



Banc Ceannais na hÉireann  
Central Bank of Ireland

Eurosystem

# PRISM Supervisory Commentary 2018

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March 2018

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# 1. Foreword

*The Central Bank's risk-based supervisory framework, PRISM, has applied to credit unions since May 2012 when we commenced the first cycle of risk assessments and on-site engagements.*

*In May 2014, we published "Credit Union PRISM Risk Assessments – Supervisory Commentary" which highlighted key risk issues identified during engagements conducted between 2012 to 2014. The commentary provided an important support to credit unions in setting out risk issues by category and our related minimum supervisory expectations. At that time we articulated our expectation that credit unions would implement governance and risk management improvement programmes, informed by our evidenced-based PRISM findings, to better position them to respond to the challenging operating environment.*

*Since the introduction of PRISM in 2012, the sector has undergone extensive change through a phase of restructuring and consolidation. Today the largest 53 credit unions account for 55% of total assets and 50% of membership in the sector. This has coincided with the strengthening of the regulatory framework for credit unions including the introduction of comprehensive governance and risk management requirements.*

*It is now timely to again provide evidenced-based supervisory commentary to the sector on our PRISM risk assessments and on-site engagements. The commentary sets out our findings on key areas including strategy and business model risk as well as an update on the current status of governance and risk management standards across the sector. We have also set out our supervisory expectations, which together with our evidenced-based findings, should provide credit unions with useful insights to support the enhancement of their governance, risk management and operational frameworks.*

*There are examples of credit unions that have successfully addressed risks identified during our supervisory engagements leaving them positioned to undertake business model development and ensure sustainability into the future. However, given the level of focus on credit union governance and operational risk in the 2014 supervisory commentary, it is concerning that over 60% of individual risks identified in the course of supervisory engagements considered for this report related to governance or operational risk. Effective governance and systems and controls remain vital for credit unions to derive the benefits of restructuring and consolidation and to exploit the strategic opportunities from business model development. It is important that each credit union's own risk appetite and risk tolerance inform their strategic selection of new business initiatives. Credit unions must embed systems and controls to acceptable levels before considering significant business model development.*



Patrick Casey

**Registrar of Credit Unions**

**March 2018**



## 2. Executive Summary

In undertaking supervisory engagements with credit unions we have two main objectives:

- To drive standards of best practice in credit unions while ensuring compliance with regulatory requirements; and
- To ensure early-stage risk detection, intervention and risk mitigation.

Strong governance culture and the identification and mitigation of risks is core to ensuring the protection by each credit union of the funds of its members and the maintenance of the financial stability and well-being of the sector. Our supervisory engagement with credit unions is key to ensuring that we achieve our vision for the sector of 'Strong Credit unions in Safe Hands'.

- We see 'strong credit unions' as being financially strong and resilient, enabled by sustainable, member-focused business models underpinned by effective governance, risk management and operational frameworks.
- We see that 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 member's product and service expectations.

A credit union's foundations are its governance, risk management and operational capabilities. Through our PRISM<sup>1</sup> engagement credit unions are required to manage risks in a systematic and structured fashion. The responsiveness to and quality of the remediation of these Risk Mitigation Programmes (RMPs) distinguishes progressive and risk-focused credit unions from their peers.

Our supervisory approach supports business model development through on-site engagement designed to strengthen the core foundations of governance, risk management and operational capabilities, in order to support safe, sustainable growth. Credit unions that positively engage with supervisors and effectively implement RMPs are best positioned to undertake business model development and ensure sustainability into the future.

We supervise credit unions in a manner that is proportionate and appropriate to the nature, scale, and complexity of individual credit unions. Our supervision approach has been designed to accommodate differing approaches for risk profiles, enabling us to proportionately differentiate between credit unions of different size and risk. While we expect all credit unions to meet minimum regulatory standards, our supervisory expectations are higher for medium and large-sized credit unions.

Fundamentally, we regulate and supervise the sector to ensure that credit unions are financially sound and safely managed, so they can serve the needs of their members.

In May 2014, we published "Credit Union PRISM Risk Assessments – Supervisory Commentary" (the 2014 Report) which provided an overview of our PRISM findings and an update on the current status of governance and risk management standards and practices across the sector. The 2014 report

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<sup>1</sup> The Probability Risk and Impact System (PRISM) is the Central Bank's risk-based framework for the supervision of regulated firms.

highlighted significant issues identified during PRISM engagements and set out minimum expectations for credit unions.

This supervisory commentary provides an overview of seven risk categories of the PRISM framework<sup>2</sup> where findings were identified. The commentary is based on 955 individual risk issues, identified across these risk categories during on-site PRISM engagements. These risk issues form the basis for 113 final RMPs issued to credit unions between January and October 2017 on foot of our on-site engagements.

There is some evidence of improving standards of corporate governance across the sector, evidenced by the progress in the nature of the risks being identified during our supervisory engagements as previously identified risks are addressed. However, this is not uniform. We continue to find differing standards across the sector and while some credit unions demonstrated relatively sound governance and risk management practices, in a substantial number of credit unions significant governance and risk management issues were identified. It is notable that issues identified are found in credit unions of all sizes, and not just confined to smaller entities.

Those credit unions demonstrating stronger governance have typically moved beyond a mere 'tick-box' compliance attitude to exhibiting a more integrated risk governance culture, with a strong awareness and understanding of the impact of unmanaged risk. Such credit unions are more likely to leverage appropriately the important supports to the board provided for in the 2012 enhanced governance framework of internal audit, risk management and compliance in order to provide them with an improved understanding of the risk profile of their credit unions so that they can drive the necessary changes and improvements.

Strong governance is fundamental to a well-run and strongly performing entity, and together with effective systems and controls contribute to the essential prudential foundations to underpin the sustainability of the credit union. We expect credit union boards to have a strong awareness and understanding of the impact of poor governance and unmanaged risk.

A summary of our analysis of the issues identified in each of the seven risk categories of the PRISM framework considered is set out below. Further detail on this analysis is set out in section 4 of the paper.

### **Governance Risk**

It is concerning that such a high percentage of issues identified relate to governance, representing 37% of all of the risks identified. However there is a shift in emphasis within RMPs issued with less focus on board and management operational dysfunction and increased focus on weaknesses in risk oversight, reporting and management systems with a particular focus on the quality of engagement between boards and the internal audit and risk management function.

Examples of issues being identified by either the internal audit or risk management function but boards failing to respond appropriately were identified. Issues were also identified in relation to the level and quality of discussion and challenge by boards. As highlighted in the 2014 report, the functional roles of

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<sup>2</sup> The PRISM System of risk-based supervision outlines the probability risk categories used by supervisors to assess a credit union's risk probability. Further detail can be found in the ['PRISM Explained'](#) Guidance issued in February 2016.

compliance officer, risk management and internal audit are intended to support boards and management in discharging their key responsibilities. Boards, who have the ultimate responsibility for the control, direction and management of the credit union, should be able to leverage off these functions to improve their governance capability. This will only occur where there is greater quality engagement between board members and these key functions, resulting in proactive responses from boards to matters raised by these functions.



