



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Business Model Strategy: Guidance for Credit Unions

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1. Introduction and Regulatory Context

Introduction

The traditional business models of all financial institutions are being challenged by changing consumer expectations, as consumers increasingly expect choice, ease of access along with efficient speedy decisions and service fulfilment across all delivery channels. Meeting these expectations requires business model and operational change, enhanced capabilities, new processes and investment in enabling technologies. The scale of investment and resources required to implement necessary change can be significant.

While business model challenges are affecting all financial service providers, credit unions are particularly affected due to their lack of scale, common bond profile, member demographics, as well as financial and operational capability. Their core savings and loan business model has remained largely unchanged for decades, and accordingly most credit unions have limited experience of material change implementation.

Regulatory Context and Purpose of this Guidance

The legal framework governing credit unions and their business model is set out in credit union legislation and regulations. This framework provides for a range of business activities, associated prudential limits and requirements covering lending, savings, investments and permitted additional services. Therefore, credit unions operate within a defined geographical, associational or industrial common bond and offer savings, loans and additional services to their members. In effect, the framework sets the boundaries in which business models and strategies are formulated, implemented, governed and managed by credit unions.

Where credit unions plan to expand their activities, for example offering additional products and services, they are expected to demonstrate the capability and capacity to prudently develop, implement, govern and manage the activities. Should the Central Bank (the Bank) consider a new additional service to be in the members, credit union and public interest, then it may approve and thus permit a credit union to offer the additional service. The Bank's functions in this regard are set out in Appendix 1.

It is important therefore that credit unions demonstrate sound and prudent risk focussed strategy formulation, business planning and implementation. Critical to this, is a forward looking orientation and rigorous consideration of business model sustainability and enabling strategy. Boards and Management are expected to have a clearly defined and articulated business model strategy through which they prudently plan for and implement changes to their business model. Board and Management ownership of strategy and its implementation is crucial, as is a risk-focussed approach to employing the resources and developing the capability and capacity needed to safely and soundly manage risks inherent in business model strategies, particularly in expanding the scope and depth of existing and new business activities.

This guidance has been informed by the Bank's supervisory experience in assessing credit union business model strategy risk and strategic plans. The Bank has noted weaknesses in Boards and Management strategic orientation, thinking, formulation of strategies and plans and in their implementation. Furthermore, a lack of inter-credit union coherence in defining business model strategy and appreciation of business model risks is also

notable. Unstructured business model development and incoherent strategies are unlikely to realise business model sustainability at individual credit union level or sectoral level. Credit unions collectively need to implement coherent business model strategies to ensure business model sustainability is achieved. In this respect, they need to collaborate in addressing business model strategy along with defining and implementing plans to affect necessary changes.

The overall purpose of this guidance, in line with the Bank's regulatory and supervisory mandate¹, is to address the structured, risk-focused formulation and implementation of business model strategy by credit unions. Consequently, this guidance sets out:

- A structured business model strategy risk assessment framework identifying ten key risk areas along with associated risk considerations credit unions should address when formulating and implementing business model strategy; and
- The Bank's supervisory expectations of credit unions, which it expects credit unions to factor into their formulation and implementation of their business model strategy.

It is the Bank's intention that this guidance should be used by credit unions to support the formulation and effective implementation of their business model strategy and to support their development of sound business practice in risk based strategic decision-making, governance and management. Accordingly, the risk assessment framework and risk considerations forms part of the Bank's PRISM risk assessment model and supervisors will address and assess how credit unions are meeting its supervisory expectations.

This guidance does not seek to propose a particular business model – it is a matter for credit unions to determine their desired business model and enabling strategies, commensurate with their risk capacity and appetite, operational capabilities and financial capacity. The risk considerations and associated supervisory expectations set out in this guidance are not intended to be definitive guidance on the wide-ranging topic of business model strategy nor should they be interpreted as an exhaustive list.

As change may also involve inter-credit union collaboration through shared services and joint venture initiatives, this guidance addresses associated business model risks and sets out the Bank's expectations in respect of such collaboration.

This guidance uses a credit union 'Business Model Risk Assessment Framework' to address business model strategic risk. The framework, which has been adapted from the Business Model Canvas², is used to highlight risks and set out the Bank's expectations of credit unions in defining and implementing their business model strategy. The framework suggests a methodology for credit unions to consider when addressing risks inherent in business models and strategies to transform and develop them.

¹ 'Control and Supervision of Credit Unions by the Bank', Section 84 of the Credit Union Act, 1997

² A. Osterwalder. The Business Model Ontology: A proposition in a design science approach. PhD thesis, Université de Lausanne, 2004. <https://strategyzer.com/canvas/business-model-canvas>. Please also see Appendix 2.

This guidance also explains the Bank's 'Earned Flexibility' approach to the transformation and development by credit unions of their business models through additional services approval and explains the Bank's regulatory approval processes.

Business Model Risk – Supervisory Approach

Assessing business model risk is a core component of the Bank's PRISM supervisory approach. The Bank's supervisors assess a credit union's business model against the credit union's risk profile, and ability to plan for, successfully implement and deliver its business model strategy. Where necessary the Bank will require risk mitigation and contingency planning by credit unions where it believes they are incurring undue risk.

Under PRISM, the Bank's supervisors address and assess business model risks using the framework mentioned above and guidance set out in this document. This guidance informs credit unions of the nature of business model risks and what the Bank expects of credit unions when defining and implementing their business model strategies.

The Bank considers the nature, scale and complexity of each credit union, applying proportionality in its supervisory approach and assesses business model risk accordingly. In doing so, the Bank's supervisors will assess revenues, costs, financial planning and reserves (capital) management. The Bank's approach is to challenge the appropriateness of Board and Management plans to address their credit union's current and future sustainability. In cases where viability is a serious concern, supervisors will challenge credit unions on their service continuity intentions and contingency resolution planning.

Legal Basis

This paper does not constitute legal advice and any guidance provided should not be construed as legal advice or legal interpretation. Guidance does not constitute secondary legislation and credit unions must always refer directly to the Credit Union Act, 1997 (the 1997 Act), provisions of financial services legislation and other enactments, including regulations made thereunder, and any code or other legal instrument as the Bank may issue from time to time when ascertaining their statutory obligations. Guidance is not intended to be exhaustive or to set the limits for the steps to be taken to meet statutory obligations. It is a matter for credit unions to seek legal advice regarding the application of relevant legislation to their particular set of circumstances.

Structure of this Guidance

This guidance is structured as follows:

Section	Content
Section 1	Introduction.
Section 2	Considers credit union business model sustainability challenges.
Section 3	Considers the role of Boards of Directors, CEOs and management teams in defining and implementing business model strategy and sets out the Bank's *supervisory expectations in this regard.
Section 4	Describes the credit union Business Model Risk Assessment Framework, considers risks and sets out the Bank's *supervisory expectations of credit unions.
Section 5	Summary.
Appendix 1	Sets out the Bank's Approval Powers, Methodology and Processes.
Appendix 2	Explains the Bank's 'Business Model Strategy - Risk Assessment Model'.

*Supervisory expectation are set out under risk headings in blue boxes.

Terminology

In this guidance the following terms have these meanings;

Term	Meaning
Credit Unions	Boards of Directors, CEOs and management teams (unless individually differentiated).
CEO	Chief Executive Officer – the Manager of a Credit Union (S.63A of the 1997 Act).
Business Model	The logic used by credit unions to operate and create, deliver and capture value for members and the credit union.
Business model sustainability	Successfully responding to external change drivers and unforeseen risk events, while continuing to provide valued products and services to members today and into the future.
Business model strategy	The strategies and tactics used to implement the business model.
The Strategic Plan	The strategic plan documenting a credit union's business model strategy and objectives as defined in Section, 76A (1) of the 1997 Act.
Business plans	How strategies and tactics are to be implemented.
Financial plan	The expected revenues, operational costs and balance sheet structure.

Term	Meaning
Capital management	How capital will be accreted, and protected (buffer maintained).
Capital buffer	Reserves as % of total assets, in excess of the minimum reserve requirement.
ALM	Asset and Liability Management.
Risk management strategy	Aligning risk appetite, risk capacity and business model strategy.
Transformation	Building sustainable business models to deliver member propositions.
Propositions	The blend of products and services designed to deliver on the needs and expectations of groups of people (segments) who share the same needs and expectations.
Development	Expanding, enhancing propositions.
The 2016 regulations	S.I. No. 1/2016, Credit Union Act 1997, (Regulatory Requirements) Regulations 2016 (as amended).
The 1997 Act	Credit Union Act, 1997 (as amended).
Risk Appetite	The aggregate level and type of risk a credit union is willing to assume, within its risk capacity, in implementing its business model and achieving its strategic objectives.
Risk Capacity	The maximum level of risk a credit union is able to assume given its capital base, its risk management and control capabilities, and its regulatory framework.

2. Safe and Sound Business Model Transition

Current credit union financial sustainability metrics illustrate the main challenges facing the sector³. These challenges include delivering on members' changing expectations, competition from existing and new competitors along with addressing unsustainable operational costs and lack of scale and scope economies. Consequently, credit unions are currently faced with three significant sustainability challenges:

1. Improving revenues by growing loans and non-interest income;
2. Addressing operational effectiveness and efficiency – costs to serve; and
3. Enhancing capabilities to deliver on members' needs and expectations.

