SUBMISSION FROM

THE CREDIT UNION DEVELOPMENT ASSOCIATION

IN RESPONSE TO

The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions CP76

31st March 2014

Introduction

CUDA welcomes the opportunity to provide commentary in response to the Central Bank's paper on the proposed introduction of a tiered regulatory framework for credit unions. We support the introduction of a strengthened regulatory framework and an opportunity to consider the most appropriate mechanism for achieving this goal.

We commend the Central Bank for proposing a mechanism for tiered regulation and for opening the process to public consultation. The two category approach as proposed provides an alternative to that illustrated in the Report published by the Commission on Credit Unions (30th March 2012) and allows stakeholders and credit unions to consider different approaches. CUDA has considered various approaches and has consulted with its member credit unions on this. In light of this consideration, CUDA proposes a 3 tiered approach built upon three distinct business models – this mechanism will not only suit the current business requirements but, will enable credit unions to meet member needs in the future and help ensure the sustainability of the sector.

Credit unions have been adapting to a new emerging framework with the introduction of PRISM and the enactment of the 2012 Credit Union and Co-operation with Overseas Regulators Act. Many credit unions have embraced the new framework with huge changes to governance and management structures, and heightened risk awareness through robust policies, procedures and risk management systems. However, during this time, credit unions have struggled to maintain a business status quo. The Commission's Report emphasised concerns with falling loan to asset ratios, declining profits from investments and increased costs[1]; it proposed a tiered regulatory approach that would support the management of risk, and the development of the sector in a changing environment. The proposed 2 category process does not successfully achieve these goals.

Our observations are set out in two parts. We provide general commentary in Part 1 and elaborate on the requirements in order to maintain strong credit unions, provide the services and products needed by members and protect core credit union business – lending, savings and investments, and in doing so help future proof the sector.

Part 2 sets out our responses to the questions put forward by the Central Bank. In answering the questions posed, we elaborate on a more sustainable alternative with the introduction of tiered regulation built upon the business models in operation within credit unions and those they should be allowed prudently develop.

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[1] Chapter 3 Current Financial Position of Credit Union Sector in Ireland, Page 19

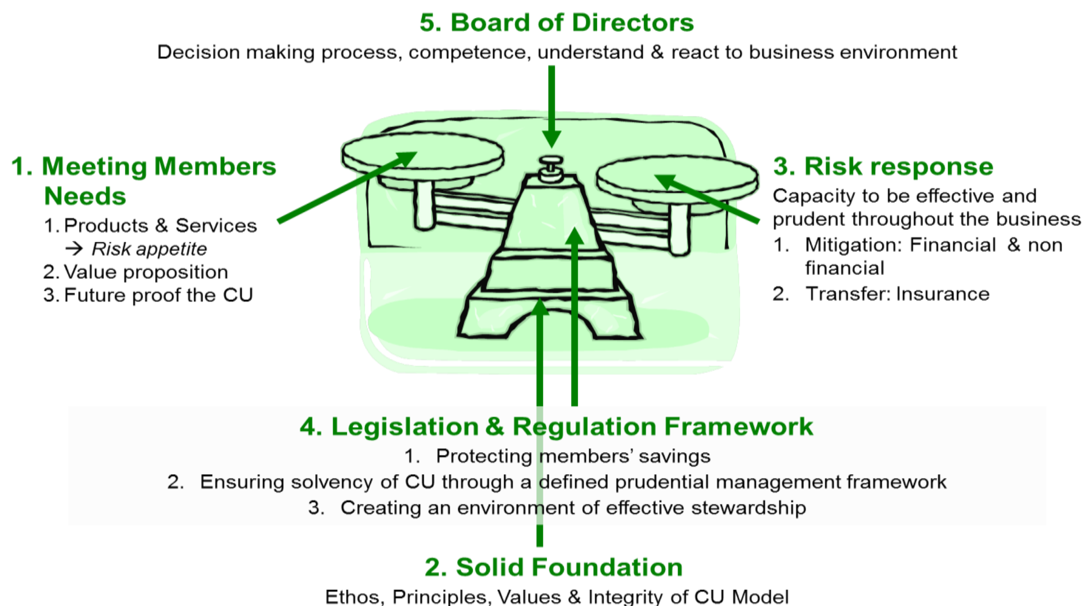
In our submission we highlight our concerns with the current proposal, and the potential impacts they will have on credit unions, which can be summarised as follows:

- **Over reliance on scale as a bench mark for a tiered regulation approach**
- **Inadequate consideration for high level legislative and regulatory which credit unions are now bound by**
- **Disjointed connection between tiered regulatory approach and PRISM**
- **Over-emphasis on the elimination of risk as opposed to the management of risk**
- **Reduction of the decision making function of the Board**
- **Insufficient consideration for future advancement and changes to the credit union business model**
- **Lack of incentive to become highly specialised in a niche product or service**
- **Inappropriate association of thresholds to the regulatory reserve ratio**
- **Restricted lending abilities**
  - **Homeloans' limitations**
  - **SME lending limitations**
  - **Restricted persons' limitations**
- **Restricted investments abilities**
- **Restricted savings abilities**

We will be happy to elaborate further on any points made in this submission.