**Operational Risk**

Operational risks represented 24% of risk issues identified.



While we see evidence of increased awareness of operational risk, the risk issues identified highlight our concerns with the effectiveness of internal processes and systems. In some credit unions we identified failures to document processes and procedures. In other instances, while processes and procedures were documented, credit unions were failing to implement them effectively. A significant number of issues were also identified in relation to inadequate segregation of duties with examples of individuals holding responsibilities for multiple functions in credit unions increasing the risk of error and misappropriation.

**Credit Risk**

Credit risks identified in the sample of RMPs reviewed for this report represented 19% of risk issues identified.

It is notable that we are still finding significant issues with credit underwriting processes including examples of credit unions failing to assess member capacity to repay before providing loans and failing to document rationales for credit decisions.



### Strategy / Business Model Risk

Strategy and business model risks represented 13% of risk issues identified. While the majority of credit



unions now have a strategic plan in place, the risk issues identified in this area highlight concerns regarding the quality, effectiveness of implementation and level of review of such plans. Strategic thinking about how to evolve the credit union business to adapt to the challenging operating environment needs to be a fundamental part of the board and management conversation. Strategic planning must be undertaken within the context of the credit union's stated risk appetite and be aligned to its operational capabilities, as well as member product and service expectations.

### Capital, Market and Liquidity Risk

The other risk issues identified related to capital, market and liquidity risks. Not surprisingly, the low interest rate environment continues to represent a challenge for the sector. Against this background it is vital that credit unions have a clearly articulated investment risk appetite, reflective of the fact that member's funds are being invested by the credit union and the statutory obligation to ensure no undue risk to member's funds. We would therefore expect this be reflected in investment policies and in the investment decisions made by credit union boards.

The risk issues identified and supervisory expectations provided in this report should support credit union boards in developing and embedding governance and risk management frameworks. The information in this report will also inform our supervisory engagements and approach with credit unions for 2018 and beyond. It is of concern that for some credit unions RMPs are recurring through our PRISM cycles. This suggests that these credit unions have not sufficiently mitigated risks previously highlighted following prior supervisory engagements. An evaluation of the quality and effectiveness of remediation of RMPs issued will be a key focus of our 2018 on-site engagement programme to ensure that all credit unions are moving towards an integrated risk governance culture with a strong awareness and understanding of the impact of unmanaged risk.

### 3. Background

Risk-based supervision, carried out through our PRISM framework is fundamental to the execution of the Central Bank's statutory mandate to ensure that each credit union protects the funds of its members. PRISM enhances our ability to deliver judgement-based, outcome-focused supervision for the sector.

Since the introduction of PRISM in 2012, our supervision of the sector has involved over 700 PRISM on-site engagements with credit unions. Over the last five years, many credit unions have had at least two on-site engagements with the Registry of Credit Unions (RCU) and in some cases more than this level of engagement. Following each PRISM engagement, where issues are identified the credit union is issued a RMP setting out issues identified relating to key risk areas where remediation actions and improvements in governance and risk management are required. As part of this process, the credit union is provided with an opportunity to respond to RCU, prior to finalisation of the RMP.

It is now timely to again provide supervisory commentary to the sector on our credit union risk assessments to set out our findings on key areas such as strategy and business model risk, as well as the current status of governance and risk management standards across the sector.

#### PRISM Objectives

RCU's approach for PRISM engagements with credit unions has two main objectives:

1. To drive standards of best practice in credit unions while ensuring compliance with regulatory requirements; and
2. To ensure early-stage risk detection, intervention and risk mitigation.

The ultimate responsibility of a credit union board is to ensure that it employs sound governance and effective risk management standards and practices. In order to help ensure this from a prudential perspective, RCU deliver RMPs to credit unions. Our expectation is that the board and management will engage in a constructive and proactive manner in addressing such findings to ensure that identified risk issues are mitigated within appropriate timeframes as specified in the RMP.

Strong governance culture and the identification and mitigation of risks is core to ensuring the protection by each credit union of the funds of its members and the maintenance of the financial stability and well-being of the sector. Our supervisory engagement with credit unions is key to ensuring that we achieve our goal of 'Strong Credit Unions in Safe Hands'.

- We see 'strong credit unions' as being financially strong and resilient, enabled by sustainable, member-focused business models underpinned by effective governance, risk management and operational frameworks.
- We see that 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 member's product and service expectations.



A credit union's foundations are its governance, risk management and operational capabilities. Through our supervisory engagement credit unions are required to manage risks in a systematic and structured fashion, by setting out the mitigating actions to be taken to address them.

### Supervisory Proportionality

We supervise credit unions in a manner that is proportionate and appropriate to the nature, scale, and complexity of individual credit unions. Firm size combined with risk are the drivers of the frequency of inspections (including mandatory meetings) enabling us to proportionately differentiate between credit unions of different size and risk.

While we expect all credit unions to meet minimum regulatory standards of sound practice in governance and risk management, our supervisory expectations are higher for the medium and large-sized credit unions, who should have the resources, capabilities and competencies to run more complex operational undertakings, and in particular engage in safe and prudent business model and balance sheet transformation.

## 4. Overview of PRISM Risk Assessment Findings

This supervisory commentary is based on 955 individual risk issues, identified across seven risk categories of the PRISM framework during on-site engagements. These risk issues form the basis for 113 final RMPs issued to credit unions between January and October 2017 on foot of our on-site engagements.

In addition to providing an overview of PRISM findings relating to Governance, Operational Risk, Credit and Strategy / Business Model for the sector as a whole, the supervisory commentary also provides analysis across three asset classes of credit unions as follows:

- Class 1 - Greater than €100m in assets
- Class 2 - Between €25m and €100m in assets
- Class 3 - Less than €25m in assets

Table 1 below sets out our findings across the three asset classes.

Classification	No. of Credit Unions	As % of total credit unions in this asset class <sup>3</sup>	No. of risk issues in this asset class
Assets greater than €100m	22	42%	199
Assets between €25m and €100m	55	45%	421
Assets less than €25m	36	37%	335
<b>Total</b>	<b>113</b>		<b>955</b>

Table 1

Figure 1 below sets out risk issues identified by risk category as part of the findings.

