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Re: Request for immediate development of policy responses to support credit unions respond to COVID-19 challenges

29 May 2020

Dear Kevin,

I refer to your letter of 7 April 2020 regarding your request for the immediate development of policy responses to support credit unions in response to COVID-19 challenges, and your updated request letter dated 22 May 2020.

As you note, credit unions have been identified as an 'essential service' provider by the Government in the context of COVID-19 restrictions. As we communicated to all credit unions in our COVID-19 circular dated 31 March 2020, we recognise the unique role that credit unions play in the delivery of financial services in local communities across Ireland, the need for which is heightened at this time.

In recent weeks, as you will be aware the Central Bank of Ireland (the Central Bank) and the European authorities have taken proactive steps to ensure the financial system can continue to service consumers and the broader economy despite the impacts of the COVID19 pandemic. In line with our mission of safeguarding stability and protecting consumers, the Central Bank is seeking to contain those economic effects and do everything in our power to protect consumers, households and businesses. Our actions, working with our European colleagues, span the full spectrum of our mandate.

As we regularly point out, our engagement with the credit union sector far exceeds the Central Bank's engagement with any other regulated sector. During the ongoing crisis, we welcome the opportunity to engage with you and your team on a very regular basis, exchanging views on a range of topical issues concerning credit unions. In addition, we would be happy to host a workshop session with CUDA , to discuss the issues you raised in your letters , and to clarify our views on each one.

We have carefully considered the broad range of issues CUDA raises requesting immediate policy development. They reflect many fundamental questions regarding credit union policy, including those central to the protection of credit unions members' interests and their funds. While some of the issues you have raised are linked directly to COVID-19, others relate to broader financial and operational challenges for credit unions, which existed prior to the crisis and will likely persist after it.

We give such policy considerations our full attention, examining the impacts not only on credit unions and their members, but also on the wider implications for the financial services sector, in line with the Central Bank's statutory mandates.

We have set out by way of context, our statutory mandate towards credit unions and the current status of credit union operational and financial resilience and associated challenges.

Our statutory mandate

Through recent legislative and regulatory changes and the evolution of our supervisory approach, we have continued to ensure that credit unions operate under a framework that is both tailored and proportionate. In doing so we have sought as regulator and supervisor to ensure such changes are grounded in our statutory mandate - namely the protection by each credit union of the funds of its members, and the maintenance of the financial stability and well-being of credit unions generally[1]. As regulator we work with individual credit unions on their business continuity, operational capability and financial resilience, so that they can continue to provide essential services to their members in a safe, prudent and sustainable manner. This aligns with our statutory mandate towards credit unions and our broader mission to serve the public interest.

Given the broad scope of the policy development areas identified in your letters, it seems important to clarify roles and responsibilities in relation to framework change for credit unions. CUDA will be aware that it is the Houses of the Oireachtas that are responsible for enacting primary legislation, and that the Central Bank has regulation-making powers in a number of specific areas as prescribed by such legislation, subject to consultation with the Minister for Finance and other relevant bodies[2].

The Credit Union Act 1997 (the 1997 Act) contains the primary legislative framework for credit unions. As noted by the Commission on Credit Unions '*policies and principles should be set out in primary legislation with the relevant standards and procedures to be dealt with in Central Bank regulations*'[3]. In that regard, please note that in respect of a number of the areas CUDA has addressed to us requesting immediate policy development for credit unions, primary legislation is in fact required.

[1] Section 84(1) Credit Union Act, 1997.
[2] Section 84A and Section 182A of the Credit Union Act, 1997.
[3] Report of the Commission on Credit Unions Chapter 10 – 10.1.6.

Credit union – operational resilience and challenges

This is a time when members' need to access credit union services. We all recognise the challenges being faced by many credit unions to continue providing services to members in light of COVID-19. Thus far in the crisis, it is commendable that all credit unions continue to serve their members' needs. To date, only a small number of credit unions have made the operational decision to close their office doors. All of those continue to provide services to members by alternative means. As the crisis continues to unfold, and more credit unions face organisational stress, further temporary office closures are likely to occur. This underlines the benefit of *ex ante* business continuity planning, and our ongoing supervisory engagement on this risk area with credit unions.

