Consultation Paper CP76 – Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions

A Submission to the Registry of Credit Unions

31st March 2014

Dubco Credit Union Limited

Introduction

Dubco Credit Union Limited ('Dubco') has assets of €110m+ and reserves of 12%+. The approach of Dubco has historically been to be prudent in the payment of dividends and in the maintenance of reserves. Further to the receipt from CBI of the above document, Dubco makes the following observations.

Operating environment

Declining returns / viability issues

The current operating environment for credit unions is challenging. Investment returns and loan books continue to decline, resulting in significant decreases in credit union surpluses, with some credit unions facing current and/or future year projected deficits. Dubco has confirmed a challenging future operating environment for some larger credit unions though its analysis of the financial statements of several of these organisations. It has both projected loan book declines at recent historic rates, and applied investment returns at recently projected rates, in that analysis.

Mergers

Mergers are being considered by many credit unions as a solution to the challenges of future viability. However, cost savings and benefits from such engagements appear to be minimal. Rather, many credit unions stress the opportunity such mergers bring to develop new business offerings post merger. Where cost savings are made, such savings are, by definition, finite, meaning that two credit unions currently challenged by future viability will, post merger, continue to be challenged by future viability, without the development of services. Mergers with cost savings alone will only push the financial viability issue for such merged entities out one or more years.

Additional services

The need for the credit union sector to develop rapidly outside of its traditional areas of business and to develop alternative and income enhancing strategies is therefore urgent, and obvious.

Proportionality

The report of the Commission on Credit Unions refers to proportionality …*'regulatory requirements in place for credit unions should be proportionate to the nature, scale and complexity of the credit union'*. Dubco agrees with this sentiment.

A concern Dubco has in relation to current, and proposed, regulatory requirements, is that they may impact negatively on the ability of credit unions to develop and become stronger. While Dubco agrees with the need to be regulated and to be compliant, and recognises that improvements are necessary and beneficial, care needs to be taken that regulatory changes are not out of proportion to the risks that they are trying to manage.

Development of a Growth Environment
The view of Dubco is that credit unions should be encouraged to expand and become financially stronger. In such an environment members would be encouraged to save, to borrow and to avail of other credit union services. The challenge for the regulator is to create an environment that is both compliant from a regulatory perspective, and that can also grow. Dubco's hope is that any regulation put in place in the future will facilitate and encourage growth.

Absolute limits
It will be noted in the detailed response of Dubco to CP76 below, that Dubco in general does not agree with absolute limits. These tend to ignore the quality and complexity of what lies behind each credit union. *By their very nature absolute values must cater for the weakest credit union*, and in the view of Dubco this should be avoided if possible.

Category 1 & Category 2
The restrictions on Category 1 credit unions will increase the financial viability risk of credit unions. Dubco suggests that lending and investment opportunities should be the same for both types of credit unions, with restrictions not based on absolute values only. This would ensure that both credit union types can maintain viability as best as they can, and use the same business model, the main difference being the relative sizes of investments and/or lending and other opportunities given the size of each credit union.

Conclusion
Dubco welcomes this opportunity to provide feedback on CP76.

Dubco would like to expand responsibly and sensibly, and hopes that current and future regulation will facilitate the well being and future growth of credit unions generally, and not have a negative long term effect on the sector.

Detailed comments on CP76 are contained in the accompanying Appendix.

Appendix

Submission from Dubco Credit Union - CP76

Illustration		Current	Prop-osed change	Impact of change	Proposed New
		€m		€m	€m
Dubco Assets 2013	A	€ 110	2%	€ 2.20	€ 112

Ref	Page	Issue
4.3	15	**categorised as category 2 … minimum operational risk reserve requirement'**

This has been suggested elsewhere in the document as being potentially 2%.

Observation

The requirement to build up reserves would in all likelihood prevent Dubco from paying dividends for a number of years in the current environment of declining loan books and declining investment returns. Dubco's strategy over the years has been to have a reserve 'padding' in excess of the minimum reserves required by CBI. This padding would be eliminated by what is proposed if Dubco chose to pursue the Category 2 classification.

We suggest that income earned be separated between 'category 1' income and 'category 2' income, and that the 10% minimum reserve continue to apply to 'category 1' income and a 12% (2% in excess of 10%) minimum reserve be applied to 'category 2' income and be called 'operational risk reserve', to distinguish it from other reserves. This would result in the proposal being incremental and essentially proportional, which makes sense to Dubco.

An incremental reserve approach would also ensure that credit unions that decided to undertake some commercial initiatives in order to strengthen their financial position would not be effectively punished by the imposition of a further 2% overall reserve for doing so.