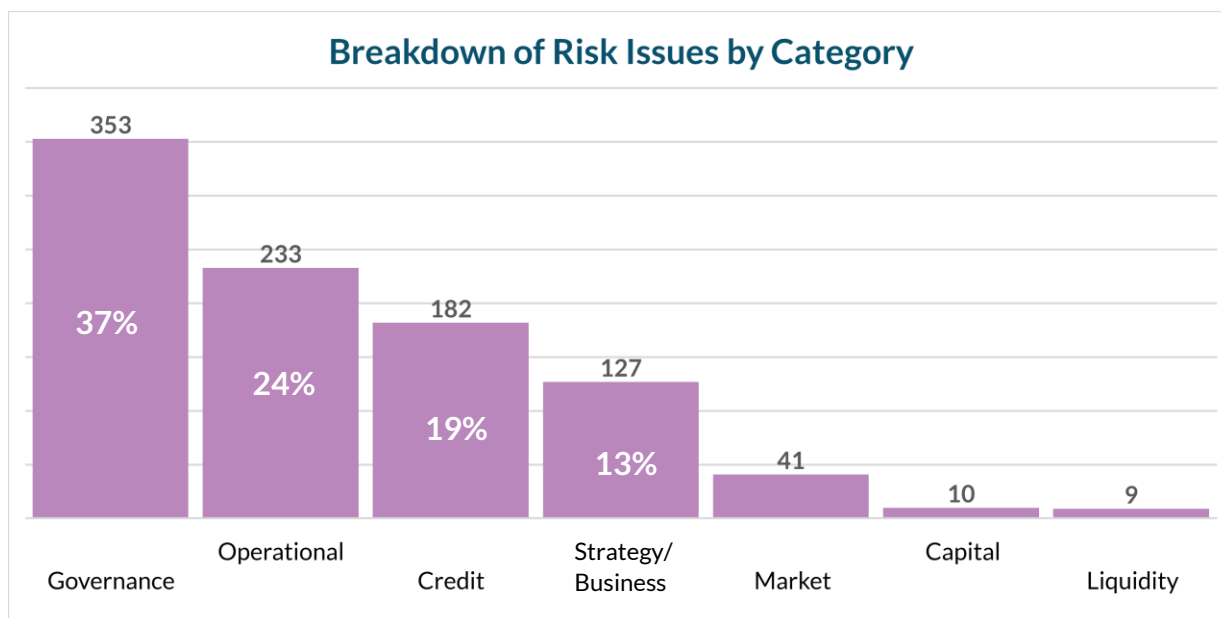


Figure 1

In the following sections, we will set out our supervisory expectations for each of the risk categories, which should assist credit unions in assessing their performance and in implementing actions to mitigate identified risks.

<sup>3</sup> Figures from Prudential Returns as at 30<sup>th</sup> September 2017

## 5. Governance Risk

### *General Expectations*

Sound and effective governance within the credit union is underpinned by strong leadership and oversight of key functions. The ultimate responsibility for the control, direction and management of the credit union remains with the board. Boards need to ensure they have adequate and appropriate resources and systems in place to meet their legal and regulatory obligations. They must also ensure they have effective governance structures in place, including effective risk management, internal audit and compliance functions.

The Credit Union Act, 1997 (the 1997 Act), sets out comprehensive governance requirements for credit unions that are designed to provide a framework to promote strong governance standards with a particular focus at board and management level. Section 66A of the 1997 Act requires that a credit union's governance arrangements include a clear organisational structure with well-defined, transparent and consistent reporting lines. Additionally, the 1997 Act sets out a number of roles, reporting lines and oversight arrangements which must be put in place in each credit union.

*Our primary supervisory expectations relating to governance risk include the following:*

- An effective and comprehensive governance framework should be evident in the credit union, including clear accountabilities and an appropriate performance management framework for relevant officers and staff.
- Effective engagement with internal audit, risk management and compliance functions should be evident. Boards should have an awareness, challenge and undertake action in relation to findings and issues identified by these functions.
- Clear separation between the roles of the board (non-executive) and management (executive). This separation should be underpinned by clear roles, responsibilities, reporting lines and accountabilities.
- A strategic, forward-looking focus at board level, with quality discussion and challenge of strategic plans and associated targets evident at board meetings. The ongoing monitoring and tracking of metrics to assess the implementation and effectiveness of the strategic plan is key to effective governance and driving the future direction of the credit union.
- Appropriate and timely reporting to the board in order to support decision-making on key strategic issues. Such reports should be well understood at board level and there should be evidence of discussion, challenge and follow-up from the board in relation to such reports.

### *Best Practice Example*

There are examples of credit unions that have successfully addressed governance risks identified during our supervisory engagements leaving them better positioned to undertake business model development and ensure sustainability into the future.

In one such case, governance and strategy/business model risk issues were identified by the supervision team, the cause of which was the structure and operation of the board of directors. A weak nomination committee which was receiving little or no support from the board had resulted in limited natural rotation on the board and a lack of a number of skillsets. Limited challenge by directors to the management of the credit union and consideration of the inherent risks of the credit union was also noted by the supervision team.

The credit union actively engaged with and fully implemented the RMP issued by the Central Bank which included a board rotation programme supported by a newly proactive nomination committee, with more focus on succession planning. The nomination committee identified skills gaps on the board and sourced and recruited new directors accordingly.

This resulted in a significant improvement in the quality of directors and the performance of the board overall. The actions completed by the credit union have significantly strengthened the board and have resulted in an improved strategic focus of the board.

This new strategic focus by the board has been key in supporting business model initiatives including applying for and receiving approval for Member Personal Current Account Services (MPCAS). RCU would now view this credit union as one which can be a driver and a leader of business model development within the credit union sector.

### *Governance Risk Findings*

Sound governance is an essential foundation to underpin the viability and development of individual credit unions. A credit union's foundations are its governance, risk management and operational capabilities. Strengthening those capabilities will enable credit unions to address the challenges they face. The risk management framework in particular should enable credit unions to identify, manage and mitigate risks to deliver a sustainable business model for members. The current challenging environment for credit unions highlights the importance of having sound governance and risk management practices within a clearly articulated framework.

Of significant concern is the high proportion of governance risk issues identified during PRISM engagements. These ranged from 35-38% of all risk issues identified across the three asset classes. The scale of governance related risk issues is concerning in light of the time that has elapsed since the new governance framework was introduced in 2012 and the extensive work undertaken by RCU in developing and supporting the implementation of governance requirements for credit unions.

In Table 2 below, we provide details on the number of credit unions included in this sample, and outline the number of governance risk issues identified in each, as a percentage of all risk issues.

Asset Class	No. of Credit Unions	Governance Risk issues identified	Total number of issues identified	Governance risk issues as % of all issues identified
Greater than €100m	22	74	199	37%
Between €25m - €100m	55	162	421	38%
Less than €25m	36	117	335	35%
<b>Total</b>	<b>113</b>	<b>353</b>	<b>955</b>	<b>37%</b>

Table 2

In Figure 2 below, we provide detail of the percentage of governance risk issues identified in each of the classes of credit unions during the on-site engagements.