For many credit unions, successfully responding to these challenges will require major change, as they will need to change elements of their business models including product/service propositions, delivery channels, core processes and operational models. As new business lines are introduced, credit unions will need to assess associated regulatory frameworks and their ability and capacity to effectively meet governance, operational, compliance and risk management obligations. Consequently, business models, including consolidated multi-branch operations, are likely to become more complex, and accordingly, credit union risk profiles will change.

With many individual credit unions having limited resources, deciding where and how to compete is central to strategic thinking and decision-making. Credit unions need to be quite clear on what members' needs and expectations they are going to deliver on. A full-service business model may be a worthy long-term ambition, but it must be grounded in what can feasibly be delivered on over the short to medium term and reflect current business models and competitive marketplace dynamics.

As business model strategy may also impact balance sheet structures and risk profiles, credit unions will need to align their strategy with their risk appetite and risk management capabilities. It is similarly important to align strategy with well-grounded financial planning. Financial risk assessment and planning should project the effect of business model strategy on financial performance and should be stressed using plausible assumptions.

Given relative size, resource and operational constraints, many credit unions are looking to collaborate through shared services and strategic partnerships with third party service providers. The capacity to realise scale and scope economies and access specialist services, that would otherwise be unavailable or unduly expensive to an individual credit union, is considered a key benefit of a shared services approach. Properly structured and managed, such arrangements can result in economies of scale and enhanced operational effectiveness. In addition, they can provide scope economies through new products and services along with access to technical competence and risk management capabilities. Such collaborative arrangements have their own unique business model risk profiles, which credit unions will need to understand and factor into their own business model and risk management strategies. Shared services are discussed further in Section 4.7 'Partners, Outsourcing and Shared Services'.

³ Reference to the Central Bank six monthly publication, 'Financial Conditions of Credit Unions'.

3. The Role of Boards of Directors and CEOs

It is the responsibility of a credit union's Board of Directors ("Board") to define a vision for their credit union and set out the strategic plan that will deliver on that vision. Section 55 (1) (a) to (c) of the 1997 Act sets out a Board's responsibilities and functions when setting the strategic plan for the credit union, monitoring the implementation of the plan and reviewing it on at least an annual basis. Section 63A (4) (a) and (b) of the 1997 Act provides that the Chief Executive Officer (CEO) is tasked with preparing and proposing strategies for the strategic plan to the Board and with implementing strategies agreed by the Board to standards set out in the strategic plan or as otherwise required by the Board. Section 76A (2) of the 1997 Act sets out what must be included in the strategic plan. Credit unions should also be familiar with the guidance contained in the Credit Union Handbook in this regard.

Principles of sound strategic planning

Business model strategy needs to be grounded in an informed, rigorous assessment of business model and associated balance sheet and financial risk. Working towards a desired business model frequently includes developing propositions, expanding the range of products, services and delivery channels, enhancing operational capabilities, developing or acquiring new skills and redesigning processes. These plans typically cover marketing, operations, IT, finances, lending, savings (funding), risk and compliance. Together they form a credit union's Strategic Plan to implement the targeted business model.

Assessing where the business model is today, and where it ought to be tomorrow, should result in a business model strategy setting out goals, objectives and implementation plans with time-bound, measurable quantitative and qualitative outcomes. A structured and integrated approach to managing change is necessary for successful implementation. Assessing the current and future operational risk and balance sheet risk profiles should be undertaken with reference to the credit union's risk appetite and capacity. Credit unions need to be clear on the risks they are capable of assuming and their risk appetite and business model strategy should be aligned with one another. Credit unions should consider their risk capacity including the amount and type of risk they can prudently manage based on their risk management systems and internal control capabilities, financial and operational capacity and capital strength. Lack of clarity regarding risk appetite can result in excessive ambition or undue conservatism. Both present risks to business model sustainability.

Once agreed, business model strategy reflected in a strategic plan, should include Board oversight and performance review processes. Performance oversight, review and management implementation should be based on logical key performance indicators and measurable outcomes that allow CEOs and management teams progress to be assessed by their Boards and deviations from expected performance managed.

Sound governance, including assurance that a credit union is managing its risks, as well as effective systems of control, are an essential foundation underpinning individual credit union business model sustainability and sectoral financial stability and resilience. Successful delivery on business model strategy is fundamentally reliant on risk oversight and management functions operating effectively. Before engaging in significant changes to

their business model, credit unions should have developed and embedded governance, business management and risk management frameworks to levels commensurate to the scale and complexity of the business.

When formulating their business model strategy, credit unions should consider the scale and scope of change being considered and reflect on their ability to implement the change. Should viability pose a significant challenge, credit unions may have to consider strategies to ensure service continuity and effective resolution.

It is critically important that business model strategy, business plans, and financial planning are grounded on:

- realistic assumptions – which should be stressed for negative events; and
- rigorous assessment of the staff, operational and financial resources and the risk management capability needed to successfully implement the business model strategy

SUPERVISORY EXPECTATIONS

In terms of credit union business model strategy formulation and implementation, the Bank expects to see:

- Achievable goals and objectives grounded in fact-based analysis and assumptions underpinning expected revenues and costs and recognising cyclical factors;
- Assessment of implementation capabilities (financial, operational, staff resources and competencies);
- Clarity on how governance, functional structure and operational models will be aligned with business model strategy and business plan implementation;
- Alignment of business model strategy with the credit union's risk appetite;
- Objective assessment by risk and compliance functions of the risks associated with business model strategy and its implementation; and
- Effective Board oversight of strategy and associated business plan implementation, including risk assessment and where required effective risk mitigation.
- Where viability is a serious concern, credit unions should formulate contingency strategies to enable service continuity, including transfers of engagement and effective resolution.

4. Business Model Strategy - Risk Assessment Framework

A business model may be said to describe the logic used by credit unions to operate and create, deliver and capture value for members and the credit union. There are a number of methodologies that may be used to describe business models and to decide how a business model might be transformed and developed. They provide a logical framework for identifying the potential impact of changes to each component of the business model and help firms to appreciate the scale of changes needed to transform and develop their individual business models. Such methodologies help firms to identify key dependencies required for success and to analyse weaknesses and vulnerabilities, as well as strengths and opportunities.

Developing an enhanced and sustainable model, which builds on the strengths of the current model while supplementing it with new products and services is challenging. Successful implementation of business model strategy frequently requires significant investment in business process redesign, product and service development, delivery channels, and the operations, risk and compliance frameworks of a credit union. Formulating business model strategy requires a structured approach that reflects inherent risks, particularly where significant changes are to be made to the business model. Decisions to proceed with investment in new services and/or expansion into new ventures requires critical assessment of the costs and benefits as they apply to the credit union and its unique situation. The manner and pace at which the individual credit union intends to transition or adjust its business model should match its capacity to realistically deliver this transition.

Risk Assessment Framework

The business model risk assessment framework utilised by the Registry of Credit Unions (the Registry) is an adaption of the Business Model Canvas, which is described in Appendix 2. The Canvas is also utilised by many credit unions and by the 'CEO Forum on Business Model Development' as a basis for business model analysis. In addressing business model strategy and risk, ten interrelated components are considered as follows:

1. **Common Bond:** the differentiated groups of members to whom the business model is to deliver value.
2. **Member Relationships:** the ongoing relationship (physical and virtual interaction) established with members.
3. **Delivery Channels:** the routes for reaching new and existing members, for sales and ongoing relationships.
4. **Value Propositions, Products and Services:** the value delivered in terms of products/services and other attributes.
5. **Revenue Streams:** the new and recurring value being paid for products/services and other attributes.
6. **Key Activities and Key Resources:** Key Activities are the activities needed to deliver on value propositions, while key resources are the resources (physical, financial, staff, know-how, software etc.) needed to deliver on value propositions.
7. **Key Partners, Outsourcing and Shared Services** are the business partners, suppliers, collaborating entities in formal partnerships that are involved in the supply of products and/or services.
8. **Cost Analysis:** the costs of delivering value propositions.

9. **Financial planning:** the effect of business model change on financial performance.
10. **Balance sheet considerations:** the effect of business model change on the balance sheet.

The components above allow business model risks to be considered and associated risk expectations addressed. The following sections set out risk considerations under each of the headings above and also sets out the Bank's supervisory expectations of credit unions.

4.1 Common Bond

Common bonds vary depending on their type – community, associational or industrial. Community common bonds represent a small local economy having unique characteristics. Some may have growing populations, strong housing construction activity and vibrant commercial businesses whilst others may have aging, declining populations with limited commercial activity. Industrial/associational common bonds also differ with some having a growing, active membership and others a declining and inactive membership base.

The common bond has several attributes credit unions should take account of when considering their business model strategy:

- Demographics & Psychographics;
- Competitors propositions and activity;
- Local economic conditions; and
- General economic conditions.

Demographics & Psychographics

Common bonds represent a broad population of people having differing characteristics - needs, expectations and behaviours. These characteristics frequently differ between discernible groups or segments. Identifying what members' real needs are, what they expect, and how they want to relate to their credit union is fundamental to successfully designing and delivering on value propositions. While demographics explains 'who' the buyer is and 'what' needs and expectations they may have, psychographics explains 'why' they buy. Understanding both is needed to effectively reach a target audience.

Segments can have any combination of member attributes including those:

- having needs that require a distinct product/service offering;
- who are reached through different distribution channels;
- who want different types of relationships;
- having different income and wealth profiles; and
- willing to pay for different aspects of products/services.

For example, some people may value face-to-face contact and others value online access. Many people, influenced by new technologies, expect firms to provide digital services such as internet, mobile and social media services, servicing and fulfilment.