As set out in the circular we issued on 16 April 2020, we expect credit unions to continue to meet their regulatory and statutory obligations on an ongoing basis. However, the Central Bank also recognises that many credit unions are under or will encounter significant organisational stress. Our view is that some limited and time-bound regulatory flexibility may allow credit unions to better serve their members, and in turn serve the wider economy.

Therefore, as outlined in our April circular, we have introduced some temporary flexibility for credit unions – alongside similar measures for other regulated sectors - in the areas of reporting and Risk Mitigation Programme (RMP) timelines. Similarly, a pragmatic approach is being taken where Pre-approval Controlled Function (PCF) roles need to be filled on a temporary basis because of COVID-19.

Credit union – financial resilience and challenges

In terms of the overall financial position of the sector, credit unions have come into this crisis with a strong reserves position, with a sector average reserve ratio of 16% as at 31 December 2019. This highlights that many individual credit union boards have chosen to prudently maintain additional reserves over the 10% regulatory minimum requirement. Credit unions have also maintained high levels of liquidity, with a sector average liquidity ratio of 39% as at 31 December 2019.

Notwithstanding this strong financial position, many credit unions continue to face well-documented sustainability challenges impacting their financial performance. The root cause of these challenges are commercial in nature.

The business model is suffering from reduced loan demand over recent years (outpaced by stronger savings growth). Surplus funds not lent out to members are appropriately not exposed to undue risk, and they yield limited investment returns reflective of the current low interest rate environment. The operational business model lacks scale efficiencies and suffers from high operating costs. This all translates into low loan to asset ratios (sector average 28%), low return on assets (sector average 0.6%) and high cost income ratios (sector average 82%).

Commercial challenges have left the sector today facing an imbalance between lending and savings. We have seen that the desired structural shift in the sector's balance sheet cannot be achieved through change in regulation.

A more fundamental business model transformation is required, one based upon a clear future vision and strategy, requiring collective delivery and execution via sector collaboration. Legislative framework change can support the change process, but it cannot lead it. Ultimately leadership and management capability within the sector, must drive the change process.

The economic outlook presents further unwelcome challenges given the expected downward direction of the cycle on foot of COVID-19 and other potential negative economic impacts (e.g. Brexit). Therefore, as ever and particularly now at a time of crisis, it is imperative that the leadership of the sector ensures that credit unions take steps to protect and support their financial position. It is fundamentally important that a prudent approach is maintained to lending, investments, liquidity and capital, as this will best serve the longer-term interests of credit union members.

You set out six areas of significance for CUDA in your 7 April letter in terms of immediate policy development. Below we set out our response under each of your headings by addressing your questions which are included in italics.

The content below is also relevant in the context of your letter of 22 May and the articulation of CUDA's nine 'evolved' requests set out in that letter. There is a significant level of overlap between the issues raised in your letters of 7 April and 22 May, and therefore our responses in this letter deal with both sets of policy queries from CUDA. The one area that does not overlap relates to restructuring, which was not raised in the 7 April letter[4].

As you know, the Registry of Credit Unions has worked extensively with sector stakeholders to support consolidation in the credit union sector, with a view to placing the sector on a sounder footing and contributing to the financial stability and well-being of credit unions. While we are clear on our role and mandate in terms of credit union restructuring, we are open to engaging with you on any new proposals or recommendations CUDA has in relation to restructuring under the existing credit union framework. Perhaps this is something that we could discuss at our proposed workshop.

1. Humanitarian Lending

Will the Central Bank ensure credit unions are not disadvantaged (profitability, liquidity, solvency) having acted in good faith?

Referencing humanitarian lending, your 7 April letter states that credit unions are '***granting loan moratoria and emergency lending in line with their modus operandi and currently without any government support***' and asks if the Central Bank '***will ensure they are not disadvantaged having acted in good faith***'. However, it is not clear what CUDA considers are the issues that could arise in this

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[4] The observations set out in the introductory section and section 1 of this letter are directly relevant to request 1 and 3 in your 22 May letter, section 2 addresses requests 4 and 9, section 3 addresses request 5, section 4 addresses request 6, section 5 addresses request 7 and section 6 addresses request 2.

context regarding the regulatory aspects of the areas you reference, namely in respect of ***profitability, liquidity and solvency***.