Part 1: General Commentary

In previous papers CUDA spoke of the "weighing scales" approach to regulation - offering a wide range of consumer lending products is simply part of what even relatively small credit unions do in other advanced countries, the key is to get the balance right…meeting member needs, managing the risks involved and having the appropriate governing framework. This approach is depicted in the diagram below:



The scales become unbalanced if too much weight is placed on any one component. Overly restrictive regulation takes the decision making power away from the Boards and this inadvertently could create a concentration risk leading to more "risky" responses as the credit union seeks to maintain stability and viability. Unintentionally, this is due to an inability to sufficiently lend due to regulation based limitations, and reduced investment choices.

The proposed approach, contained in CP76, reduces the decision making process by attempting to eliminate risk, rather than manage it, and thus will restrict credit unions. This can have a crucial negative impact on a Board's ability to manage a viable business. This is the democratic process that is at the centre of credit unions since their inception. The Report of the Commission stressed that a Board of Directors must decide on a vision for their own organisation;[2] whilst the Commission identified leadership as being a possible issue – this

[2] Chapter 7 Future Models of Credit Unions, Page 79

difficulty should be addressed through enabling regulation to empower Boards to become the main drivers of change.

The advantage of introducing a tiered regulatory approach at this juncture is that the credit unions have already undergone significant internal change. The prudent management of risk is central to the 2012 Act and to the Central Bank's supervisory approach PRISM. The introduction of a tiered regulatory approach ought to acknowledge the momentous internal changes that are already giving rise to stronger governed credit unions. In this regard, CUDA would caution against the restrictions placed on credit unions under the proposed 2 category regulatory approach as it is somewhat disjointed from the high level legislation and regulation that has already taken place. We shall expand on this concern in Part 2.

The approach finally adopted for a strengthened regulatory framework will have a profound long term effect on the sector. Tiered regulation should not have the outcome of pigeon holing credit unions into restrictive and unsustainable regulatory models. Enabling regulation will empower credit unions under the transparency of tiered regulation. If the correct approach to tiering is not achieved, the outcome is a weakened financial model at a time when prudent development and growth should be encouraged.

A tiered regulatory framework should focus on defining sustainable *business models* and regulating to enhance that approach. This is the approach proposed by CUDA. What will emerge is that regulation and risk will not be based solely on the product and service offered by a credit union but on the policies and procedures in place which will reflect the competence of Board and management, and on prudent risk management.

Part 2 expands on the alternative approach to the proposed 2 category regulatory approach. CUDA focuses on distinct 3 business models built upon the 3 tiered approach illustrated by the Report of the Commission. It is our long held belief that the major long-term competitive advantage that every credit union can enjoy comes from being locally-owned and controlled and operated exclusively for the economic benefit of its owners. Each credit union's specific business model – the scope of services it provides and the means it employs to deliver those services – should be chosen by its democratically elected officials to best meet the needs of its own, unique community of members.

To succeed in the future, some (and perhaps many through consolidation) credit unions will choose to move to the next stage of development and offer a full range of consumer lending, deposit and other financial services (as have credit unions in North America and Australia). Doing so does not entail radical changes to their fundamental business model or to their basic organisational and governance structures that now exist following commencement of the CUCORA 2012 and related regulations.

Part 2:

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 methodology proposed in the Consultation Paper. The approach places too much emphasis on scale as a parameter for categorising credit unions, as a result it pigeon holes credit unions based on an overly simplistic technique into restrictive and unsustainable regulatory models.

The Consultation Paper provides that the proposed tiered regulatory approach allows credit unions the "*flexibility to operate different aspects of their business with differing levels of nature, scale and complexity",* for example a credit union could opt to "*invest in a limited range of investments but may engage in more sophisticated lending activities.*" We do not agree that the proposed approach achieves this level of flexibility. Such flexibility comes at a cost whereby a credit union that may seek to specialise in a particular product or service, as appropriate to their membership, is required to apply to Category 2 and in doing so must meet *all* of the requirements imposed on a Category 2 credit union - such as establishing various committees, employing in-house risk management officers and other staff, etc. Furthermore, in contradiction to providing a specialist or highly developed product or service, the credit union will be subjected to restrictions aligned to that product or service that will prohibit development – lending restrictions are a clear example. The "*prudent development*" which the Consultation Paper claims in our view is restrictive development. [3]

The Commission recommends that the *"new tiered approach to regulation should be based on nature, scale and complexity of the credit union concerned".* Tiering based on the business model of the credit union captures all three elements. We are of the view that the proposed 2 category approach and indeed, the three tiered approach as illustrated in the Commission, over emphasises *scale* as a bench mark for regulation. The business model is the defining element of good regulation; scale is one important component inherent in any business model.