Segmentation risks arise when a product/service proposition no longer reflects people's needs, expectations and behaviours. A mismatch may result in ineffective servicing, reduced appeal, unsuitable products and reduced sales etc. that will ultimately negatively affect revenues.

While there may be a perception of demand, in reality this may not translate into expected sales and revenues. The product/service may not be viable as operational costs outweigh revenues. Risks occur with inaccurate or overly optimistic analysis of demand; when new sales and revenues are being projected; and when new products/services are being designed and delivered. Consequently, the product/service does not generate the revenues or its costs are such that it becomes a drain on credit union resources, with adverse financial outcomes.

From a business growth perspective, common bond population size is relevant e.g., some community common bonds may have a population of 3,000 while others may have 30,000 or more. Similarly, employment numbers define associational/industrial common bonds. The opportunities to offer products/services may be limited to quite small numbers of people, many of whom are inactive members, are not members and/or have no need for the offering.

Competitors

Common bonds also include competitors. They will have well developed segmentation strategies matched with product/service propositions, increasingly digitised delivery channels and targeted marketing programmes. New entrants, such as Fintech firms, may offer compelling innovative propositions. Their presence will affect people's perception of value and their expectations and behaviours. For example, many people now expect speedy fulfilment of loan applications and access to online and remote services, because these services are available to them from competitors. Frequently, dominant competitors establish the servicing standards for all firms. Should a credit union not be able to offer similar propositions then it may not be able to effectively meet members' expectations. It may have to reassess its value proposition and determine how it intends to position itself to offer its products and services.

Economic Conditions

Common bonds are exposed to general economic conditions and to unique local conditions. Failure to anticipate economic risks may negatively affect revenues, sustainability, and for some, viability. Should loan demand decline, margins will be eroded, as costs are frequently misaligned with volumes. This is particularly the case with small firms such as credit unions that have higher costs to serve and upward sloping fixed costs. Unique local conditions such as unemployment rates and work-force demographics may also expose the business model to risks.

Benign economic conditions can quickly change and negatively affect borrowers' repayment ability. Credit unions should be aware of cyclical risks and accordingly carefully assess their credit risk profile and capital management plans. Capital buffers, which may reflect benign economic conditions, need to be risk assessed in light of alternative scenarios.

SUPERVISORY EXPECTATIONS

When assessing common bond risk, the Bank expects credit unions to demonstrate:

- A developed understanding of members' demand, needs and expectations, grounded in objective analysis;
- Clarity on segmentation characteristics (differing needs and expectations);
- Propositions aligned to segmentation characteristics;
- Analysis of potential market and demand for existing and new products/services/propositions;
- Assessment of competitor's business model strategy and their propositions; and
- Assessment of local economic risks based on common bond type.
- Assessment of general economic conditions and cyclical trends.

4.2 Member Relationships

Member interface relates to the interaction between members and potential members and the credit union. Interactions may differ by product, proposition, by member segment and by member servicing needs and expectations. In many cases, this interaction is ongoing – for example branch face-to-face servicing, self-servicing using online banking, mobile banking apps and social media engagement channels.

Credit unions enjoy a strong and trusted brand⁴ and are recognised for their quality of member interaction. Trust based on the ability to deliver on members' expectations, is a critical success factor and if damaged can severely affect business performance.

Successful credit unions actively listen to their members and act on lessons learned by making changes to their business and operational models. They know what satisfies and what dissatisfies their members and continuously engage with them to assess and analyse their needs and expectations.

Risks occur when servicing and fulfilment falls short of members' expectations, and they decide to move elsewhere. Reputational risks arise with service failures, which over time may undermine brand value and may also arise if a credit union overpromises and under-delivers. Other risks also arise with servicing failures. These are difficult to quantify as frequently people do not complain and shop elsewhere. How a credit union responds to service failures and complaints may damage its reputation. Service failures can lead to significant financial costs as remediation may incur quite large costs. Regulatory enforcement action includes fines and media publicity that could undermine member confidence in their credit union and negatively affect business and financial performance

⁴ Credit unions identified as top Irish brand for customer experience for fourth consecutive year in 2018 <http://thecxcompany.com/wp-content/uploads/2017/06/CXi-Report-2018.pdf> and were also ranked number one out of 100 companies surveyed for the 2018 RepTrak® report as having the best public reputation with the public.

Consumer conduct

The Consumer Protection Code 2012 (CPC), the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) Minimum Competency Regulations 2017 (MCR) and Minimum Competency Code 2017 (MCC) currently apply to credit unions authorised as insurance intermediaries with respect to their insurance intermediary business. The MCC/MCR also apply to credit unions when providing mortgages. They do not apply to other regulated activities carried out by credit unions, for example, their core lending and term deposit business. The Central Bank has articulated its intention, following further consultation, to apply the MCC/MCR to credit unions for their core lending and term deposit business⁵.

The European Union (Consumer Mortgage Credit Agreements) Regulations 2016, which transpose Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (the Mortgage Credit Directive) into Irish law, apply to credit unions who are involved in the provision of mortgages to their members. These Regulations include requirements relating to:

- Financial education;
- Information and practices preliminary to the conclusion of the credit agreement - including conduct of business obligations when providing credit to consumers;
- Creditworthiness assessment; and
- Sound execution of credit agreements and related rights.

Consistent with the member centric ethos of Irish credit unions, it is the Bank's expectation that credit unions maintain a consumer focused approach when advancing credit and when dealing with borrowers in arrears, treat borrowers fairly and sympathetically, with the objective of assisting the borrower to meet their lending obligations.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions to have:

- A clear definition of servicing standards, performance indicators and how these will be monitored, reported on and addressed; and
- A responsive approach to material service failures and complaints.

⁵<https://www.centralbank.ie/docs/default-source/regulation/how-we-regulate/authorisation/minimum-competency/minimum-competency-code-2017-and-minimum-competency-regulations-2017.pdf?sfvrsn=12>

4.3 Delivery Channels

Delivery channels are the means by which a credit union delivers its propositions to its members and potential members. Communication, fulfilment, servicing and sales are a credit union's interface with its members.

Channels are used to:

1. Raise awareness of products/services and value propositions;
2. Help people search for and evaluate propositions;
3. Allow people to save, borrow and use other products and services; and
4. Provide servicing support, payment services and make service enquiries etc.

Channels include branch, over the counter, post, telephone, e-mail, internet (website and social media) and mobile (smart-phone/tablet) devices. They also include marketing channels such as advertising etc.

Delivery channels continue to evolve as technologies and digitisation radically change delivery processes and systems. In some cases, new entrants are disrupting traditional delivery models with new business models. Incumbents in turn are transforming their delivery channels by investing heavily in their IT systems, process re-engineering and developing their online, mobile and social media search, fulfilment and servicing platforms. The scale and pace of channel development is increasing. As upfront channel transformation and development costs are significant, credit unions need to give careful consideration to the resources, costs, operational complexity and risks involved in offering and operating a multi-channel delivery platform.

Risks arise when channels do not deliver on expectations, are ineffective and require substantial manual processing intervention. Poor design may lead to rising costs to serve and servicing failures. People's frustration with poor fulfilment and servicing causes them to go elsewhere, communicating their dissatisfaction to their friends/acquaintances and commenting on social media.

Risk factors also affect the effectiveness of delivery channels including;

1. Quality of implementation – people, processes and systems;
2. Matching changing behavioural patterns – customer search, access and servicing expectations; and
3. Competitor activity – their propositions and multichannel delivery effectiveness.

SUPERVISORY EXPECTATIONS

Given the operational and technical complexity in offering multiple delivery channels, the Bank expects credit unions to:

- Carefully assess their delivery channel approach;
- Analyse members servicing and fulfilment expectations; and
- Ensure their IT strategy reflects the technical abilities, outsourcing requirements, operational capacity, and the staffing and financial resources needed to design and deliver on required servicing and fulfilment channels.

4.4 Value Propositions, Products and Services

Value propositions are the blend of products and services designed to deliver on the needs and expectations of groups of people (segments) who share the same needs and expectations. Value propositions are key to competing, as they should leverage a firm's competitive difference – how it differentiates itself from its competitors.

Propositions have quantitative attributes - price, speed of service, distribution channels etc. They also have qualitative attributes such as design, member experience, brand, effectiveness and performance. As competing propositions are compared to one-another by consumers, typically higher value propositions lead to more sales and revenues, and low value propositions do not.

Risks arise when the products, services and/or channels are not valued or not used. Risks also arise where investments in new propositions do not realise the expected benefits and may damage customer relationships.

The more important proposition risk factors include:

1. Proposition design and marketing;
2. Fulfilment and servicing standards and quality;
3. Changing consumer expectations;
4. Pricing;
5. Existing and new competitor's propositions; and
6. General economic environment.

New products and services require careful design, positioning and significant expenditure on development and marketing. Credit unions come under the scope of the European Banking Authority ("EBA") Guidelines on product oversight and governance arrangements for retail banking products⁶, which provides specific guidance in this area. Retail banking products include mortgages, personal loans, deposits, payment accounts, payment services, and electronic money. Product/service development and management is an integral part of internal governance. Consumer protection and firm conduct are at the heart of product oversight and design considerations and guide much of the regulatory requirements.