COVID-19 clearly presents challenges for borrowers which for some will lead to requests for flexibility from banks, credit unions and other credit providers. In terms of the overall approach in dealing with borrowers, the Central Bank expects regulated firms to take a consumer-focused approach, and act in their customers' best interests in the current environment.

More specifically, on requests to credit unions from their members for loan forbearance, our engagement with individual credit unions indicates that to date the overall level of such requests by number and by value, is not extensive in the context of sector lending. In addition, some credit unions have advised that they are providing emergency credit to members affected by COVID-19.

With regard to any decisions by individual credit unions to provide additional credit or temporary payment flexibility to their members affected by COVID-19, as set out in our circular of 31 March 2020, we expect individual boards to retain ownership of credit underwriting assessments and decision making.

Our supervisory expectations when considering such requests are that individual credit union boards should take account of the relevant regulatory framework requirements, their own stated credit risk appetite and the financial position of their credit union. It is also important that credit union members in receipt of such temporary payment flexibility, be provided with sufficient information to understand how the arrangement will operate, the financial impact on their loan, and how their case will be treated when the arrangement comes to an end. Ongoing engagement with distressed borrowers is important, to ensure that the most appropriate and sustainable solutions are put in place for borrowers.

In our supervisory engagements, we will expect credit unions who have granted their members credit forbearance related to COVID-19, to have conducted effective credit assessments and to have clearly documented their decisions and any related matters. In this way, it will be clear where a credit union has operated in line with its stated risk appetite, and to the extent that it has not, the rationale for this will be clearly recorded and available for review. Credit union board ownership is central to this process.

More broadly, through RMPs and our supervisory interactions, we have stressed the importance of credit unions continuing to focus on identifying, managing and mitigating risks. Credit risk is clearly a key risk given that loan portfolios can come under stress in a crisis. The level of distress in credit unions' loan books should be prudently considered and be reflected in provisioning levels (discussed further below in response to Item 4 of your 7 April letter). Robust governance and effective risk management remain fundamental to the ongoing protection of members' funds.

Supports provided to banks and credit unions

Your 7 April letter refers to supports provided to banks and states that the **'*exact form and timing of support for credit unions is currently unclear*'.**

As you are aware credit unions operate under a distinct framework from banks which recognises the uniqueness of credit unions, and is both tailored and proportionate. Accordingly, while the regulatory frameworks for credit unions and banks differ, for commercial decisions such as the provision of flexibility to support borrowers through measures such as payment breaks, we are of the view that credit unions have a similar level of commercial flexibility as banks.

Payment breaks provided by credit unions receive the same treatment as other lenders within the Central Credit Register (CCR), as has already been advised to credit unions and representative bodies.

Clarity has been provided to banks across Europe in relation to the treatment of payment moratoria related to COVID-19. Specifically, payment moratoria/payment breaks need to meet the criteria set out in the European Banking Authority's (EBA) Guidelines[5] for those bank loans not to be considered 'forborne', or in default, due to the issuing of a payment break. Also, the granting of a payment break is not itself a trigger for non-performing classification.

As there is no equivalent requirement for credit unions for automatic designation of loans as forborne (and associated provisioning requirements), an equivalent measure to the EBA's COVID-19 measure has not been necessary for credit unions. The tailored credit union framework already provides the flexibility needed for credit unions, without any change arising from COVID-19 necessary.

It is important to note that, while both credit unions and banks can provide COVID-19-related payment breaks without the necessity to automatically recognise a provision, ultimately all lenders must consider the borrowers' long term capacity to repay the loan.

Furthermore, in the area of capital buffers for banks, the European Central Bank (ECB) has taken some COVID-19 actions on Pillar II guidance and the Capital Conservation Buffer, and the Central Bank also has reduced the Countercyclical Capital Buffer (CCyB). Credit unions are not subject to any of these additional capital requirements – therefore recent changes to these additional capital buffer requirements for banks, are not relevant to credit unions. The Pillar II requirements and other capital buffers are designed to address risks not covered by the minimum (Pillar I) capital requirements which apply to banks. The key point to note in this context is that, for both banks and credit unions, minimum capital requirements have remain unchanged.