As a result regulation should be built upon a model that appropriately encapsulates the nature, scale and complexity of the credit union business. In developing a business model, which will be the back drop of the tiered regulation, prudent development is encouraged through risk assessment and competence.

[3] Section 4 Overview of the Proposed Tiered Regulatory Approach for Credit Unions, Page 13 Consultation Paper CP76

CUDA proposal of a three tier mechanism built upon three distinct business models supports Boards of Directors obtaining clarity on their basic business proposition. We see a strong correlation between the business model approach, the requirements for a strategic plan as determined in CUCORA 2012[4] and the helpful section in the Credit Union Handbook on 'Strategic Plan'.[5]

It is well understood that credit unions exist to serve the financial needs of individuals, for the most part as consumers [which can also include sole traders]. Credit unions are not a "poor man's bank," nor do they target businesses or the rich. Instead, they serve ordinary people from all walks of life, and they have thereby earned their place as a trusted source of financial services for more than half of all Irish citizens.

While we do not believe that credit unions will have a significant role in serving business firms for the foreseeable future, some credit unions may perform limited services for local clubs, charities and other community organisations, that should not involve taking undue credit risk or detract from their primary mission of serving individual members[6].

The Commission's Report correctly identified needed reforms to credit union governance, risk management and the use of technology, as well as to their supervision, depositor protection, resolution and stabilisation. While, like all other stakeholders who participated in the Commission, we agreed that those changes are essential if credit unions are to continue playing an important role in the Irish financial services market. But necessary as those changes are, we believe they will be insufficient to assure long-term sustainability unless credit unions are permitted to substantially increase the percentage of assets profitably loaned out to members.

As the Commission pointed out, credit unions are thriving in the U.S., Canada, and Australia, notwithstanding the global financial crisis. Certainly, that comes in part from them having adopted years ago the management, governance and regulatory reforms the Commission recommended for Ireland.

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[4] Refer to Section 76A(1) and 76A(2)(b)

[5] Credit Union Handbook, Section entitled Strategic Plan, version 1.0 published September 2013

[6] Rationalisation of the credit union movement will often require mergers being arranged between credit unions that do not share a common bond. This was the practical experience of U.S., Canadian and Australian regulators when those countries went through similar periods of sector consolidation. As a result, the common bond concept will inevitably diminish in importance. Hence, as is the case in those other countries, the Credit Union Regulator will need to consider how it exercises its extensive power on this matter.

But the key difference lies in the fact that credit unions in those countries make most of their money from lending that is hardly done at all by credit unions here.

We hope this facilitates the reader understand the vital underpinning model that the approach to Tiered Regulation will have on the future for credit unions in Ireland, and that rather than use it as a blunt instrument to downsize credit unions it must prudently remove the obstacles that exclude Irish credit unions, who can manage the inherent risks, from making many of the most important types of loans that modern consumers need.

In summary the three business models are:

Model 1: Co-operative Finance Company

This is the original credit union business model in Ireland, a low-Cost Loans and demand Savings provider.

Within this model, credit unions may be authorised to simply lend, with a lending budget based on an upper threshold, and to accept savings [without restriction].

This model will also compliment the Commission proposal for the first tier that should serve *"smaller credit unions that want to operate a simpler business model…under a simpler regulatory regime".*

Model 2: Co-operative Savings and Loan

This is similar to what many credit unions operating today, where credit unions offer a broader range of savings and lending products. This is a natural default position for all Credit Unions that enables them continue to serve their members as they do today and within the legislative and regulatory permissions available to a credit union today.

Model 3: Co-operative Bank

This model is akin to a full-service, depositor-owned bank. Model 3 supports the Commission's recommendation for a third tier in that it will serve *"larger credit unions that are capable of operating on a more sophisticated basis*" and will "*offer a wider range of products and services and engage in a broader range of lending and investment activities*".