At a high level, internal governance requirements are set out in the European Banking Authority (EBA) 'Guidelines on internal governance'⁷. While these guidelines do not apply to credit unions, the elements dealing with business model strategies may be relevant to credit unions when developing new products and/or considering significant changes to product offerings:

⁶ EBA, "Guidelines on product oversight and governance arrangements for retail banking products" EBA/GL/2015/8 (22 March 2016)

⁷ [EBA, "Guidelines on internal governance" EBA/GL/2017/11 \(21 March 2018\)](#)

Fig 1: Guidelines on Internal Governance

Section 18 - 'New products and significant changes:

150. 'new product approval policy (NPAP) should cover every consideration to be taken into account before deciding to enter new markets, deal in new products, launch a new service or make significant changes to existing products or services'

151. 'NPAP should set out the main issues to be addressed before a decision is made. These should include regulatory compliance; accounting; pricing models; the impact on risk profile, capital adequacy and profitability; the availability of adequate front, back and middle office resources; and the availability of adequate internal tools and expertise to understand and monitor the associated risks.'

152. 'The risk management function and the compliance function should be involved in approving new products or significant changes to existing products, processes and systems.'

Source: European Banking Authority, Guidelines on Internal Governance, 21 March 2018

Whether product/services are developed by credit unions or by third party service providers, it is important that credit unions have fully analysed the risks involved and have access to the technical competence required to monitor, assess and report on risks on an ongoing basis.

Lending Products

When considering new lending products, credit unions should assess their propositions, target market and borrowers' risk profiles. For example, overdraft risk characteristics differ significantly from term lending risk characteristics, and small business lending differs to personal lending.

The provision of new forms of lending products may require upskilling underwriting and credit risk management, knowledge, skills and capabilities. It is important that credit unions have the requisite lending skills and abilities – overreliance on one or two individuals can result in key person risk. Similarly, where reliance is placed on external expertise, credit unions should ensure that this augments the robustness of lending processes and does not replace material lending or credit risk management activity.

Any decision to offer House Loans and business loans should be carefully assessed in terms of complexity and ultimate contribution to ROA. These products require significant investment in expertise and processes along with investment in operational resources to underwrite, process, secure, issue and manage. The Bank's guidance paper, 'Long term Lending – Guidance for Credit Unions'⁸ should be considered in credit union decision making when addressing such lending activity.

When considering new forms of lending, credit unions should assess the impact the new business may have on their balance sheet risk profile. Analysis should reflect on how lending strategies affect loan portfolio risk characteristics and how they can also affect balance sheet funding and liquidity profiles.

⁸ [Central Bank of Ireland. "Long Term Lending – Guidance for Credit Unions" \(18 December 2017\)](#)

SUPERVISORY EXPECTATIONS

The Bank expects credit unions to:

- have a well-developed understanding of their end-to-end lending processes to ensure that risks are identified and managed. This is important when designing and implementing new lending products and associated processes; and
- have assessed and planned for the lending and credit risk management skills, knowledge and experience (competencies) needed to support their loan propositions.

Savings Products

All credit unions continue to rely on on-demand shares as the primary member savings offering and source of funding. Some have relatively small deposit account balances. Plans to expand longer term lending may require consideration of asset/liability maturity gap as the duration of the loan portfolio gets longer. This may include decisions concerning the funding mix of on demand shares/deposits and term deposits.

Decisions to develop deposit offerings, particularly fixed rate products should be assessed from cost, liquidity and interest rate risk perspective. As deposits can be rate sensitive, credit unions will need to be cognisant of market rates and competitor activity.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions:

- To analyse the affect their funding programmes will have on their balance sheet profile, particularly liquidity and interest rate risks, as part of the credit union's ALM process; and
- When deciding to offer longer-term deposits, to carefully assess their capacity and ability to attract and retain funds, particularly when expanding longer term lending activity.

Payment Services

Payment services have expanded to include electronic direct debits and credit transfers with many credit unions offering online and mobile payment services. Credit unions should reflect relevant financial services guidance and regulations within their process design and risk oversight systems and controls.

Credit unions should utilise technical expertise in assessing their payment process efficiencies and risks. As the scale and scope of payments and systems expands, credit unions should risk assess any payments offering and should not rely on third party service provider assurances. Such solutions add to operational complexity, require technical competencies and risk oversight systems.

When providing electronic payment services credit unions rely on third party payment service providers. These relationships are critical to delivering a reliable service. Credit unions should refer to MPCAS operational risk

management expectations as they apply to payment services and payment accounts. These are set out in the MPCAS approval application form, under risk management expectations, page 22.⁹

SUPERVISORY EXPECTATIONS

As electronic payment services are provided by third party service providers, the Bank expects credit unions to;

- Ensure that their service providers are firms of sound financial standing, having strong established business operations and reputations with the financial resources, operational capacity and capability to assure service continuity; and
- Assess third party service providers' business model risks as they relate to the credit union's business model.

Third Party Products / Services Business Lines

Generally, third party products and services cover activities such as intermediating third party general insurance, life insurance, pensions, loan repayment protection and retail investments. These will require separate authorisation as an intermediary and application under the Bank's additional services framework. Credit unions should be aware of changes introduced under Insurance Distribution Directive¹⁰ in relation to provision of advice and which applies with effect from 1 October 2018.

Additional products/services, if not supported by member demand and uptake, may result in increasing costs. This is particularly the case with advisory type products, which require significant upfront investment and ongoing costs related to minimum competencies, administration and compliance processes and systems.

Credit union's risk consideration needs to address scale economies, as cross-selling third-party business lines frequently requires a significantly active member base. They need to assess intermediary business models and focus on their key success factors, acquisition and servicing costs.

Credit unions also need to address the range and scope of consumer protection regulations, competency codes and guidelines when planning for and offering third party provider's product and service business lines. Failure to develop effective compliance programmes could lead to regulatory sanctions and reputational damage.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions:

- To have a Board approved business plan setting out the intended intermediary business model proposition and the value to be created for members and the credit union, demonstrating how:

⁹ [Member Personal Current Account Services Application Form, Risk Management Expectations, Operational Risk, page 22](#)

¹⁰ Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on Insurance Distribution transposed in Ireland by the European Union (Insurance Distribution) Regulations 2018 (SI No 229 of 2018) and the European Union (Insurance Distribution) (Amendment) Regulations 2018 (SI No 520 of 2018).

- expected revenues will be realised;
- costs will be managed;
- business model and financial risks will be effectively mitigated and managed; and
- compliance with AML/CFT and consumer protection obligations will be met.
- When planning to offer additional products/services requiring approval, to refer to the Bank's 'additional services' approval framework (attached as an Appendix to this paper).

Fees and Charges

Developing non-interest income revenue earning capacity involves charging fees for existing and new products/services. Fee earning approaches need careful design of both manual and electronic charging and collection processes to protect against charging errors. Remediating errors may expose a credit union to reputational damage, regulatory sanction and loss of business.

In many cases, levying fees and charges on products/services are subject to the Bank's additional services approval or exemption from approval under regulations. Credit unions need to ensure that their fee charging processes and systems comply with applicable prudential and consumer protection regulations and guidance.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions to have:

- Documented fee charging policy and procedures;
- Ongoing monitoring and reporting on compliance obligations; and
- A responsive risk management framework to identify and mitigate any potential errors.

4.5 Revenue Streams

Interest Income

A key measure of credit union sustainability is the loan to asset ratio. Revenues are expected to be sufficient to cover all costs and provide a surplus. Rates offered for new loans and existing loans, yields a gross interest margin, which after deducting operational costs, generates the surplus (net profit) from which savers are remunerated, business models are developed and capital grown.

Given the current low level of loans, interest income is highly sensitised to pricing decisions. This is particularly the case where savings driven balance sheet growth continues at pace and in many cases is materially higher than growth in new lending. Consequently, credit unions should assess the effect business model strategy will have on future revenues.

In terms of quantifying expected revenues, credit unions need to guard against overly optimistic lending projections (volume and pricing). Furthermore, pricing decisions need to factor likely effect on expected revenues. Assumptions should also anticipate loan portfolio default risk profiles, which should be stressed for the impact of an adverse economic cycle.

What may appear to be a higher margin than achievable in investments for example, may after accounting for costs of acquisition and administration, produce only a marginal gain, if any at all. Pricing decisions need to reflect various financial projections based on realistic and stressed assumptions.

Non-Interest Income

Developing non-interest income sources will require careful planning as fee generating products and services have distinctive characteristics, risk profiles and compliance burden costs. For example, offering personal insurance lines requires specific operational competencies, systems and process capabilities and compliance with consumer protection regulations and minimum competency regimes. Credit unions intending to develop fee income streams should carefully reflect on the time, money and resources required, and regulatory authorisations required, in the case of investment and /or insurance intermediation.

SUPERVISORY EXPECTATIONS

In terms of revenues the Bank expects credit unions to:

- Have a well-developed understanding of their interest income and non-interest income revenue model;
- Objectively analyse and assess lending, savings and additional services growth potential;
- Ground revenue projections on realistic assumptions including default risks, associated loan arrears cycles, supported by informed analysis;
- Assess the impact of pricing decisions; and
- Ensure that new products/services are assessed from a revenue/cost perspective to appreciate the impact on core business financial performance.

4.6 Key Activities and Key Resources

Key activities are the policies, procedures, processes, capabilities and abilities required to make the business model work. A credit union's operational model comprises its processes, procedures, staff, information systems, risk and compliance systems and software architecture. Core processes include marketing, sales, lending, savings, servicing, account maintenance, payments and IT management along with risk and compliance management processes.

