Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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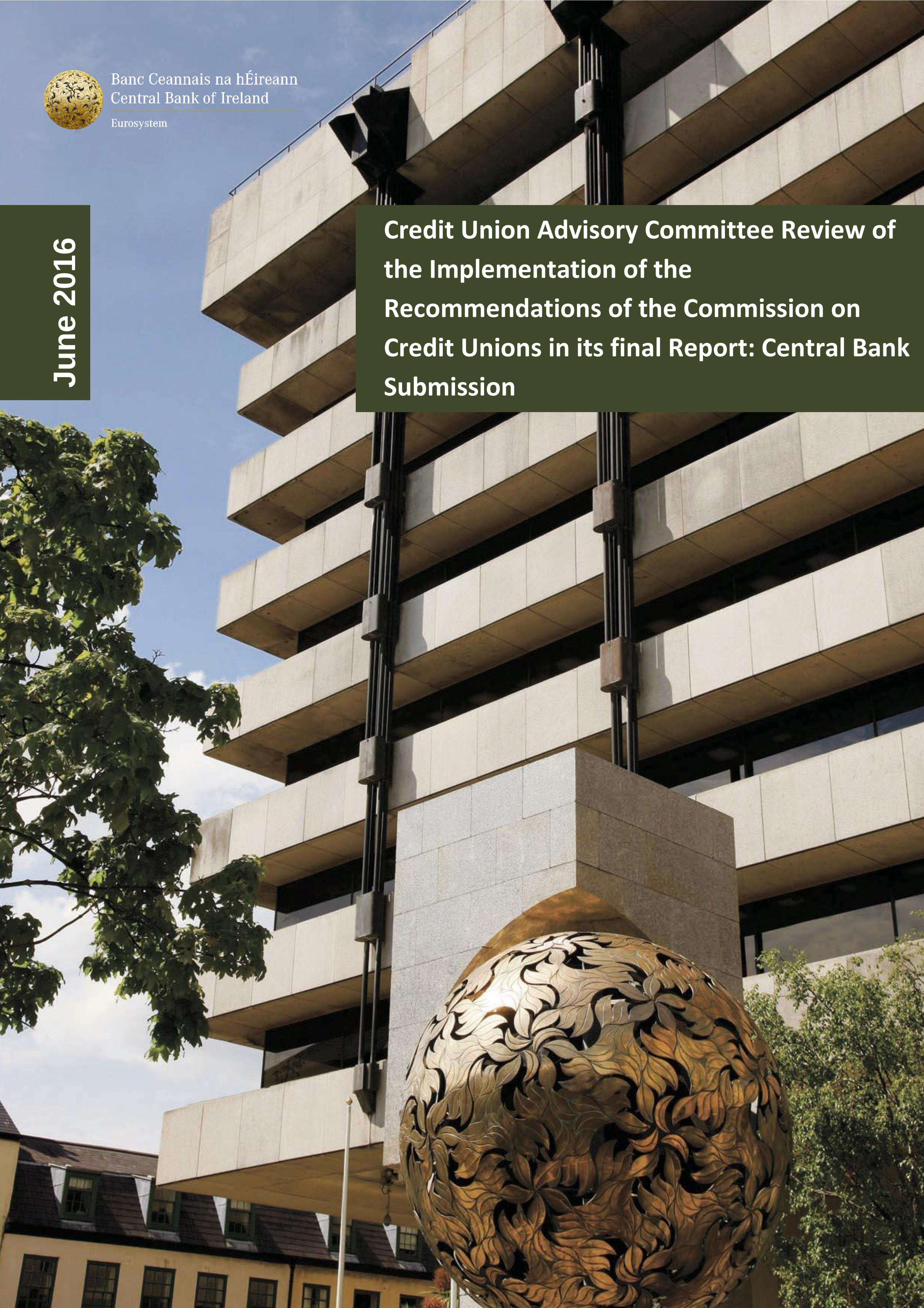
Credit Union Advisory Committee Review of the Implementation of the Recommendations of the Commission on Credit Unions in its final Report: Central Bank Submission



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1. Overview

The Registry of Credit Unions (RCU) is responsible for the registration, regulation and supervision of credit unions. Under the Credit Union Act 1997, (the 1997 Act) the functions of the Registrar of Credit Unions are to regulate credit unions with a view to the:

- Protection by each credit union of the funds of its members; and the
- Maintenance of the financial stability and wellbeing of credit unions generally.

The Central Bank acknowledges the important role which credit unions play within communities as a provider of choice and competition within the financial sector. Our regulatory and supervisory actions are taken to ensure that the sector can survive and thrive into the future, and has the capability to adapt to the changing environment and meet the needs of members in a modern and progressive way.

The sector is currently facing a number of key challenges evidenced by the significant decline in the sector's loan to asset ratio. The reasons for this include the impact of both the crisis – especially the fall in household and small business borrowing and underlying structural factors. These structural issues include the ageing membership base of the sector, and the difficulties which many credit unions face in changing their business offerings to attract younger borrowers by offering the services they want, via the channels they expect and which often require technology investment that smaller credit unions, in particular, struggle to deliver. While the economic situation has now improved and credit unions are showing some signs of benefitting, the sector is still grappling with the combined effects of the crisis and its structural challenges, which indicates that the potential of the sector to benefit from the wider economic upswing is somewhat limited.

The Central Bank acknowledges the scale of the challenges which credit unions have dealt with over the past half-decade, and the efforts undertaken by management, boards, members and volunteers, to help deal with the impact of the crisis and its aftermath on their credit unions and their members. Many credit unions took appropriately conservative responses – such as increased provisioning, cutting dividends and significant efforts to adopt new regulations – to steer through the difficult period. Further strong efforts and indeed strong leadership at the sectoral level are needed now to address the financial weaknesses and especially the structural challenges to position credit unions for growth and development ahead.