The approach is illustrated in the high level summary below:

Nature, scale and complexity of the business model increases

- The level of activities and services to members increases
- Increased skill and minimum competences required
- Increased risk management [procedures, systems, competencies] required

Model 1 Co-operative Finance Company	Model 2 Co-operative Savings and Loan	Model 3 Co-operative Bank
Member shares are capital from which loans are made	More than the single share account is offered.	Member accounts are primarily deposits with limited share accounts: Current accounts, savings, term deposits Alternative sources of capital are available.
Withdrawal of shares is discouraged	Different types of accounts pay different rates of interest, access control in hands of members, ATMs, EFT, cards, mobile, etc. along with some or many 3rd party payment services,	Full range of payment and transaction services: ATMs, EFT, cards, mobile, etc. along with some or many 3rd party or owned payment services, HP, Leasing,
Principal product is low cost, consumer loans to members, secured by their shares	May have some competitive fees for certain services; Broader range of lending products, including broad range of consumer loans [including secured options e.g. home mortgages], sole trader, limited SME - all as currently permitted; Insurance and other competitively fee-based products offered.	Competitive fees integral part of business model. Deposits pay market rates; Full range of consumer, car, credit\debit card, home mortgage loans, SME loans, Commercial loans; Extensive range of Insurances, pensions, wealth management services, and other fee-based products and services offered
Members share in the surplus, if there is any after reserve requirements are met	Evolve from dividend only model, Deposits pay market rates;	Evolve from dividend only model. Deposits pay market rates;

While it is natural to expect that for credit unions to successfully move to Business Model 3, scale will be critical, however, with increasing cost to serve members, scale is also becoming more applicable to business model 2.

CUDA continues to hold its belief that credit unions should continue to focus on first evolving their ability to meet the core business objectives of providing high quality, fairly priced savings and loans to ordinary people using modern, effective means to do so. These core products can be augmented by competitive fee earning products to supplement interest income bearing products. This will establish the competencies and confidence for those who wish to move to business model 3.

CUDA believes that this approach will naturally give rise to restructuring and amalgamations as credit unions that do not have the skills and capabilities to manage a high business model will look to join forces with a credit union that already offers a wider range of services and products, or together they can do more for their combined members than when operating alone. Restructuring of this nature, will be determined and driven by members needs and could give rise to common bonds merging and credit unions cooperating.

The business model proposed above also compliments greater co-operation between credit unions[7]. Credit unions that develop significant abilities and competencies can offer these skills by way of co-operation arrangements to other credit unions. Under the proposed 2 category approach obstacles restrict credit unions specialising in any one service or emphasising any one particular aspect of the business as there is an obligation to incur the costs of having the full suite of skills and requirements to upgrade and remain in a higher category.

At the back drop of these restrictions, a concerning aspect for credit unions with the emergence of tiered regulation is the inability to meet member needs and improving the well-being of members and their community as obliged to do so under the governing legislation[8]. Credit unions that currently provide products and services to members will be restricted from doing so under the proposed 2 category approach. This is not the function of tiered regulation - it has the effect of providing restrictions on credit unions that do not currently exist; the Consultation Paper suggests that Category 1 reflects the current operative business model. This is not the case. Restrictions in deposit and savings' products are an example.

Furthermore, with regard to the proposed 2 category approach we see no logic as to why all credit unions start the process as a Category 1 credit union. We would be of the view that the Central Bank has access to the necessary

[7] The sixth of the Rochdale Principles states that co-operatives cooperate with each other, as first set out by the Rochdale Society of Equitable Pioneers in Rochdale, United Kingdom, in 1844.
[8] Section 6(e) Credit Union Act 1997 (as amended)

information that would enable them to categorise credit unions accordingly. Many credit unions underwent comprehensive PRISM inspections by the Central Bank, yet the information derived from such inspections and the risk categorisation of credit unions under the PRISM regime is remarkably absent from categorisation under the proposed 2 category approach. It is unacceptable that a credit union's ability to meet its members' needs will be impacted as credit unions are forced into category 1 and subsequently expected to overcome the unquantified obstacle of applying for category 2 status.

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 operation of the 2 category approach as defined in the Consultation Paper is too simplistic. It imposes restrictive regulation and does not reflect current business requirements, or the potential development of credit unions. We have set out our concerns under the sub-headings used in the paper. It is important to point out that the following observations are based on our own analysis and figures obtained by CUDA. We will be in a position to further analyse the financial impact of the current proposal on the core business of a credit union once the Central Bank has completed, and made available, the regulatory impact analysis.

