recommends the deletion of subsection 4.1 (l) to ensure consistency with this.

### **Subsection 3.1 of the Draft Standards of Fitness and Probity**

In subsection 3.1 of CP 62, the wording could be interpreted to mean that a person shall have qualifications, experience, competence AND capacity (as in all four in all circumstances). This interpretation would be at odds with the view of the Registrar of Credit Unions that F&P would not result in mandatory qualifications for all positions. The ILCU requests that clarification is provided which sets out that a combination of one, two, three or four of these components is required of CF's and PCF's in meeting the standards.

### **Provision of Information by Candidates**

Section 13.8 of the guidance on the existing F&P regime states:

*“If a regulated financial service provider has insufficient information available to enable it to conclude on reasonable grounds that the F & P Standards are being complied with, particularly if due to lack of co-operation by the person, the F & P Standards may not be met. The regulated financial service provider should bring this to the attention of the person and allow them an opportunity to provide the required information.”*

The ILCU would request that clear guidance is provided for the benefit of the nomination committee regarding the timely assessment of candidates for election to voluntary CUCF-1, and CUCF-2 positions. The ILCU would like to highlight that the deadline of the credit union's AGM restricts the amount of time which the nomination committee will have to complete the due diligence process on candidates for directorship positions. This would also apply to the candidates seeking election to the board oversight committee (supervisors). A time limited, as prescribed in guidance, is afforded to the candidate to produce the necessary supporting documentation to facilitate the credit unions due diligence process. After this period the Chair of the Nominations Committee would reserve the right to deem the candidate unsuitable for nomination on the ground of insufficient information.

### **Removal of CF's and PCF's Post Appointment**

In relation to CF's and PCF's who are voluntary officers, how does the Central Bank propose such individuals will be removed from their position if they fail to meet the F&P standards on an on-going basis? The ILCU recommends that this issue is clarified in guidance issued on the F&P regime for credit unions.

## 7. Response to Consultation Questions

(i) Do you agree with the tailored approach to the designation of CFs and PCFs for credit unions in the draft Regulations?

**Yes**

Do you think any additional CFs or PCFs should be designated?

**No**

(ii) Do you agree with the phased approach for the implementation of the Fitness and Probity regime for credit unions?

**Yes, with the exception of credit unions acting as restricted retail intermediaries (see question vi below).**

(iii) Do you think the draft Standards cover all relevant matters for credit unions? If you have other suggestions, please provide them along with the supporting rationale.

**Yes, on the basis that the Central Bank makes the necessary amendments as outlined in the preceding sections of this document.**

(iv) Do you think that the Central Bank should issue guidance on the Fitness and Probity regime for credit unions?

**Yes.**

(v) Are there any additional areas of the Fitness and Probity regime for credit unions which the guidance should cover? If you have other suggestions please provide details along with the supporting rationale.

**All guidance should be clear and prescriptive. It should also be in line with the recommendations made in sections six and four of this document.**

(vi) Do you agree with the implementation timeframe for the application of the existing Fitness and Probity regime to those credit unions also authorised as retail intermediaries? If you have other suggestions please provide them along with supporting rationale.

**No, see section three of this document for suggestions.**