The Central Bank's vision for the sector is for a thriving credit union sector that provides choice in the financial system, while carrying out its important role at community level and meeting our financial stability and regulatory requirements. To get where we are now to where the sector needs to be will be difficult but we see four main requirements for sector recovery and growth: further restructuring, drive for new younger active borrowers, marked increase in core lending, and business model development in a multi-step, risk managed way.
The introduction of the strengthened regulatory framework for credit unions - as recommended by the Commission on Credit Unions (Commission) – undertaken over a number of years - has been positive for enhancing the credit union sector's safety and soundness The move to a strengthened

regulatory framework is consistent with regulatory developments more generally for financial institutions, where there has been a move to more prescriptive requirements and more intrusive supervision in recent years. Overall, the framework remains proportionate to the nature, scale and complexity of the credit union sector in Ireland.

The provision of regulation making powers to the Central Bank provides flexibility so that the Central Bank can, in the future, review and update the regulations as appropriate on a timely basis following consultation. The Central Bank is keen to ensure that the regulations remain appropriate for the credit union sector. Where credit unions set out a clear path on how they wish to develop, the Registry of Credit Unions will consider any amendments to the regulations that may be appropriate. Clarity on how development proposals fit within the risk appetite of credit unions and contribute to viability of credit unions will be important elements of this process to ensure that sector development is prudent and appropriate.

2. CUAC Review of the Implementation of Recommendations in the Report of the Commission on Credit Unions

At the Registry's appearance before the Credit Union Advisory Committee (CUAC) on 4 April in relation to its review of the implementation of recommendations in the Report of the Commission on Credit Unions (the Report) the following areas were prioritised;

1. Tiered Regulation;
2. "Section 35"/longer term lending limits;
3. Consultation Process between credit unions and the Central Bank;
4. Governance in credit unions;
5. Restructuring;
6. Business Model Development; and
7. Common Bond.

This document summarises the Central Bank's response in relation to these areas.

2.1 Tiered Regulation

Background

Following on from the recommendations of the Commission on Credit Unions, the Central Bank consulted on the introduction of a tiered regulatory approach for credit unions in 2013[1]. Based on feedback received, including specific feedback on the timing of the introduction of a tiered regulatory approach, a decision was made not to introduce a tiered regulatory approach at that time. This decision, on timing, took account of the significant changes required in credit unions to implement the strengthened regulatory framework and the voluntary restructuring of the credit union sector.

[1] CP76 Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions was published in December 2013

Additionally, submissions received as part of the consultation indicated that there was a wide range of views among respondents on the specific scope and purpose of a tiered regulatory approach, in particular on the number and operation of tiers. A specific example was the views expressed on the approach to smaller credit unions. The Registry's proposal envisaged allowing smaller credit unions to undertake a wider range of services and activities than was proposed in the Commission three tier model. It would have also allowed smaller credit unions to have the flexibility to choose to retain their existing model, rather than be required to operate a more limited model (such as that proposed for Type 1 credit unions by the Commission). Responses received as part of the consultation process indicated that there was an expectation that smaller credit unions would be subject to reduced requirements under a tiered regulatory approach. Many of the requirements of the strengthened regulatory framework are however set out in legislation and therefore cannot be removed for smaller credit unions. In practice though, the requirements are reduced where a smaller credit union operates a simpler business model, as these requirements apply in proportion to the nature, scale and complexity of the business being undertaken by the credit unions.

Taking account of the feedback on the scope and purpose of a tiered regulatory approach consultation in 2013, it was determined that a process of further communication, engagement, clarification and consultation with the credit union sector would be required before taking a decision to introduce a tiered regulatory approach for credit unions.

Central Bank Current View

The Central Bank has some concerns that calls for the introduction of a tiered regulatory approach from the sector are based on a view that a tiered regulatory approach will set out a 'blueprint' for sector development and is therefore a prerequisite for business model development. As publically articulated, the Central Bank is supportive of business model development within the sector but does not see this as dependent on the introduction of a tiered regulatory approach.

However, the Registry certainly envisages scenarios where certain credit unions could be permitted to offer a wider range of services within the regulatory framework. The Registry is working with the sector to ensure that prudent and appropriate development can be facilitated. A sector stakeholder dialogue forum is used by the Registry to gain a better understanding of how credit unions want to develop their business model and to identify whether any changes may be required to the regulatory framework to facilitate prudent development.

Our favoured approach to tiering is that changes to the regulatory framework would be driven by well thought out and viable business model proposals. The provision of regulation making powers to the Central Bank can facilitate this type of approach, whereby regulations can be made for a particular class or classes of credit unions, to permit them to undertake additional activities, for example investing in a specified class or classes of investments or undertaking a particular type of lending.

International Approaches

At the time of the consultation and feedback on CP76, the Central Bank assessed relevant approaches in other jurisdictions that had some form of tiered regulation. At that time the UK and Ontario, Canada regulated their credit unions on a two tier basis.

United Kingdom

The UK operated an effective 2-tier system ('version 1 and version 2' models) for credit union activities, with the respective rules set out the Credit Unions Sourcebook. Since then, the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) undertook a joint consultation, published in June 2015, on the reform of the legacy Credit Unions Sourcebook[2], part of which was a proposal to replace the historical "version 1 and version 2" models with a flexible framework, based on a credit union's specific business model. To permit credit unions to have more flexibility in core activities, including investment, the PRA proposed the introduction of a revised approach to their supervision[3]. In a policy statement issued in February 2016, they acknowledged there was no common general theme in responses on the proposed framework for additional activities, although there was recognition that the historical 'Version 1 / Version 2' classification should be replaced[4]. Following the publication of the Policy Statement, the changes, including the proposal to remove 'version 1 and version 2' models were introduced on 6 February 2016.

Ontario, Canada

Currently, the Credit Unions and Caisses Populaires Act, 1994 (CUCPA) tiers credit unions into class 1 and class 2 credit unions. However, a recent review of the CUCPA undertaken on behalf of the Minister of Finance [5] recommended the removal of differentiated rules for small credit unions. The rationale for this recommendation is based on the fact that the CUCPA applies more restrictive rules to credit unions with assets of less than $50 million if they do not engage in commercial lending. The review noted that there are only 37 credit unions with assets less than $50 million each, and they represent less than two per cent of aggregate system assets. About half of these credit unions engage in commercial lending, so these differentiated rules apply to fewer than 20 credit unions. Most small credit unions have established prudent lending and investing policies, and many are well capitalized through retained earnings. The prescriptive rules are now seen as unnecessary, if not arbitrary. The recommendation is for Ontario to abolish differentiated rules for small credit unions. It has also been recommended that the regulator should continue to monitor the investment and lending policies put into place by each credit union to ensure they are appropriate given the credit union's ability to manage risk.

