Registry of Credit Unions

Central Bank of Ireland

PO Box 559

Dame Street

Dublin 2.

28th March 2014

CP76 - Introduction of a Tiered Regulatory Approach for Credit Unions

Dear Registrar,

St. Patrick's Credit Union (ESB Staff) Ltd (SPCU) is a national industrial credit union whose common bond (membership) is derived from current and retired employees of ESB and its wholly owned subsidiary companies. The Credit Union's assets at 30th September 2013 amounted to €301.6 million and it services the needs of 11,300 members. The Credit Union was established in 1962 and has been affiliated to the Irish League of Credit Unions since inception.

Over-arching View:

At the outset, we wish to state that the introduction of a Tiered Regulatory Approach for Credit Unions is to be broadly welcomed. It helps to address the limitations of "one-size fits all" approach to regulation and it also provides a framework to facilitate credit unions that are at varying stages of maturity.

On initial reflection, the 2-Tier approach as outlined certainly appears to be a 'cleaner' and less arbitrary approach than the 3-Type model outlined in the Commission Report. The approach appears supportive of a well-structured, well-defined CU Sector, placing more 'structure' on individual Credit Unions whilst allowing 'larger' more-ambitious credit unions to grow. The approach also appears to support or perhaps even drive consolidation within the sector which, if done properly and when seen through the prism of a robust credit union sector in the future, is to be welcomed.

Notwithstanding this, there are a number of specific areas that we have concerns about and in this submission we will address each area in the order outlined in the consultation paper.

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Regulated by the Central Bank of Ireland

Executive Summary:

St. Patrick's Credit Union (ESB Staff) Ltd (SPCU) are broadly in support of tiered regulatory approach. We do however have concerns around specific items outlined in the consultation paper, namely:

- Maturity Limits (for lending) as proposed are not sufficient to support a well-developed category 2 credit union
- Investment decision-making:
  - Flexibility is required around any future guidelines and should be broad enough to allow credit unions, with the competence and appropriate risk management systems to make sound investment decisions, the capacity to do so across a wider range of investments than is currently the case
  - Given the size, seriousness and reliance of investments in the sector, SPCU contend that an 'expert group' be established to address this element
- Proposed restrictions around savings limits (eg 100k max) have the potential to introduce considerable competitive distortion in the market. Existing limits should remain in place.
- Governance proposals are to be welcomed in principle but the sector should consider following developments and identifying best practice in the wider commercial world and in line with the Companies Act
- Operational risk reserve: Proposal around how it may be implemented is vague and the suggested percentage levels are onerous
- Liquidity proposals will limit credit unions ability to create income from investments
- Provisioning approach as outlined appears reasonable and in line with strong practice
- Timeframe appears reasonable

From a broad perspective, SPCU suggest that it be considered that an 'expert group' be established not only to address the investment element of regulation but with a view to achieving an acceptable, functioning 'fit-for-purpose' regulatory framework that is proportionate and based upon the nature, scale and complexity of the credit unions concerned and will support the establishment of business model that establishes a vibrant and viable sector in the future (note: an investment expert group may be a 'sub-set' of a broader sectoral expert group).

Section 4:

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.

SPCU believes that a two-tiered approach as outlined at a high-level appears to be reasonable. However, there are a number of individual suggestions in the paper that either cause concern or need further clarification before a final determination is made.

Section 5:

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.

SPCU's response is to go through the specific sub-sections in Section 5 and feedback on those areas that require comment accordingly:

Section 5.2 Lending:

Section 5.2.3 Maturity Limits (for lending)

For category 2 credit unions, the longer term lending limits in section 35(2) will apply (i.e. up to 40% of the loan book can be outstanding for more than five years and up to 15% of the loan book can be outstanding for more than 10 years).

In the consultation paper, under section 5.2,(pg 22) it states that *"lending limits will be related to reserves"*. However, section 5.2.3. outlines maturity limits that are currently in existence and bear no relation to reserves. Any extension of maturity limits is to be welcomed but the proposal to only apply lending maturity limits that are already in existence for future Category 2 Credit Unions is insufficient.

Furthermore, it is generally known that the lending profile of more mature credit union models reflects that the large majority of their lending portfolio is for mortgages (eg. over 70% in Canada). If, as suggested in the consultation paper, only 15% of the loan book can be outstanding for more than 10 years, this is not reflective of a more mature model. Nor does it address and support the type of borrowing that is most in demand in the Irish market-place. Therefore, considering that the proposal makes no provisions for amendments to maturity limits this could result in a competitive constraint on growth in a credit union's loan book.