Risk factors to consider include:

- **Execution risks** – service interruptions, failures, poor quality servicing, internal non-compliance etc.;
- **Performance risks** – adverse staff performance, software design flaws, poorly defined processes;
- **Capacity/Capability risks** – inability to deliver on propositions and/or lack of technical skills, knowledge and experience; and
- **Fraud** – unexpected losses stemming from internal or external persons deception or other fraudulent actions.

Resource Considerations

Business activities incur, inter alia, credit, liquidity and operational risks that should be managed within effective risk management and compliance frameworks (policies, procedures and processes). Credit unions should assess their critical and important functions and ensure that associated operational risks are assessed, analysed and reflected in business model strategy and implementation plans.

Offering a new business line and products frequently requires assessment of the competencies needed to manage associated risks. For example, lending to small business and farmers requires differing skills, knowledge and experience (competencies) than required when lending to consumers. New business lines also need to be enabled through policies, procedures, processes and systems. If not properly defined and implemented, such activities can amplify operational risks and negatively affect credit and liquidity risks. Credit unions should ensure that the required competencies, governance, systems and controls are in place prior to launching a new product or service. Failure to do so could expose the credit union to significant business, credit and operational risks.

Similarly developing delivery systems requires technical skills to assess, analyse, monitor, report on and manage related operational risks, particularly risks incurred through digitisation of systems and external threats. Frequently new business lines and delivery systems require technical skills and operational capabilities that have to be developed or externally sourced. Where outsourced, credit unions should ensure they have the requisite skills and abilities to manage relationships with third party service providers, outsourcing arrangements and their inherent risks.

Information Technology Considerations

In recent years, operational models have become more complex as new products/services and channels have been added. Operational risk profiles have changed with the addition of electronic payments, online and mobile access channels. In many cases, as a result of consolidation activity, credit unions are operating multi-branch operations. In addition, there is a greater use of risk management, compliance and provisioning software and models.

Effective process design is important in realising operational efficiencies, servicing standards and ensuring effective risk and compliance oversight and management. Any material change to core processes should be supported by risk-based process design and implementation plans. This is particularly important when engaging in new business, products and services and when outsourcing business activity to third party service providers.

Credit unions need to assess their IT strategy and ensure it is aligned to their business model strategy. IT risk profiles are increasing due to growing complexity of IT risk factors, including those driven by the types and numbers of systems used, expanding branch networks, and increased connectivity to external IT networks.

Development of online and mobile channels and new products and services is resulting in more technically complex operational models and an expanding number of third party service provider interfaces. Credit unions should refer to the Bank's policy paper 'Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks'¹¹ which sets out the Bank's minimum expectations of firms.

Credit unions should also refer to the Bank's report on 'IT Risk in Credit Unions – Thematic Review Findings'¹², which sets out expectations, covering:

- IT governance;
- IT Security;
- Business continuity; and
- IT outsourcing.

Where a credit union is using a risk assessment model (e.g. provisioning, credit scoring etc.) it should consider model risks that arise when models have errors in coding etc. Model Risk¹³ can be defined as the potential loss an institution may incur, as a consequence of decisions that could be principally based on the output of such models.

SUPERVISORY EXPECTATIONS

In terms of **Key Activities**, the Bank expects credit unions:

¹¹ [Central Bank of Ireland, "Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks" \(September 2016\)](#)

¹² [Central Bank of Ireland, "IT Risk in Credit Unions – Thematic Review Findings" \(January 2018\)](#)

¹³ Capital Requirements Directive IV, Article 3.1.11

- To critically assess their operational activities and capacity to implement change; and
- Ensure material risks are assessed, analysed, monitored, reported on and where necessary mitigated.

In terms of **Key Resources**, the Bank expects credit unions to;

- Assess the competencies, capabilities and resources (staff, technical, operational) needed to implement their business model strategy;
- Assess their IT strategy and systems capability to support their business model strategy; and
- Reflect these assessments in business and financial plans and their implementation.

4.7 Partners, Outsourcing and Shared Services

Third party service providers are a growing aspect of business models with outsourcing spanning, inter alia, core processors, back and middle office services, risk management, compliance management, internal audit and new product support.

Section 76(j) of the 1997 Act, which enables outsourcing, sets out credit union obligations when outsourcing material business activities (processes, services and activities). Section 76(j)(9) states *'where a credit union has outsourced activities, the credit union remains legally responsible for compliance with requirements imposed under financial services legislation in respect of those activities.'*

Outsourcing of core functions fundamental to the substance of the credit union is considered incompatible with a Board's obligations and responsibility from a governance perspective. Such core functions include, inter alia, setting the strategy, the risk policies, and, accordingly, the risk bearing capacity of the credit union. Management functions such as the setting of strategies and policies in respect of the credit union's risk profile and control, the oversight of the operation of processes, and the ultimate responsibility towards members and supervisors should not be outsourced. Similarly, the extension of credit, underwriting and related decision-making may not be outsourced.

Risk considerations when outsourcing include, inter alia:

- Governance and management of the relationships;
- Legal - enforceability of contracts;
- Operational risk;
- Transaction risk;
- Sub-outsourcing risk;
- Substitutability;
- Concentration risk;
- Service and business continuity arrangements; and
- Reputation of the provider.

One aspect of recent business activity has been the outsourcing of new products and services to third party providers. Credit unions responding to third party service provider's propositions should establish the business case and undertake appropriate risk-based due diligence. Reliance on service provider's representations is not a substitute for risk-based business case and due diligence assessment. Credit unions should have clear strategic rationale for outsourcing and carefully consider governance oversight and risk management processes and systems.

A key consideration in using any third party service provider is protecting the member relationship. Contractual arrangements should reflect that the shared service entity will comply with applicable privacy laws and will employ verifiable safeguards to protect member information and provide that the shared service entity has no proprietary rights to the member relationship and will cooperate with the transfer of the business as the credit

union dictates. It is critical to the management of the relationship that the performance expectations be objectively and measurably stated, monitored and deviations managed.

In respect of outsourcing material business activity, credit unions must comply with Section 76J of the 1997 Act, and are also directed to the Credit Union Handbook as an additional source of reference. Credit Unions should also refer to the Bank's 'Report on Thematic Outsourcing Inspections in Credit Unions'¹⁴.

Credit unions should also consider the Central Bank paper - "*Outsourcing – Items and Issues for Discussion*"¹⁵. The paper sets out minimum supervisory expectations concerning the management of outsourcing risks, highlights some of the key risks and evolving trends associated with outsourcing and sets out key issues that regulated firms should consider in order to mitigate these risks effectively. Consideration should also be given to the draft EBA 'Draft Guidelines on Outsourcing arrangements'¹⁶.

Shared Services

Business model sustainability is increasingly dependent on realising economies of scale and scope. Sectoral collaboration in the form of credit union owned shared service firms and joint ventures is an emerging trend and has been a feature of credit union business model development internationally.

Shared services refers to inter-credit union commercial collaborations through which outsource service firms established by credit unions provide a range of services to their client credit unions. Such firms have many forms and frequently their success is dependent on forming value generating, strategic alliances with other third party service providers.

The capacity to access specialist services that would otherwise be unavailable or unduly expensive to individual credit unions is a perceived benefit of a shared services approach. Properly structured and effectively run, they can result in scale and scope economies, access to technical resources and enhanced risk management competence.

Success factors in credit union collaboration¹⁷ include:

- Collaboration needs to be strategic. There must be a compelling business case identifying business objectives and expected benefits such as improved operational efficiencies, enhanced member products and services, access to expertise, risk mitigation and sharing of excess capacity.
- Collaborative ventures need a long-term commitment, investment and resourcing if they are to be viable and sustainable. Frequently they will require collective adherence to operational standardisation.
- Whilst there is likely to be some duplication/overlap, in particular at early stages of establishing shared service initiatives, the challenge for credit unions is to eliminate unwarranted duplication. This may be

¹⁴ [Central Bank of Ireland, Report on Thematic Outsourcing Inspections in Credit Unions 2017](#)

¹⁵ [Central Bank of Ireland, Discussion paper 8 – Outsourcing – Findings and Issues for Discussion, Nov 2018](#)

¹⁶ [Consultation on draft Guidelines on Outsourcing \(EBA/CP/2018/11\)](#)

¹⁷ A Road Map for Credit Union Back-Office Collaboration, M Taylor, Filene Research Institute.

challenging at individual credit union level - however, it is a critical risk consideration as otherwise the overall outcome could be enduring elevated cost.

By their nature, shared services providers have their own business model risk profile, particularly when they involve the outsourcing of business activities that may be regulated or subject to supervision. They also have a unique risk aspect, as they may become captive of their credit union owners who are also their customers. Shared service business model risk profiles also differ, depending on the nature of services provided.

Establishment costs can be substantial, especially upfront investment in start-up shared services business models. Building value generating shared service business models requires commercial discipline, the absence of which, results in failures, poor outcomes and elevated costs. In such cases, credit unions need to guard against doubling down on failing shared service business models. In considering the appropriateness of any proposed shared service outsourcing arrangement, credit unions are expected to address the underlying net benefits and obligations of such arrangements.

While a shared service solution may involve client credit union ownership, shared services are nonetheless essentially third party outsourced service providers and credit unions must comply with their obligations as set out in Section 76(J) of the 1997 Act. Service arrangements should be documented, with appropriate governance, risk oversight, mitigation and management safeguards, and where necessary, service standards validated by independent validation/assurance expertise. A credit union's risk and compliance management systems and internal audit, should, *inter alia*, establish a clear line of risk oversight of such outsourced activities, and provide for detailed management and Board reporting. Service contracts must reflect Section 76(J) requirements including those providing for the supervision of third party provider services by the Bank in accordance with Section 76J(5).