Proportionality in Supervision

In the Irish context, while the requirements set out in legislation and regulations apply to all credit unions, our expectations on how an individual credit union implements these requirements takes account of nature, scale and complexity. We supervise the implementation of the regulations in a

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[2] https://www.fca.org.uk/static/documents/consultation-papers/cp15-21.pdf
[3] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp2215.pdf
[4] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps416.pdf
[5] http://www.fin.gov.on.ca/en/consultations/cu-cp/legislative-review.pdf

manner that is proportionate and appropriate to the scale, complexity and issues of each individual credit union.

Our 2015-Q1 2016 supervisory engagement with the low impact credit unions[6] was a case in point, where our focus was predominantly on the most significant areas relating to business model viability - financial resilience, governance, credit and market risk and certain operational risks. Our supervisory engagement model used extensive onsite engagement with the sector to bring a focus to strategic planning, governance, risk management and controls. We did not expect the sophistication of risk management and governance structures appropriate for larger credit unions.

The Registry of Credit Unions has developed a Supervisory Engagement approach for credit unions for 2016-2018 informed by the recommendations contained in the ICURN Peer Review Report 2015 and our experience of the 2015-Q1 2016 supervisory engagement approach. Under this approach our supervisory assessment emphasis will be on firm risk profile rather than impact. For smaller credit unions, with the most simple business models, our engagement will focus on key processes and viability – similar to our 2015 Temporary Engagement Model. For larger credit unions, with more complex business models, our expectations are highest. Such credit unions are expected to have well developed risk management systems, strong controls and governance frameworks, as well as a responsive risk based strategic orientation.

Conclusion
In summary, while the Central Bank is open to the concept of a tiered regulatory approach, we recognise that tiered regulation can mean different things to different stakeholders. It is important that the debate on tiering does not distract from the need for the sector to set out an intended future direction: a proposed path to ensure future viability; which products and services it envisages offering to members and how credit unions will grow income and membership. The Central Bank supervises credit unions in a manner that is proportionate and appropriate to the nature, scale, complexity and specific issues arising in individual credit unions.

This type of differentiated supervision is a more flexible framework than pre-defined tiers; it provides flexibility for credit unions to tailor a business model which allows them to develop their business in areas relevant to member needs. We believe that in practice tiering is achieved through a proportional approach to supervision and differentiated application of common rules. This can be enhanced through facilitating prudent development in those credit unions that can demonstrate that they have a clear vision on how to develop and the competence and capability to successfully implement such development.

2.2 Section 35/longer term lending limits

Background
The longer term limits set out in section 35 of the Credit Union Act, 1997 (1997 Act) were originally as follows:

[6] Credit unions with total assets ≤ €10 million.

- total gross outstanding loans with greater than 5 years to maturity could not exceed 20% of outstanding loans;
- total gross outstanding loans with greater than 10 years to maturity could not exceed 10% of outstanding loans.

In September 2006, a review group on longer term lending was set up by the Minister for Finance following a recommendation made by CUAC. The review group published a report on 4 February 2007 which recommended that the Section 35 lending limits should be increased for loans over five years to maturity from 20% to 40%, and over ten years from 10% to 15%, where certain specified financial criteria have been met.

Further to these recommendations, section 35 of the 1997 Act was amended to extend the limit on loans over 5 years to 30% and to provide that credit unions could apply for an increase in the 5 year and 10 year lending limit to 40% and 15% respectively. The Central Bank applied additional liquidity requirements for credit unions where lending over five years is greater than 20%. An application process for credit unions to apply for extensions to longer term lending limits to 40% and 15% for loans over 5 years and 10 years respectively was developed (application form available at the link below).

https://www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/credit-unions/applying-for-approvals/200710-ltl-limits-note-and-application-form.pdf?sfvrsn=0

The longer term lending limits for credit unions previously set out in section 35 of 1997 Act are now contained in the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (the Regulations).

Impact of Longer Term Lending Limits

The longer term lending limits now set out in the Regulations (and previously set out in section 35 of the 1997 Act) are often cited as an example of a regulatory barrier to business model development in the areas of longer term lending and mortgages in the credit union sector. In this context it is useful to look at the current maturity profile of credit union loan books. The March 2016 Prudential Return indicates that, for the sector overall, total gross loans over 10 years amount to 2.14% of total loans in the credit union sector compared to the limit of 10%. Of the credit unions who are currently engaged in lending over 10 years, three quarters of them have less than 3% of their total gross loans outstanding for over 10 years. There are currently c.11% of credit unions engaged in lending or 10 years, who have total gross outstanding loans over 10 years above 5% of their gross loan book. Credit unions which extend residential mortgages to members are also subject to the Central Bank's macro prudential limits on loan-to-value and loan-to-income, introduced in 2016.

The table below provides data on longer term lending broken down by asset size.

Credit Union Longer Term Lending	
Asset Band	**>10 years**
<20m	1.01%
€20m - <€40m	1.38%
€40m - <€60m	2.33%

€60m - <€100m	1.95%
€100m or greater	2.72%

This relatively limited use of the scope for longer term lending allowed in the framework could be interpreted as evidence of limited appetite in the sector to undertake substantial longer term lending, or to depart significantly from the predominant business model of relatively short term credit and funding, given the additional balance sheet management considerations that would arise.

However, we note the case put forward by some stakeholders that, from a practical point of view, the maturity limits may impact on the capacity of credit unions to undertake certain types of longer term lending. For example some business lines may be un-viable for some credit unions given the costs associated with putting in place the systems and expertise required to undertake this type of business. We have also received feedback on difficulties associated with the conditions required to be met in order to be approved for an extension to longer term lending limits permitted under the Regulations[7].