The Consultation paper outlines that credit unions may "*be permitted to provide a specific class of home loan to members within the lending limits, including the maturity limits*" (pg. 24) and goes on to indicate the potential for offering 25-year home loans (within set criteria). However, by restricting the lending and maturity limits to existing limits, such a product offering, whilst very welcome and potentially providing some opportunity to improve the loans-to-asset ratios across both individual credit unions and the sector as a whole, it is unlikely to be sufficient to either address the issue fully or address members' demand.

To take a basic case, applying the suggested regulatory framework limits, a credit union with a 50m loan book, could offer a mere 25 mortgages of 250k at which point it would have reached its longer-term (10 years+) limit. No financial institution could launch such a product with such restrictions.

Therefore SPCU believes that the proposed amendments to limits will not:

- sufficiently address the current imbalance in the sectors' loan to asset ratio
- support a truly viable 'credit' model for the credit union sector,
- address the current needs and demands of the members.

The thrust of issuing home loans is very much to be welcomed, indeed, SPCU contend that it is needed. The criteria and the business model itself need to be examined first however before unrealistic limits are set in any regulatory framework.

Section 5.3 Investments:

Currently, SPCU holds the largest investment portfolio in the sector (c.0.25bn). Given the ratio of investment to loan income as a result of this, we would suggest that more flexibility and options around allowable investment instruments should be provided to Credit Unions with larger portfolios (potential Category 2s). Flexibility on investment and portfolio decisions can be managed by individual credit unions having more sophisticated risk management structures in place and obtaining independent advisory services from providers who do not sell product and whom the Central Bank of Ireland (CBI) can sign-off as 'fit and proper' to deliver such advices.

With decision-making fully documented and robust risk management structures in place, the CBI can be confident that decisions are being made from both a safety of member funds and business perspectives.

It is crucial that any regulatory framework around investments should provide the appropriate scope and flexibility for individual credit unions and their Boards to manage investments in a manner conducive to achieving the credit union's investment objectives. The credit union should be able to select and approve appropriate asset classes, determine an asset allocation with relevant limits, and establish investment constraints on matters such as maturity profile and counterparty exposure, all of which can be outlined in their investment policy.

SPCU have been doing this for some time and within the guidelines. However, given the current market of lower yields on authorised asset classes and investments and the nature of the sector's balance sheet, it is imperative that new guidelines provide (a) the requisite flexibility around the allowable investments that Category 2 credit unions are capable of managing and (b) the ability for category 1 credit unions to obtain acceptable returns, within appropriate risk tolerances, that underpin their viability.

Further, establishing Category 2 credit unions as centres of investment expertise would also facilitate the potential for future shared services or 'hub' models which will support industry restructuring and provide greater efficiencies across the sector.

SPCU contend that the investment element of the new regulatory framework is so crucial that it warrants the CBI to establish an 'expert group' to address this element not just in the context of the maximisation of investment returns within acceptable risk tolerance, but in the context of the viability and future of individual credit unions and the sector as a whole.

The current practice is for the CBI to issue 'Guidelines' around investments. This implies that investment decisions can be made *outside the guidelines*, assuming a Credit Union has taken appropriate advice and the Directors are 'comfortable' with the decisions being taken.

Clarification is required as to whether it is new *guidelines* that will be issued or whether the CBI is being more prescriptive over the allowable investment decisions.

For category 1 credit unions, it is contended that the narrower constraints on allowable investments has the potential to push the decision-making towards the acquisition of 'product'-type investments. In the light of previous experience within the sector, such a dynamic is not to be welcomed.

In summary, SPCU believe that flexibility is required around investment decision-making and that any future guidelines must be broad enough to allow credit unions with the competence to make sound investment decisions the capacity to do so across a wider range of investments than is currently the case. This will allow credit unions to maximise the return on investments, which is crucial to return on assets, whilst still protecting members' savings.

To achieve an outcome that is likely to be acceptable to all parties within the sector, **SPCU recommend that an 'expert group' be established to propose an investment guideline framework** that will work within the parameters of the final tiered regulatory framework and supports and underpins credit union viability in the future.

Section 5.4 Savings:

Savings:

It is stated that Category 2 Credit Unions will be able to offer savings up to €100,000, with category 1 capability at the lower of €100,000 or 1% of the credit union's assets. Currently, the limits for aggregated shares and deposits are €200,000 or one per cent of the total assets of the credit union. While clarification is required as to the specific definition of 'savings' in this proposal, if we assume it is the maximum amount per member (eg. total value of shares and deposits), this is likely to have significant implications on the current member balances for a number of larger credit unions including SPCU.