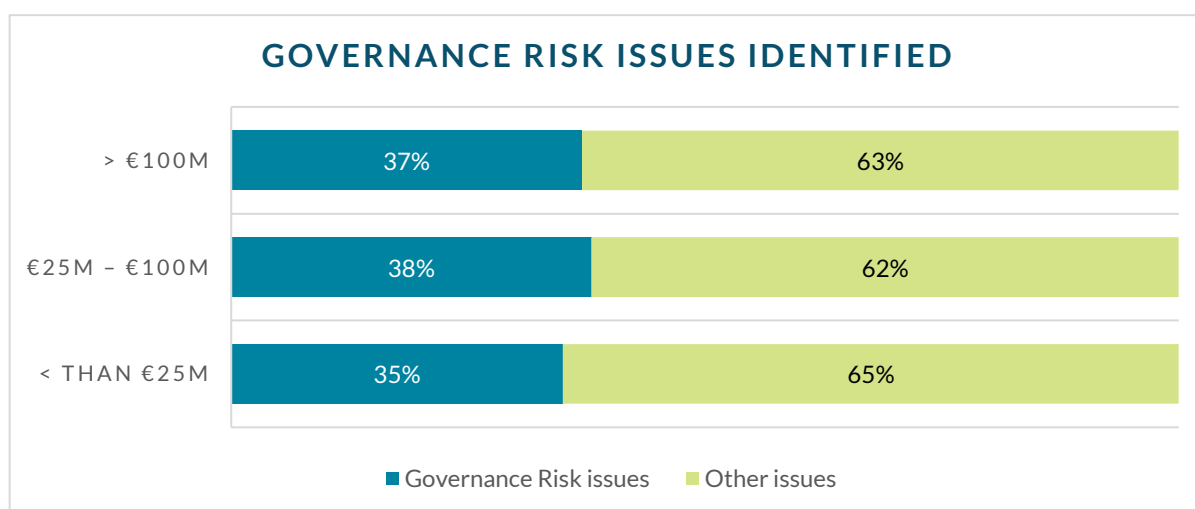


Figure 2

### Overall Governance Risk Findings

As part of our engagements across the sample of credit unions, a number of recurring risk issues were apparent in credit unions from all three asset classes;

- Ineffective engagement with the Internal Audit (IA) function, including a lack of written responses or challenge to reports from the IA function by the board was noted in our findings in credit unions across the three asset classes. A failure to adequately monitor the quality of the IA functions was also noted.
- Weakness in relation to the IA function, IA plans were found to be lacking in detail and did not demonstrate that a comprehensive work plan was in place.
- Ineffective engagement with the risk management and compliance functions, including failure to adequately monitor the quality of the outputs of these functions. In addition, there was a lack of board awareness of issues highlighted, as well as failure to provide written responses to the reports provided by these functions.
- Lack of adequate performance review framework within the credit union with failure to review the performance of individual directors, management and key staff.

The findings below highlight risk issues that were particularly prevalent in each specific asset class. However, many of these findings were also identified in the other asset classes and accordingly all credit unions should consider the findings set out below in addition to those set out above.

### Asset Size 1 (Greater than €100m)

The assessments in the greater than €100m asset class of credit unions highlighted the following risk issues:

- Numerous instances of insufficiently detailed risk management and compliance reports being presented to boards, with a lack of a minimum level of detail for these credit unions.
- Evidence of risk management officers and compliance officers not having the required time and/or resources to carry out the full extent of their duties.
- Examples of weaknesses concerning testing of branch locations (where applicable), including lack of evidence of testing by IA function, risk management and compliance testing in these branches.

### Asset Size 2 (From €25m to €100m)

The assessments in the €25m to €100m asset class of credit unions highlighted the following risk issues:

- Noted absence of evidence of discussion and/or challenge of the findings of risk management and compliance reports presented to the board at meetings. Lack of written responses from the board to the findings of these reports.
- Board minutes lacked sufficient detail to evidence the nature and extent of discussions on matters or decisions taken.
- Evidence of lack of formal risk management and compliance training for directors and staff. In some cases, adequate training was not provided to the officer responsible for risk management and /or compliance.
- Board Oversight Committees failing to meet legislative requirements e.g. not reporting on the performance of the board of directors and failing to hold meetings with the board as required.

### Asset Size 3 (Less than €25m)

The assessments in the less than €25m asset class of credit unions highlighted the following risk issues:

- Boards were operationally focused, failing to focus on strategic direction and planning.
- Board Oversight Committees not functioning effectively, not holding required meetings or maintaining any written evidence of review of the performance of the board.
- Evidence of key-person risk in relation to CEO or individual staff members. Over-reliance or dependency on the skillset of one individual to assume multiple roles.
- Many instances of the risk and compliance functions not being embedded.
- Inadequate reporting of risk / compliance issues, and a lack of awareness at board level of issues identified by these functions.
- Lack of pro-active succession planning.

## 6. Operational Risk

### *General Expectations*

Operational risk is the loss resulting from failed internal processes, people and systems or from external events. It is important for a credit union to develop a sound appreciation for material operational risks arising from significant business activities and how these risks are interrelated. Risks should be identified and their management and mitigation addressed in policies, procedures and processes. Operationally it should be possible to see where risks are being monitored and reported and where required action is being taken to mitigate identified risks. It is concerning that operational risk represents 24% of overall issues identified as part of our engagements with credit unions. A number of shortcomings in these areas require significant remedial work.

Since commencement of the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (the 2016 Regulations), credit unions are required to hold reserves in relation to operational risk. However, where operational risks are identified, the credit union's priority should be the management and mitigation of such risks through the implementation of appropriate processes and controls. The existence of an operational risk reserve does not negate the requirement to appropriately mitigate operational risks. The overarching expectation here is that a credit union shall have an appropriate framework to identify the operational risks it is exposed to, or is likely to be exposed to, and provide for the management and mitigation of those risks in the credit union's risk management system.

*Our primary supervisory expectations relating to operational risk include the following:*

- Operational risk can be wide-ranging, with significant consequences both reputational and financial. In this regard, it is important that operational risks are identified early-on, thereby enabling comprehensive assessment having regard to the nature, scale, complexity and risk profile of the credit union's business.
- The board of the credit union must take ultimate responsibility for the identification, assessment, management and monitoring of the operational risk that the credit union is exposed to.
- Appropriate and effective systems of control are at the core of mitigating operational risk. These include regular verification and reconciliation of transactions and accounts, as well as appropriate segregations of duties including procedures to deal with key person risk.
- We view IT as a major enabler of strategy and business development for credit unions. For this reason, the operational risks associated with this area need to be appropriately managed and monitored closely, given the pace of change in this area. Credit unions are expected to have appropriate business continuity arrangements in place and to ensure data is managed securely. Credit unions should refer to '[IT Risk in Credit Unions - Thematic Review Findings](#)' published in January 2018 for additional guidance on our expectations in relation to the management of IT risks.

### Operational Risk Findings

We are concerned to note the high proportion of operational risk findings, representing up to 27% in one asset class. In Table 3 below, we provide details on the number of credit unions included in this sample, and outline the number of operational risk issues identified in each, as a percentage of overall risk issues.

Asset Class	No. of Credit Unions	Operational Risk issues identified	Total number of issues identified	Operational Risk issues as % of overall issues identified
Greater than €100m	22	50	199	25%
Between €25m – €100m	55	115	421	27%
Less than €25m	36	68	335	20%
<b>Total</b>	<b>113</b>	<b>233</b>	<b>955</b>	<b>24%</b>

Table 3

In Figure 3 below, we provide detail of the percentage of operational risk issues identified in each of the classes of credit unions during the on-site engagements.

