Interim Report of the Commission on Credit Unions

September 2011

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Executive Summary

Background

This is the interim report of the Commission on Credit Unions and was presented to the Minister for Finance, Mr. Michael Noonan, T.D., on 30 September 2011. The purpose of this report is to inform the preparation of credit union legislation, to be published by end-2011, and to make initial recommendations regarding the strengthening of the regulatory framework of credit unions including more effective governance and regulatory requirements. A final report will be provided to the Minister for Finance by end-March 2012.

The Government established the Commission on Credit Unions on 31 May 2011 to review the future of the credit union movement and make recommendations in relation to the most effective regulatory structure for credit unions, taking into account their not-for-profit mandate, their volunteer ethos and community focus, while paying due regard to the need to fully protect depositors savings and financial stability.

The current financial position of the Credit Union Sector in Ireland

As of June 2011, 86% of credit unions hold at least 10% of assets as total realised reserves, 56 credit unions are below that level, with 27 credit unions seriously undercapitalised.[1] These figures will change at year-end.

Average liquidity has remained high, at about 46%, with only 13 credit unions failing to meet the 20% regulatory requirement.

The average loan to asset ratio in 2011 was 42.45%.

[1] Credit unions are required to hold a minimum of 10% assets in Total Regulatory Reserve. As of the 30 June 2011, 71% of credit unions have reported that they are in compliance with this requirement. Also see endnote viii.

While the financial challenges faced by individual credit unions and the credit union sector are evident, they are not impossible to overcome. However, the challenges highlighted in this report point to a clear need to reform how credit unions are governed and regulated. A strengthened and re-vitalised sector can be in a position to play an increasing role in the retail financial landscape.

Recommendations

A summary of the Commission's recommendations is set out under the Chapter headings.

Deposit Protection, Resolution, Stabilisation and Liquidity

Deposit Guarantee Scheme - The Commission recommends that credit unions remain subject to the general deposit guarantee under the Financial Services (Deposit Guarantee Scheme) Act 2009 and that their financial contributions under the scheme should commence.

Viability – The Commission recommends a number of factors to be taken into account when assessing a credit union's viability, including capital adequacy, loan impairment and delinquency, investment impairment, governance capacity and ability to restore capital reserves.

Resolution - The Commission recommends that the resolution powers intended to be granted to the Central Bank under the Central Bank and Credit Institutions (Resolution) (No.2) Bill 2011 when enacted, should be considered for those credit unions that meet the intervention conditions or grounds set out in the Bill.

Stabilisation Mechanism - The Commission recommends the establishment of a steady state stabilisation mechanism for credit unions that are facing difficulties but are otherwise considered by the Central Bank to be 'viable'. Stabilisation actions to be carried out by the Central Bank should include the provision of technical and financial advice, mandatory changes to governance structures, changes to the business and operations, and capitalisation of the credit union.

Stabilisation should be time-bound and any credit union that fails to comply with the conditions of the stabilisation process should enter the resolution process.

Stabilisation Fund - The Commission recommends the establishment of a statutory stabilisation fund, financed by credit unions and controlled and governed by the Central Bank. A statutory credit union stabilisation oversight committee should be established and should report its conclusions to the Minister for Finance and the Governor of the Central Bank. The work of the committee will not in any way interfere with the independent authority of the Central Bank to act as it sees fit within the statutory framework.

Governance of Credit Unions

Risk Management - The Commission recommends that each credit union must appoint a risk management and compliance officer and that the credit union's annual report should include a risk management and regulatory compliance statement. The Commission recommends the adoption of risk management and compliance systems for credit unions. The risk systems should address, among other things, lending, liquidity, investment and operational risks and should involve the preparation of a Risk Management Plan.

Internal Audit - The Commission recommends that each credit union should develop an internal audit function.

Fitness and Probity - The Commission recommends that Part III of the Central Bank Reform Act 2010 be commenced for credit unions. This will provide the

Central Bank with the powers to set out the Regulations and Code of Fitness and Probity for the credit union sector.

Minimum Competency Requirements - The Commission recommends that the Central Bank set out a Minimum Competency Code for the credit union sector that would take account of the voluntary ethos of credit unions.

Regulation of Credit Unions

The Commission recommends that the powers and functions intended under the Central Bank (Supervision and Enforcement) Bill 2011 be applied to credit unions. The Commission notes that there is an urgency to the issues involved. However, the Commission could not, at this time, arrive at a single position as to the statutory mechanism for applying these powers and functions to credit unions.