There are two other key points that need to be stated around 'savings' and the imposition of any limits:

Firstly, whilst practically all credit unions would like to increase the size of their loans books, the current demand in the economy, and therefore amongst credit union members, is predominantly for saving rather than borrowing. It is a matter of record that members trust their credit union in a way they do not trust banks. As we have witnessed, the members' desire is to deposit their funds with their credit union – not with other financial institutions. If members wish to save rather than borrow, each credit union should service that need insofar as possible and without restriction on the amount the member wishes to place in the credit union – after all, one of the Credit Union Operation Principles is ***"to encourage thrift through savings"***.

Secondly, the proposed restrictions around savings, in our opinion, have the potential to introduce considerable competitive distortion in the market. The potential restrictions proposed in this paper, even for category 2 credit unions, could result in funds being diverted away from the credit union sector towards other financial institutions. And if the investment amendments as suggested in the consultation paper are implemented, this will potentially result in a flight of capital from Irish to overseas institutions. Considering the potential impact of this unintended consequence, we propose that the existing limits remain in place.

Section 5.7 Governance:

Under section 5.7.2 Additional Governance Requirements (pg 30) there is a proposal around 'dedicated' functions/officers. Although 'dedicated' is explained as 'referring' to an in-house resource, further clarification is required as to what is ruled either in or out as an acceptable solution. As a general consideration, SPCU reflected on whether the example is consistent with the principles of proportionate regulation in the CU sector and on balance we believe that the CBI is at risk of becoming overly prescriptive and/or intrusive in the day-to-day operational affairs of credit unions.

In principle, we welcome the proposal to have 'an external review of the board every three years'. However, we would be concerned around the role of the Board Oversight Committee if such proposals come into being and would seek information as to how the Central Bank see the role of the Board Oversight Committee developing if such proposals come to fruition.

Secondly, we are mindful of the lack of expertise across the broader business community in assessing Board performance particularly as evidenced in recent times across a number of public bodies. Therefore, we are strongly of the opinion that any such review(s) will need to add real value to the operation of the Credit Union and the sector as a whole otherwise it is a requirement without benefit.

Accordingly, we would suggest that as this whole area is only in its infancy in the wider commercial world (governed by the Companies Acts), the sector should consider following developments and identifying best practice rather than re-inventing the wheel with a bespoke and potentially more onerous solution for a voluntary, not-for-profit sector like the CU sector.

Section 5.9 Reserves

"Consideration will be given to a risk weighted approach for Credit Unions following restructuring of the sector".

This is an extremely broad statement which is not elaborated on in any meaningful way in the consultation paper. We would suggest that this area be extremely well investigated for both the follow-up consultation paper and Regulatory Impact Analysis (RIA) with a granular impact analysis conducted of any proposal under this heading.

5.9.2: Operational Risk Reserve

"Consideration will be given as to whether this will be based on:

- The Basel Basic Indicator Approach adapted for Credit Unions; or
- An additional specified percentage of assets, eg. 2%. (pg. 31, Consultation Paper)

The suggested proposal around how any operational risk reserve be calculated is vague in the detail on how it would be applied. In the Basel paper as referenced by the consultation paper, there is no "basic indicator approach *adapted for credit unions*". Therefore, if such an approach is to be adopted, this suggests that the CBI/Registrar will be adapting it for the credit union model.

If the secondary approach (percentage of assets) is adopted, under what criteria will the percentage be calculated? The suggested 2% appears arbitrary. It is also punitive from a Balance Sheet perspective.

Any approach to an operational risk reserve requirement will need to be thoroughly investigated and justified before implementation. It is difficult to form a view until the appropriate level of detail has been provided but the amount suggested (2% of assets) is punitive and appears excessive.

Again, a detailed consultation and impact analysis will need to be conducted before supporting any such approach.

Section 5.10 Liquidity

The proposals around liquidity requirements (eg, definition extended; unattached savings limits, etc) are more restrictive and will limit credit unions ability to create income from investments. Economically, we are currently at a low-point in the credit-cycle. This means that demand for lending is low whilst members continue to save with institutions they trust.

In a recent speech delivered to the CUDA conference (Jan 2014), the Registrar stated:

"...that more broadly credit unions need to consider both the current level of operational costs and income generation (irrespective of source) and the resulting implications for their business model. This goes to the very heart of viability and sustainability. Credit unions should be alive to these issues as they consider their strategic and business planning".

It is imperative that income generation, *irrespective of source,* is not unnecessarily limited or restricted by rules (or guidelines that have the effect of rules), that impose competitive constraints as set out by the Regulator.

The proposals around liquidity will narrow the ability to generate income around investments. Given the challenge to the viability of individual credit unions and the sector as a whole, this needs to be forensically analysed in the RIA before finalisation. A competitive analysis should also be conducted.