1. LENDING

It is crucial that, within the context of maintaining a viable business, credit unions can best serve their members going forward. It is imperative that regulation does not prevent access to credit for those that need it, and, can afford it. The Report from the Commission noted that credit unions are significantly under-lent[9]. A tiered regulatory approach should aim to address good and sensible lending practices. Ordinarily the return on interest derived from loans is higher than the return on investments. Enabling regulation should allow for the growth of prudent lending. In order to achieve this there is a need to recognise a more fluid application as opposed to a rigid regulatory-first approach. By way of example, Category 1 refers to loans with maturity limited to 15 years; consider a credit union who provided a loan for this period; however, during the course of the term, the borrower required an extension of the term thus bringing the borrower beyond the 15 year limitation. The business decision should materialise from the expertise and competence to assess the ability to repay - and the risk attached, *and,* not on whether the credit union must move from one category to another in

[9] Chapter 7 Future Models of Credit Unions, page 79

order to meet the requirements of the member. Regulation restricting good business decisions is concerning, *a barrier which we do not believe exists for competing Institutions*. The nature of a business should not change depending on whether a credit union offers a loan over 15 years or 16 years. The defining factor is the quality of the governance structure to mitigate and manage the risk - the proposed 2 category approach currently ignores this. Furthermore, we do not believe it gives sufficient regard to the vital role policies play in the management of the business and the statutory obligations on Boards to develop policies, in particular those relating to prudential requirements.[10] The 2012 Act specifically requires a credit union to put on place policies having regard to the credit union's lending limitations.[11]

We appreciate determining structural parameters in not an easy task – one has to recognise the different models operating within credit unions, however, we fear a collapse of basic services provided by credit unions, i.e. providing loans, will be lost by the need for a credit union to "fit within" tiered regulatory compliance if not appropriately addressed.

Restrictions on the ability to lend are illustrated in Chart 1 and Chart 2 below.

Chart 1 demonstrates restrictions on the number of home loans that can be provided by a category 2 only credit union and the impact such restricted lending limits will have on returns.

Chart 1: Home Loans

	Current Loan Book	**15% > 10 years**	**Number of Loans 150k\ 200k**	**Build over 5 years**	**Avg Interest @ 2% for first 5 yrs**	**Next 5 years**
1	29,945,000	4,491,750	37	898,350	50,300	89,800
2	37,745,400	5,661,810	47	1,132,362	63,400	113,200
3	57,166,100	8,574,915	71	1,714,983	96,039	171,500
4	30,872,900	4,630,935	39	926,187	51,900	92,620
6	30,371,100	4,555,665	38	911,133	51,020	91,110
6	57,221.200	8,583,180	72	3,842,970	96,131	171,660
7	48,015,700	7,202,355	60	1,440,471	80,670	144,050

Illustration purposes only

[10] Section 55(1)(o), Credit Union Act 1997, as amended by CUCORA 2012
[11] Section 55(1)(o)(i)

It is evident from the above Chart that the returns from home loans, in particular due to the limited volume that a credit union can offer (for instance, with a loan book of €30 million a credit union is limited to 37 home loans). The obvious difficulty with this is that once the volume is reached (i.e. 37) the credit union is effectively barred from offering further home loans for numerous years *and indeed form any loans governed by Section 35 that are greater than 10 years.*

Furthermore, credit unions are obliged to demonstrate the ability to underwrite such loans, and incur the cost of achieving the capabilities required. Without the ability to increase the volume returns, especially after 5 years, it is questionable, under the proposed structure, if a viable product line exists for any credit union to offer. Furthermore, the cost to implement this product line will far outweigh the limited earnings that can be made because of the limit restrictions. This is especially concerning for future developments for the sector.

Chart 2 below illustrates the restriction on non-personal lending. The concentration limits proposed under CP76 for non-personal lending are:

- both Category 1 and Category 2 credit unions can undertake lending to other credit unions up to a total amount outstanding of 12.5% of Regulatory Reserves;
- both Category 1 and Category 2 credit unions can undertake community lending up to a total amount outstanding of 25% of Regulatory Reserves;
- Category 1 credit unions can undertake commercial lending up to a total amount outstanding of 25% of Regulatory Reserves; and
- Category 2 credit unions can undertake commercial lending up to a total amount outstanding of 100% of Regulatory Reserves

We can appreciate, for prudent management purposes, the use of upper thresholds based on regulatory reserve ratios, however, we have concerns with the low percentage limits as it may restrict credit unions developing these types of products now and in the future. Conscious of the need to grow the loan interest income in order for some Boards to future proof their credit unions consideration should be given to the removal of limits. In situations where credit unions have the skills and capabilities and can support this via the appropriate policies and procedures we view the inclusion of thresholds as a restriction on credit unions that wish to develop such lending products, or indeed as their membership needs evolves over time, they may in the future wish to specialise in one or some of these products.

Chart 2 below illustrates the limited income that could be generated as a result of the limits proposed. Similar to the home loans scenario above it is questionable as to the viability of providing such products.