The Central Bank acknowledges that these conditions, originally developed in 2007, may no longer be appropriate for the credit union sector and has undertaken to review these conditions. As a first step to making the existing longer term lending limits more usable the Central Bank agreed to undertake work on potential changes to the conditions attaching to approvals for existing longer term lending limits as part of the sector stakeholder dialogue process. Some initial proposals on how the conditions could be amended have been put forward by the Central Bank for discussion within the group and members of the group have undertaken to carry out some analysis on the impact of such proposals on individual credit unions and report back to the group. Following further discussion/feedback the Central Bank will consider the next steps in terms of formally proposing any amendments and consulting with the wider sector.

Central Bank View

Having considered feedback received on both CP76 and CP88, as well as feedback received through other engagements with the sector, the Central Bank determined that a better understanding of credit unions' aims regarding longer term lending - including further developments on the provision of mortgages to members - is required before amending the longer term lending regulations.

This is one of the key areas being considered within the dialogue with the sector on business model development, which commenced in November. As part of the dialogues, a sub group is undertaking analysis on the sector's objectives/goals in relation to longer term lending. As a first step to making the existing longer term lending limits more usable, the Central Bank is reviewing its conditions attaching to approvals for longer term lending limits. This will be followed by a broader discussion on the appropriateness of the limits themselves, which will be informed by feedback on objectives/goals in relation to longer term lending.

[7] The current conditions for approval for an extension to longer term lending limits include a requirement to have arrears of less than 5%.

The provision of regulation-making powers to the Central Bank (on commencement of the remaining sections of the Credit Union and Co-Operation with Overseas Regulators Act 2012 (2012 Act)) provides flexibility so that the Central Bank can, in the future, review and update the regulations as appropriate, on a timely basis following consultation. The Central Bank is keen to ensure that the Regulations, including lending limits, remain appropriate for the credit union sector. If there is clarity on how the sector wishes to develop longer term lending and how this will contribute to the viability of individual credit unions and the sector as a whole, taking account of risk appetites, asset and liability management implications associated with longer term lending and the expertise required to underwrite such lending, we will consider any amendments to the lending limits that may be appropriate.

2.3 Consultation Process between credit unions and the Central Bank

Background

The Commission Report recommended that a consultation protocol be put in place between the Central Bank and credit unions. This recommendation was implemented with the publication of the Consultation Protocol for Credit Unions (the Protocol) in November 2012.

Formal Consultations undertaken 2012-2014

Since the introduction of the Protocol, the Central Bank has engaged in four consultations. Details of these are as follows:

Consultation Paper	Date Consultation Paper published	Date Feedback Statement published	Number of Submissions
CP62 Fitness and Probity Regime for Credit Unions	18/12/2012	18/06/2013	13
CP76 Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions	23/12/2013	30/06/2014	164
CP83 Fitness and Probity regime for Credit Unions that are also authorised as Retail Intermediaries	01/08/2014	19/12/2014	16
CP88 Consultation on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act	27/11/2014	31/07/2015	117

While the consultation process plays an important part in the decision making process, the Central Bank makes the final decision regarding the regulation of credit unions, taking account of our statutory mandate. Many instances have arisen however, over the course of the four consultations set out above, where the Central Bank has made changes to initial proposals following consideration and evaluation of feedback received through formal consultation. Feedback from stakeholders is also valuable for the development of guidance and supporting documentation which accompanies regulations.

The Central Bank is open in its response to feedback received from credit unions, indicating where and how it agrees and disagrees with the feedback received. All submissions received are made available on the Central Bank website.

Examples of changes made to initial consultation proposals and the contribution of feedback to the development of guidance are set out below.

CP62 (Fitness and Probity Regime for Credit Unions)

- Much of the feedback reflected in the Feedback Statement to CP62 resulted in additional guidance being created for credit unions on the introduction of a Fitness and Probity regime, including:
    - Submissions sought clarity on the Standards of Fitness and Probity for Credit Unions. To address this, additional guidance was placed in the Guidance on Fitness and Probity for Credit Unions, containing minimum due diligence expectations for credit unions assessing a person’s competence and capability to undertake a controlled function (CF) in a credit union.

CP76 (Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions)

- Some of the feedback received in relation to CP76 informed and resulted in changes to the regulatory framework:
    - Some respondents raised concerns at the requirement for certain credit unions to have dedicated risk management, compliance and internal audit functions. Despite the tiered regulatory approach not being implemented, the feedback received has been reflected in the proportionate approach taken in this area. This was reflected in the Feedback Statement to CP76 and the Risk Management Chapter of the Credit Union Handbook, which indicates that, while for larger credit unions it is expected that these roles are held by dedicated officers, that it is up to the individual credit union to determine whether they should have dedicated officers for these roles, taking account of the nature, scale, complexity and risk profile of the credit union.
    - Feedback relating to the application of maturity limits for investments in CP76 was reflected in a change to the way maturity limits were applied in the investment regulations.
    - Some submissions did not agree with the proposed limit that investments in a single counterparty be limited to 100% of a category 2 credit union’s regulatory reserves. Concerns included the increased complexity involved in monitoring compliance with the limit and the impact the limit would have on credit union investments in domestic counterparties. In light of this feedback, counterparty limits remained unchanged.

CP88 (Consultation on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act)

- Following a review of the feedback in relation to CP88, a number of changes were made to the Regulations, examples of these include:
    - On the proposed €100,000 savings limit, the Regulations were amended to provide that credit unions with assets over €100 million could apply to the Central Bank to increase individual member savings in excess of €100,000; the transitional arrangements were amended to provide for credit unions that have individual member savings in excess of €100,000 at the commencement of the regulations to apply to the Central Bank to retain these savings where they can demonstrate that it is appropriate and prudent for them to do so; and the transitional arrangement for the savings limit was extended from six months to 12 months;
    - The proposed short term liquidity requirement of 10% was reduced to 5% and this requirement is under review to consider its appropriateness in the future.
    - In response to feedback received in relation to the investment regulations the Central Bank committed to engaging with the credit union sector in relation to business model development. Regulation 25(2) was added to the Regulations which makes reference to the fact that the Central Bank may prescribe, in accordance with section 43 of the 1997 Act, further classes of investments for credit unions which may include investments in projects of a public nature. The regulation provides that investments in projects of a public nature include, but are not limited to, investments in social housing projects. This represents an explicit acknowledgement of investments in social housing as a potential asset class for credit unions which could be provided for through a new regulation.
    - For approval of loans to related parties the approval functions assigned to the board of directors or sub-committee of the board of directors in the proposed regulations for loans to related parties were amended. In the Regulations there is now a requirement for loans to related parties or amendments to existing loans to related parties to be approved by the credit committee or the credit control committee as appropriate.
    - Feedback received in relation to the additional services that credit unions would like to develop included insurance on an introduction basis. Under the Regulations credit unions can now offer this service to their members on an exempt basis (i.e. without the need for a specific approval from the Central Bank).