5.12 The Central Bank is seeking views on the following:

(i) 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.

Broadly, a two category approach appears reasonable. However, the specific items as outlined in this submission are areas for concern.

(ii) Are there any areas where credit unions could provide new additional 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.

None at this time outside of those highlighted in the consultation paper.

Section 6: Provisioning

6.3 The Central Bank is seeking views on the following:

(i) 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.

Broadly, the provisioning approach as outlined appears reasonable. As with much of the consultation paper, it is only when we see the deeper detail, will we be able to provide really informed feedback.

Section 7: Timelines for the Introduction of the Tiered Regulatory Approach

7.2 The Central Bank is seeking views on the following:

(i) 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.

Timeframe appears reasonable.

(ii) 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.

As outlined above, SPCU would like to see an expert group established to help shape a more detailed and appropriate regulatory framework that will underpin the future vibrancy and viability of the sector. Assuming that one can be established and deliver on its findings within the timeframe set out, then we are in agreement with it. We do however believe that an appropriate timescale be allowed for such a group to deliver on its remit. If this requires some extra time (say an extra three months), that would be acceptable to achieve the correct outcome.

Some Final Thoughts:

When considering a regulatory framework for the credit union sector, the following are key questions:

- What is the credit union business model?
- Are Credit Unions competing with banks or money-lenders?
- Or somewhere in between?
- And are they being regulated accordingly?

The Credit Union model was established for those who could not access credit elsewhere. It is not a 'return on equity' model - it is a social – lending model. The continuous regulations being introduced are questionable in terms of their proportionality and appropriateness to the model. There is no doubt that the increased regulation and restrictions in ability to practice that such regulation enforces, will lead to a diminution in the ability of credit unions to service their members in an appropriate fashion.

At this point, as has been recognised by the Registrar, there is insufficient demand to keep the CU sector operating at or close to full capacity. From an economic perspective, policymakers have not and are not making the decisions that indicate a commitment to 'structural increases' in demand. Many individual credit unions have an ageing membership that demands either some form of re-structure of the model (of which there is support for currently) or a re-evaluation of the type of services required to serve the current membership demographic (for which the traditional credit union model is not ideal). This latter point will mean a shift in mind-set and expectations for all parties – members, credit unions and the regulator – and the sector has a way to go to achieve this.

The existing weak growth in the economy reflects the decisions, by households and firms, to economize on their expenditure in the aftermath of the bust. Concurrently, the government has been cutting budgets, increasing taxes (be they direct or indirect) and not replacing staff, all of which equals no stimulation for growth. The ECB's approach (continuance of low interest rates; support funding for banks, etc) should have helped on the consumer sentiment side (as low interest rates should equate to higher demand) but these efforts have not been enough to offset the steep decline in demand as evidenced in the credit union sector's declining loan book.

It has been mooted that weak growth is perhaps a secular (i.e., permanent) phenomenon rather than a cyclical one with commentators suggesting that even if the economy accelerates, this provides no assurance that it is capable of sustained growth at normal interest rates. Although credit unions set their own loan interest rate insofar as possible (although again within the constraints of 1% per month

max), the idea of an economy with sustained growth at normal interest rates would lift demand for credit union lending products. However, the reality is that there are a number of factors that are likely to continue to restrict the economy, namely, slow growth in the labour force, slow productivity growth, a rise in risk aversion, higher costs for financial services, and low rates of growth in consumer spending. As our friend on the ad might say, "*Welcome to the new normal*".

These have major implications for the Credit Union model in Ireland. The question is, "does the tiered regulation provide sufficient opportunity to counteract much of the impact of these challenges?" If not, is it an opportunity lost?

Conclusion

SPCU broadly welcomes the consultation process by the Central Bank in relation to introducing a tiered regulatory approach and developing the investment framework for credit unions. As outlined in our submission, whilst welcoming the approach, we do however have reservations about the specifics of the proposals and we are concerned that they do not strike the correct balance between regulation and viability.

We believe there needs to be more meaningful engagement with expert parties (along the lines of what we briefly set out above) to address all facets of the proposal for tiered regulation to ensure that any regulatory changes underpin the sector's viability. In the spirit of the sector's co-operative principles, it is time for the sector, the regulator and relevant experts to provide the appropriate knowledge and insight, and to co-operate and collaborate to achieve a functioning 'fit-for-purpose' regulatory framework that is proportionate and based upon the nature, scale and complexity of the credit unions concerned.

We would be obliged if these points are given due consideration by the Central Bank.

Yours sincerely,

Robert Cooper,
CEO.