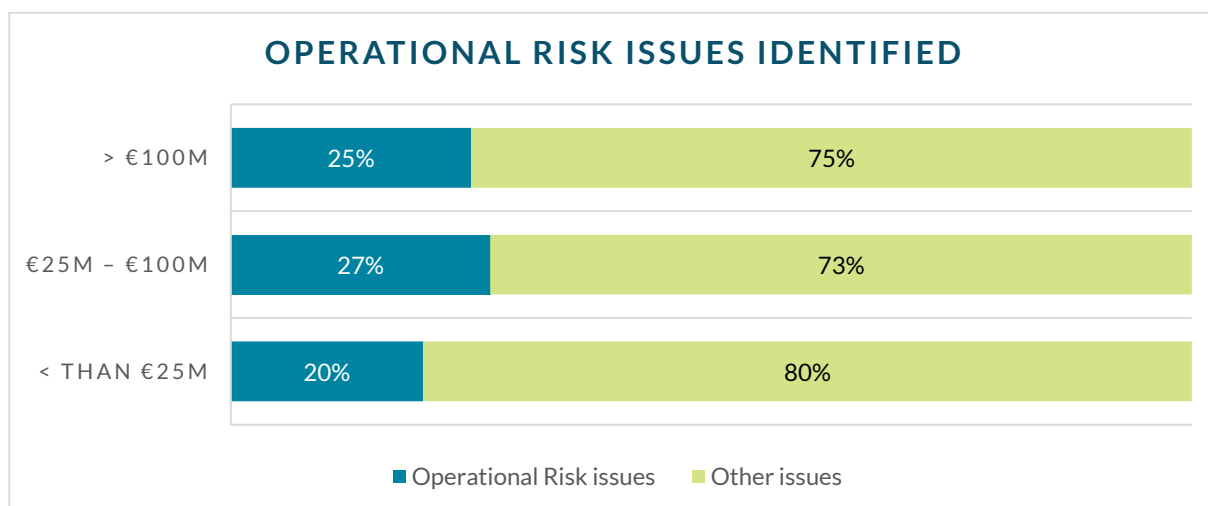


Figure 3

### Overall Operational Risk Findings

As part of our engagements across the sample of credit unions, a number of recurring risk issues were identified in credit unions from all three asset classes;

- Lack of formal remediation plans to address findings of IA reports. We also noted a lack of any tracking of issues raised in IA reports. This undermines the effectiveness of the IA function.
- Failure to adequately test Business Continuity Plans (BCPs) to ensure their effectiveness. In some cases an absence of any BCP was noted.
- Weaknesses concerning bank reconciliations, including failure to document an agreed procedure, failure to ensure that review and sign-off of the bank reconciliation is conducted and instances of reconciliations being incorrectly performed.
- Evidence of weaknesses in relation to Anti Money Laundering and Countering the Financing of Terrorism (AML/CFT) frameworks, with insufficient reporting, inadequate risk assessments and numerous examples of incomplete member due diligence records. This is of particular concern given in 2015, the Central Bank published a Report on Anti-Money Laundering/Countering the



Financing of Terrorism and Financial Sanctions Compliance in the Irish Credit Union Sector, which highlighted significant weaknesses across the sector in a number of control areas. This report should be considered by credit unions to inform the development of their AML/CFT frameworks.

The findings below highlight risk issues that were particularly prevalent in the specified asset class. However, many of these findings were also identified in the other asset classes and accordingly all credit unions should consider the findings set out below in addition to those set out above.

#### **Asset Size 1 (Greater than €100m)**

The assessments in the greater than €100m asset class of credit unions highlighted the following risk issues:

- Instances of credit unions failing to properly test the BCP of the credit union, including the role of some key service providers in the resumption of service.
- Weaknesses related to cash management controls including a lack of documented policies and procedures for cash management. In a small number of cases, supervisors noted the delivery, by staff of cash to local banks, with the potential to place member funds at risk.
- Failure to carry out an independent review of the effectiveness of the integration process post-transfer of engagements (where applicable). The lack of such reviews leads to the risk that the newly enlarged entity may not have embedded the required policies, procedures and systems and controls across its operations.

#### **Asset Size 2 (From €25m to €100m)**

The assessments in the €25m to €100m asset class of credit unions highlighted the following risk issues:

- No documented policies, procedures or independent oversight in place in relation to the operation of cash draws performed by the credit union.
- Numerous instances of credit union's IT server not being kept in a secure environment with restricted access. This allows for unauthorised access, which may increase security risks and/or risk of damage to the server that may impact the credit union's operational capacity, creating a risk of business disruption for member services.
- A large number of issues arising relating to inadequate segregation of duties concerning key operational areas within the credit union, with one individual holding responsibility for authorisation, approval and review of some functions.

#### **Asset Size 3 (Less than €25m)**

The assessments in the less than €25m asset class of credit unions highlighted the following risk issues:

- Instances of local businesses (which may not be members of the credit union) supplying cash to the credit union for operational reasons.
- Significant instances of key person risk/dependency on an individual to conduct a wide range of activities within the credit union. This leads to the risk of significant disruption if this person becomes unavailable for an extended period. This key person dependency in smaller credit unions gave rise to inadequate segregation of duties for operational matters.

## 7. Credit Risk

### *General Expectations*

Given the importance of credit to the overall business model of credit unions of all sizes, we expect high standards of credit risk management from a prudential perspective. In order to satisfactorily manage and mitigate credit risk, credit unions must ensure that credit assessment processes are based on coherent and clearly defined criteria, the process of approving and amending loans is clearly defined and documented in credit policies and that the credit process is consistently implemented. It is the responsibility of the board to ensure that there is an effective credit function in place, which is fully compliant with all legislative and regulatory requirements.

*Our primary supervisory expectations of prudent lending and credit risk management standards and practices include the following:*

- As required under the 1997 Act, the member's ability to repay shall be the primary consideration in the underwriting process and the credit union must manage and control lending to ensure the making of loans does not involve undue risk to member's savings. Credit unions must satisfy themselves that they are fully appraised of the borrower's financial position before granting a loan.
- Comprehensive and tailored credit policies, reflecting the relevant legislative requirements as well as the current practice and procedure within the credit union, must be put in place and actively implemented and adhered to. The policy should reflect the range of lending undertaken by the credit union and the board's stated risk appetite and tolerances in relation to lending.
- Supporting rationale must be clearly documented with lending decisions. The decision to grant or deny a loan should be supported by a suitably detailed rationale.
- An appropriate provisioning framework must be in place to ensure the recognition of loan losses as early as possible within the context of relevant accounting standards and the adoption of a sufficiently conservative and comparable approach to the measurement and recognition of provisions relating to loans.
- High quality, comprehensive management information related to the lending function should be available on a timely basis to the board, management and other relevant parties to support analysis of the credit risk of the credit union's lending exposures and to inform decision making.