Dubco does not agree with an additional risk reserve requirement of 2% on all assets. Dubco proposes a separate incremental reserve requirement being placed on income generated from 'Category 2' activities, being 12%, which would be 2% above the existing annual reserving requirement. This approach would encourage initiative in credit unions.

4.5	16	**… comply with additional requirements…'** Dubco would agree with increased regulatory requirements if they make sense. Dubco is concerned that additional requirements would recognise the need of the credit union sector to be viable and capable of expansion and development. Through engagement with its members, Dubco recognises the very important part it plays in the lives of many members, and that by default the credit union sector plays in Ireland. ***Dubco would encourage proportionality in respect of regulatory requirements, such that they would encourage (or facilitate) rather than discourage the development of the credit union sector.***
4.7	16	**… permitted to apply to CBI on an annual basis to move from category 1 to category 2 …'** Dubco suggests that if a CU believes it is compliant that annual should be changed to quarterly. A credit union that is ready to apply just after an annual deadline would effectively be losing out on one year of operation at tier 2, which could be commercially damaging to the credit union. ***Dubco agrees with set times at which a credit union can apply to move to tier 2, but believes these should be quarterly rather than annually.***
5.1.2	19	**…. Lending limits will apply including the current S35 longer lending maturity limits …. and a maximum loan maturity of 15 years'** Dubco believes that if a CU has the opportunity to lend safely in excess of the current limits, that it should be able to do so. Section 35 potentially prevents credit unions from making good loans, and therefore negatively impacts on the financial stability of those credit unions and the development of the sector that would accompany strength and stability. The emphasis should be on the quality of the loan, and not the duration. In view of the significant cash that credit unions have to lend, Dubco suggests that a limit of 15 years is restrictive. Rather, it suggests a limit of 20-25 years for property related loans in Category 1 and 2 Credit Unions, accompanied by a minimum loan to value ratios for property loans. Dubco notes that this is referenced on Page 24.

		Dubco observes that the emphasis appears to be significantly on absolute values, rather than the quality of the business that can be undertaken, or the different classes of member. ***Dubco suggests that Section 35 is a potentially crude and restrictive instrument and should be replaced by an emphasis on the quality of the loan book rather than on the absolute value of loans that can be issued. Dubco agrees with the home loan proposals later in the document, but suggests they should be available to both categories of CU. The emphasis in respect of this latter point is that boards of directors and management teams should be trusted, monitored and regulated, to perform responsibly. It would appear to Dubco that the infrastructure to strengthen responsible performance has recently been implemented.***
5.1.2	19	**…. Investments … permitted duration no longer than category 1 credit unions' (5 years)** Dubco considers 5 year limits to be too low and recommends a limit of 11 years (rationale below). A 5 year limit would reduce the income of many credit unions. Dubco believes that both category 1 and category 2 credit unions should be able to avail of the same opportunities. The different scales of each should ensure a proportional appropriate risk in each credit union. Dubco also suggests that maximum investment terms be increased to at least 11 years. 10 years appears to be a cut off mark for many investing organisations, with the yield slightly over 10 years therefore being more attractive than the yield under 10 years. ***Dubco suggests that a 5 year limit on investments is commercially punitive, and suggests a maximum investment term of 11 years for commercial/practical reasons.***
5.1.2	20	**…savings … up to €100,000** An absolute value doesn't make sense to Dubco. Perhaps 0.3% of total assets or 2.5% of regulatory reserves should be considered.

The restriction proposed could prevent members who have significant borrowings from building up a savings portfolio in the credit union. It could also prevent a strong credit union from expanding due to a shortage of funds, which if it was already a fully lent credit union would immediately stop the growth of that credit union. A fully lent credit union would also probably be in a position to attract significantly in excess of 100,000 due to its income generating capability.

Given the already stringent guidelines in respect of liquidity, Dubco believes the stringency envisaged is unnecessary.

Dubco can understand why a credit union should be restricted in the amount of savings it can accept, but suggests that proportional (e.g.%) restrictions rather than absolute restrictions would be more appropriate. Dubco believes the proposed changes should be setting credit unions up to succeed, and not to be restricted where they are viable and strong and expanding entities.

Based on Dubco Data - Dubco proposal				
	€m	*%*	*Max €m per Dubco*	**Prop-osed by CP76 - €m**
Potential --> % of total assets	*110*	*0.30%*	*0.33*	
Potential --> % of reserves	*14*	*2.50%*	*0.35*	**0.1**

5.1.2 20 **Borrowings - maximum of 25% of total savings**

This restriction does not apply to banks, and Dubco would view it as a competitively unfair restriction that will restrict the most successful of credit unions in the future. It would therefore appear to run contrary to the desire of the regulator to develop the sector, in that credit unions will only develop until this hit this limit, which is effectively a glass ceiling on growth of credit unions.