In conducting due diligence and risk assessment in advance of contracting for services from shared service providers it is important that credit unions ensure that they understand the value provided by the arrangement, in terms of expertise, cost and impact on profitability and overall alignment with business model strategy and risk appetite. In this regard, it is important that due diligence comprehensively addresses inherent risks including financial, legal, operational, compliance, reputational and business continuity risks.

Credit unions need to have a full appreciation of their legal obligations arising from a shared service arrangements. Analysis should address investment costs, income and cost flows, potential requirement for further investment and possible further costs of participation. Participants should understand exit costs and arrangements and legal implications in the event of early termination.

It is the responsibility of credit unions to understand the relative dynamics and complexity of third party products and services, whether using a shared services approach or otherwise. Credit unions should be able to demonstrate that outsource risks are addressed within their business strategy and risk appetite.

SUPERVISORY EXPECTATIONS

In respect of outsourcing using outsourced service providers, the Bank expects credit unions to:

- have a well-defined outsourcing strategy and supporting business case addressing expected benefits, revenues, costs and risks;
- have a well-developed business case and business plan for outsourced services demonstrating intended outcomes and the value to be created for the credit union and its members;
- have engaged in rigorous due diligence assessment of the service provider's business model risk profile and how it will deliver on expected services;
- set out how outsourced services are to be integrated within the credit unions business model;
- assess the risks incurred in outsourcing a material business activity; and
- demonstrate how compliance with S76 of the 1997 Act will be achieved and maintained when outsourcing material business activities to outsource service providers.

In terms of shared service providers, the Bank expects to see consideration by credit unions of their:

- **Financial commitment:** their contribution to establishment costs and ongoing capital funding requirements;
- **Legal commitment:** the contractual obligations;
- **Operational commitment:** their integration of third party services with their operational model; and
- **Strategic commitment:** a willingness to commit with other credit unions to ensuring shared service business model sustainability.

4.8 Cost Analysis

Credit union business models exhibit a relatively high cost/income metric that currently trends around a median level of 75%¹⁸. While scale efficiencies are difficult to achieve for small firms, this ratio is also reflective of reduced income levels and rising fixed costs. Over the longer term, this cost profile is unsustainable given increasing costs to serve, lower margins and the need to invest in business model transformation.

Consequently, it is important that credit unions address their operational model and costs and define plans to enhance efficiencies. Credit unions should comprehensively assess and address costs by business activity line for both existing and new business lines / activities.

In new product or service selection, decision-making should be informed by fact-based analysis of new business acquisition costs. As some initiatives may not succeed, credit unions should prudently plan for this possibility. Similarly, the costs of business development may outweigh expected benefits and it may take time for a service to break-even. Credit unions should be conscious of the financial and resource commitments and plan accordingly.

Targeting a new area of business frequently requires significant financial and operational resource commitments, which if not understood and planned for could negatively affect financial and operational performance. Strategies to develop advisory services and expand lending activity into new areas result in additional costs arising from upskilling, implementing new processes and systems and engaging third party technical services. Credit unions need to consider their cost base in the context of new initiatives and other costs (e.g. provisioning) which will further increase cost levels.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions to:

- Have a well-developed understanding of their fixed and variable costs, and their underlying cost drivers by core business lines – savings and loans;
- Have a developed understanding of cost drivers: staffing, operational processes and free to member services and insurances; and
- Rigorously assess the costs incurred in implementing their business model strategy and to stress test cost assumptions.

¹⁸ [Central Bank of Ireland, "Financial Conditions of Credit Unions: 2013-2018" \(Issue 3, August 2018\).](#)

4.9 Financial Planning

From a financial perspective, business model strategy and business plans need to be assessed, planned for, monitored and reported on. It is critically important that business model strategy and plans are considered from a financial risk perspective and reflected in key financial performance indicators; including the sustainability metrics set out in this section.

Material financial risks can arise from inter alia:

- Overly optimistic assumptions on expected sales and revenues;
- Overly optimistic assessment of costs to develop and deliver propositions;
- Misalignment of risk appetite with business model strategy;
- The emergence of sudden, unexpected losses;
- Failure of business plans – new products/services are loss making;
- Operational failures resulting in significant remediation costs; and
- Third party service provider failure to provide services.

Financial planning should project the anticipated outcomes of strategy implementation on financial performance and should be stressed using severe but plausible assumptions. Financial plans should be aligned with business model strategy and business implementation plans, and should be closely monitored. Material deviations should be addressed as they may indicate unanticipated business model risks are being incurred.

Default risks and associated loan arrears cycles need to be factored into risk considerations and financial planning. Such risks are closely tied to the economic cycle, and credit unions need to take a long-term outlook to appreciate the risks to which borrowers could be exposed over the duration of their loans and impact on financial outcomes. This is particularly the case with longer term lending products such as mortgages and this issue and related considerations are addressed in our December 2017 paper “Long Term Lending - Guidance for Credit Unions”¹⁹.

The Bank considers that business model sustainability is partly reflected in five important metrics;

1. Loans to Asset (LTA) Ratio – gross loans outstanding as a percentage of total assets;
2. Cost Income Ratio – operational costs as a percentage of total income;
3. Operational Cost Ratio – operational costs as a percentage of total assets;
4. Return on Assets (ROA) – surplus after dividends/interest rebates as percentage of total assets; and
5. Capital buffer – total realised reserves in excess of the 10% minimum requirement expressed as a percentage of total assets.

Other relevant metrics include:

6. Loan interest margin – the rate earned on gross loans expressed as a percentage;
7. Investment yield on surplus funds – interest income generated from investments expressed as a percentage;

¹⁹ [Central Bank of Ireland, “Long Term Lending – Guidance for Credit Unions” \(18 December 2017\)](#)

8. Non-interest income to total income – fee and other non-interest income as a percentage of total income;
9. Loans growth – growth in loans as percentage;
10. Savings growth – growth in savings as a percentage;
11. Provisions – provisions as a percentage of gross loans;
12. Arrears – loan arrears expressed as a percentage of total loans, including analysis by business line and vintage; and
13. Growth in active members – members who both save and borrow.

Together these metrics capture business model performance in terms of revenues, costs and capital. Their interpretation is key to understanding their underlying financial drivers.

SUPERVISORY EXPECTATIONS

In terms of financial planning, the Bank expects to see:

- Financial projections grounded on realistic assumptions and reflecting the expected benefits and costs of implementing business model strategy;
- Rigorous assessment of expected revenue streams, net income margins, operational costs and return on asset performance;
- Financial projections stress tested using severe but plausible assumptions;
- Logical key performance indicators, linking financial performance with strategy implementation, monitored, risk assessed and reported on to Boards by CEOs and their management teams; and
- Active consideration by Boards of material divergence from anticipated performance evidenced by outcomes-based decisions and monitored remediation plans (where required).

4.10 Balance Sheet Considerations

Credit unions are wholly reliant on retail deposits (member savings) for funding and can only accumulate capital from retained earnings (surplus). As their business model strategy will affect assets, funding, liquidity and capital profiles, credit unions should assess how the balance sheet will change over time as business model strategy is implemented. Credit unions should have a capital management plan, which reflects the changing nature of the balance sheet profile. Credit unions should take account of expected profitability and its effect on reserves.

For example, making larger longer-term loans will change the loan portfolio risk profile having implications for interest margins, operational costs and loan loss provisions. Similarly lengthening the duration of loan portfolios requires careful consideration of liquidity and interest rate risks.

Credit unions need to carefully assess their maturity mismatch profile should they lengthen the duration of their loan and investment portfolios. Funding plans need to consider maturity mismatch and use of longer term savings i.e. fixed rate deposits.

Expanding the scope of products and services frequently results in more complex, sophisticated operational models. This is particularly so with regulated products/services requiring investment in risk and compliance capabilities, processes and systems. As the mix of products/services changes, so does the operational risk profile and assessment of operational risk capital.

SUPERVISORY EXPECTATIONS

The Bank expects credit unions to have carefully assessed and planned for balance sheet transformation and assessed the effect of their business model strategy on the following;

1. Loan portfolio risk characteristics

Decisions to change the mix of lending should be supported by risk gap analysis that should assess the changing nature of credit risks and implications for the credit union's risk appetite, lending and risk management capabilities. Decisions may also result in changes to loan interest income, yield, margins and loan losses which will affect financial performance. Consideration of how change will affect capital is also required, as is clarity on levels of capital required to support a changing credit risk profile.

2. Loan loss provisions

Changes to the loan portfolio risk profile may affect loss provisions where for example credit risk profiles change. New lending activity and programmes should be monitored closely to assess actual loss performance to expected performance.

3. Funding profile and mix (on-demand v term deposits)

Decisions to engage in greater levels of longer-term lending and/or longer-term investments should be considered in terms of the savings profile. Decisions may lead to offering fixed term/time deposits that have unique risk characteristics and operational capability requirements.

4. Investment portfolio

Decisions on the mix and duration of investment portfolio should be carefully aligned with expected loans growth performance and liquidity requirements.

5. Liquidity profile

As with funding, any extension of the loan portfolio investment book duration or funding mix should be assessed for the resulting liquidity risk profile. This is particularly relevant where material change is planned in lending duration.

6. Interest rate risk

Decisions to engage in fixed rate pricing of loans and deposits along with longer-term investments effects interest rate risk. Such decisions along with loan, liquidity and funding decisions should be reflected in ALM planning reflecting the nature of the balance sheet as assets and liabilities change.