Prudential Rule Book - The Commission recommends the introduction of a Prudential Rule Book, to set out in detail what is required of credit unions in each of the relevant areas as set out in 6.2.8. The rulebook will draw on the regulation-making powers of the Central Bank (Supervision and Enforcement) Bill 2011 with additional provisions where required.

Impact of New Regulations - When setting out a new regulation, the Commission recommends that the Central Bank undertake a Regulatory Impact Analysis in line with existing requirements and best practice. The Regulatory Impact Analysis should be cognisant of the new regulation's impact on the development of credit unions.

Proportionality of Regulation - The Commission recommends that the regulation of Irish credit unions should be based on the complexity of their individual business models and the level of risk undertaken by individual credit unions.

Administrative Sanctions - The Commission recommends that the Central Bank's administrative sanctions regime under Part III C of the Central Bank Act 1942 should be extended to credit unions.

Conclusion

This report sets out a range of recommendations that are intended to strengthen the credit union regulatory framework and provide for more effective governance and regulation. These recommendations will inform the proposed credit union legislation that will be laid before the Oireachtas by year-end.

While this interim report and the resulting proposed legislation will make a significant contribution to the necessary reform and development of the credit union sector in Ireland, the work of the Commission is not complete. In the second phase of the Commission's work it will turn its attention to setting out a strategy for the future evolution of the credit union sector.

The credit union sector in Ireland continues to play a crucial role in helping to meet the financial, economic and social needs of many people and their communities. While the challenges faced by the credit union sector are significant, they are far from being insurmountable. A strengthened and re-vitalised sector can be in a position to play an increasing role in the retail financial landscape.

This report does not impact on the independence of the Central Bank in the performance of its statutory functions and this report is without prejudice to the performance by the Central Bank of its statutory functions.

Chapter 1 – Introduction

1.1 Introduction

1.1.1 The credit union movement has had a presence in Ireland for over 50 years and the number of credit unions has grown to over four hundred, with almost three million credit union members. However, the credit union sector has not been immune to the recession, in particular, the effects of rising unemployment, declining property prices and falling domestic demand. While the financial challenges are evident, they are not insurmountable. However, the challenges that the Irish credit union sector faces are not wholly related to economic factors. Other contributory factors include the business decisions of some credit unions and the deficiencies in the statutory regulatory framework. It is clear to the Commission that there is a need to reform how credit unions are governed and how they are regulated. The work of the Commission has focused on achieving this. It is the Commission's strongly held view that the credit union sector can be in a position to play an important part in Ireland's financial landscape.

1.1.2 The work of the Commission has relied on the main stakeholder bodies and a number of independent people coming together in a frank and open forum to set out how they believe the credit union sector should develop. This interim report is the synthesis of these discussions to date and, as such, the majority of recommendations were achieved by consensus.

1.1.3 This interim report was provided to the Minister for Finance, Mr. Michael Noonan, T.D., on 30 September 2011, as required under its Terms of Reference. The purpose of this report is to inform the preparation of credit union legislation, to be published by end-2011, and to make initial recommendations regarding the strengthening of the regulatory framework of credit unions including more effective governance and regulatory requirements. A final report will be provided to the Minister for Finance by end-March 2012.

1.2 Establishment of the Commission on Credit Unions

1.2.1 The Government established the Commission on Credit Unions on 31 May 2011 to review the future of the credit union movement and make recommendations in relation to the most effective regulatory structure for credit unions, taking into account their not-for-profit mandate, their volunteer ethos and community focus, while paying due regard to the need to fully protect depositors savings and financial stability. The Commission's Terms of Reference are set out in *Appendix 1*.

1.2.2 The Minister for Finance appointed Professor Donal McKillop, Professor of Financial Services, School of Management, Queens University, Belfast as member and Chair of the Commission on Credit Unions (referred to in this report as the 'Commission'). The Minister also appointed as members of the Commission:

- Mr. Kieron Brennan, Chief Executive Officer, Irish League of Credit Unions,
- Ms. Fiona Cullen, Head of Legal Department, Irish League of Credit Unions,
- Mr. Billy Doyle, Management Committee, Credit Union Development Association,
- Ms. Eileen Fitzgerald, Senior Manager in the Citizens Information Board, with responsibility for MABS,
- Mr. Eamonn Kearns, Financial Services Division, Department of Finance, replaced by Mr. Aidan Carrigan, Financial Services Division, Department of Finance,

- Mr. Tom McCarthy, Chief Executive Officer, Irish Management Institute,
- Mr. Tim Molan, National Secretary, Credit Union Managers Association,
- Mr. Robert Moynihan, Independent Compliance and Risk Management Consultant,
- Mr. James O'Brien, Registrar of Credit Unions,
- Mr. Daniel J. O'Gorman, Solicitor,
- Mr. Joe O Toole, Former Senator, and
- Prof. John Wilson, Professor of Banking and Finance, St. Andrews University, Scotland.