Dubco is concerned that this proposal is a glass ceiling that could restrict the development of some credit unions

5.1.2 20 **Additional Services**

Dubco agrees that additional services should be capable of being offered to members. If members purchase a service elsewhere, why not purchase it from their credit union.

5.1.2 20 **Liquidity - further requirements including stress testing and maturity mismatches**

		Given that shares are very stable in credit unions, Dubco suggests that maturity matching may not always be necessary. Dubco suggests that maturity matching should only apply where savings products are being offered by a credit union for a period in excess of 1 year, and where the sum involved is in excess of (say) 5% of total assets, given the restrictive liquidity requirements already in place. The exact mechanism of the proposed stress testing needs to be known before Dubco can comment further on this element of the point. ***Further detail is required in respect of the above before Dubco can comment in any more detail.***
5.1.4	21	**Category 2 - dedicated risk management officer, compliance officer & internal audit function** These requirements would appear to be significantly out of proportion to the risks within credit unions, and will place unnecessary financial and HR burdens upon credit unions. The expertise of existing risk and compliance officers also risks being lost as most credit unions will not warrant full time such officers. If a credit union has a requirement for a part time compliance person, and has in house expertise that currently fulfils compliance and other duties, then if an external party is brought in to do compliance there will not be a full time role for the current compliance officer. If the CU intends to retain existing compliance expertise, then that person will have to stop performing their other duties. The CU will not have a full time compliance role for that person. In both cases a difficult HR situation is being created in that part of a role will effectively be made redundant as a result of the proposed legislation. The vast majority of credit unions have operated well over the years. Dubco's concern is that over regulation is being proposed because of the failures / weaknesses of a tiny minority of credit unions, all of which failures / weaknesses have now been or are being addressed. CBI has already significantly improved the regulatory environments of credit unions and should possibly pause before imposing further costs on credit unions.

		Dubco believes this requirement is out of proportion to the nature of credit unions and will place an unnecessary financial and HR burden on many credit unions.
5.2.2	23	**Lending concentration risk - lending to other CUs 12.5%, community lending 25%, category 1 commercial 25%, category 2 100% - all %'s being of commercial lending** The principal item of concern to Dubco above is the lending restriction to/from other credit unions. A potential scenario Dubco envisages is where Credit Union A is very successful and is fully (100% lent with Credit Union B being only 50% lent. 'A' therefore needs funds, and 'B' has the funds to lend. If both CUs had assets of €100m and reserves of €10m, A could only borrow €1.25m from B, whereas B potentially needs far in excess of this amount over the short to medium term. Dubco therefore suggests that the lending capability should be very significantly greater. Financially, such a scenario makes complete financial sense. 'A' borrows €10m at (say) 3% from 'B'. 'A' lends on to customers at (say) 7%, while 'B' earns 3% instead of (say) 1.5% available in Ireland today. Both would have engaged in a commercially sensible arrangement. Such lending could be over various terms, which would address maturity dates, and would also appear to be congruent with the desire of the CBI to encourage closer cooperation and ultimately mergers between credit unions. If cooperation was as close as I have suggested above, it would appear that mergers would blossom in at least some of these situations. It would also be income enhancing for both parties. ***Dubco suggests that the lending to CUs limit of 12.5% of reserves is unnecessarily restrictive and contrary to a CBI philosophy of having CUs working more closely together, and ultimately merging.***
5.2.3	23	**Maturity limits - S35** ***Already referred to elsewhere. Dubco disagrees with absolute limits, which are potentially crude instruments.***

		Dubco agrees with property lending proposals. Suggests they should be available to both Category 1 & 2 CUs. Limits on loan size (% limits) could address over lending on individual loans, especially by smaller CUs. ***CUs should also be allowed to extend investment property loans, subject to appropriate LTV% and repayment over an appropriate period of years.***
5.2.4	24	**Restricted Person Limits** ***Dubco suggests that the proposed limits be doubled. Given the challenges in recruiting volunteers, it would be most unfortunate if this clause excluded a good potential member from joining a board, and often the most committed members are those who encourage family members to use their credit union extensively. Dubco also suggests that such figures be inflation proofed.***
5.2.6	25	**Lending Practices & Policies - S 35** ***Dubco considers this to be a potentially crude instrument, as referred to elsewhere.***
5.3.1	26	**Investment Classes and Limits - 5 year limit** Dubco disagrees with 5 year limit - it will impinge negatively on credit union profitability and viability.
5.3.2/3	26	**Investment Classes and Limits - 100% of regulatory reserves - Category 1 & 2** ***Dubco suggests that the limit be higher and possibly related to overall asset size.*** ***Category 1 CUs should also have the same flexibility as Category 2 CUs in this regard.***
5.3.3	26	**Investment Classes and Limits - 7 year limit for bank deposits, corporate bonds - Category 2** ***All investments should be capable of extending to 11 years and not the 7 and 10 years proposed. Returns tend to be higher where an investment matures in just above 10 years.***
5.3.3	26	**Investment Classes and Limits - 50% regulatory reserves for bank bonds - Category 2**