Sector Stakeholder Dialogues on Business Model Development

In the Feedback Statement to CP88, the Central Bank recognised that the formal consultation process, designed for the introduction of regulations, may not be the most appropriate forum for credit unions to discuss proposals on the areas where credit unions wish to develop their business model. It was also acknowledged that a public consultation may not be the most effective means of engaging with the sector in relation to proposals on specific areas of business model developments. The Central Bank accepted that a limitation of such a transparent consultation process is that credit unions may not want to share specific business plans in feedback (which will be published), given their sensitive nature.

In response, the Central Bank, as indicated in the Feedback Statement to CP88, initiated a sector dialogue forum with a view to gaining a better understanding of how credit unions want to develop their business model. The stakeholder meetings are aimed at discussing the Central Bank's business model transformation expectations and providing credit unions with a well-grounded basis to develop risk-based and feasible transformation initiatives. The group has agreed terms of reference and five meetings have been held to date. The priorities identified for 2016 include:

- a review of longer term lending limits;
- publication of sectoral data; and
- clarity on the additional services framework.

The Central Bank is committed to having clear, open and transparent engagement with stakeholders in fulfilling its financial regulation and supervisory objectives. The aim of consultation is to have a structured engagement with credit unions, their representative bodies and other relevant stakeholders in order:

- to seek, receive, analyse and respond to feedback received;
- to build consensus where possible between all such parties on new regulations; and
- to inform the decision-making process.

Peer Review

The ICURN Credit Union Peer Review made a number of recommendations in relation to communication and guidance for credit unions. The Central Bank agrees that communication and engagement with the credit union sector is a key part of the Central Bank's relationship with the sector to support the achievement of appropriate standards. We are committed to on-going engagement with the sector through participating in meetings, seminars, working groups, stakeholder training sessions etc. to embed messages regarding the strengthened regulatory framework and to listen to the views of the sector on aspects of the framework. The Central Bank is continuously reviewing its engagement with the sector, and is open to new forms of engagement.

2.4 Governance in Credit Unions

Background

Prior to the establishment of the Commission on Credit Unions, governance weaknesses in credit unions had been identified as a significant issue in the sector. The final report of the Strategic Review on the Credit Union Sector, published in January 2011, found that governance structures in credit unions were generally poor and made a number of recommendations including the introduction of a clear set of mandatory governance standards and guidelines supported by appropriate enforcement mechanisms[8].

[8] 1.4.74/1.5.9 Strategic Review of the Credit Union Sector – January 2011

One of the key goals of the Commission on Credit Unions was to develop a strengthened regulatory framework which would include more effective governance and regulatory requirements. The Report sets out detailed governance standards for credit unions. The majority of these governance standards were reflected in the 2012 Act which provides a framework to improve governance standards in credit unions with a particular focus at board of directors and management level. The Report also recommended that the Fitness & Probity regime be applied to credit unions.

While at an overall level governance weaknesses remain an issue in the credit union sector, the Central Bank believes that the combination of the introduction of detailed governance requirements for credit unions and the introduction of a tailored Fitness & Probity regime for credit unions has, in general, contributed to improved standards of governance in the sector. The introduction of clear governance requirements in legislation provided clarity on the functions of key roles within credit unions and provides a framework to implement a separation between the two distinct sets of roles (i.e. the executive or operational roles, and the non-executive or governance roles). The reduction in maximum board size and the introduction of the Fitness & Probity regime for credit unions have been catalysts for board renewal in a number of cases.

Improvements in governance culture take time to embed, however, and further progress is required before achieving the standard of governance that best protects the financial stability of the sector and protection of members' funds. Functions and structures introduced in the strengthened regulatory framework, including internal audit, risk management and compliance and requirements around compliance reporting, should support improvements in governance culture as they become embedded in credit unions. Ultimately the key measure of improved governance standards will be in terms of outcomes regarding the governance of key processes such as credit within credit unions.

Reported Compliance Rates

Since 2014 credit unions have been required to submit an Annual Compliance Statement to the Central Bank, providing information on a credit union's reported compliance with the requirements of Part IV of the 1997 Act, which includes provisions relating to the management and governance of the credit union. Comparing data on Annual Compliance Statements from 2014 and 2015 shows improvements in reported compliance rates in relation to governance requirements.

- In the 2015 return, 281 credit unions self-reported non-compliance with the requirements of Part IV of the 1997 Act, compared with 354 credit unions who self-reported non-compliance in 2014;
- The total number of credit unions self-reporting material breaches has fallen: from 152 credit unions in 2015 compared with 207 in 2014. (The total number of material breaches by credit unions in 2015 was 1,081 compared with 2,371 material breaches reported for 2014.)

Fitness & Probity

The introduction of the Fitness & Probity regime for credit unions has also focused attention on the competence and capability of individuals taking up key roles in credit unions. Under the regime, which has applied to all credit unions since 1 August 2015, credit unions are required to carry out due diligence on individuals who intend to take up certain roles in the credit union. The roles of chair and manager in a credit union require pre-approval from the Central Bank.

As part of the Central Bank's pre-approval process:

- over 800 Individual Questionnaires have been submitted by 324 credit unions since the commencement of the F&P regime in 2013;
- To date, 70 interviews have been carried out with individuals who were applying for the role of manager or chair of a credit union;
- Five applicants have withdrawn following specific or assessment interviews. One applicant has been issued a 'minded to refuse' letter, with the applicant subsequently withdrawing;
- 11 side letters have been issued (these letters are issued where an individual receives pre-approval for the role, and where the Registry of Credit Unions is of the view that the individual could benefit from additional training in certain areas).