### *Credit Risk Findings*

While total sector lending has contracted significantly since 2011, falling from €5.7bn in 2011 to €4.4bn in 2017<sup>4</sup>, we have found that overall, credit risk management still presents a significant challenge for the sector. In our findings, credit risk represents a high proportion of all risk issues identified across the credit unions we visited.

<sup>4</sup> September 2017 Prudential Returns (Registry of Credit Unions)

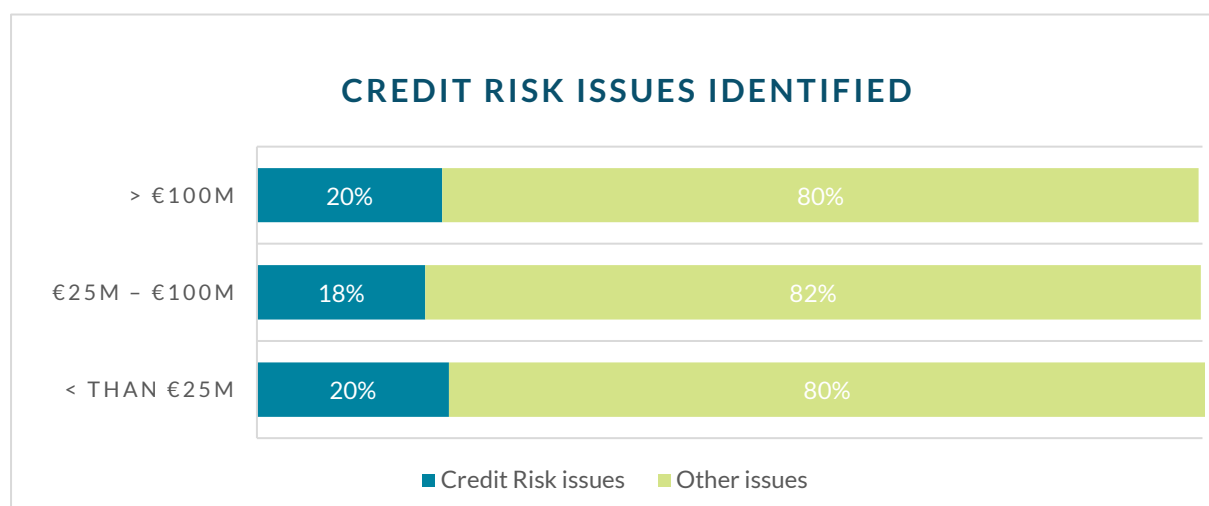
The 2016 Regulations include specific provisions regarding categories of lending, and requirements and limits relating to these categories of lending. A number of credit unions had not reflected these changes within relevant policies and procedures.

Table 4 below provides a breakdown of credit risk issues identified during PRISM engagements by specific asset class. Within the table, we provide detail on the number of credit unions included in this sample, and outline the number of credit risk issues identified in each, as a percentage of all risk issues.

Asset Class	No. of Credit Unions	Credit Risk issues identified	Overall issues identified	Credit Risk issues as % of overall issues identified
Greater than €100m	22	39	199	20%
Between €25m - €100m	55	75	421	18%
Less than €25m	36	68	335	20%
<b>Total</b>	<b>113</b>	<b>182</b>	<b>955</b>	<b>19%</b>

**Table 4**

In Figure 4 below, we provide detail of the percentage of credit risk issues identified in each of the classes of credit unions during the on-site engagements.



**Figure 4**

#### Overall Credit Risk Findings

During the engagements, a number of fundamental weaknesses were identified in relation to the credit function in each asset class of credit union. As part of our engagements across the sample of credit unions, a number of recurring risk issues were apparent in credit unions from all three asset classes;

- Weaknesses in underwriting practices, including lack of supporting rationale for loan approval. Failure to include such rationale makes it difficult to evidence and understand why certain loans were approved.
- Failure to accurately assess member repayment capacity / debt-to-income ratios. We noted discrepancies and differences in approach as to how these ratios are calculated, or failure to consider the thresholds for such ratios, as per the approved policy of the credit union.

- Incomplete or missing documentation on file in relation to the assessment of member's income and outgoings, including examples of missing member account statements, no evidence of income verification or analysis of income and outgoings as part of the underwriting process.
- Evidence of top-up loans being issued to members, without appropriate consideration of the potential risky nature of this lending and the potential effects on member's overall indebtedness.

The findings below highlight risk issues that were particularly prevalent in each asset class. However, many of these findings were also identified in the other asset classes and accordingly all credit unions should consider the findings set out below in addition to those set out above.

#### Asset Size 1 (Greater than €100m)

The assessments in the greater than €100m asset class of credit unions highlighted the following risk issues:

- Shortcomings in credit policies including examples of insufficiently detailed policies that did not reflect the 2016 Regulations and in addition, they did not reflect current credit union practices.
- Failure to adequately assess and verify self-employed member's income and expenditure as part of the loan application. Inconsistencies in approach to this type of member overall.
- Lack of a defined credit risk appetite in relation to larger lending, or growth in this element of the loan book.
- Lack of a stand-alone, board-approved house loan policy in place in credit unions who offered such a product.
- Fundamental weaknesses and shortcomings relating to the underwriting and assessment of house loans. These weaknesses are reflective of the findings set out in the Thematic Review of House Loans report<sup>5</sup>.

#### Asset Size 2 (From €25m to €100m)

The assessments in the €25m to €100m asset class of credit unions highlighted the following risk issues:

- Lack of any clear 'exceptions-based' reporting for loans issued outside of risk appetite.
- Failure to outline a clear policy position on top-up loans for members. In addition, there was a significant amount of top-up lending noted in a number of credit unions in this class.
- Inadequate documentation / evidence of assessment for self-employed member loan applications.
- Multiple instances of spousal/partner income being taken into account when assessing member's income, despite the fact that spouse/partner was not party to the loan in question.

#### Asset Size 3 (Less than €25m)

The assessments in the less than €25m asset class of credit unions highlighted the following risk issues:

- Failure to conduct quarterly internal loan book reviews, as required by Section 35 Regulatory Requirements for Credit Unions.
- Shortcomings in credit policy including policies which do not reflect best practice or the Lending Chapter of the Credit Union Handbook.
- Failure to specify the need for segregation of duties around the authorisation and pay-out of loans.

<sup>5</sup> [Thematic review of House Loans in Credit Unions](#), issued January 2018

## 8. Strategy/Business Model Risk

### *General Expectations*

Maintaining clear and effective strategic focus remains a challenge for credit union boards. Since our last commentary issued in 2014, many credit unions have moved on to the next iteration or revision of their strategic plans. Meeting member's product and service expectations must be at the heart of such plans, on a basis that is within the credit union's capabilities. It is of critical importance that this emphasis on strategic thinking and planning is evident in credit union strategic plans.