Chart 2: Non personal lending

	Reserves 2013	To Other CU 12.5%	Community Commercial (1) 25%	Avg Annual Lending	Income @3% margin	Commercial (2) 100%	Avg Annual Lending	Income @3% margin
1	10,000, 000	1,250,000	2,500,000	500,000	15,000	10,000,000	2,000,000	60,000
2	5,000,000	625,000	1,250,000	250,000	7,500	N/A	N/A	N/A
3	20,000,000	2,500,000	5,000,000	1,000,000	30,000	20,000,000	4,000,000	120,000

Illustration purposes only

A third area of concern on the proposed lending arises in relation to restrictive person limits. Credit unions are currently obliged to set up special committees to approve loans to restrictive persons. The Consultation Paper proposes introducing financial limitations and requirements for lending to such persons for both Category 1 and *Category 2* credit unions. CUDA has grave concerns with the introduction of such financial limitations which provides blanket restrictions without taking any account of the credit worthiness of individual members.

This further restricts the ability of the credit union to generate an income. It seeks to eliminate any risk that may be associated with such borrowers without taking cognisance of the ability of the Board, through the special committee, to manage the risk associated with borrowers that fall within this category.

The proposal appears to take no account of the higher governance and risk management obligations imposed on a Category 2 credit union, or indeed the vast range of recently introduced policies and procedures, including appropriate conflicts of interest policies and procedures. One would expect to see mandatory limitations reduced or removed where internal oversight and competences have increased. Has the Central Bank identified heightened risk in lending practices to this category of borrower?

Finally, and more importantly, we would question the constitutionality of imposing restrictions on a category of members merely by reason of their association with another member. Effectively, an individual member could be denied a loan, based not on *their personal credit worthiness*, but based on the lending threshold being reached to other members within this regulatory determined class of members.

2. SAVINGS

Section 8(2) of the 2012 Act will remove the statutory requirement set out in Section 27(4) of the 1997 Act to limit deposits to a maximum of €100,000. We

welcome this as it allows credit unions going forward to compete with Banks and other institutions for deposits and savings' products. It also allows credit unions to consider more sophisticated deposit and savings accounts. However, the tiered regulatory approach inexplicably proposes to reintroduce the limit of €100,000 for all credit unions, both the proposed Category 1 and 2, and in the case of Category 1 it further proposes a limitation of the *lower* of €100k or 1% of assets. This provides further restrictive measures than is currently under legislation and gives rise to question what, if any, relevance this has to Tiered Regulation?

Such limitations places credit unions in an anti-competitive position especially for credit unions that wish to develop and offer products comparable to other financial institutions, e.g. Banks. It is also questionable whether such a limitation will allow credit unions to meet members' needs now and into the future. The Commission noted in its Report that member needs are changing and credit unions will have to develop to meet these changes. It is crucial that credit unions have the ability to manage long term or significant deposits holdings, and are not restricted from doing do. Indeed, as far back as 2006 CUDA stated in its publication, *Call To Action, Re-inventing Credit Unions for the 21st Century,* "to truly excel in their core business, credit unions need to begin by offering a much broader array of modern savings and lending products". A tiered regulatory approach is a means of lifting the restriction for those credit unions that have the ability to manage and extensive deposit and saving deposit.

On a side issue, we are not certain of the reasoning behind the limitation of €100,000, and assume it is connected to the DGS. However, we believe a more favourable approach is policy guidance on notifying members as to the DGS limitations which, in turn, leaves the members free to make informed decisions.

Furthermore, the Consultation Paper proposes to limit total deposits to a maximum of 50% of total savings for Category 1 credit unions and 75% for Category 2 credit unions. This restricts the move to a more developed asset and liability matching model and will have a future impact on the development of the sector. The credit unions should be free under the right risk management structures to match long term deposits with long term loans, which in turn will assist greater liquidity management.

In welcoming the comment that "*the definition of liquid assets will be extended to include investments with more than three months to maturity that have an explicit written guarantee that the funds can be accessed by the credit union in less than three months…*" we do not believe that this is either a matter for Tiered Regulation, or a matter requiring consultation, and would request that this definition be effective forthwith.

3. INVESTMENTS

CUDA has contributed to the detailed analysis work conducted by Davy in assessing the impact of the proposed changes to investment classes and limits. Much constructive work has been carried out by credit unions in recent years, guided and directed by the Registry of Credit Unions, to ensure that their investment risk exposure is appropriately mitigated. Unfortunately, the Consultation Paper does not provide any insight to the rationale for proposing such radical changes to the investment framework.

The proposal is that all credit unions will be initially restricted to Category 1, while some, based on asset sizes close to or above €100 million, and other qualifying criteria yet to be outlined, will be allowed apply for Category 2 status. Based on some high level assessment with member credit unions it is our considered belief that Investment income will be adversely affected and subsequently the proposal will act as a further impediment to growth and development of some credit unions.

The proposed investment framework will increase reliance on call deposits as *Collective investment schemes* will not be available to credit unions and partial access accounts are unlikely to be available in the forthcoming Basel III investment world. This could see a reduction of up to 0.75% on yields – which is a very significant drop in earnings for credit unions.