The Central Bank is undertaking themed Fitness and Probity inspections in 2016 to assess the quality of due diligence being undertaken at the credit union level and the role of the nomination committee in the selection of candidates proposed for election to the board of directors. The review of due diligence will help to provide clarity on the level of due diligence carried out in credit unions and the extent to which credit unions satisfy themselves that individuals comply with the Standards of Fitness and Probity for Credit Unions.

We believe that the Fitness & Probity regime for credit unions provides a formal framework within which credit unions can assess the competence and capability of those taking up key roles within credit unions, thereby ensuring that there is sufficient focus on ensuring that only appropriate individuals take up such roles.

Overall, while, in our more recent supervisory engagements, which include review of governance and compliance, we have seen evidence of improvement in regulatory areas arising from prior engagements[9] in respect of a number of credit unions, we are still identifying instances of poor quality of compliance including in the area of governance. Accordingly, while there is some evidence of improvements in governance in credit unions, further progress is required.

2.5 Restructuring

The Commission Report 2012 noted that restructuring can be viewed in two ways:

1. As a way of addressing the current weaknesses in the sector
2. As a business strategy for credit unions that want to achieve the scale necessary to move to a more efficient and sophisticated business model.

It recommended that the credit union sector should be restructured on a voluntary, incentivised and time-bound basis and that restructuring should be overseen by a board established on a short-term basis with a view to completing the process within four years. Following on from these recommendations, the Credit Union Restructuring Board (ReBo) was established.

During the development of the Commission Report the Central Bank proposed a top down (hub and spoke) approach to the restructuring of the credit union sector. While this approach was not adopted, the Central Bank has fully supported sectoral restructuring, both through working with ReBo on their identified individual voluntary restructuring cases and also through the orientation of supervisory engagement which, since 2015, focused on viability and strategic planning and also on strengthening post-merger credit unions. For specifically weak credit unions where voluntary restructuring is not the appropriate approach, the Central Bank has taken resolution actions under Central Bank and Credit Institutions (Resolution) Act 2011.

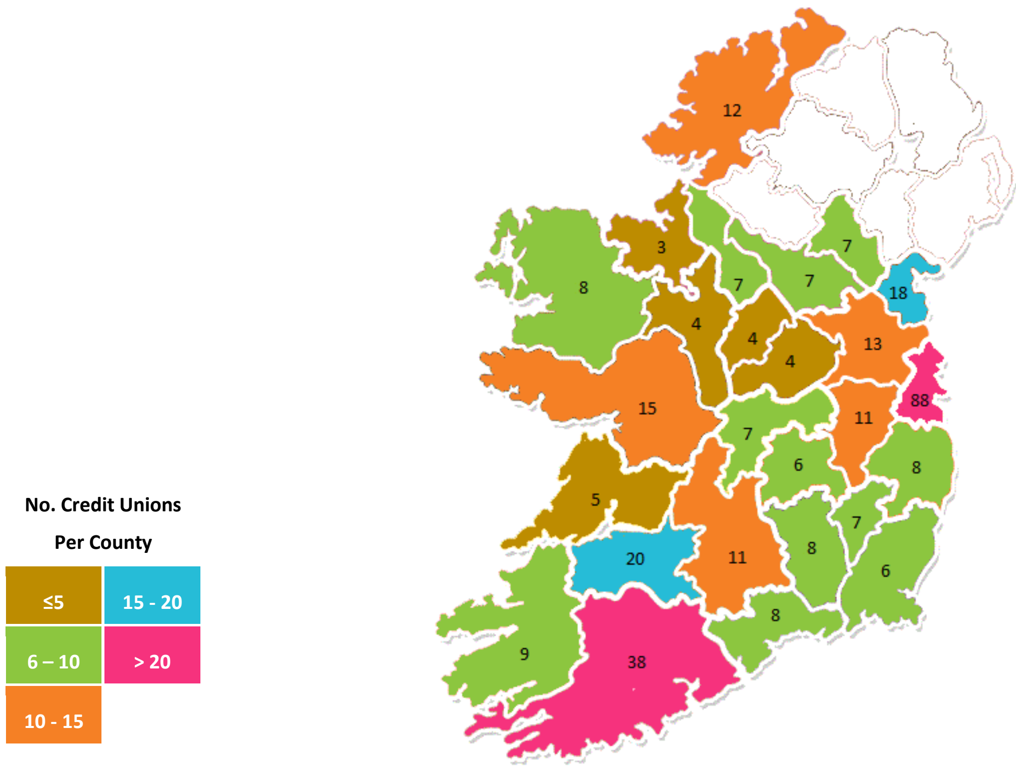
(i) Voluntary Restructuring

Since its establishment in January 2013, ReBo have facilitated 53 credit union transfers. It is notable that the rate of restructuring increased substantially in Q4 2015 and Q1 & 2 2016. Supervisory engagements in 2015 and early 2016 focused on smaller credit unions where the viability challenges were greatest.

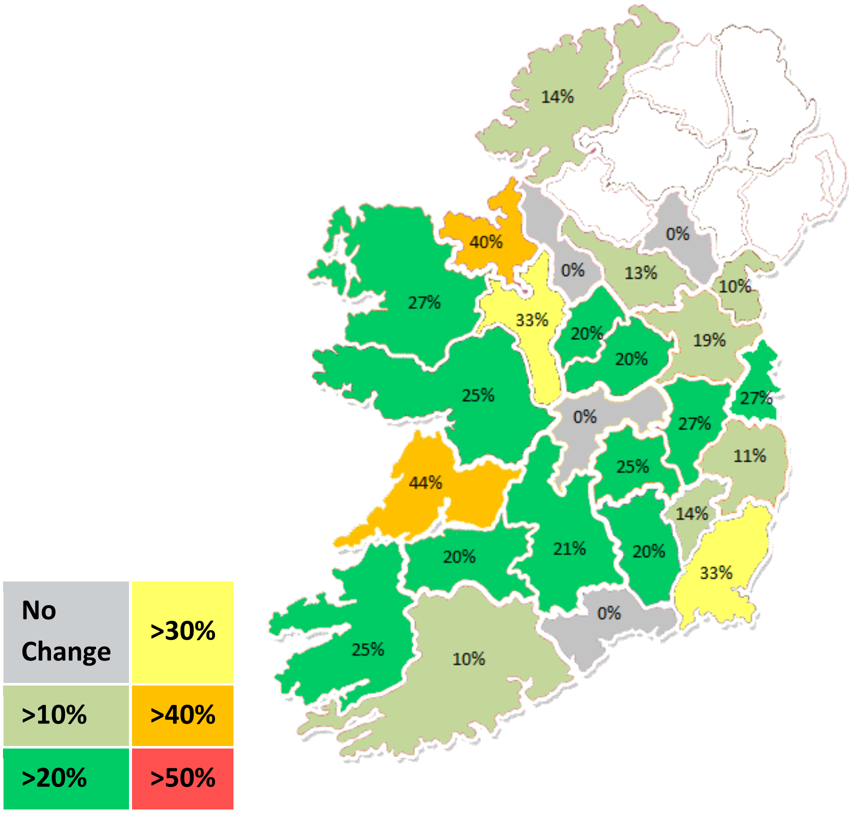
As at 20 June 2016, there were 318 active credit unions, down from 419 active credit unions at the beginning of 2008. Under the voluntary approach, facilitated by ReBo, each transfer involves a comprehensive process which is aimed at establishing the business case for the transfer, de-risking the merger process and putting the structures in place to ensure the best outcome for the merged entity and for the sector as a whole.