7. Capital Reserves

Decisions to change asset profile and mix should be considered from a capital risk perspective. A credit union should have a developed capital management plan justifying its capital buffer and capital accretion targets.

8. Operational risk profile

Decisions to expand products and services, develop delivery channels and engage in new business lines will change the nature of a credit union's operational risk profile. Consideration will need to be given to target levels of operational risk capital.

5. Summary

This paper has set out a range of risk considerations the Bank expects credit unions to factor into their business model strategy, implementation plans and risk oversight and management systems. It has also set out a range of supervisory expectations concerning these considerations, which form part of the Bank's PRISM risk assessment supervisory framework.

As credit unions respond to significant sustainability challenges, they need to develop and safely implement risk based business model strategies. Board and Management ownership of strategy and its implementation is crucial, as is a risk-focussed approach to employing the resources and developing the capability and capacity needed to safely and soundly manage risks inherent in business model strategies, particularly in expanding the scope and depth of existing and new business activities.

Constrained by resources, relative size and diseconomies of scale and scope, there is a need to prudently assess and plan for feasible and achievable business model development. In particular, business model development must be underpinned and enabled by effective risk management capabilities and capacities.

It is important for credit unions to critically assess their ability and capacity to implement business model strategy to realise expected outcomes. The Bank expects plans and their implementation to reflect realistic and achievable outcomes, which have been grounded in rigorous risk assessment and analysis of assumptions underpinning expected financial performance, profitability and balance sheet risk profiles.

Significant changes to operational models and delivery systems, enhancing products and service mix and expanding lending activity all need to be carefully planned for with associated risks analysed, monitored, reported on and effectively mitigated. Outsourcing and shared service business models will need to be prudently developed and implemented, in particular where they are intended to support for credit union's critical and important business activities.

Appendix I: Central Bank Approval Powers, Methodology and Processes

1. Earned Flexibility

The 1997 Act and regulations, including the 2016 Regulations, set out, *inter alia*, credit union prudential capital, asset and liability requirements and the savings and loans products and services that can be provided. This legislation covers additional services that require approval by the Bank before they can be provided or are exempted from approval by the Bank. The Bank's approach to considering business model and balance sheet change is dealt with in this Appendix, which sets out; how the Bank exercises its powers, its approval processes and expectations of credit unions looking for regulatory approval.

The Bank is committed to facilitating business model development by credit unions that can demonstrate they have developed or can develop the necessary capabilities required to safely and soundly manage associated risks. The Bank's commitment is guided by its vision of 'strong credit unions in safe hands' and its statutory mandate concerning the 'protection by credit unions of their members funds' and the 'financial stability and wellbeing of credit unions generally'. It is the Bank's view that:

- '**Strong Credit Unions**' are financially strong and resilient, enabled by sustainable, member-focussed business models underpinned by effective governance, risk management and operational frameworks; and
- Credit unions are '**In Safe Hands**' when they are effectively governed, professionally managed and staffed by competent, capable people who appreciate and prudently manage risks, while successfully meeting members' product and service expectations.

Having regard to the Bank's role as the prudential regulator for credit unions, the Bank can introduce requirements, through regulations or other supervisory powers (such as regulatory directions or conditions on registration), which may have consequences for the business models of credit unions, or classes of credit unions, and the services offered by them.

In addition, the Bank can approve new products/services through the additional services approval framework set out in the 1997 Act or by exempting them from requiring approval through regulations.²⁰ The Bank refers to this as '*Earned Flexibility*', which means facilitating 'strong credit unions in safe hands' to develop their business models. Credit unions looking to provide an additional product/service that is not otherwise exempt from the approval framework must make an application to the Bank for approval.²¹

²⁰ Part 9 of the 2016 Regulations specifies services exempt from the additional services requirements

²¹ Sections 48-52 of the 1997 Act set out the statutory framework for, *inter alia*, seeking approval to provide additional services.

2. Regulatory Approval – the role of the Central Bank

When exercising its ‘Earned Flexibility’ approach to credit union business model development, the Bank may have recourse to several processes, the appropriateness of which depend on the specific circumstances at issue.

This Appendix provides information on the legislative framework and decision-making processes governing the granting of permission to credit unions by the Bank to provide services other than those services specifically referred to in Part III of the 1997 Act (e.g. savings, loans, etc.). In this regard, the Bank can either –

- in normal course, assess applications submitted by individual credit unions to provide additional services and grant approvals pursuant to the framework set out in Sections 48 – 52 of the 1997 Act; or
- use its power to make regulations exempting a service from requiring such approval and such exemption may be subject to specific conditions.

This is in addition to the Bank’s supervisory powers (including imposing restrictions), arising from its statutory regulatory mandate, with respect to core services provided by credit unions, in addition to permitted additional services.

These processes may originate from different sources, and this will again depend on the specific circumstances at issue. With respect to new regulations, or amendments to existing regulations, these will be the result of policy analysis carried out within the Bank, either initiated by the Bank or prompted by proposals from external actors, e.g. credit unions or their representative bodies or recommendations by the Credit Union Advisory Committee (CUAC) to the Minister for Finance. Such regulations will apply either to all credit unions or to specific classes of credit unions. The use by the Bank of its regulation-making powers to exempt services from the approval process will require policy and legislative development and may involve general consultation. With respect to supervisory decisions, e.g. granting approvals for additional services, these arise following applications from individual credit unions and are considered by the Bank on a case-by-case basis. The Bank’s functions and powers in this context are subject to specific statutory requirements and processes, in addition to the Bank’s administrative arrangements.

2.1. Approving Additional Services

Sections 48-52 of the 1997 Act (which covers additional services) includes the Bank’s function of assessing applications by credit unions for the provision of additional services. When making a decision on an approval application, the Bank is required to have regard to the interests of the public and of the members and creditors of the credit union, to the orderly and proper regulation of the business of the credit union and to such other considerations as it thinks proper.²²

²² Credit Union Act, 1997, Section 49 (4).

For example during 2016, the Bank approved an additional service, i.e. Members Personal Current Account Service, for six applicant credit unions.

When assessing an application, the Bank considers, *inter alia*, the extent to which the credit union:

- demonstrates a robust business case;
- shows the proposal is in keeping with financial services legislation;
- demonstrates an informed appreciation of the nature of the additional service proposed and the strategic, governance, risk management, operational, financial and legal implications involved; and
- demonstrates how risks will be monitored, managed and mitigated.

2.2. Making Regulations – Regulation of Credit Union Activities

The Bank may make regulations where empowered to do so by legislation,²³ and such regulations may impact on the business models of credit unions, including with respect to core and additional services provided by credit unions. With respect to additional services in particular, the Bank may, through regulations, exempt a service from requiring its approval, conditional on compliance with such conditions as may be prescribed by the Bank. The Bank can also use this approach to ensure service definitions are in line with financial services developments generally. Examples here include the services set out in Part 9 of the 2016 Regulations.

When amending existing regulations or making new regulations, the Bank considers, *inter alia*, the impact on credit unions and sectoral financial stability.

In these cases depending on the scale and scope of change proposed, and any statutory obligations, the Bank may use its consultation policy process²⁴ through which it -

1. Issues a consultation document on proposed change, inviting submissions
2. Provides feedback on submissions

In some cases, as changes may be minor, such as amending wording, updating definitions etc. the Bank may use an expedited process. This is without prejudice to any statutory obligations to consult with specific persons before making regulations.

3. Additional information on decision-making processes

3.1. Additional Service Approval Process

The additional service approval process is subject to specific requirements set out in the 1997 Act, including with respect to the procedural requirements to be followed (e.g. adoption of a resolution by the credit union, an

²³ For example, under the 1997 Act or Part 8 of the Central Bank (Supervision and Enforcement) Act 2013.

²⁴ [Central Bank of Ireland, "Central Bank of Ireland Policy on Consultations" \(3 October 2012\).](#)

approval by the Bank pursuant to Section 49 of the 1997 Act and a change to the rules of the credit union) and the information to be submitted with an application.

In practice, the additional service approval process has four stages:

i. Intention to consider the application for additional services approval

The Bank issues a letter to the applicant credit union, indicating it is favourably disposed to considering approval that is subject to a formal application for approval. The credit union may then submit a formal application for additional services approval.

ii. Intention to Grant Approval

Where appropriate, the Bank issues a letter to the applicant credit union in which it indicates an intention to approve the credit union to provide the additional service. This letter attaches a draft of the Bank's grant of approval along with any conditions attaching to the approval. The credit union is invited to make a submission, within a specified time period.

iii. Submission (if made)

Should a credit union not make a submission then a grant of approval letter will issue to the credit union. Should it make a submission, then issues raised will be considered and if warranted the grant of approval/conditions may be changed.

iv. Grant of approval

The Registrar of Credit Unions issues a grant of approval with attached conditions to the credit union.