	Invest-ments	Restric-tion	Limit
Current limit	€m	25%	€m
Current limit	70	25%	18
Proposed limit			14

		Dubco suggests that this is too restrictive, and should perhaps be changed to exposure to each individual bank's bonds at 25%-50% of the CUs regulatory reserves per individual bank.
5.3.3	27	**Investment Classes and Limits - 12.5% of regulatory reserves invested in other CUs shares - Category 2** See point made previously. ***Dubco believes this is wholly inadequate for both Category 1 & Category 2 CUs, and also suggests it runs contrary to the current ethos of having CUs cooperate and potentially merge.***
5.10.1	31	**Liquidity Requirements** Dubco agrees with the sentiment that investments with more than three months to maturity could be included as liquid assets. Most CUs have a policy of holding investments to maturity. In the event of an unexpected liquidity event, in which such investments had to be liquidated, Dubco suggests that the CU should not be forced to change its policy to mark to market. This would ultimately be a decision for the auditor, but CBI support in this regard would certainly enable CUs to enhance profitability while at the same time minimising the highs and lows of revaluing investments, where the intention of the CU is to hold them to maturity other than in emergency situations where there is a liquidity event. ***Dubco agrees with the sentiment of liquid assets with a maturity date of in excess of 3 months being capable of being held as liquid assets. It suggests that CBI would support any CU forced to cash in investments to be held to maturity for a liquidity event in not being forced to change its accounting policy and having to revalue such investments to market value on an annual basis due to an unexpected event.***
5.10.2	32	**Additional Liquidity Requirements for Category 2** Dubco would like to understand what exactly is meant by the stress testing referred to, and cannot comment in view of this lack of knowledge.
6.2	35	**Proposed Provisioning Framework**

		Dubco has had a number of loan book reviews, none of which have identified specific under provisioning. However, as a result of these reviews, Dubco has increased its general provisioning requirements, including IBNR. A concern of Dubco is that over provisioning could result, which would cause financial difficulties for CUs. While on the one hand saying it 'wants recognition of loan losses as early as possible within the context of accounting standards', on the other hand it is stating that it may set a requirement to 'provide in full for a loan that has been delinquent for a specified period'. A one size fits all does not seem like the best solution in this case (think of industrial vs community). ***Dubco questions the appropriateness of applying minimum provision levels to all loan book arrears.***
7.2	38	**Does Dubco agree on the tiered approach?** ***Dubco's concern is that the sector is being over- regulated, and that sensible regulation risks being replaced by over regulation. The tiered approach does not make complete sense to Dubco, in the sense that core services should potentially be managed in the same way across all CUs, with levels of risk being proportionate to CU size.*** ***Dubco can see the sense in different levels of regulation being required for specific areas of activity that some CUs undertake and others don't, and has made the point that extra provisioning or reserve increases for these should be*** ***incremental and not an immediate add on*** ***to all reserves and/or assets.***
8		**Summary – suggestion re liquidity from Dubco** The liquidity levels in place for CUs impact negatively on the income generating capability of CUs. 25% liquidity less than 3 months is high. While Dubco can see the rationale for such liquidity levels, the reality is that all CUs in the country will not have a liquidity event at the same time.

Dubco would therefore encourage the Central Bank to encourage and if necessary facilitate the CU sector in developing a product (such as a less than one year unit trust with 25% immediate liquidity) that effectively gives a return that has a mix of the less than 3 months and 4-12 month return. The challenge for the CU sector would then be to identify such a product that minimises commission charges and maximises return.

Summary – CU growth

Dubco asks that CBI combines its very strong regulatory responsibility with an ethos that seeks to see the CU sector remain viable and get stronger.

The reality is that two unviable CUs when merged will become one unviable CU in most cases, without the provision of extra services. An environment that fosters growth is therefore essential.

Summary – timing

CUs are struggling with many changes. Dubco would like to see the tiering system proposed implementation date extended by at least three years, so that CUs can settle into the new environment in which they find themselves and begin to focus on becoming stronger after several difficult years of decline and regulatory strengthening.

Summary – making exceptions

Dubco suggests that the legislation should allow for Credit Unions to apply directly to CBI where in the view of the Credit Union any prescribed financial or % limit does not make commercial sense, and allow the credit union to make a commercial case for a deviation from that recommended limit.

The overall concern of Dubco is that the proposals are a one shoe size fits all and risk being overly prescriptive.