This is further compounded by the lower yielding universe of authorised asset classes and investments, the wider range of counterparties required and all at a time when it is already very difficult for credit unions to generate income.

From the perspective of effective investment portfolio management, we are unaware of any practice which basis limits on Regulatory Reserves. The RRR is a very separate unrelated aspect of the business. By introducing it as a measure to limit counterparty risk, it presents complications in terms of management. In addition, from our analysis with member credit unions, the counterparty limit of 100% Regulatory Reserves will introduce extremes for certain credit unions when the limit is translated to a percentage of the investment portfolio – one credit union may need as many as ten.

While the income derived from investments will decline resulting from these new rules, the cost of monitoring and administering them is likely to increase. There is significant more complexity being added as investments must be managed with regard to at least three reference points: unattached shares, total investment portfolio and regulatory reserves. As demonstrated above, there will also be additional counterparties required and excess liquidity harder to manage with no collective investment schemes.

Following detailed consultation with member credit unions we are also cognisant that due to the introduction of reduced counterparty limits there is potential for significant deposit outflows from the Irish banking system. When extrapolated to apply to all credit union investment portfolios this could be in the region of €2bn.

We are also concerned that the imposition of restrictive criteria could inadvertently tempt some credit unions into making riskier investments, compliant with the rules, than they would normally consider.

As referenced above we contributed to the very detailed analysis conducted by Davy and this report accompanies, as a separate document, our submission for your attention.

4. GOVERNANCE

It should be recognised that to be sustainable and viable some credit unions with professional staff will chose to move to the next stage of development and offer a full range of consumer lending, deposits and other financial services. Doing so may not, however, entail radical changes to their fundamental business model or to their basic organisational and governance structures.

Having a requirement, for instance, for a *dedicated* risk management officer, compliance officer, or, internal audit function, as defined in the Consultation Paper, does not mean more prudent risk management or compliance frameworks are in existence. We would caution against the approach proposed in the Consultation Paper when it comes to good governance. Terminology as “dedicated” and “in-house” when setting requirements for such engagements is inadequate and inappropriate. It is clearly evident that minimum competency requirements are a more appropriate bench-mark. In some instances, outsourcing the engagement may be a more prudent and viable alternative for a credit union. Whilst the 2012 Act imposes mandatory obligations on each credit union to engage such officers, the level of engagement should remain a matter for each credit union to determine based on the nature, scale and complexity of their business model. According to the Credit Union Handbook, providing the Board appropriately manage conflicts of interest, the decision making process with regard to complying with the Act should be open to the Board to make.

The Consultation Paper also provides that such officers should not hold any other responsibilities in the credit union. We would again question the logic behind a total restriction of this nature. The proposed approach ignores competencies and abilities of the officer and the ability of the Board to make a prudent decision with regard to engagement of such officers. The Act provides that such officers can hold another position in the credit union[12]. Whilst the Act also empowers the Central Bank to prescribe certain positions as inappropriate

[12] E.g. Section 76C(2)(a) and (b)

to hold whilst an officer is in the role of a risk management officer or a compliance officer, we would question whether such Sections were envisaged as permitting a blanket ban on holding other positions within the credit union.

Finally, the requirement for Category 2 credit unions to appoint external consultants to oversee Board rotation is unnecessary and disjointed from the extensive changes that have occurred under the new legislative regime. We are not going to recap on all of the new internal oversight imposed on credit unions under the Act, including the requirements for a Board Oversight Committee, significant additional policies, succession plans etc. What the Central Bank may wish to provide, as an alternative, is guidance on board rotation policies and procedures. We strongly oppose the requirement for external oversight in this regard.

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.

Products and services will depend on the demand for new and emerging requirements by members in the future. Whilst we can provide a list of products offered in the current market we would caution limiting products and services to those set out on a list. We are fearful that once a list is produced it will effectively become "closed" to new products and services, which could be detrimental to future proofing the sector. As an alternative, we advocate a process whereby additional products and services will emerge depending on the business model.

However, we also recognise that transparency is a crucial aspect when considering new products and service to members. Under the current process credit unions struggle to define the requirements for introducing a new product or service to members; currently there are no guidelines as to the parameters to when a credit union will be permitted to offer a new product or service, and as credit unions are obliged to apply on an ad hoc basis it is difficult for a credit union to appropriately plan in their strategic plan. We believe this can be achieved by developing a transparent process under which credit unions make their applications through Section 48. This will allow credit unions to consider, based on their business model, whether or not to introduce a product or service as they will be in a position to determine their capabilities and risk assessment.