The maps below represents the level of restructuring that has occurred in the credit union sector between 2008 and 2016, illustrating the percentage fall in numbers of credit unions by county.

Number of credit unions per county, April 2016 (334)



Percentage decrease per county, 2008 – April 2016



A further number of projects are currently within the ReBo process; subject to completion of the process of each case (including formal consideration by the Registry), the number of active credit unions could reduce to a range of 250-270 by the end of 2016.

A sector-wide Communique was issued on 6 April 2016, by ReBo, to highlight that post ReBo the Registry of Credit Unions will continue to engage with credit unions to facilitate future voluntary restructuring. The Registrar also issued a letter to credit unions on 27 May 2016 encouraging credit unions considering restructuring to contact the Registry and also informed credit unions that guidance on the transfer process was published in the Credit Union Handbook.

Looking beyond the conclusion of the ReBo-facilitated projects in 2016, the Central Bank will continue to support restructuring as an important contributing factor to putting the sector on a sounder footing and contributing to the maintenance of financial stability and well-being of credit unions generally. An important consideration in our on-going supervisory approach for 2016 and beyond is to ensure an appropriate focus on viability and strategic planning, and to engage with both potential transferor and transferee credit unions to progress mutually beneficial restructuring projects.

Current Issues

The Commission on Credit Unions' recommendation for voluntary incentivised restructuring is to a significant degree being achieved, and will be further supported when the ReBo-facilitated projects currently underway are finalised. However, there remain concerns regarding viability weaknesses in a number of credit unions not currently involved in restructuring, or who favour a merger but cannot find a suitable partner. We also have concerns regarding the remaining capacity of some strong credit unions – which may already have been the lead partner in multiple transfers of engagement - to continue to anchor restructuring for more (often unviable) credit unions. The Registry has no desire to unnecessarily weaken transferee credit unions and will continue to focus on de-risking such transferee credit unions in the post transfer period.

Moreover, as we move along in the restructuring phase, more mid-sized credit unions are assessing merger opportunities, including with each other, and some proposed link-ups present special challenges regarding clarity of leadership, governance and strategic focus going forward. For credit unions with viability concerns, our engagement focus is on understanding their contingent strategies, including the trigger point at which a credit union may seek voluntary dissolution if there is no other viable strategy available. These are cases where a credit union is unlikely to generate a sufficient Return on Assets to deliver a return for members, or may be operating at a loss and actually eroding its capital reserves. In such instances, where the credit union's business model is no longer viable, it is not acceptable to wait until they are approaching regulatory reserve minima before prompting necessary action.

It is important to understand if the restructuring being undertaken has or is likely to deliver the cost savings and efficiencies which put the merged entities in the best position to deal with structural challenges. Clearly, many mergers are still in the bedding-in period, but nonetheless we have concerns at the limited benefits becoming visible - as of yet - regarding cost efficiencies, service development and membership growth. In addition, the nature of the protracted period of extensive restructuring carries the risk of energy being focused on the merger process rather than the outcome – namely, the drive for financial and operational efficiencies and to use those efficiencies, and the broader capabilities of merged entities, to continue to attract younger active members and to facilitate business model development.

(ii) Involuntary Restructuring & Resolution

A small number of the transfers which have taken place have required the use of private sector funds to restore a credit union's reserves shortfall. In other cases, where a capital shortfall has arisen and where a non-Court transfer proves not to be possible, a credit union's difficulties may be addressed by directed transfer, using the powers set out in the Central Bank and Credit Institutions (Resolution Act) 2011. However, given the relatively limited number of strong transferees and with many of these already involved in other transfers, the capacity for these credit unions to become involved in further transfers (voluntary or directed) is uncertain.

To date there have only been a small number of directed transfers as the Central Bank must fulfil stringent intervention conditions set out in the Central Bank and Credit Institutions (Resolution Act) 2011. As resolution actions may require the use of public funds, the actions must be demonstrated to have been taken in the public interest.

Seeking the liquidation of a credit union is an option for use in situations, when all other resolution measures are un-viable or inappropriate and where we have serious concerns for the safety of members' funds.

It is incumbent on the Central Bank to ensure that our resolution actions – whether directed transfer or liquidation or other – represent the best overall outcome, from the perspective of protection of members' funds, the stability of the sector and the potential cost to the taxpayer from the resolution action.

2.6 Business Model Development

As set out in previous sections of this paper the Central Bank is supportive of prudent and appropriate business model development within the credit union sector.

As credit unions build on the benefits of restructuring to address financial and operational weakness, the Central Bank welcomes well-considered proposals to develop product and services, to enable the sector to compete and thrive into the future. It is important that development proposals are grounded in reality regarding how they can possibly be taken forward, especially where proposed developments could be very costly and involve heavy losses if they do not succeed.

The Central Bank wants to see credit unions becoming strong providers of Irish financial services into the future. Each step needs to be carefully assessed for risk and reward before it is undertaken, and a prudent approach will serve the sector well in the long run.