1.2.3 The Commission was supported in its work by a Secretariat provided by the Department of Finance.

1.3 Methodology of the Commission on Credit Unions

1.3.1 The Commission met for the first time on 20 June 2011 and between June 2011 and September 2011, the Commission met on 11 occasions.

1.3.2 At its first meeting the Commission set out how it was to go about meeting its Terms of Reference and agreed that the first phase of its work should focus on its interim report and that the key elements of this should be:

- Governance
- Regulation
- Risk Management
- Stabilisation mechanism
- Resolution mechanism
- Liquidity mechanism

In carrying out its work, members of the Commission provided papers on each of these issues. The Secretariat then sought to assimilate the papers into single documents for the Commission's considerations. The chapters in this interim report are the outcome of this work. The Commission also based its work on international best practice and the outcomes of academic research and these are noted in the interim report through the use of endnotes. (A comprehensive bibliography is also provided.)

1.3.3 On 24 June 2011, the Secretariat arranged for members of the Commission to be briefed by representatives from Grant Thornton and the Registry of Credit Unions on key issues pertaining to the sector:

- Strategic Review of the Credit Union Sector – Results of Phase 1,
- Current Trends in the Credit Union Sector,
- 2010 / 2011 Loan Book Reviews, and
- Prudential Capital Adequacy Review (PCAR) for Credit Unions 2011,

and, on 23 September 2011, representatives from the *National Supervisors' Forum* presented a paper making recommendations on the role and importance of Supervisory Committees.

1.3.4 The Commission also received presentations on:

- The Central Bank (Supervision and Enforcement) Bill 2011, and on
- The Central Bank and Credit Institutions (Resolution) (No.2) Bill 2011.

1.3.5 In order to fully inform itself of the issues involved, the Commission decided to hold a public consultation. The consultation process sought submissions from members of the public and interested parties that would facilitate the good functioning of the Irish credit union movement into the future. In particular, submissions were invited on the role of credit unions, their current operating model, shared services, financial inclusion, governance standards, regulatory requirements and changes to Credit Union legislation. (Set out in *Appendix 2*.) These submissions will be used to inform the Commission's final report. An overview report of the main points raised by these submissions is presented in *Appendix 3*.

1.4 Structure of the Interim Report

1.4.1 The Interim Report is set out as follows:

Chapter 2 – Overview of the Credit Union Movement

This chapter sets out the key features of credit unions that apply across all credit union movements and then compares movements across countries. Credit unions in some countries are more advanced than they are in other countries and the developmental stages can be classified as nascent, transition and mature. The chapter then sets out a brief description of the development of the Irish credit union movement from its inception in the late 1950s.

Chapter 3 – Current Financial Position of the Credit Union Sector in Ireland

This chapter examines the financial position of credit unions in Ireland. Rather than taking the current position, it compares how the sector has fared both prior to the financial crisis and throughout the present economic downturn. A forward assessment is also included with consideration of the Central Bank's PCAR and projections included in Grant Thornton's Strategic Review. The analysis in this Chapter identifies the financial strengths and weaknesses of the sector and sets the framework for the Commission's recommendations.

Chapter 4 – Deposit Protection, Resolution, Stabilisation and Liquidity

This chapter sets out the Commission's recommendations with regard to designing a prudential management framework. The Commission makes recommendations regarding (a) a deposit guarantee scheme to protect the savings of members up to a statutory minimum, (b) a resolution mechanism to deal with credit unions that are 'not viable', (c) a steady state stabilisation support mechanism, in certain circumstances and with conditions, for credit unions that are facing difficulties but are otherwise considered 'viable' and (d) a liquidity support mechanism to facilitate short-term liquidity needs for otherwise sound credit unions. Another important element of a prudential management framework is the regulatory framework and this is addressed by the Commission in Chapter 6.