[5] Issued on 2 April, Guidelines on legislative and non-legislative moratoria on loan repayments applied in light of the COVID 19 crisis.

Finally, in the area of regulatory flexibility, as communicated to credit unions in our circular of 16 April, we have provided flexibility to credit unions in terms of regulatory reporting requirements and RMP deadlines which is similar to that provided to other regulated entities (including banks). Further information on these measures is available on the COVID-19 Hub on our website.

So overall, it is clear that credit unions are not disadvantaged relative to banks in terms of the granting of loan moratoria and emergency lending in response to COVID-19 impacts. While frameworks differ, outcomes remain largely the same.

2. Investment asset qualifying criteria and limits

Will the Central Bank review qualifying assets and counterparty limits to protect credit union investment assets?
Will the Central Bank lower the risk weighting applied to Irish government bonds and/or create a de-risked solution in conjunction with the NTMA or other competent authority?

Background

Under section 43 of the 1997 Act, credit unions are required to ensure that they manage investments so that they do not involve undue risk to members' savings, and that before making an investment, the credit union board must assess the potential impact of the investment on the credit union, including the impact on its liquidity and financial position.

Given the current nature of economic uncertainty associated with COVID-19 and the prevailing asset mix within credit unions - where investments represent 66% of sector assets on average – investment risk is a key driver of financial risk within credit unions' balance sheets.

Credit union boards' investment decisions must take cognisance of appropriate levels of investment risk for credit unions, consistent with the requirement under section 43 of the 1997 Act. In addition, credit union investment decisions and investment portfolios should reflect the objects of credit unions[6] and that it is the savings of credit union members (withdrawable on demand), that are being invested by credit unions.

Qualifying assets and counterparty limit

You have stated in your7 April letter that ***'whilst some bond yields have risen, other interest rates have fallen'***. You have further noted that ***'liquidity and counterparty credit risks have also increased, especially on financial sector securities'*** and ask will the Central Bank '***review qualifying assets and counterparty limits to protect credit union investment assets***'.

[6] The primary objects and purpose of a credit union are the promotion of thrift among its members by the accumulation of their savings and the creation of sources of credit for their mutual benefit at fair and reasonable interest rates.

In the context of the need to continue to ensure no undue risk to members' savings, and the increased risks that are associated with pursuing higher returns (the risk/return trade-off), we are of the view that the range of permitted investment classes as set out in the Credit Union Act 1997 (Regulatory Requirements) 2016 (as amended) (the 2016 Regulations) remains appropriate for credit unions' investment of surplus funds.

In relation to the counterparty limit, its purpose is to facilitate appropriate levels of diversification in credit union investment portfolios. Diversification is a critical means of managing risk in investment portfolios, by helping to mitigate the impact of exposure to single counterparties, and in the current environment, this remains of critical importance to protect members' funds.

Accordingly, our expectation is that credit unions should continue to manage their investment portfolios to ensure that they achieve an appropriate level of diversification including compliance with the 20% counterparty exposure limit from March 2020. This marked the end of the two-year transitional period provided for and advised to credit unions when revised investment regulations were issued in 2018.

Risk weighting of Irish Government bonds

In your 7 April letter you ask if the Central Bank will '***lower the risk weighting applied to Irish government bonds and or create a de-risked solution in conjunction with the NTMA or other competent authority***'.

The investment regulations in place were carefully designed and structured, to set classes of investments and specific exposure and maturity limits. The framework supports balanced, diversified investment portfolios, with appropriate levels of risk for surplus funds, the source of which is members' savings.

We believe that the assignment of a differentiated risk weighting to one specific investment class or indeed a subset within a particular class which you appear to be suggesting, would not be appropriate. This could potentially have the effect of unintentionally incentivising investment in one particular counterparty, over other investment counterparties, or indeed loans to members. This could unintentionally serve to reinforce the existing imbalance in credit union balance sheets by dis-incentivising credit unions from providing credit – which is their core purpose.

More generally in terms of regulatory reserves, the current reserve requirement for credit unions is calculated on a non-risk weighted, leverage ratio basis. This is a reflection of a number of factors including: available sources of reserves (retained earnings only); the need for individual credit unions to have the capacity to absorb potential losses in absolute terms and the non-complex business model currently operated by Irish credit unions, which is predominantly focused on the provision of short-term personal lending.