*Our primary supervisory expectations relating to strategy/business model risk include the following:*

- Strategic plans must take account of the credit union's stated risk appetite to ensure that business model development strategies are aligned with the credit union's risk tolerance. This will help to ensure that the credit union carefully considers the potential risks associated with proposed strategies and that it only pursues strategies involving appropriate levels of risk. Strategic plans should be primarily forward-looking in their focus and analysis. The expectation is to see feasible and achievable business objectives, reflective of the environment and operating conditions that each credit union finds itself in. Strategic plans should be underpinned by solid, well-grounded assumptions and detailed financial forecasting. Such forecasts should be stress-tested to take account of a number of possible scenarios. By undertaking such analysis, the board can ensure it is well prepared to adapt and change as needed during the lifetime of such plans.
- Ongoing monitoring and review of strategic plans is critical to successful implementation. We expect to see evidence of proper challenge and review of the plan by the board. Such analysis should be supported by related metrics and key performance indicators, allowing for assessment of the achievement of the plan's objectives. This type of analysis also allows for assessment of any constraints or barriers to achievement of objectives.
- We expect that strategic plans should be realistic and reflective of the risks and challenges facing the credit union. If viability or transfers of engagement are frequently being discussed at board level, then these strategic issues would be expected to form part of such plans. Equally, realistic growth objectives should feature, reflective of recent financial performance of the credit union and the current operating environment. Such objectives are integral to long-term planning for credit unions.

### *Strategic Risk Findings*

We have not noted the expected level of improvements in strategic planning and business model development that is required in the context of viability challenges and given the extent of restructuring experienced by credit unions in recent years. Whilst some credit unions have made significant progress with initiatives, many credit unions are still failing to recognise and address the viability challenges they face.

Our findings from the sample of PRISM engagements reviewed still show a relatively significant proportion of issues identified under the heading of strategy/business model risk. In forming strategic plans for development, credit unions need to be able to demonstrate the feasibility of such plans, supported by detailed and robust analysis. In Table 5 below, we provide details on the number of credit unions included in this sample, and outline the number of strategy and business model risk issues identified in each, as a percentage of all risk issues.

Asset Class	No of Credit Unions	Strategy & Business Risk issues identified	Total number of risk issues identified	Strategy & Business Risk issues as % of overall issues identified
Greater than €100m	22	25	199	13%
Between €25m – €100m	55	50	421	12%
Less than €25m	36	52	335	16%
<b>Total</b>	<b>113</b>	<b>127</b>	<b>955</b>	<b>13%</b>

Table 5

In Figure 5 below, we provide detail of the percentage of credit risk issues identified in each of the classes of credit unions during the on-site engagements.

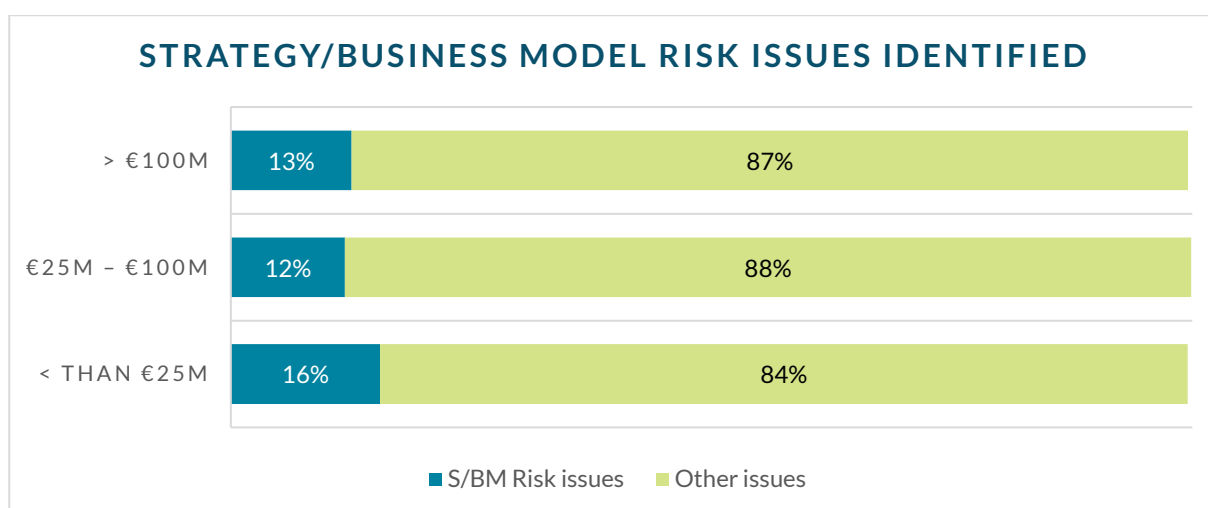


Figure 5

#### Overall Strategy / Business Model Risk Findings

It is the responsibility of the board to ensure that there is a realistic and achievable strategy in place for the credit union, which is fully compliant with all legislative and regulatory requirements. During our on-site engagements, a number of fundamental weaknesses were identified in relation to the strategy and business model in each asset classification.

As part of our engagements across the sample of credit unions, a number of recurring risk issues were apparent in credit unions from all three classes;

- Concerns in relation to the quality of strategic plans as presented. Plans were found to be out-of-date, in need of review and updating or simply not reflective of the risks and challenges facing the credit union.
- Evidence of poor quality financial forecasting, not reflective of recent trends or the current environment. Numerous cases of financial projections being insufficiently detailed or lacking any stress-testing or scenario-based analysis were also identified. Unattainable or unrealistic

projected growth figures were found to be commonplace in many credit unions, with little or no supporting assumptions to substantiate the projections in the plans.

- Supervisory teams highlighted the weak financial position of individual credit unions in a number of cases, both at present and as projected by credit unions themselves in the short-to-medium term. Supervisors provided evidence of weak return-on-assets, low loans-to-assets ratios or high/increasing cost base for some credit unions.
- Targets and monitoring criteria for assessing the performance of the credit union were not outlined within the strategic plan with the achievement of stated objectives not assessed.

The findings below highlight risk issues that were particularly prevalent in the specified asset class. However, many of these findings were also identified in the other asset classes and accordingly all credit unions should consider the findings set out below in addition to those set out above.

#### **Asset Size 1 (Greater than €100m)**

The assessments in the greater than €100m asset class of credit unions highlighted the following risk issues:

- Strategic plans lacked clear implementation steps in relation to achieving stated goals and objectives contained therein.
- For those credit unions which have completed a transfer of engagements process, there was little evidence of updated strategic plans to monitor the performance/embedding of the transfer, with no specified targets or key performance indicators in place.

#### **Asset Size 2 (From €25m to €100m)**

The assessments in the €25m to €100m asset class of credit unions highlighted the following risk issues:

- Numerous references to growth and marketing initiatives were noted, however there was limited or no budgetary allocation to support such plans. The cost of such efforts/resources does not appear to be taken into account in projections.