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 agree that the Central Bank should adopt a transparent provisioning framework for all credit unions, however, it should not devolve credit unions of the ability and responsibility to manage bad debts and loan loss provisioning. We believe that such a framework should be designed to ensure consistency and clarity and that it should achieve the objectives the Central Bank has identified, namely:

- recognition of loan losses as early as possible within the context of accounting standards;
- adoption of a sufficiently conservative and comparable approach to the measurement and making of impairment provisions in each credit union's loan books; and
- disclosures to support members' understanding of the performance of the loan book and the credit union's credit risk management practices.

Once again, this is not an issue dependent on the introduction of Tiered Regulation and we would prefer a scenario where credit unions are supported in their empowerment to manage provisioning internally as part of their good governance framework.

It is highly likely that when the new IFRS 9 becomes effective in 2015, it will require an "expected loss" provisioning methodology along the lines described in Section 6.2. Accordingly, we commend the Central Bank for taking steps now to develop a provisioning framework that will enable credit unions to obtain unqualified audit opinions when the new accounting standards become effective.

We note that a number of credit unions (including several CUDA members) are already successfully using proven, commercially available, software for assisting Boards and Management in their determination of their provisions on a basis that is IFRS 9 compliant and that comports with the other standards described in Section 6.2, namely:

- Examining the loan book on a collective basis using previous experience of losses in the loan book as well as expected cash flows to estimate the amount of losses in the loan book.
- Using historical experience to estimate the losses in the loan book that have not yet materialised and to set aside an appropriate amount of provisions.

We are also conscious that other credit unions have implemented manual methodologies to achieve these objectives.

However, to support future managing of this matter, and to ensure the Board meets its legislative responsibilities, it is believed that an automated, statistically sound solution is the only practical, cost-effective means of objectively and consistently performing the foregoing analysis on a sizeable loan portfolio. Manual processes alone are not feasible except for relatively small credit unions.

For the avoidance of any misunderstanding, irrespective of the automated statistical method utilised, we believe that at least quarterly manual reviews are conducted of the “outliers” in their portfolios[13]. Moreover, a measure of judgment is required to conservatively estimate the amount by which statistically calculated provisions need to be adjusted based on reasonable forecasts of future economic, market, and other relevant circumstances. However, use of a sound statistical model provides a consistent, objective starting point for such adjustments.

Consistent with evolving the business model of a credit union, objectively understanding the risks in a loan portfolio informs prudent product design and pricing, effective credit control activities, and better overall risk monitoring and management. For these reasons it is clear that this is not a responsibility that can or should be removed from the Board of Directors.

In light of the foregoing, we recommend that the Central Bank publish its provisioning framework for credit unions as soon as practicable. Doing so may require a separate, faster track than is contemplated for the Tiered Regulatory Approach. The goal should be to give credit unions a reasonable time to adopt compliant provisioning procedures and develop skill in using them before the framework’s effective date. That date should presumably coincide with the effective date of the new accounting standards, possibly by way of a guidance document to credit unions and included in the Central Bank’s Credit Union Handbook, for instance, as part of the requirements of a provisioning policy.

We would respectfully suggest that this topic is revisited by the Central Bank with the Representative Bodies.

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.

Tiered regulation should be introduced at soon as an appropriate tiered regulatory approach is defined. CUDA has requested, for some time, an alternative to the one size fits all approach. However, this is on the basis that the tiered regulatory approach is enabling regulation. The tiered regulatory approach as proposed under the Consultation Paper would have a dire outcome on an already struggling credit union sector. However, please see (vi) below for implementation issues. Furthermore, the process, once introduced, should balance the substantial changes that credit unions have undertook, and endured, over the last new of years.

[13] i.e. the loans whose performance may not be capable of accurate prediction by statistical means alone or that represent special circumstances. Such loans include large exposures, loans to officers and directors, restructured and rescheduled loans, etc.

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 cannot comment on commencement dates and transitional periods until a tiered regulatory approach has been decided upon. Furthermore, it is difficult to determine time frames until the outcome of the regulatory impact analysis is available.

In light of the information available to the Central Bank, in particular as a result of PRISM ratings and inspections, CUDA does not understand why credit unions could not be appropriately categorised from the offset without impinging on their current permissions. This needs further investigation and depending on the outcome may impact on the transitional periods.

We look forward to any additional queries you may have in relation our proposal for a 3 tiered approach and our proposals for the operational aspects of such an approach. We are happy to provide the Central Bank with any additional figures in relation to the impact the proposed 2 category approach may have in lending and investments. We also await the RIA in this regard.

Again, thank you for the opportunity to respond to the Consultation on the Introductions of a Tiered Regulatory Approach for Credit Unions.

Unit 3013, Citywest Business Campus, Dublin 24
Tel: +353(0)1 4693715
Fax: +353(0)14693346
Website: www.cuda.ie
Email: Elaine.larke@cuda.ie