There has been some criticism that the Central Bank is holding back the development of credit unions into new business areas, or that regulation is too restrictive. However, to date, we have not seen enough from credit unions by way of well-structured, viable and sustainable plans for development which are rooted in the current realities and challenges that have to be dealt with to move forward successfully. Many of the proposals we assess are not aligned to current business strategy, business fundamentals and capabilities. They often lack relevant cost and viability analysis, and - importantly - fail to demonstrate how the proposed new service or product will contribute to the development of the credit union(s) profitability and sustainability.

This is likely to be a multi-step process which will facilitate careful assessment of proposals, including the additional technology, expertise and governance required and proper costing and assessment for risk and potential return.

In recognition of the size and importance of this challenge, we have undertaken a series of dialogues with credit union representative bodies and managers, to discuss desired business model transformation, and to identify any changes that may be required to the regulatory framework to facilitate prudent development. We aim to give credit unions clarity on what is required in terms of a well thought-through business proposal and ensure that prudent sectoral development is not unintentionally hindered by the regulatory framework.

These dialogues give us an opportunity to listen to views on the services that credit unions plan to develop, including, for example, payment accounts, payment card services, revolving credit, and longer term lending including further developments on the provision of mortgages to members.

Credit unions have an important part to play in many parts of the financial market, where they can achieve a significant market share. Unsecured smaller-scale lending is an area of strength already, and there are fresh opportunities emerging. But being realistic, given their individual sizes, credit unions are unlikely to compete with banks across all business lines. We want to see credit unions planning for a viable and sustainable future where they will offer members the services they want and will grow and thrive and attract new members. This will take time, require investment and commitment.

We are committed to working constructively with the sector, consistent with our statutory mandate to regulate credit unions with a view to the protection by each credit union of the funds of its members; and the maintenance of the financial stability and wellbeing of credit unions generally. As set out previously the provision of regulation making powers to the Central Bank provides flexibility so that the Central Bank can, in the future, review and update the regulations as appropriate on a timely basis following consultation.

The sector is currently developing a number of proposals for business model development which are at various stages of development. These include proposals relating to the provision of mortgages to members on the provision of funding by credit unions for social housing. A group of credit unions have developed a proposal for a full service payment account broadly analogous to a bank personal current account which appropriately supports payment instruments such as debit cards. This service is subject to application and formal approval by the Registry of Credit Unions as an additional service.

Overall the sector needs to take ownership of the development of the sector business model, taking a more active role in developing coherent proposals. This includes taking account of the broader implications of proposals such as the balance sheet implications of increasing longer term lending resulting from the associated maturity transformation of assets. (For further information on our work with the sector on longer term lending approaches, please see Section 2.2 above).

2.7 Common Bond

Section 6 of the 1997 Act sets out a number of conditions for registration as a credit union, which include a condition that membership must be restricted to those who have a common bond which includes: following a particular occupation; residing or being employed in a particular locality; or being employed by a particular employer or having retired from employment with a particular employer.

Credit union common bonds are contained in their registered rules. Membership of a credit union is limited to persons who, in relation to all other members, share the common bond as set out in credit unions' registered rules. In order to amend their common bond, a motion must be passed by a majority of not less than two thirds of members present and voting at an AGM or SGM. If passed, the credit union is required to submit rules to the Central Bank for registration.

The Report noted that the common bond is a fundamental characteristic of credit unions and recommended that the common bond principle continue to be recognised in legislation.

Developments since the Commission Report

There has been an increase in the number of common bond rule amendments submitted for registration, with eight credit unions seeking to amend their common bond since 2015. This, in part, reflects the impact of restructuring activity on the concept and sustainability of the current Common Bond approach.

In reviewing proposals for amendments to common bonds, the Central Bank has noted some potential limitations resulting from the existing legislative requirements relating to the common bond. To be eligible for membership of the credit union, there must be commonality of membership in relation to **all** members with one of the common bonds set out in the 1997 Act. This has proven to be a limiting factor in particular for credit unions looking to expand industrial and non-contiguous geographical common bonds.

Under section 129(7)(a) of the 1997 Act where a transfer takes place the common bond of the transferee credit union is taken to include the common bond of the transferor credit union and the rules of the transferee credit union are amended accordingly, on and from the date on which the transfer takes effect. However, issues may arise for such a credit union if it wishes to expand its common bond further in the future (where the change to the common bond does not arise from a transfer) as they may be required, under the legislation, to demonstrate a commonality of membership in relation to all members which may not be possible as there may not be a commonality between the members brought together through the transfer.

Additionally, under the 1997 Act, credit unions can only provide services to members. Section 6 of the 1997 Act sets out the objects for which a credit union can be formed, all of which relate to members and states that a credit union may not be formed for any other purpose than those objects. As set out above, in order to become a member of a credit union, a person must fall within the common bond of the credit union. We have come across examples of business model proposals, including proposals for the provision of funding for social housing, based around providing loans to bodies (such as Approved Housing Bodies), which could not be progressed in that specific form under the current legislative requirements as the bodies would not necessarily fall within the common bond of a credit union and as such could not become a member of that credit union. Accordingly, where those circumstances regarding the common bond matter pertain, the credit unions could not provide funding by way of lending to such bodies.

International Developments

The common bond requirement for the UK is set out in the Credit Union Act 1979 as amended by the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011. This allows credit unions to have one or more common bonds which operate independently of each other with no requirement for commonality of membership between all members.

In the US, multiple group chartering or multiple unconnected common bonds are permitted for federal credit unions under legislations (Credit Union Membership Access Act 1998).

Common bonds in Canada appear broad enough to facilitate credit unions in extending their membership base. For example in the State of Ontario we understand that common bonds can be broad (in terms of area/region) while credit unions that are based on an employer common bond can potentially add members e.g. family and also extend bonds to other employers.
Therefore, consideration could be given to providing for some flexibility in relation to common bonds, while maintaining their fundamental concept. For example providing that a credit union may have more than one common bond or providing that a specific addition could be made to a common bond which could facilitate inclusion of specific entities (e.g. Approved Housing Bodies) in credit unions' common bonds.

Registry of Credit Unions

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