CORE|CREDIT|UNION

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Response to Consultation Paper CP88

February 2015

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EXECUTIVE SUMMARY

SUBMISSION FROM CORE CREDIT UNION LTD.

- Core Credit Union Ltd welcomes the opportunity to respond to the Central Bank's consultation paper on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act.
- The number of responses to CP76 reflected the palpable concerns Credit Unions have with regard to the initial proposed approach. Both the feedback statement and CP88 demonstrate that the Bank has listened to some concerns raised. However, we feel that CP88 is overly prescriptive and restrictive in core areas of our business model, namely Lending, Savings and Investments. Feedback in these areas has not been given the same consideration.
- CP88 extensively references the Report of the Commission on Credit Unions. The Department of Finance set out terms of reference for the Commission, a number of noteworthy extracts of these are:
    - "design a strategy for the future evolution of the credit union sector, to assist credit unions with a strengthened regulatory framework including more effective governance and regulatory requirements"
    - "the comprehensive strategy to enhance the viability of the credit union sector"
- By retaining and in some cases further restricting, CP88 fails to provide a framework for the evolution of the sector. Whilst governance, regulatory requirements and risk management are greatly enhanced the underlying model is stagnant. Retaining the limits of the 1996 Act in regulations which will take effect from 2016 (20 years later) cannot be considered evolution.
- The Regulatory Impact Analysis ("RIA") put forward lacks detail and vision. Strategic planning; planning for our future has become embedded in Credit Unions over the past number of years. Whilst we project forward to explore viable business models, the RIA is based on historic data from a bygone regime, one which, if we are to heed both the Central Bank and the Department of Finance has failed.

5.4 THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT RESERVES REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE

3. RESERVES PERPETUAL IN NATURE AND AVAILABLE TO ABSORB LOSSES

Should a loss-event arise causing reserves to fall below the prescribed minimum, the proposed regulations are silent with regard to how credit unions with a viable business plan and in a position to rebuild reserves will be facilitated in rebuilding reserves. In the absence of such regulations and clarification these reserves are not available to absorb losses but instead a buffer for resolution. We would propose the following amendment:

> *Insert of the following after Section 4*
>
> *(a) Where the minimum regulatory reserve of a credit union falls below the rate outlined in this section, and where the credit union can demonstrate a viable business plan, then the credit union shall be allowed a maximum period of five years to restore its minimum regulatory reserve*

4. REGULATORY RESERVE REQUIREMENT

The proposed regulations fails to recognise that reserves of Credit Unions are generated from surpluses, unlike other financial institutions who can raise capital from the market. The aim of the Commission on Credit Unions, the new act and the new regulatory regime is to facilitate a strong Credit Union Movement. Credit Unions who are proactive in developing their business models are in a position to significantly grow their balance sheet. Strong successful credit unions who do so, risk falling below the minimum regulatory reserve. Consideration must be provided in these regulations to provide for growth.

5. INITIAL RESERVE REQUIREMENT

That Ireland is one of the most successful Credit Union movements in the world is overlooked in this section. A credit union is a financial co-operative where a group of people come together for mutual self-help. They pool their resources to benefit of each other. Their ‘capital’ is the shares they subscribe. It appears that new Credit Unions need to have more reserves than existing Credit Unions. Rather than insisting that Credit Unions have the “minimum reserves plus more”, a new Credit Union should only be required to have sufficient start-up capital. A transition period to build reserves to the Minimum Regulatory Reserves should be set out. Per the proposals it will not be possible for new Credit Unions to be formed.

6.4 THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT LIQUIDITY REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

SECTION 8.2. INTERPRETATION

Wording of this section could lead to technical breaches of liquidity requirements as the wording excludes maturities of exactly 8 days from the definition.

We would suggest replacing:

"Investments with a maturity of greater than 8 days"

with the wording

"Investments with a maturity of 8 days and greater"

9.(2). LIQUIDITY REQUIREMENTS

Maintenance of short term liquid assets("STLA") of at least 10% of unattached shares

An STLA ratio of 10% represents 41 days of gross cash outflows of Core Credit Union Ltd. CRR Final Regulation No 575 of 2013[1] requires that an institution (Banks) has enough high quality liquid resources to survive an acute stress scenario lasting 30 days.

Section 32(1) and 32(2) of the Credit Union Act 1997(as amended) allows a Credit Union to require not less than 60 days' notice from a member of his/her intention to withdraw a share in the Credit Union and 21 days' notice to withdraw a deposit.

CP88 fails to present rationale as to why Credit Unions who have a simpler and less risky business model to banks in addition to holding significantly greater reserves need to hold higher levels of liquidity. Based on these factors, the STLA requirement proposed is excessive with no regard to the safeguards already contained within legislation.

[1] 25/01/2015 Retrieved from http://www.centralbank.ie/regulation/industry-sectors/credit-institutions/Documents/CRR%20Final%20Regulation%20No%20575%20of%202013.pdf

7.4 THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(VII) DO YOU HAVE ANY COMMENTS ON THE DRAFT LENDING REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

SECTION 13. CONCENTRATION LIMITS

The concentration limits outlined in 13(a) (b) and (c) are contrary to our view of the risk profiles for these loan categories.

Loans to Credit Unions shall not exceed 12.5% of regulatory reserves, yet loans to unregulated commercial entities who may have little or no capital can be 50% or regulatory reserves. The Central Bank Strategic Plan 2013 – 2015 outlines how the CB intends to deliver on its mission of ***"Safeguarding Stability, Protecting Consumer".*** The RCU's vision is ***"Strong Credit Unions in Safe hands"***. Despite these two laudable visions the draft regulations suggest that the policy division of the Central Bank does not support its own visions.

The maximum allowable for community loans is restricted to 25% of regulatory reserves. Again we would question this limit as our experience show community loans to have a low risk profile.

We call on the Central Bank to publish the historical and statistical evidence supporting the risk rationale adopted by the Central Bank regarding concentration limits prior to publishing final regulations. This data will provide Credit Unions with beneficial information to develop robust policies.

SECTION 14. LARGE EXPOSURE LIMIT

The new proposals reduces our limit by 32% (€360,000). The limit set out in our current lending policy is significantly below this amount. We consider this proposal prudent.

SECTION 7.2.3. TOTAL LARGE EXPOSURE LIMIT

Whilst not outlined in the draft regulations, page 28 of the consultation paper discusses ***"Total Large Exposure Limits"***.

We have looked at two scenarios with regard to the proposals; based on our current Credit Policy in the first example it would not be possible for us to breach the proposals. In the second 'extreme' example we would exceed our risk tolerance by an order of magnitude to reach the limits. Based on the above Total Large Exposure Limit appears to be arbitrary in nature, not cognisant of Credit Union lending practices or of the proposed concentration or maturity limits as outlined in CP88 itself.

SECTION 15. MATURITY LIMITS

As we outlined in our response to CP76 *(Shankill, Ballybrack and District, Sallynoggin-Glenageary and Dalkey Credit Unions Response)* we feel the limits outlined are excessively restrictive and run contrary to the findings of the Commission on Credit Union. Instead of allowing Credit Unions develop a robust and viable business plan these limits will impact and damage the viability of all categories of Credit Unions.

On a macro level Europe is possibly entering into long-term stagnation punctuated by recessionary periods and accompanied by low inflation and/or deflationary episodes and pressures[2]. Quantitative easing is being implemented at a European level. Both of these point to a continued low interest environment.

At a time when the ECB is doing everything to force financial institutions to increase credit supply, limits proposed in CP88 continue the status quo of the regulatory and prudential frameworks of Irish Credit Unions. Paragraph 2.3.5 of the Report of the Commission on Credit Unions, March 2012 states ***"That Ireland is not identified as a mature movement is due to many factors including limited product development, <u>the failure to evolve the regulatory and prudential frameworks</u>, failure to adopt an integrated IT system for the delivery of services and limited centralised service support"***.

Whilst we acknowledge that the Central Bank is listening to the view of many respondents to CP76 delaying the introduction of a tiered regulatory approach, the 'one size fits all' approach of CP88 will have unintended negative consequences for the Credit Union sector.

SECTION 16. REQUIREMENT FOR HOUSE LOANS

DEFINITION OF HOUSE LOAN, CATEGORY OF LOANS AND CLASSES OF LOANS

There is potential confusion with regard to lending for home improvements and other house related loans which represent a high percentage of Credit Union personal lending. CP88 introduces categories of lending and a new category for house loans. Part (b) of the definition of house loans stated on page 27 of CP88 states ***"improve or renovate a house on the property that is already used as their principal residence".*** Section 16 of the proposed regulations states: ***"Where a credit union grants a house loan, it shall ensure that the credit union holds the first legal charge on the property for each house loan issued after the commencement of these Regulations".***

Our interpretation of the proposals are as follows:

[2] 08/02/2015 Retrieved from: http://trueeconomics.blogspot.ie/2015/02/322015-japanification-of-europe.html?m=1

(1) A home improvement loan of €70,000 advanced under the category [S.12(1)(d) of the proposed regulations] "House loan" attracting a lower rate of interest **must have** a first charge registered against the property as defined in S.16 of the proposed regulations.

(2) A home improvement loan of €40,000 advanced under the category [S.12(1)(a) of the proposed regulations] "Personal Loan" and the Class of Home Improvements at our standard rate of interest **would not be required** to have a first charge registered, i.e. S.16 of the proposed regulations does not apply to the Category of Personal Loan.

Point (2) above sets out a clear example of the confusion. A literal interpretation of S.16 of the proposed regulations would not allow this home improvement loan. Similarly, with the same literal interpretation, a first legal charge would be required for a member wishing to borrow €10,000 to upgrade their windows and insulation in their home. We don't believe that this is the intention of the regulations.

To avoid confusion the wording must be changed. CP76 discussed a class of home loan where as a class a distinguishing factor of a home loan would be that a Credit Union would hold a first legal charge on the property rather that making it a requirement for all home related lending, large and small. We would propose the following amendment to the proposed regulations:

> *Insert the following after Section 12.(2)*
>
> *(3) An unsecured loan made to a member to improve or renovate a house on the property that is already used as their principal residence, is not subject to Regulation 16.*

SECTION 20.1. RELATED PARTIES

The proposals does not make allowance for loans made to related parties which are covered by their shares presenting no risk to the Credit Union. In such circumstances a loans officer of the Credit Union should be allowed assess and issue the loan as normal without prior approval.

8.4 THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT INVESTMENTS REGULATIONS? IF YOU HAVE SUGGESTION PLEASE PROVIDE THEM ALONG WITH SUPPORTING RATIONALE

Diversification is one of the most important components to minimise risk in an investment portfolio. The proposed regulations further restricts a Credit Unions opportunity to diversify its portfolio and follow one of the most basic elements of portfolio theory.

Within investment portfolios there are generally five main risks, these are currency, market, credit, liquidity and operational risk.

Currency Risk: The current and proposed regulations eliminates currency risk

Market Risk: Relates to the impact of changes in interest rates on the value of investment portfolios. In the current low interest rate environment the concentration of investments to bonds and deposits as per these and current regulations have resulted in a significant decline in yields on investment portfolios. This is at a time when stock indices are generating high yields. Had Credit Unions been allowed to develop diversified portfolios the decline in the portfolio return could have been minimised.

Credit Risk: Relates to the possible loss in asset value due to the default of counterparties. The proposals are again concentrating credit risk to similar asset classes. The significant majority of Credit Unions investments are concentrated in the Irish Banks and the Sovereign maximising credit risk instead of minimising it.

Liquidity Risk: Relates to the possible losses or difficulties that could arise in converting assets into cash. As Credit Unions investments are concentrated into deposits and bonds liquidity risk is minimised.

Operational Risk: Relates to the risk arising from inadequate or failed internal processes. The new governance and risk management systems already introduced by the 2012 Act minimised this.

Credit Risk is directly increased by the existing and proposed new regulations. A complete rethink of Investment Regulations is required, this need is even greater for the +€100million asset size credit unions.

29. COLLECTIVE INVESTMENT SCHEMES

The restriction of collective investment schemes (“CISs”) to instruments specified in regulation 25(a), (b) or (c) is difficult to understand. CISs professionally managed and structured have access to thousands of funds and instruments. These would allow Credit Union access to invest in multi-billion funds maximising diversification and minimising risk.

9.4. THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT SAVINGS REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

Undoubtedly there will be many submissions which will highlight the arbitrary nature of a €100,000 limit, the anti-competitive aspect of same, the moral hazard and negative message which such a limit presents. We concur with these sentiments however we wish to focus on how this limit will directly impact the sustainability of the Credit Union business model and the unintended consequence of increasing risk.

SAVINGS REQUIREMENTS

ASSET/LIABILITY MANAGEMENT & MATURITY MISMATCH

The Credit Union Act 1997 (as amended) introduces the requirement for Credit Unions to have policies in relation to asset/liability management and maturity mismatch policies ("A/L MM policies").

The Gini coefficient for Ireland in 2012 was 31.2% and quintile share ratio was 5.0[3]. Both these measures of income inequality show that a small percentage of the population have a large percentage of the income.

The use of savings to fund loans has been standard practice in banking for centuries. Known as "maturity transformation"[4] it is a core function which allows banks/Credit unions perform for the economy. This means that a credit union holds assets, such as loans, that extend over several years and cannot be easily cashed in during this time, and they take deposits/savings that can be withdrawn at short notice. In other words there is a fundamental mismatch between the two sides of credit unions balance sheets. Although maturity transformation has gone on for centuries, this practice is in fact inherently risky. Hence the requirement for A/L MM policies.

To arbitrarily limit deposits/shares that a credit union can hold stymies our ability to introduce effective A/L MM policies. Income inequality mentioned above places significant wealth with a small percentage of people. Should the business model of the Credit Union be allowed develop as envisaged by the Commission on Credit Unions, then the development of savings/deposit products will become a necessary and effective

[3] 09/02/2015 Retrieved from http://www.cso.ie/en/newsandevents/pressreleases/2014pressreleases/pressreleasesurveyonincomeandlivingconditionssilc2012/

[4] Anat Admati & Martin Hellwig: The Bankers New Clothes (Princeton University Press, 2013)

means to balance the mismatch between both sides of the balance sheet. This cannot be done effectively under the current proposals.

We call for a complete removal of any savings limit.

REGULATORY IMPACT ANALYSIS

76A. of CUCORA 2012 sets out the requirement of a Credit Union to have a strategic plan which sets out the objectives of a Credit Union for at least three years.

The RIA is fundamentally flawed by focusing on historic data. The aim of CP88 is to introduce regulation to allow Credit Unions develop while protecting members' savings. If Credit Unions develop new lending categories, then effective means of managing the associated risk will be needed. To do so Credit Unions should be allowed to develop long term savings products, i.e. 3 Year and 5 year deposit accounts where members could have amounts exceeding the €100,000 proposed limit which can help alleviate the maturity mismatch in the balance sheet.

The RIA should at a minimum contain projected figures which maximise a Credit Unions core activity of lending under the proposed limits. These projections must include the implementation of effective risk management through A/L MM policies taking into account the distribution of wealth in the economy.

10.4. THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT BORROWING REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

38. BORROWING REQUIREMENTS

Further to the development of an tiered regulatory regime which should adopt a more comprehensive model we feel the proposed 25% limit is appropriate

11.4. THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING:

(I) DO YOU HAVE ANY COMMENTS ON THE DRAFT REGULATIONS ON SYSTEMS, CONTROLS AND REPORTING ARRANGEMENTS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

SYSTEMS, CONTROLS AND REPORTING ARRANGEMETNS

We feel that the proposals match the nature scale, and complexity of Credit Unions

12.3 THE CENTRAL BANK IS SEEKING VIEWS ON THE FOLLOWING

(I) DO YOU HAVE ANY SUGGESTIONS ON ADDITIONS, AMENDMENTS OR DELETIONS TO THE SERVICES AND RELATED CONDITIONS THAT ARE INCLUDED IN THE DRAFT REGULATIONS? IF YOU HAVE SUGGESTIONS PLEASE PROVIDE THEM ALONG WITH THE SUPPORTING RATIONALE.

SCHEDULE 1.3 – AUTOMATED TELLER MACHINE SERVICES

Clarification is required if Debit Cards; i.e. VISA or MasterCard, are included under ATM cards

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