We believe there is no rationale to change to a risk weighted approach given the current asset mix of Irish credit unions, the nature of the business model and the costs associated with

implementation for credit unions. One of the "Additional Observations" contained in the 2019 Peer Review Report suggests that the Registry of Credit Unions conduct additional stress-testing on regulatory reserves under the existing leverage ratio and risk-weighted reserve approach. We will consider this suggestion as we plan our work around implementation of the Peer Review Team's recommendations.

De-risked investment solution

In relation to a '***de-risked investment solution'*** as you refer to it, it is unclear what specific advantage the type of product that you envisage would provide to credit unions. Currently credit unions can access Irish Government bonds through the primary and secondary markets. All such bonds are guaranteed by the Government and pay investors the market determined rate of return. Also, it is important to note that it is not within the mandate of the Central Bank to create or design investment products on behalf of regulated entities.

3. Liquidity on an individual credit union and sectoral basis

Will the Central Bank provide appropriate supports or communications to reflect credit unions play a critical role in maintaining confidence in the overall financial system?
Will the Central Bank consider a sector liquidity mechanism or guarantee scheme for credit unions facing temporary liquidity squeeze's?

You have noted that ***'many credit unions are experiencing savings inflows as banks close branches or members reallocate their life savings across deposit guaranteed institutions***' and have asked if the Central Bank will ***'provide appropriate supports or communications to reflect credit unions play a critical role in maintaining confidence in the overall financial system***'.

The business model challenges associated with depressed loan demand have been referenced above. It is evident that credit unions have for some time faced commercial challenges associated with excess funding given savings inflows outpacing credit union lending. We continue to expect credit unions to undertake proactive asset and liability management, giving consideration to their assets mix and specific funding requirements (taking account of the objects of a credit union), and endeavouring to manage their savings inflows accordingly.

Our statutory mandate is concerned with ensuring the protection of members' funds by credit unions and the financial stability and well-being of credit unions generally. Our communications to the sector support this, however credit union commercial challenges associated with an imbalance between savings and loans is a matter for each individual credit union to manage. If individual credit unions are concerned about their financial circumstances, they should engage with their supervisor in the Registry of Credit Unions.

You also note that '***some credit unions may experience outflows as members utilise savings to cover living costs and income shortfalls***' and ask if the Central Bank will '***consider a sector liquidity mechanism or guarantee scheme for credit unions facing temporary liquidity squeezes***'.

On the issue of potential savings outflows, we note that credit unions have entered this crisis with high levels of liquidity, well in excess of minimum liquidity requirements. Credit unions are also required to have liquidity management policies in place to ensure that they can meet their obligations as they arise. Through regulatory reporting, we continue to closely monitor liquidity levels in all credit unions. To date, liquidity remains at a stable level across the sector.

The Central Bank is not mandated to create centralised liquidity mechanisms for credit unions – it is a matter for the sector. We do recognise that such mechanisms have key benefits and they feature in more advanced credit union movements internationally, where credit unions collaborated to put them in place. Indeed, the Central Bank highlighted the lack of such a mechanism in Ireland was a factor which informed the business and house lending changes introduced in January 2020.

Consideration of alternative sources of liquidity in times of stress is an important part of contingency planning, and the Central Bank encourages credit unions to consider their contingency liquidity arrangements - both at an individual level and a collective basis. Individual credit unions should contact their supervisor if they have concerns in relation to their liquidity.

4. Financial accounting guidance for year-end Sept 2020

Can CUDA and the Central Bank work together to provide practical guidance for Auditors in relation to provisioning and accounting?
Will the Central Bank consider temporary waivers, year-end extensions or suchlike measures for the financial year ending Sept 2020 (and potential write backs at a later date)?

<u>Temporary waivers and year-end extensions</u>
Accuracy and transparency from boards on the financial position of their credit unions and associated financial disclosures, are of paramount importance for members at all times and particularly in times of crisis or stress. Any perceptions of potential information vacuums would not support sound decision-making, or member confidence in their credit union.

It is our understanding that ESMA's actions on publication of financial reports, to which you refer in your 7 April letter, were in response to operational challenges associated with the preparation and publication of financial reports in line with deadlines under the European Transparency Directive. These reporting requirements and deadlines are not applicable to credit unions.

In terms of planning for 2020 credit union financial year-end, as in previous years, we will continue to issue a circular to all credit unions in advance of year-end highlighting the key matters to be considered as part of the year-end process. For 2020 year-end, this will of course be informed by particular issues associated with COVID-19. We also encourage credit unions to engage early with their external auditors as well as their supervisor in the Registry of Credit Unions, in order to identify any potential issues or areas for consideration - so that they can plan for the required actions and avoid any unnecessary delays in the year-end process.

We recognise the operational challenges for credit unions associated with the preparation, audit and publication of year-end accounts. However, given the potential negative impacts of any delays and the timeframe available before the financial year-end, we suggest that energies and resources should be focused on ensuring that operational issues are addressed as far as possible, to ensure the timely publication of financial information for members. We are happy to work with CUDA if there are operational issues identified in this regard.

Where any specific issues are identified by individual credit unions in relation to their planning preparation, audit or publication of accounts, we request that those credit unions engage with their supervisor in the Registry of Credit Unions as early as possible.

Provisioning

In terms of loan provisioning, the underlying purpose is to ensure that losses are recognised as early as possible to support clarity and transparency on the performance of loan books and the financial position of individual credit unions.

Financial Reporting Standard 102 (FRS 102) - the accounting standard applicable to credit unions - requires an '*incurred loss*' approach to the calculation of bad debt provisions on loans. This contrasts to banks who use an '*expected loss*' approach, making comparisons in terms of loan loss treatment less meaningful given the differing frameworks. The core principle with respect to impairment is that there must be objective evidence of it before a provision is recognised. Where it is deemed that there is objective evidence of impairment, the credit union board must recognise a provision.

Our Provisioning Guidelines for Credit Unions (April 2018) were put in place to ensure credit unions have appropriate procedures for assessing and measuring credit risk, to support judgements about the risk of lending exposures. Under the guidelines, the Central Bank expects that credit unions undertake a loan impairment review on at least a quarterly basis, to help to ensure the recognition of loan losses as early as possible in accordance with applicable accounting standards.

As set out in the guidelines, it is the overall responsibility of the board of each credit union to ensure the adequacy and accuracy of its loan provisioning. The Central Bank expects credit unions to continue to apply a conservative and comparable approach in the measurement of provisions, and to regularly assess loans for objective evidence of impairment. This will be based on all available information at assessment, including for instance unforeseen changes in the economic cycle.

While provisioning frameworks differ between banks and credit unions, as set out above, neither are required to make an automatic provision where a payment break is provided due to COVID-19. However, for both banks and credit unions, they will need to consider circumstances where borrowers may face longer term financial difficulties, to ensure that risk is identified and measured in a true and accurate manner.

COVID-19 impacts will include different consequences for member capacity to repay loans in line with contract. Some borrowers may be impacted on a temporary basis, and their loan repayments

will shortly resume in line with contract. For others, impacts may be longer term in nature and may have a more significant impact on their ongoing ability to repay their loan. These particular factors and circumstances need to be considered by each credit union board, as part of their objective loan provisioning assessment in line with the existing provisioning framework. It has never been more important to ensure that distress within individual credit union loan books is not underestimated through loan classification and provisioning assessments.

Finally, as part of our supervisory work we are engaging with external auditors in relation to provisioning by credit unions, so that there is awareness on the continued need for the 2018 provisioning guidelines to be implemented consistently across the sector. Additionally, we will be focusing on provisioning as part of our supervisory engagements with individual credit unions.

5. Treatment of breaches of compliance requirements

Will the Central Bank adopt a pragmatic approach in the event of non-material breaches and material breaches which occurred due to factors outside the control of the credit union and did not impact the financial health of the credit union or its members?

Our supervisory expectation is that credit unions comply with their regulatory obligations and in the event of a potential or actual material breach, they engage at an early stage with their supervisor in the Registry of Credit Unions. It is not possible to answer your question in general terms nor is it possible to give an ex-ante commitment on the Central Bank's approach. The reason for this is that in the event of a breach, the specific circumstances giving rise to the breach are taken into account in determining what supervisory or enforcement actions may be taken. This would include an assessment of the nature, seriousness and impact of the particular breach including consideration of:

- whether the breach was deliberate, dishonest or reckless;
- the duration and frequency of the breach;
- whether the breach reveals serious or systemic weaknesses of the management systems or internal controls relating to all or part of the business;
- the extent to which the breach departs from the required standard; and
- the impact or potential impact of the breach on the orderliness of the financial markets, including whether public confidence in those markets has been damaged or put at risk.

Information on the Central Bank's enforcement tools is available on the Central Bank website with detail on the Administrative Sanctions Procedure set out in the Outline of the Administrative Sanctions Procedure 2018 document.

6. Solvency

You have raised a number of questions in your 7 April and 22 May letters in relation to solvency breaches each of which is dealt with below.

Temporary waivers from capital requirements

Will the Central Bank provide temporary waivers to credit unions who breach their 10% and 7.5% capital ratios but remain a viable long-term business?

Adequate reserves support a credit union's operations, provide a base for future growth and protect against the risk of unforeseen losses. Credit unions need to maintain sufficient reserves to ensure operational and business continuity and to protect members' savings. In line with your earlier questions, adequacy of reserves is also key to maintaining member confidence and on-going sector stability.

However, it seems clear that most credit union boards have prudently decided to hold additional reserves in excess of the 10% minimum regulatory reserve requirement with a sector average reserve ratio of 16% as at 31 December 2019.

A credit union can make transfers into and out of its reserves in excess of the 10% regulatory minimum reserve requirement, as long as the credit union board has satisfied itself that the total level of reserves held are appropriate. In doing so, the board must take prudent account of the scale and complexity of its business, its risk profile and prevailing market conditions. Credit unions should also give consideration to the challenges and limitations associated with replenishing its reserves, given that retained earnings represent the only source of reserve generation.

Where an individual credit union has concerns about the impact of COVID-19 on its capital position, we expect that they would engage with the Registry of Credit Unions on a timely basis to outline the particular circumstances arising and their plans to address matters and we would engage with the credit union accordingly.

Cost of Utilising Statutory Funding Mechanisms

Will the Central Bank work with CUDA to implement a solution which makes sector stabilisation and resolution funds available to credit unions on an affordable basis?

The legislative and regulatory framework makes provision for a range of 'safety net' mechanisms in line with best international practice as it relates to deposit taking institutions. The Oireachtas has, through primary and secondary legislation, put in place the Statutory Stabilisation Fund and the Credit Institutions Resolution Fund (CIRF), as forms of such safety nets to support credit unions and their members at times of financial distress.

Statutory Stabilisation

The Credit Union and Co-operation with Overseas Regulators Act 2012 (the 2012 Act) enables the Minister for Finance to provide stabilisation support to credit unions from the Credit Union Fund where such support is requested and approved by the Central Bank. The 2012 Act specifies that the Central Bank can only approve the provision of stabilisation support to a credit union under certain conditions, including the requirement for credit unions to have regulatory reserves at or in excess of 7.5% of total assets and where in the opinion of the Central Bank the credit union is viable as a

credit union[7]. Any stabilisation support provided from the Credit Union Fund must be repaid by the credit union receiving stabilisation support.

Please note that under EU State Aid requirements approval of the scheme, including the terms of recoupment of the cost of stabilisation by the fund, is a matter for the EU Commission.

Credit Institutions Resolution Fund (CIRF)

The Central Bank and Credit Institutions (Resolution) Act 2011 (the 2011 Act) provides the Governor of the Central Bank with resolution powers which aim to effectively and efficiently resolve authorised credit institutions[8] that are failing or likely to fail, while also seeking to protect the taxpayer, the stability of the financial system and the economy.

The 2011 Act also established the CIRF. The purpose of the CIRF is to provide a source of funding for the resolution of financial institutions. To date, the resources of the Resolution Fund have been utilised to fund the resolution of six credit unions under the 2011 Act, including three cases where the resolution action taken was a directed transfer, and three cases which involved liquidation.

The costs to credit unions associated with statutory stabilisation and resolution fund levies are matters that should be directed to the Minister for Finance.

Replenishing Capital

Will the Central Bank allow credit unions to replenish their capital, including seeking permanent capital, diversify into longer-term funding from government or other low-risk sources?

Under existing capital requirements for credit unions as set out under the 2016 Regulations, all capital must be perpetual in nature. All reserves must meet the criteria set out in Regulation 3(1) and 3(2) of the 2016 Regulations. These requirements ensure that capital is of appropriate quality and capable of absorbing losses. This follows regulatory best practice globally, and helps to ensure the protection of member funds.

In relation to funding, even if longer term by its nature it is withdrawable, and clearly would not meet the above-mentioned criteria. As you are aware, credit unions are currently predominately funded by member savings, which is regarded as a stable source of funding. Indeed as noted above, one of the commercial challenges facing credit unions is excess funding given savings growth outpacing lending growth - so it is unclear what benefit alternative funding sources, including funding from Government, would provide to credit unions. Credit unions already have more than sufficient funding available at present, to meet the lending demands of members.

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[7] Section 65(4) of the Credit Union and Co-operation with Overseas Regulators Act 2012 sets out items that the Bank may have regard to before making the decision to approve stabilisation support.

[8] This legislation now applies to credit unions only as credit institutions now come within the remit of the Bank Recovery and Resolution Directive (BRRD) which was transposed into Irish law on 15 July 2015.

Sale or securitisation of loans

Will the Central Bank allow credit unions to sell or securitise their loan assets to free-up capital?

This has not been raised before in the context of regular prior reviews of the legislative and regulatory framework for credit unions. It is not referred to under the 1997 Act and indeed it would seem that the sale or securitisation of members' loans would not have been envisaged by the Oireachtas when that legislation was originally enacted, or considered when it was revised in 2012.

More fundamentally the sale or securitisation of member loans would represent a significant change to the operation of credit unions and for members. It would need to be considered by all stakeholders, including individual credit unions and their members and the Oireachtas. In particular, the objectives and reasons for considering such a change and the potential impacts on members and the operation of common bonds would need careful consideration.

Finally, we would note the current short term duration of credit union loan portfolios which would make application of securitisation challenging in a credit union context. We would further note the current level of available sector funding and capital and would question if securitisation is currently required and if now is the appropriate time, given the current crisis, to begin such a discussion, taking account of the key commercial and financial challenges facing credit unions.

Summary

Finally, in delivering on our statutory mandate - to ensure the protection by each credit union of the funds of its members and the maintenance of the financial stability and well-being of credit unions generally - we will continue to support all credit unions through our supervisory engagement.

We recognise credit unions will need to take commercial decisions in supporting members affected by COVID-19. It is fundamentally important that a prudent approach is maintained to lending, investments, liquidity and capital, as it will best serve the longer term interests of credit unions and their members. Therefore, it is imperative that particularly at this time, the leadership of the sector ensures that credit unions continue to focus on their financial and operational resilience.

In the context of our mandate, we believe that clarity and transparency are important in terms of our engagement with sector stakeholders on regulatory matters that affect credit unions and their members. With this in mind, we have decided to publish our correspondence on our established policy positions to provide clarity and transparency to all credit unions and their members, and to contribute to the broader sector dialogue on these matters.

It is important to also note that there are costs associated with engaging on regulatory change issues. As sector regulator, we value coherence and considered thought on proposed changes presented to us, including substantiation with underlying supporting rationales. You will appreciate that we are keen to continue to engage with the sector and its representatives regarding your regulatory change agenda – recognising both our ongoing engagement with you and the level of associated regulatory change for credit unions, far exceeds that of other regulated sectors.

However, as noted above regulatory change cannot address fundamental commercial challenges. We would therefore encourage the leadership of the sector to dedicate its collective thinking towards those broader commercial challenges in service of credit union sustainability.

For now, given the ever-changing developments associated with COVID-19, we stress the continued need for early engagement by credit unions, on any emerging issues, with their supervisor in the Registry of Credit Unions. In the meantime, we will also continue to engage constructively with all sector stakeholders, including CUDA, recognising that we all have a role in supporting credit unions in delivery of services to their members in a safe and sustainable way. We believe our proposed workshop would provide an appropriate forum to clarify our position on the important policy questions you have raised through your recent correspondences.

Yours sincerely

Patrick Casey
Registrar of Credit Unions