3.2. Additional services applications – business case expectations

While each business case for additional service approval will differ depending on scale, scope and complexity of proposed change, the Bank expects, in addition to the mandatory information requirements of Section 49(2) of the 1997 Act, a business case to include the following;

i. Description of the proposed change

This typically will include a description of

- the intended product/service/business line and/or
- the intended change (enabling regulation)

ii. Rationale for change

It is important for proposers to demonstrate clarity in strategy, objectives and expected outcomes. In many cases this will require setting out the strategic rationale for the proposed change and its fit with the credit unions business model strategy and risk appetite. Rationale should cover:

- Identification of expected benefits to the credit union and its members
- Evidencing these benefits (quantifiable and qualitative measures)

iii. Business model development

In general, consideration of the intended business model development will cover:

- Product/service proposition
 - Market for the service/product
 - Competition analysis
- Target market (what members needs and expectations will be met, what is the size of the market and what are the intended sales volumes etc.)
- Servicing channels (how will the service be provided)
- Operational model –
 - how will the service be delivered (core processes)
 - operational resourcing and competencies required
- Where a new business line is being proposed, which has its own business model characteristics, then the proposal should describe the intended business model and business development strategies

iv. Risk assessment

Depending on the risk characteristics of the proposed change, proposers should describe the nature of risks associated with the change, how these risks will affect the credit union's current risk profile. Risk headings may include:

- Financial Risk
- Operational Risk
- Credit Risk
- Liquidity Risk
- Investment Risk
- Compliance Risk
- Reputational Risk
- Legal Risk
- Transactional Risk
- Business and Service Continuity Risk

v. Balance sheet implications

Where change will materially affect balance sheet structure, the Bank expects a detailed consideration of the current balance sheet risk profile and plans to address risk as the profile changes.

vi. Regulatory assessment

Proposers should set out relevant financial service legislation and regulations and demonstrate their compliance requirements. As many proposals will require either (a) the removal of an inhibitor or (b) creation of an enabler, the intended regulatory change should be described.

vii. Operational model

Proposals should illustrate the intended operational model identifying

- Core processes
- Required operational capabilities
 - People skills, knowledge and experience
 - Operating systems
- Outsourcing

With new business lines, proposers should set out how they intend to develop the abilities and capabilities to provide the services/products.

viii. Governance and Management

Proposals should set out the governance and managerial competencies required to oversee and manage the business and associated risks. They should set out how they intend developing the requisite oversight and managerial competencies to manage the business and its associated risks. Where outsourcing material business activities, proposers should set out the intended governance and management system.

ix. Financial Model

Proposals should provide financial projections covering at least a three-year period and set out the assumptions the projections are based on. The projections of income and expenditure and balance sheet should be stressed using severe plausible assumptions.

3.3. Making Regulations

The following stages are of relevance to regulations made by the Bank in this context:

1. Publication of a Consultation Paper (“CP”);
2. In these cases, it is likely that intended changes will be published as a CP, which will include a Regulatory Impact Assessment. Stakeholders are invited to make submissions on the Bank’s proposed regulations;
3. Consideration of submissions;
4. Submissions are analysed by the Bank and the proposed regulations may be subsequently changed;
5. Response to CP submissions; following statutory consultation, the Bank publishes its response to submissions which sets out its consideration of issues raised in the submissions;
6. Statutory consultation: when issuing regulations the Bank must consult with, inter alia, the Minister for Finance, the Credit Union Advisory Committee (“CUAC”) or any other body that appears to the Bank to have expertise or knowledge of credit unions generally. The relevant consultation requirements will depend on the legal basis at issue;
7. Making of regulations: a statutory instrument (S.I.) is signed on behalf of the Bank. Once signed the regulations and conditions have the force of law from a specified date and form part of the legislative framework of the 1997 Act and regulations.

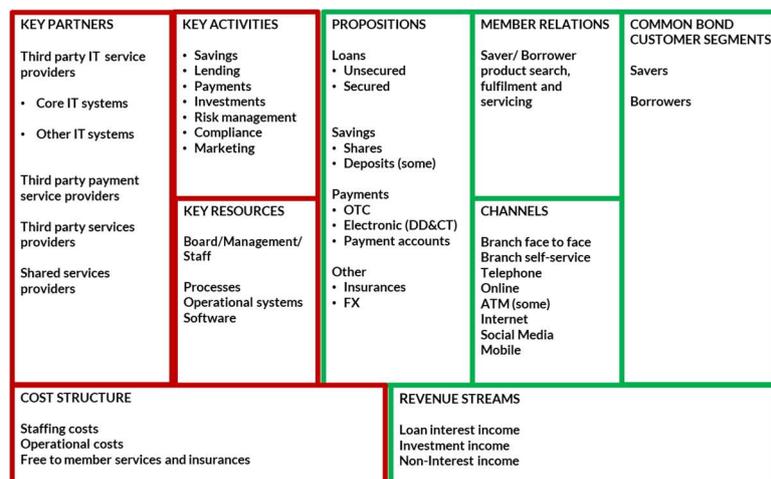
Appendix 2: Business Model Strategy - Risk Model

A business model may be said to describe the logic used by credit unions to operate and create, deliver and capture value for members and the credit union. In considering business model strategy, a well-known business model definition and abstract called the Business Model Canvas (BMC) is widely used by commercial firms, public service bodies, NGO's and cooperatives. Developed by Alexander Osterwalder, the BMC²⁵ is used to describe business models and to decide how a business model might be transformed and developed. It helps firms to appreciate the scale of changes needed to transform and develop their business models. Importantly the BMC reflects the inherent customer centricity of credit unions' culture, ethos and business models, which are focused on delivering valued products and services to their members who are also their owners.

The BMC allows for a clear, visual representation of the current business model for decision makers to reflect upon. It allows understanding as to how the nine core building blocks relate to each other and the different ways these relationships can be changed to increase efficiency or effectiveness. It facilitates an iterative approach that allows users to evaluate changes to their business model and their impact.

The schematic below is a high-level illustration of the BMC in the context of the current credit union business model. The areas in green are concerned with marketing and selling products and services and the revenues that flow from them. Areas in red are concerned with how these products and services are delivered and the costs of doing so.

Fig. 1: Credit Union Business Model Canvas



The BMC allows consideration of business model strategy by credit unions across its interrelated components:

1. **Common Bond:** the differentiated groups of members the business model is to deliver value to.
2. **Delivery Channels:** the routes for reaching new and existing members, for sales and ongoing relationships.
3. **Member Relationships:** the ongoing relationship (physical and virtual interaction) established with members.

²⁵ A. Osterwalder. The Business Model Ontology: A proposition in a design science approach. PhD thesis, Université de Lausanne, 2004. And <https://strategyzer.com/canvas/business-model-canvas>.

4. **Value Propositions:** the value delivered in terms of products/services and other attributes.
5. **Revenue Streams:** the new and recurring value being paid for products/services and other attributes.
6. **Key Resources:** the resources (physical, financial, staff, know-how, software etc.) needed to safely and prudently deliver on value propositions.
7. **Key Activities:** the activities needed to safely and prudently deliver on value propositions.
8. **Key Partners** are the business partners, suppliers, collaborating entities in formal partnerships that involve the supply of products and/or services.
9. **Cost Structure** represents the operational costs of delivering value propositions.

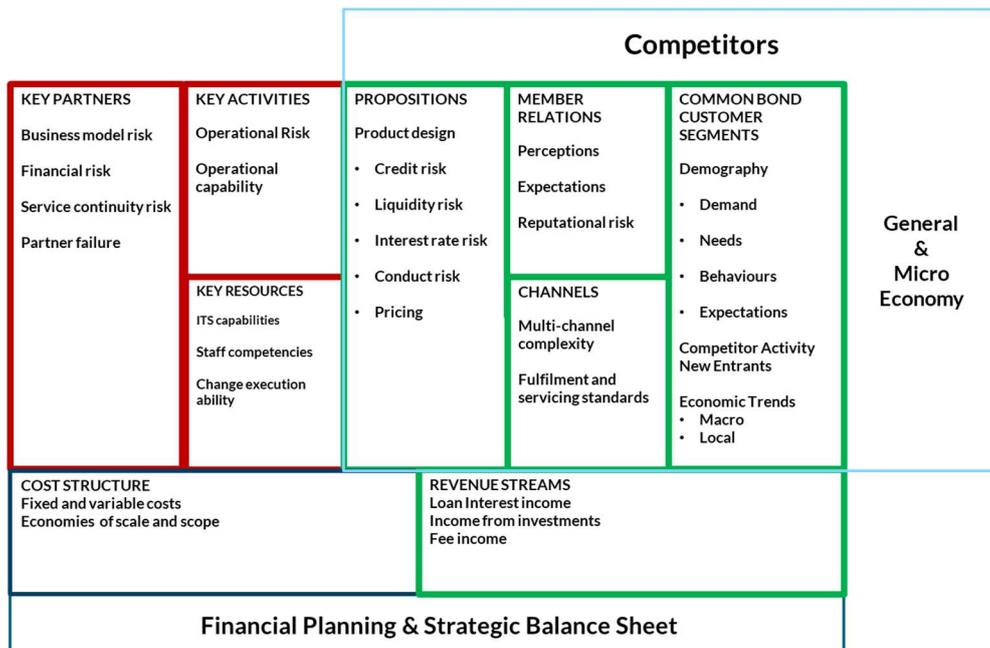
The BMC can be used to define a credit union’s business model strategy – as it is concerned with identifying and fulfilling members’ needs and expectations. It illustrates how the different elements of a business model are interrelated. For example, developing online lending services will affect member relations, delivery channels, loan propositions along with lending processes, staffing, software and third party service providers. Additional costs will be incurred (and saved) and interest income generated.

While the BMC describes how the credit union intends to provide value to its members, from a business model risk assessment perspective it has been adapted by the Bank to incorporate:

- external change drivers;
 - demographics & psychographics
 - competition
 - economic conditions
- financial planning; and
- balance sheet implications.

The adapted BMC framework for business model risk assessment is depicted below:

Fig 2: Credit Union Business Model Risk Assessment Framework





Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem