CONSULTATION PAPER CP 76

Introduction of a Tiered Regulatory Approach for Credit Unions

SUBMISSION

Fern Software Limited & Progress Systems Limited

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TABLE OF CONTENTS

1. Introduction

1.1 Fern Software Limited

Fern Software was established in 1979 and now has over 400 sites in 40 different countries, dealing with many different regulatory bodies. Fern's Customer Support and Development teams cover a range of front and back office banking solutions: shares, savings, deposits, loans (consumer and business), credit management, SEPA compliance, regulatory reporting, management reporting, CRM and a full suite of cloud based solutions, such as Internet banking, hosted banking systems and mobile payments.

Customers include Credit Unions, Microfinance Institutions (MFIs), Village Banks, Development Banks, Retail Banks and enterprise development agencies providing loans and support to SMEs.

For further information please visit the company's web site www.fernsoftware.com

1.2 Progress Systems Limited

Progress Systems Limited, employing 30 people, is based in Parkwest Business Park, Dublin 12 and is one of the leading IT Suppliers to the Irish Credit Union Market. We currently have 125 Credit Unions in the Republic of Ireland, with 35 of the top 100 largest Credit Unions amongst our Users.

In the past two years, we have achieved ISO27001 Certification for our Company and Support Services to our Credit Union Users and our product, Progress Banking.net, has been successful in a Grant Thornton "Fit for Purpose" and "Internal Calculations & Reporting" audits which were completed in 2013 and 2014.

Progress Banking.net is developed using the latest Microsoft .net technologies and provides the full range of internal functions such as SEPA compliance, ID verification, value dating and process workflows and all necessary external functionality such as credit checking, EFT flows and internet banking.

Progress is committed to the Irish Credit Union Movement. We keep our product and services in line with all Data Protection and Central Bank of Ireland Guidelines. We constantly work to have the most functional system in the marketplace and to provide the most professional and secure service possible to our Credit Union customers now and into the future.

For further information please visit the company's web site www.progress.ie

1.3 Technology in Use

In addition to member accounting systems, CUs have access to a full range of technologies and service delivery channels from a choice of suppliers:

- interactive voice response
- internet banking
- SMS / text messaging
- SEPA EFT services (Paypath, mandated payments, incoming/outgoing debits and credits)
- card services (ATM / debit cards)
- Billpay and Payzone
- imaging / document management systems

Systems are being continuously updated and use development platforms that are suitable for large-scale transaction processing and reporting. The established systems in use in CUs are proven to be resilient, reliable and safe over a long period of time. The vast majority of credit unions are well served by their systems and suppliers and this is supported by independent research[1] [2]

[1] Report of the Commission on Credit Unions, March 2012, p.46 Overall 87.4% satisfaction with IT suppliers
[2] ILCU National Technology Committee Survey 2004, 89% satisfaction with IT suppliers

2. General Observations

General observations in relation to the proposed approach under CP76.

1. The two tiered approach doesn't appear to meet the aspirations and recommendations of the Commission on Credit Unions. Initially all credit unions will be classified as category 1 credit unions, and on an ongoing basis only 30 out of 390 credit unions would qualify to be classified as category 2 credit unions (Ref. Section 3 below)
2. All major stakeholders should participate in the regulatory impact analysis. The Central Bank of Ireland should share relevant sectoral data to allow an assessment to be made of the impact of individual regulations. (Ref. Section 3)
3. The proposed regulatory approach appears to impose additional regulatory requirements and restrictions on all credit unions, regardless of size. This will restrict the development and growth of the sector. There is no explanation of the rationale for these new requirements and restrictions. (Ref. Section 4)
4. Beyond the tiered approach, regulations that were intended to take into account of the "nature, scale and complexity (and risk profile)" of credit unions, need to be clearly and unambiguously defined by the Central Bank of Ireland (i.e. under what circumstances and at what thresholds, individual regulatory requirements will apply). (Ref. Section 4)
5. There are major IT system changes and reporting changes associated with a tiered regulatory approach approach and regulations that involve different thresholds and limits depending on the nature, scale and complexity of each credit union. The proposed changes need to be unambiguously specified in detail before they can be consistently programmed, tested, documented, integrated into existing systems and rolled out to credit unions. (Ref. Section 4)
6. There are many additional services all credit unions would like to provide. The status of some services needs to be clarified under the exempted additional services regulations. Further legislative changes are required to allow credit unions to collectively provide services to their members. (Ref. Section 5)
7. A simple provisioning framework is required. Existing methods of calculation are overly complex (Ref. Section 6)
8. The implementation of the strengthened regulatory framework and new regulations should occur on a phased basis as recommended by the Commission on Credit Unions. (Ref. Section 7)
9. Given that credit unions are in the process of implementing new legislation, dealing with significant economic challenges and are focused on restructuring, it would not appear to be an ideal time to implement a tiered regulatory framework with additional requirements. The beginning of a phased implementation should be deferred from April 2015 by 12 – 18 months. (Ref. Section 7)

3. Proposed Tiered Regulatory Approach

3.1 Do you agree with the proposed tiered regulatory approach for credit unions?

We support the introduction of a tiered regulatory framework, while emphasising that it will add to the complexity of processing and reporting in credit union systems. However, the proposed regulatory approach that all credit unions will be subject to a strengthened regulatory regime and *"initially all credit unions will be designated as category 1 credit unions."*[3] does not appear to reflect the aspirations or recommendations of the Commission on Credit Unions.

The Commission on Credit Unions recognised the benefits of a tiered regulatory approach and recommended an approach based on three types of credit unions. The Commission[4] warned against:

(a) adopting a "one-size-fits-all" approach to regulation

> *3.8 The Commission recommends the introduction of a strengthened regulatory framework which credit unions will have to adapt to as it is phased in over time. However, credit unions should not be regulated on a one-size-fits-all basis; rather a tiered regulatory approach should be adopted.*

(b) the increasing regulatory burden on smaller credit unions

> *3.9 The Commission considered that some of the new regulatory requirements may not be required for those smaller credit unions that want to operate a simpler business model. Therefore, it is recommended that those credit unions be permitted to opt for a more limited business model under a simpler regulatory regime.*

(c) the need to facilitate service development in the sector.

> *3.10 Some larger credit unions that are capable of operating on a more sophisticated basis should be allowed to offer a wider range of products and services and engage in a broader range of lending and investment activities. This should be permitted under a more sophisticated regulatory regime for these credit unions.*

A survey of credit unions raised reservations about the regulatory authority and regulatory framework which the Commission sought to address in its recommendations.

> *7.5.3. The survey returns identified both the current regulatory authority and the regulatory framework as considerable external constraints on the development of credit unions. This suggests the credit unions have some reservations about the present regulatory authority and regulatory framework* [5]

Under the proposals in CP76, one-size-fits-all would apply at least initially, and given the assets requirements for designation as a category 2 credit union, only about 30 credit unions out of a total of 390 would be eligible to make an application for reclassification.

[3] CP76 Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions. 4.2 p.13
[4] Report of the Commission on Credit Unions, March 2012 p.v – p.vi
[5] Report of the Commission on Credit Unions, March 2012 p.82

3.2 Nature, Scale and Complexity

The Bank describes nature, scale and complexity as follows:

> *The nature, scale and complexity of a credit union is determined by the individual characteristics of that credit union, e.g. asset size, profile of membership, the nature and range of activities and services it undertakes and the operational model of the credit union. In addition, complexity can vary in different areas of a credit union's business…………The blend of these characteristics will vary for each credit union and this is taken into account in the application of regulatory requirements in the regulatory framework. This provides credit unions with the flexibility to operate different aspects of their business with differing levels of nature, scale and complexity within the current regulatory framework.*[6]

CP76 recognises that Type 1 credit unions in the Commission Report may choose to operate a more limited business model *"and the governance arrangements and prudential requirements that take account of nature, scale and complexity will automatically apply in a manner proportionate to the business undertaken"*.

In this approach, the number of credit union categories becomes less relevant as the blend of characteristics appears to determine the regulatory approach. The Bank proposes to make regulations for lending, investments, savings, borrowings, additional services, governance, reserves and liquidity. It is essential the Bank sets <u>quantifiable</u> parameters so that credit unions and their systems suppliers are clear where and when specific regulations will apply for programming purposes.

The Commissions recommendation gave an option.

> *10.2.4 Furthermore, the Commission recommends that regulations made pursuant to the legislation should be necessary, effective and proportionate having regard to the nature, scale complexity of credit unions* ***<u>or</u>*** *(for emphasis) to the class or classes of credit union to whom the regulations will apply. This would also facilitate a tiered approach to regulation as recommended in Chapter 7*[7]*.*

Ideally, regulations should apply to a class or classes of credit unions based on asset size, as in general the nature, scale and complexity of operations correlates with asset size. A three-tiered approach is more reflective of the current operating environment and development of the sector.

3.3 On-Going Operation of Tiered Regulatory Approach

CP76 states *"On an on-going basis, credit unions will be permitted to apply to the Central Bank on an annual basis to move from category 1 to category 2"*.

Accepting the preparatory work is required for reclassification, a credit union should be allowed make an application to be reclassified at any point and not just as part of an annual process.

A decision to move to a lower category should also be permitted apart from in exceptional circumstances.

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[6] CP76 Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions. 4.1 p.13

[7] Report of the Commission on Credit Unions, March 2012 p.119

3.4 Regulatory Impact Analysis

It is stated, *"the second consultation will set out the detailed operation of the tiered regulatory approach in the draft regulations, and will include a Regulatory Impact Analysis. The Regulatory Impact Analysis will take account of the feedback received in this initial consultation".*[8]

It is important that all stakeholders are able to undertake their own Regulatory Impact Analysis. The Central Bank of Ireland should make sectoral data available, (in the same way as it did to the Commission on Credit Unions for its report) to allow this to happen.

[8] CP76 Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions. p.12

4. Operation of the Two Category Approach

4.1 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?

We believe the regulatory approach should be simple and easy to understand, as it is in other jurisdictions. The proposals as outlined are complex taking into account not just the category of credit unions but the nature, scale and complexity of activities that may prove to be subjective, if not quantified by the Bank. The proposals indicate ***a far more restrictive regulatory environment for the vast majority of credit unions***. Currently, less than 10% of credit unions would be eligible to apply to be reclassified as category 2 credit unions based the assets requirement of €100m.

The introduction of more than one category of credit union with different regulatory requirements and limits will necessitate a redesign of systems to accommodate parameters for multiple limits that are subject to change by the regulator and by credit union changing classifications.

4.2 New Systems Requirements

5.1 Summary of Proposals for each Category
New limits will apply for category 1 and category 2 credit unions in the areas listed. The provision of further additional services will have system implications but the main challenge continues to be regulatory approval.

5.2.1 Classes of Lending (NEW REQUIREMENT)
There are four new loan classes proposed to be tracked and reported on as concentration limits will apply.

5.2.2 Concentration Limits (NEW REQUIREMENT)
The concentration limits are new. What is the proposed record date for regulatory reserves (i.e. end of month, end of year)?

5.2.3 Maturity Limits (NEW REQUIREMENT)
Proposal for a maximum maturity of 15 years is new. The specific class of home loan to category 2 credit unions and the maximum maturity of 25 years is new.

5.2.4 Restricted Person Limits (NEW REQUIREMENT)
The proposal regarding aggregate lending limits to be applied to restricted persons is new and will involve each credit union having to produce family trees for officers. Each credit union could have literally hundreds of restricted persons to be flagged on their systems based on the definition of a member of the family:

> *'member of the family', in relation to any person, means that person's father, mother, grandfather, grandmother, father-in-law, mother-in-law, spouse or civil partner, cohabitant, son, daughter, grandson, granddaughter, brother, sister, half-brother, half-sister, uncle, aunt, nephew, niece, first cousin, step-son, step-daughter, step-brother, step-sister, son-in-law, daughter-inlaw, brother-in-law or sister-in-law;*

Currently, officers' savings and loans are reported as related party transactions in the financial accounts. The proposal could result in officers and their family members being treated less favourably that other members by being unable to borrow from the credit union (e.g. aggregate restricted persons limit). It may also act as a disincentive for individuals to volunteer as credit union directors.

5.2.5 Large Exposure Limits (NEW REQUIREMENT)

The large exposure limits are new. What is the proposed record date for regulatory reserves (i.e. end of month, end of year)?

5.2.6 Lending Practices and Policies (NEW REQUIREMENT)

New reporting requirements for lending to restricted persons.

5.4 Savings (NEW REQUIREMENT)

The proposal is to make savings **more restrictive** than currently is the situation, which is €200,000 or 1% of the total assets. The proposed maximum for savings is €100,000.

Also, what is to happen in the case of credit unions where members currently exceed the proposed limits?

5.11 Other Prudential Requirements (NEW REQUIREMENT)

Additional requirements in relation to the frequency and operation of business continuity testing for category 2 credit unions are new. Bank expectations in relation to business continuity and outsourcing requirements for both categories of credit union should be clarified.

5. Additional Services

5.1 Are there any areas where credit unions could provide new additional services to their members?

YES. There are many areas where credit unions would like to provide additional services to their members. Some of these services are best provided on a shared basis and this was recognised by the Commission on Credit Unions.[9]

> *3.22 International experience shows that there is scope for improved collaboration and efficiency through shared services arrangements and the Commission recommends that these should be facilitated in legislation for Irish credit unions.*

Meaningful participation by the credit union sector in the National Payments Plan[10], requires credit unions to share infrastructure and provide access to non-members (i.e. members of other credit unions and bank customers). Reciprocity and sharing are the basis of many payment services and have been a feature of credit union ATM services since 1996. The 1997 Act and the 2012 Act failed to recognise this.

In order for credit unions to adopt a new business model and compete, they have to be able to offer services to members on a collective basis. This requires further changes to legislation to recognise what already exists and to provide a development path for the sector.

5.2 Feedback to the Commission on Credit Unions

In order to inform its work, the Commission on Credit Unions undertook a survey of credit unions. The survey questionnaire highlighted the desire for new products and services.[11]

> *4.7.3 The questionnaire asked that respondents identify, to a maximum of four, new products and services which it is now important that the credit union provides to members. The question was open-ended in that respondents were not asked to choose from a prescribed range of products and services. This information is collated in Table 8 by asset category. Five product/service lines prove to be important to a substantive number of credit unions – debit/laser cards 62 (40.5%) of credit unions; online banking/online services 56 (36.6%) of credit unions; EFT 45 (29.4%) of credit unions; ATMs 33 (21.6%) of credit unions; and insurance products and services 26 (17.0%). Many of these services, for example EFT, are already on offer by some credit unions but it is clear that there exists a latent demand by many others to enhance their existing product and service range. For larger credit unions (assets greater than €60m) technology based services (debit/laser cards and online banking/online services) are the key product demands. For credit unions with assets between €20m and €60m the new product requirements are online banking/online services, debit/laser cards and EFT, while for those with assets less than €20m it is online banking/online services, ATMs and EFT[12].*

The Commission expressed the view that new services should be provided on a regional or local basis rather than through centralised units.

[9] Report of the Commission on Credit Unions, March 2012 pvii
[10] National Payments Plan – A Strategic Direction for Payments, April 2013
[11] Report of the Commission on Credit Unions, March 2012, p.43 Table 8.
[12] Report of the Commission on Credit Unions, March 2012, p.42.

4.13 Shared services are viewed to be a critical element in the future development of credit unions, with sharing thought to be more appropriate on a regional or local basis rather than through centralised unit(s)[13].

7.11.4 Given the lack of appetite amongst credit unions for sharing of services on a centralised basis, regional alliances or CUSOs may be the more appropriate mechanisms for facilitating the sharing of services between credit unions in Ireland [14]

The Commission on Credit Unions recommended that CUs fully utilise existing systems to automate payments and expand delivery channels. It also recognised that modern technology is already in place to support the businesses of the vast majority of CUs.

7.12.8 RECOMMENDATIONS ON INFORMATION AND COMMUNICATIONS TECHNOLOGY[15] The ICT needs of credit unions are being driven by changing consumer preferences and increasing regulatory requirements in terms of systems and controls. Credit unions need to gain greater benefits from their investments in ICT by fully utilising existing systems to automate payments and expand the delivery channels and services available to members. Modern technology is already in place to support the businesses of the vast majority of credit unions, whether individually, in groups or collectively. Greater use of existing systems' features and an increase in electronic funds transfers could reduce costs and improve services. In particular, credit unions need to look at online banking and credit checking, become direct debit originators and opt for access to clearing where payments accounts are part of their business strategy.

5.3 Exempted Additional Services

Those services currently exempted from requiring the express approval of the Central Bank before a credit union may offer the service are:

- Telephone, internet and fax access to the credit union by the member
- Third party payments
- Automated teller machine services (ATMs)
- Discount for goods and services
- Budget account scheme
- Bill payment services
- Euro drafts and bureau de change
- Money transfers
- Money Advice and Budgeting Service (MABS)
- Service centres
- Draws
- Standing orders
- Direct debits
- Financial counselling
- Will making
- Gift cheques
- Electricity budget meter cards or tokens, and
- Savings Stamps

and on an agency basis:

- Insurance services
- Group health insurance schemes and
- Personal Retirement Savings Accounts (PRSAs)

[13] Report of the Commission on Credit Unions, March 2012, p.52
[14] Report of the Commission on Credit Unions, March 2012, p.90
[15] Report of the Commission on Credit Unions, March 2012, p.92

The following modern variations on existing exempted services should be included as exempted service or prescribed by the Bank:

▪ Money management accounts	(where funds are available for withdrawal and not considered a liability or attached savings)
▪ Acceptance of debit cards	(as a method of making an EFT payment to a credit union account including cashback which is the equivalent of a member presenting a cheque that exceeds the value of a lodgement)
▪ Debit cards	(which are used at ATMs, at Points of Sale and online and are indistinguishable from ATM cards. In 2013, there were more than 4.3m active debit cards in circulation in the State[16])
▪ Prepaid debit cards	(the Travel Money Card which is an exempted service in S.I. 223 of 2004 is a prepaid debit card. Uses of prepaid debit cards for other purposes should be exempt).
▪ Mobile services	Covered by the fact that telephone and internet access is exempted: mobile services were probably not envisaged at the time but utilise telephony and internet technologies to provide account access, e.g. mobile wallet

ATM services have evolved into debit card services that fulfil the definition in the list of exempted services [17]

> *"that is to say a service which enables a credit union member to withdraw funds from his or her credit union account by means of a credit union branded ATM card"*

S.I. No 223 of 2004 (Exemption from Additional Services Requirements) Regulations 2004 recognised ATM services as an extant service in credit unions. It also included third party EFT payments **to** credit union accounts. This was amended by S.I. No 838 of 2007[18] to allow for payment **from** credit union accounts prior to credit unions joining BNPP. The definitions of ATM and Debit Cards have been inseparable since Laser (now discontinued) was first introduced in 1996. Cards are now simply designated debit cards or credit cards.

5.4 Third Party Payments

S.I. 838 of 2007 amended Paragraph 2 of S.I. 224 of 2004 as follows.

> *"2. Third Party Payments,*
> *that is to say any service whereby a credit union member may arrange to have transferred to* ***or from*** *his or her account third party payments by way of electronic funds transfer or otherwise."*

A general point is that EFT payments do not just consist of third party payments. Members also receive payments from and make payments to their own accounts at other institutions, including banks and other credit unions.

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[16] IPSO – Review of Irish Payments 2013, March 2014
[17] S.I. No 223 of 2004 – Credit Union Act 1997 (Exemption from Additional Services Requirements) Regulations 2004
[18] S.I. No 838 of 2007 (Exemption from Additional Services Requirements) Regulations 2007

5.5 Amendments to Legislation

The Commission on Credit Unions recognised the need for legislation to facilitate shared services.

> *3.22 International experience shows that there is scope for improved collaboration and efficiency through shared services arrangements and the Commission recommends that these should be facilitated in legislation for Irish credit unions.* [19]
>
> *7.11.2 As set out in Chapter 6, services may be shared in a number of ways including the establishment of central credit unions, corporate credit unions, Credit Union Services Organisations (CUSOs), or local alliances.* [20].
>
> *7.11.7 While sharing services is to be encouraged as a mechanism for increasing economies of scale and promoting cooperation between credit unions, this should not expose the credit union to undue risk. The Commission recommends that the establishment of shared service arrangements should be facilitated, by legislation where necessary.* [21]

Current legislation does not provide for these structures in the context of credit unions providing services collectively to their members, as opposed to shared services for back-office support functions.

Section 6 – Conditions for Registration

Section 6 of the Credit Union Act 1997 covers the conditions, objects and common bond of a credit union. The objects of credit unions refer to ***"its members"*** and services for ***"their mutual benefit"***. There are no objects allowing the provision of services to non-members (i.e. members of other credit unions or customers of other financial institutions).

Card / EFT networks require economies of scale and operate on the basis of sharing / reciprocity arrangements. Credit unions have been providing ATM services to one another and bank customers since 1996. They have been Associate Members of the clearing system since 2007. It can be argued that sharing / reciprocity arrangements with other credit unions and banks is for the mutual benefit of its members in that sharing / reciprocity arrangements may be a prerequisite for network participation and is essential to generate interchange income from acquired transactions, as a means of offsetting costs.

There is also a limited demand for branch sharing arrangements between credit unions, which would also be covered by Section 6 of the Act.

Amendments to legislation are required:

1. To allow for the establishment of a variety of regulated structures to oversee and provide services that are consistent with the objects of credit unions.
2. To allow for the expansion of the objects of credit unions to cover services to members of other credit unions and customers of other financial institutions where such services are for the mutual benefit of its members.

In both cases, the approval of the Central Bank of Ireland would be required.

[19] Report of the Commission on Credit Unions, March 2012 p.vii
[20] Report of the Commission on Credit Unions, March 2012, 7.11.2 p.90
[21] Report of the Commission on Credit Unions, March 2012, 7.11.2 p.90

Section 49 – Approval of New Services

The current process of approving new services places credit unions at a competitive disadvantage compared with the relatively unrestricted decision making of their main competitors.

> *7.10.4 Notwithstanding that the legislation is intended to clear the way for individual credit unions to offer a wide range of services to their members, credit unions find the current procedure for approval of new additional services as slow and cumbersome. Some suggest that the requirement for a general meeting moves the decision-making away from the board and that it denies credit unions the ability to respond quickly in meeting new members' needs.* [22]

Removing the requirement for a decision at AGM is welcome. However, the approval process is excessively lengthy, at up to four to eight months depending on whether the credit union intends to provide the services as agent or principal. It is also unclear what constitutes a new service (e.g. acceptance of payments from bank debit cards, online account access, mobile apps). New payment methods to and from existing account types are sometimes classed as "additional services". The debit card service is a case in point. The requirement to seek approval for new services and lengthy delays to approvals is having an adverse impact on development and innovation in the sector.

[22] Report of the Commission on Credit Unions, March 2012, 7.10.4 p88

6. Provisioning Framework

6.1 Do you agree that a provisioning framework should be developed for credit unions as proposed in section 6.2?

The Guidance Note on Credit and Credit Control for Credit Unions (October 2007) and the Section 35 Requirements for Credit Unions (October 2013) have in many case been superseded by inspection reports and Bank initiated reviews that put forward other methods of calculating provisions (e.g. roll rate methodology).

Systems suppliers would welcome clarity, certainty and a simplified approach in relation to provision calculations. This works well in other jurisdictions.

7. Timelines

7.1 Do you agree that the tiered regulatory approach should be introduced at this time?

Credit Unions are going through major changes in implementing new legislation and a new regulatory framework, while addressing significant business challenges. Experienced officers are being required to step aside and the capacity of volunteer boards of directors to absorb changes is limited. Overload and inexperience are significant risks. A period of consolidation is required before the tiered regulatory approach is adopted. It could also be argued that restructuring should be allowed to happen before the new approach is introduced.

7.2 Do you agree with the proposed timelines for the introduction of the tiered regulatory approach set out in section 7.1?

The timelines show a period of six months between the publication of regulations and their coming into force. CP76 points to major system changes. The regulations need to be specified and fully understood before system changes can be programmed, tested and rolled out.

The Central Bank will have to take responsibility for specifying requirements and liaising with systems suppliers to answer questions and ensure changes are consistently applied. The Bank will also have to specify the content and format of regulatory reports, as these may have an impact on data capture and retention. The lessons learned from the implementation of the Section 35 Requirements should inform the approach.