#### **Asset Size 3 (Less than €25m)**

The assessments in the less than €25m asset class of credit unions highlighted the following risk issues:

- Concern expressed in relation to the assessment of the current financial position and the quality of strategic planning in these credit unions. Numerous examples of existing weaknesses in the financial position not being reflected in strategic planning.
- Evidence of board meetings being operationally focused, board minutes did not evidence discussion by the board of the performance of the credit union against strategic objectives.
- Strategic plans did not realistically assess the viability challenge facing the credit union and did not address the strategic options available to the credit union.

## 9. Capital Risk

### *General Expectations*

Adequate reserves are necessary to 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 future sustainability and to protect member's savings.

The regulatory reserve requirement sets out the minimum reserve requirement for credit unions. However, credit unions are expected to operate with a level of reserves above the regulatory reserve minimum requirement. It is for the board of directors of each credit union to decide on the amount of reserves to hold in excess of this minimum requirement having taken prudent account of the scale and complexity of the credit union's business, its risk profile and prevailing market conditions.

We would expect that credit unions should be performing informed analysis to consider the impact that any areas of concern may have on the reserve/capital base of the credit union, e.g. falling income levels or increased cost-base. With many credit unions facing viability challenges given declining loans-to-asset ratios, this presents a significant risk to interest income and in turn the reserve/capital base of the credit union.

We would expect to see frequent monitoring and reporting on capital/reserve levels, where they may represent an area of concern for the credit union, or may be sensitive to changes in relation to balance sheet composition.

### *Overall Capital Risk Findings*

Overall, the findings in relation to capital risk as part of our sample represented a small proportion of findings. Notwithstanding this, the capital issues we reported were of concern in the cases identified.

The inflow of members savings continues to present a challenge for credit unions if they do not closely monitor such levels, and it may have a detrimental effect on reserve levels if not appropriately managed. In some cases increased savings levels are already placing pressure on credit union reserves.

A small number of credit unions, which face a combination of financial and strategic challenges, continue to cause concern to us due to the potential threat to their future viability. The quality and nature of financial planning evident in these credit unions gave rise to concerns, primarily as they did not demonstrate a recognition of the potential detrimental effect on reserves that the realisation of their financial forecasts could have.

In a small number of credit unions, the carrying value of premises represented a significant proportion of assets. Should these valuations require impairment, this could have a significant impact on the overall capital position.



## 10. Market and Liquidity Risk

### *General Expectations*

Our primary expectation in this area remains that a credit union shall manage its investments to ensure that those investments do not (taking account of the nature, scale, complexity and risk profile of the credit union) involve undue risk to member's savings and, for that purpose, before making an investment a credit union is required to assess the potential impact on the credit union, including the impact on the liquidity and financial position of the credit union. As with all material risk activities, we expect to see an articulation of risk appetite and limits along with effective investment policies and risk management systems in place in all credit unions.

As highlighted by the recent 'Financial Conditions of Credit Unions 2012 – 2017' publication, whilst investment-to-asset ratio has increased significantly across the sector since 2012, the corresponding investment income has contracted. This trend, reflecting the low interest rate environment, continues to present an area of risk for credit unions that requires active management and monitoring. Against this background it is vital that credit unions have a clearly articulated investment risk appetite, reflective of the fact that it is the funds of members that are being invested and the statutory obligation to ensure no undue risk to member's funds. This should be reflected in investment policies and inform credit union investment decisions by credit union boards.

The competent management of investment portfolios remains vital, particularly given the high ratio of investments-to-assets across the sector referred to above. Reliance on external advice and outsourced investment advisors continues to be a key feature of the investment strategy in a large number of credit unions. Where credit unions use external investment advisors, their boards should be mindful that responsibility and accountability for investment decisions remains with the board.

### *Overall Market/Liquidity Risk Findings*

Findings in relation to market and liquidity risk represented a small proportion of all findings. However, we noted instances of shortcomings in relation to liquidity and investment policies across the sample. Examples included policies not reflective of regulatory requirements and insufficient detail on the organisational arrangements setting out the roles and responsibilities of officers involved in investment and liquidity management.

Supervision teams also reported instances of investment products which did not appear to be in compliance with legislative requirements at the date the transaction was entered into. In these instances, when seeking investment advice the credit unions relied on verbal assurance from their investment advisors to guarantee the products were in compliance with current legislative requirements at the time, including the 1997 Act.

In some instances, RMPs indicated issues regarding levels of investment knowledge in individual credit unions and the level of training being provided to relevant officers. The board and management failed to demonstrate sufficient understanding of the products within the credit union investment portfolio.

Alongside these deficiencies, we were also concerned by a lack of documented procedures for monitoring, reviewing and reporting on the credit union's liquidity position against prescribed liquidity targets. This leads to insufficient/informal reporting arrangements, including the frequency, form and content of reporting on the adequacy of liquidity to the board of directors.

## 11. Conclusion

As was the case in 2014, the supervisory engagements with credit unions reviewed for this report identified significant governance and risk management issues requiring credit unions to take remediation actions.

While standards of corporate governance have shown some improvement across the sector, this is not uniform and there is a need for continuous focus as embedding strong governance is fundamental to a well-run and strongly performing entity. While we did identify some progress in the nature of risks being identified, sound governance and effective systems of control are an essential foundation to underpin the viability and development of credit unions, and we expect to see evidence of a strong awareness and understanding of the impact of poor governance and unmanaged risk.

Credit unions should consider this supervisory commentary to inform their own self-assessment and review of their governance and risk management frameworks and the remediation of identified risks. Credit unions should also utilise the other publications and supporting documents that are provided by RCU, including the Credit Union Handbook, FAQs, as well as other reports available such as thematic reviews findings and our commentary on the Annual Compliance Statement.

Our supervisory approach for credit unions is designed to accommodate proportionality taking account of asset size and risk. In 2018 we are further refining our supervisory approach to further differentiate on a proportionate basis between small credit unions (under €40m total assets), medium credit unions (€40m-€100m total assets) and large credit unions (over €100m total assets).

For small credit unions, our supervisory approach will see us focus primarily on viability risk. Small credit unions continue to be required to meet minimum regulatory standards with a particular focus on financial, governance, credit and operational risks. In 2018, we will incorporate a desk-based supervisory approach, augmented by a number of targeted on-site engagements for those credit unions with higher risk profiles. Under this approach, credit unions will be subject to RMPs and there will be scheduled bi-lateral engagements with key role holders in credit unions.

For medium and larger credit unions we will continue our programme of on-site engagements which will focus on risk characteristics. Accordingly, we will deploy greater intensity and depth of engagement with those medium and larger credit unions with elevated risk profiles for whom expected standards are highest in terms of governance, and systems and controls. A significant focus in 2018 will be on the credit union's strategy, business model and risk appetite, along with its governance capability and capacity.

In light of the number of recurring risk issues identified in this report, a key focus for our 2018 on-site engagement programme will also be an evaluation of the quality and effectiveness of remediation by credit unions of RMPs issued.

Our expectation is that all credit unions undertake the necessary actions to ensure that risk issues identified in RMPs are remediated within appropriate timeframes to ensure that the credit union has appropriate and effective governance and risk management frameworks in place to support viability and sustainability.



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