Chapter 5 – Governance of Credit Unions

This chapter sets out the Commission's recommendations with regard to the governance of credit unions. The issue of governance is at the core of strengthening the regulatory framework and setting out a strategy for the future evolution of the credit union movement. The Commission makes recommendations regarding (a) risk management and compliance, (b) an internal audit function, (c) fitness and probity and (d) minimum competency requirements.

Chapter 6 – Regulation of Credit Unions

This chapter sets out the Commission's recommendations with regard to the regulation of credit unions. The Commission recommends that the Central Bank (Supervision and Enforcement) Bill 2011 is applied to credit unions and outlines the implications that this proposed legislation is likely to have on credit unions with regard to the areas of (a) inspections and investigations, (b) the powers of the Central Bank to make regulations and introduce a Prudential Rule Book, (c) the provision of reports and disclosures, (d) administrative sanctions and (e) regulatory direction. The Commission also gives particular attention to the Central Bank's powers to make regulations and to those elements that are likely to form a significant part of any future Prudential Rule Book, namely, (a) risk management systems, (b) capital risk, (c) lending risk, (d) liquidity and funding risk, (e) investment risks, (f) savings and borrowings and (g) operational risk.

1.4.2 In this interim report, a number of recommendations by the Commission focus on a basic principle being included in the proposed legislation for end-2011, with the more complex issues of how these might be implemented (e.g. issues around proportionality) forming part of the Commission's deliberations during the second phase of its work. If, during the course of such deliberations, the Commission identifies a point or a number of points that ought to be included as a provision in the proposed end-year legislation it will submit its views in writing to the Minister for Finance for his consideration.

1.4.3 By end-March 2012, the Commission on Credit Unions will provide the Minister for Finance with its Final Report. The main focus of the second phase of its work will be on setting out a strategy for the future evolution of the credit union sector. The Commission will seek to define the role of credit unions in the context of a restructured financial services sector and will propose a model for modern credit unions and define the structure and parameters within which financially viable credit unions will operate. The Commission will examine options for restructuring the credit union sector, including proposals made by the Central Bank, and will make recommendations on the possibility of voluntary consolidation or restructuring of the credit union sector over time, recognising the need to maintain local presence and taking into account the not-for-profit mandate, the volunteer ethos and community focus of credit unions. Furthermore, the Commission will examine and make recommendations regarding options for shared services between credit unions and the introduction of modern information technology and management information systems.

1.4.4 In the second phase of its work, the Commission will consider further the Grant Thornton report *Strategic Review of the Credit Union Sector – Results of Phase 1* and the submissions provided by the members of the public and other interested parties through the consultation process.

Chapter 2 – Overview of the Credit Union Movement

2.1 Introduction

2.1.1 This chapter has a number of objectives. First, the key features of credit unions are described. These features apply across all credit union movements in that their organisational form is relatively homogeneous across countries. Second, descriptive statistics are documented on credit union movements worldwide with movements additionally classified in terms of a developmental typology (nascent, transition and mature). Third, a brief description of the development of the Irish credit union movement is presented.

2.2 Distinctive Nature of Credit Unions

2.2.1 Credit unions are self-help cooperative financial organisations geared to attaining the economic and social goals of members and wider local communities. Each credit union is governed by its members. The membership elects (from within that membership) unpaid volunteer officers and directors who establish the policies under which the credit union operates. Voting within the credit union is on a one-member, one-vote basis. Credit unions cannot do business with the general public due to charter limitations based on serving a membership that is characterised by a common bond. The common bond is based on a pre-existing social connection (such as belonging to a particular community, industrial or geographic group). This helps circumvent problems of imperfect information, which are inherent in many financial transactions. However, the common bond also limits commercial diversification, and in many jurisdictions has become less important as the movement has matured.

2.2.2 In contrast to most other forms of financial services organisations, credit unions are not required to simultaneously satisfy shareholders' profit expectations and disparate customer needs. (See Box 1.) Furthermore, credit union managers are not awarded bonuses linked to equity shareholder value measures.[i] Instead credit unions exist to attain the economic and social goals of the people who comprise their membership and surplus monies generated from business activities belong to the members. The distribution of any surplus may take a number of forms, including: allocation among members in proportion to their transactions; the development of common services to benefit all members; or the development of the business of the credit union. A key element is that any surplus should be distributed in a way that avoids one member gaining at another's expense.

Box 1 – Differences between Credit Unions and Banks

Credit Unions	Banks
Not-for-profit, member-owned financial cooperatives funded primarily by voluntary member deposits.	For-profit institutions owned by shareholders.
Conduct business solely with their members, and their members are in turn the owners of the credit union, there is a coincidence of ownership and consumption.	Conflict between depositors and borrowers (the customers) and shareholders (the owners).
Members share a common bond, such as where they live or work.	Typically serve middle-to-high income clients. No restrictions on clientele.
Credit union members elect a volunteer board of directors from their membership. Members each have one vote in board elections, regardless of their amount of shares in the credit union.	Shareholders vote for a paid board of directors who may not be from the community or use the bank's services. Votes are weighted based on the amount of stock owned.
Surplus monies generated from business activities belong to the members, distribution method decided by members.	Shareholders receive a pro-rata share of profits.
Financial services provided are primarily basic savings and loan products with some insurance offerings.	A wide range of financial services are on offer.
Local outlets, limited use of ATMs, internet and phone technology for the provision of services.	Branch network, sophisticated technology based provision and delivery of services.
Exist to attain the economic and social goals of members.	Exist to maximise profit and shareholder wealth.

2.2.3 For all their distinctive features, credit unions are (first and foremost) financial institutions, which primarily accept deposits (or shares) and make loans. In this regard they are similar to commercial banks.

However, with commercial banks there is an inherent source of conflict between depositors and borrowers (the customers) and shareholders (the owners). The former want competitively priced financial products, while the latter require as high a return as possible on their capital investment. The implicit assumption is that commercial banks place greater emphasis on maximising profits and shareholder value. In that credit unions conduct business solely with their members, and their members are in turn the owners of the credit union, there is a coincidence of ownership and consumption. However, credit unions still face a potential conflict between borrowing members (who want access to low-cost credit) and saving members (who want a high rate of return on funds invested)[ii].

2.3 Credit Unions Worldwide

2.3.1 Credit unions have become a significant global phenomenon. (See Box 2 for brief descriptions of the credit union movements in a number of countries.) Table 1 classifies credit union movements and presents some descriptive statistics on credit unions. In 2010, there were 52,945 credit unions operating in 100 countries. These credit unions had a membership of 188 million which equates to a population penetration of 8% and had total assets under their control of approximately $1,461 billion.

2.3.2 Some insights into patterns of credit union development can be uncovered with the aid of organisational life-cycle theory which assumes that credit unions follow an evolutionary development path that can be partitioned into distinct phases of growth: Nascent (formative), Transition and Mature[iii]. Credit unions positioned within each of these stages can be characterised by various financial and organisational attributes.[iv] This is shown on a country-specific basis in Table 1.

Table 1 – Geographic Location and Classification, 2010

Country/Region	No. of Credit Unions	Membership	Assets ($ million)	Penetration[1] (%)
Mature Credit Unions				
United States of America	7,491	91,758,307	926,610	44
Canada	877	10,763,934	256,187	46
Australia	105	3,400,000	53,420	23
South Korea	963	5,578,995	42,200	16
Transitional Credit Unions				
Kenya	4,020	3,918,490	3,703	17
Hong Kong	44	74,086	908	1
ROC Taiwan	336	203,767	743	1
Sri Lanka	8,440	895,132	59	6
Singapore	31	225,725	929	6
Thailand	2,339	3,621,119	37,984	8
Ireland	409	2,955,000	20,052	67
Great Britain	480	891,283	1,191	2
Poland	59	2,176,541	4,728	8
Fiji	29	15,243	25	3
New Zealand	29	184,937	478	6
Caribbean	447	2,805,296	4,805	17
Latin America	1,745	15,678,012	48,124	5
Nascent Credit Unions				
Africa[2]	13,541	13,627,90	2,167	8
Asia[3]	10,009	27,201,231	56,603	3
Russia	130	207,710	162	-
Ukraine	679	1,631,300	414	5
Worldwide (100 countries)				
All countries	52,945	187,986,967	1,460,552	8

Source World Council of Credit Unions (Raw Statistical Data, 2010)
[1]The penetration rate is calculated by dividing the total number of reported credit union members by the economically active population.
[2]The regional total for Africa does not include Kenya, which is classed as a transitional credit union industry.
[3]The regional total for Asia does not include Korea, which is classed as a mature credit union country or Hong Kong, Singapore, Sri Lanka, ROC Taiwan and Thailand which are classed as transitional credit union countries.

2.3.3 Credit union movements at a nascent stage of development tend to have a small assets size, high levels of structural regulation, a tight common bond, a heavy reliance on volunteers and provide basic savings and loans products. Transition movements are characterised by large asset size, evolving regulatory and supervisory frameworks, fewer common bond restrictions, higher levels of product diversification, development of professional trade associations, less reliance on volunteers, development of central services and a greater emphasis on growth and efficiency. Finally, mature movements have large asset size, have undergone structural deregulation accompanied by increased prudential regulation, have support mechanisms in place, have a loose common bond, diversified product portfolios, professionalization of senior management, centralised services including liquidity support mechanisms and adoption of electronic technologies.

Box 2 – Comparing Credit Union Movements

Credit unions in the **United States of America** account for approximately 10 per cent of all consumer savings and deposits in the US. Credit union numbers in the US peaked in 1969 at 23,690 and have declined by on average of 3% per year since that date. For the most part the reduction in numbers occur through mergers although some credit unions have failed (for example, in 2011 to date, 105 credit unions have closed (i.e. healthy credit unions choosing to merge with only twelve credit unions liquidated or involved in a purchase and assumption order and nine being placed in conservatorship). The average capital-to-assets ratio in 2009 was 13.8%, well above the 7% threshold requirement for being categorised as 'well capitalized'. Only 5.2% of credit unions fell below this 7% threshold.
Poland has 61 credit unions (*spółdzielcze kasy oszczędnościowo-kredytowe*, 'SKOK credit unions') serve a large number of small depositors – estimated at more than 2.1 million as of mid-2010 – from a country population of over 38 million. The first credit union started in Poland in 1992 and the sector has experienced remarkable growth since then. The largest credit union, SKOK Stefczyka, had 350 branches and 670,000 members, one third of the total. In 2010 total assets of SKOKs amounted to about 1.4% of total banking sector's assets. No SKOK has been liquidated during the current economic downturn. The capital ratio required to be classed as meeting the regulatory norm is 4%. In 2008 the average capital ratio was 5.9%, 1.5% in 2009 and 3.1% in 2010.
At the end of 2010 there was a total of 434 credit unions in **Great Britain** which is a decline of 185 (30%) since 2002, the date at which the Financial Services Authority (FSA) took over formal regulation of the sector. McKillop et al. (2011) note that the decline in numbers has been mainly accommodated by a transfer of engagements to other credit unions although some credit unions have failed with subsequent implications for the FSA's compensation scheme (approximately 60 have failed since 2002; 7 credit unions have failed in 2011). Credit union membership now equates to 1.25% of the population compared to less than 1% in 1999. In Great Britain, a distinction is made between Version 1 and Version 2 credit union. The latter can lend larger amounts and for longer periods relative to the former and can offer a wider range of ancillary services. Version 2 credit unions also face much stiffer capital, liquidity and supervision requirements. The capital to assets requirement is at least 8% for large (greater than £10m) Version 1 credit unions and for Version 2 credit unions.

2.3.4 At the present time, nascent industries can be found primarily in the developing countries of Africa, Asia and the former Soviet bloc. In these regions, they are often seen as vehicles for reducing poverty within more general microfinance programs. There are, of course, notable exceptions such as Poland and Lithuania where credit union development has been rapid over the last decade with credit unions in these countries extending financial services to the general population. From Table 1 we note that in terms of assets, membership and population penetration the movements in the US, Australia and Canada are viewed as mature. The interim stage between nascent and maturity is that of transition. The earlier mentioned movements in Poland and Lithuania could be viewed as in the transition stage as is the movement in Great Britain. It can take about 20 years for a movement to develop from transition to maturity.

Box 2 continued – Comparing Credit Union Movements

Since the 1980s, the number of credit unions in **Australia** has declined from over 700 to 106 as of end December 2010. In 2010 there were a total of 11 mergers including a merger between credit unions which were ranked as second and fourth largest in 2009. Australian credit unions have weathered the financial crisis well. Indeed between 2009 and 2010 underlying profits increased by 37.3%. The continued focus by credit unions on their core strengths in the mortgage and retail deposit markets means that credit unions have remained protected from the direct impacts of the financial crisis. The average capital adequacy ratio in 2010 was 17.7%.
The credit union movement in **Canada** can be divided into two separate subsystems. The first one is the usual autonomous credit unions / *caisses populaires* of which there are 379 with assets of about $131 billion and 6.06 million members. There has been a steady decline in credit unions / *caisses populaires* from 1,500 in 1987 to 379 at the end of March 2011. They operate across 1,725 locations. There is a very heavy concentration within the sector. For example at the end of 2010 the 5 largest credit unions (1.3%) held $46 billion (36%) in assets and 1.572 million (31%) members. The largest 10 credit unions (2.6%) held $60 billion (47%) in assets and 2.018 million (40%) members. The other system, Desjardin is concentrated in Quebec, parts of Ontario and parts of New Brunswick. This is a full Federated network system and consists of 476 Credit Unions with about 5.5 million member and 45,000 staff and 128.7 billion in assets.
There has been a steady decline in credit union numbers in **New Zealand** since 1985 when numbers peaked at 312. At the end of 2010 there were 29 credit unions with 6 credit unions transferring engagements during the year. Credit union membership totalled 184,137 and total assets amounted to NZ$669m. Overall reserves were NZ$104m which represented 15.55% of total assets. During 2010 one of the two trade associations was dissolved. A survey by RaboBank (*Public Confidence in the Financial System*, April 2011) indicated that a small number of clientele (10%) use credit unions (and building societies) and this hasn't changed over the last 10 years. The survey also notes that credit union members are most likely to be aged 35 plus and that while consumer lending by banks increased rapidly over the last ten years it has remained broadly constant for credit unions. The capital ratio defined as (general reserves, other reserves and retained earnings as a percentage of total assets) was 15.62% in 2010 and 15.65% in 2009. Any consideration of the credit union movement in New Zealand should take into account the impact of the State supported Kiwibank on credit union membership. The Kiwibank, founded in 2002 and community based, with a local structure of a branch for every 20,000 of population, competes with and replicates many credit union services.

2.3.5 Ireland is also classified in the transition stage although it has an extremely high penetration level (67%).[v] That Ireland is not identified as a mature movement is due to many factors including limited product development, a failure to evolve the regulatory and prudential frameworks, the failure to leverage appropriate ICT infrastructure for the delivery of services and limited service support systems.

2.3.6 The typology contains an assumption about a development path for credit unions albeit that within any one credit union movement, at a given moment in time, individual credit unions may not be, nor want to be, at the same stage of development. The typology emphases maturity as being the most advanced stage of credit union development. However, it must also be recognised that there is nothing, in theory, to prevent a further stage beyond maturity which entails the transformation of credit unions beyond their current cooperative form to an entirely new form of organisation through, for example, demutualisation[vi]. However, the output of such a stage would render the institutions no longer credit unions and the Commission does not consider this form as appropriate or necessary.

2.3.7 More recently the declining fortunes of the Irish economy have not only put an additional brake on credit union development but arguably have resulted in a significant regression. For some credit unions their business model is now under pronounced pressure due to falling consumer expenditure and a rising unemployment rate. Personal consumer expenditure fell by 1.1% in 2008, 6.9% in 2009, 0.8% in 2010 and is projected to fall by 1.8% in 2011 while the unemployment rate increased to 6.3% in 2008, 11.8% in 2009, 13.6% in 2010 and is forecast to be 14.4% for 2011.

2.4 Irish Credit Unions: An Historical Perspective

2.4.1 In Ireland the first credit unions were formed in 1958. A year later there were three credit unions with a total of 200 members and €530 in savings. In 1960, the Credit Union League of Ireland was established to foster the growth of credit unions. The League then evolved into the Irish League of Credit Unions (ILCU).[vii] By 1962, there were 18 credit unions, and this figure grew exponentially during the 1960s.

2.4.2 Throughout the 1970s and 1980s there was continual growth in credit union numbers, members and savings. In 1984 there were 389 credit unions, with 527,000 members and €293 million in savings. Since the late 1980s, there has been a levelling off in the establishment of new credit unions, although strong growth, both in savings and membership, has continued. During the 1990s there were, on average, three new credit unions formed per annum, with no new credit unions established after 1999. At the end of 1996, there were 434 credit unions with a membership of 1.7 million and savings of €2,267 million.

2.4.3 By 2000, the comparative figures were 438 credit unions, 2.2 million members and savings of €4,618 million. In 2003, **the Credit Union Development Association (CUDA)** was formed "as a response to a more competitive and increasingly complex business environment" and it now has 12 member credit unions. By 2004 credit unions numbers had fallen to 424, but savings continued to grow and stood at approximately €9,336 million while membership increased to 2.6 million. By June 2011 there was a further fall in credit union numbers to 408 but savings had increased to €12,222 million and membership to approximately 2.9 million.

2.4.4 The Credit Union Act 1966 provided the first legislative framework for the credit union movement in Ireland. Under the 1966 Act, the Registrar of Friendly Societies was designated as the regulatory authority for credit unions. This Act was repealed with the enactment of the Credit Union Act 1997.

2.4.5 The 1997 Act included a relaxation of common bond definitions, an increase in the duration and amount of savings and loans allowed and also permitted credit unions to provide additional services. The 1997 Act also addressed other key issues:

- registration and membership
- operation of credit unions
- management of credit unions
- meetings and resolutions
- control and supervision of credit unions by the Registrar of Friendly Societies

- accounts and audit
- disputes and complaints
- amalgamations and transfers of engagements
- winding up
- appointment of credit union administrator
- appointment of examiner
- offences and civil proceedings

2.4.6 The establishment in 2003 of the Irish Financial Services Regulatory Authority, as the sole regulatory authority for all financial service providers, resulted in the credit union sector moving from a largely self-regulated sector to a regulatory regime consistent with other financial services providers. In 2010, the creation of a unitary Central Bank of Ireland with responsibilities for central banking and financial regulation meant that credit unions are now regulated and supervised by the Registrar for Credit Unions within the Central Bank. While it is important that the credit union movement has a legislative framework that is appropriate for credit unions, in recent years, as the reaction of the Irish government to the financial crisis has developed, credit unions have come within the scope of significant new and proposed pieces of legislation: Financial Services (Deposit Guarantee Scheme) Act 2009, Central Bank Reform Act 2010, Central Bank and Credit Institutions (Resolution) (No.2) Bill 2011. The Commission considers that this approach, which also applies to Government decisions on transposition of European Union Directives, must be monitored carefully to ensure the credit union difference is not diluted and lost. An objective of the Commission is to seek solutions to evolving and growing the credit union movement in line with its ethos and guiding principles.

2.5 Summary

From the analysis the following points emerge:

2.5.1 Credit unions are self-help financial cooperatives that pursue the economic and social goals of members and wider local communities.

2.5.2 In credit unions there is a coincidence of ownership and consumption which translates into a reduced potential for conflict and less incentive for risk-taking behaviour in comparison to, for example, for-profit shareholder based financial institutions. In part, this explains why credit unions (worldwide) have fared better than banks during the financial crisis.

2.5.3 Credit unions play a crucial role in acting as a balancing influence on the market power of banks in the retail financial services industry.

2.5.4 In Ireland, credit unions play a significant role in the provision of financial services, with membership of credit unions accounting for a greater share of the total population than in almost any other country.

2.5.5 The credit union movement in Ireland has not as yet progressed beyond a transition stage of development. In part this centres on limited product development, limited service support systems and a less well developed prudential framework.

2.5.6 The number of credit unions has remained broadly constant over the last two decades. This contrasts with the experience in the six benchmarked countries where the norm (with the exception of Poland) is one of contracting numbers with commensurate increases in scale for those that remain. Contraction in other countries has occurred through transfer of engagements, amalgamations and liquidation.

Chapter 3 – The Current Financial Position of the Credit Union Sector in Ireland

3.1 Introduction

3.1.1 This chapter provides a sector review of the Irish credit union movement for the period 2006 to 2010 (June 2011 where data is available). In recent times adverse financial and economic conditions in Ireland have created significant problems for credit unions. By considering this period the Commission is in a position to examine how the sector has fared both prior to the financial crisis and throughout the present economic downturn. This analysis is designed to identify the financial strengths and weaknesses of the sector and to frame the Commission's work on appropriate prudential management, regulatory and governance frameworks. The data upon which the analysis is based was provided to the Commission on Credit Unions by the Central Bank.[2]

3.2 Asset Distribution

3.2.1 Table 1 describes the credit union sector in terms of asset size. Of the 408 credit unions in Ireland (June 2011), more than half (216) have assets less than €20m and almost three-quarters have assets less than €40m (299 credit unions). Only 30 credit unions have assets in excess of €100m of which 4 have assets in excess of €200m. When the average asset sizes of community and industrial credit unions are

[2] In providing the data, the Registrar wishes to note that (1) there are limitations in relying on the numbers reported given the structural weakness the Registrar has identified in governance, management accounting and reporting systems in the credit union sector; (2) the information provided from the Prudential Returns submitted by credit unions is management account information and is unaudited; (3) there is a concern that the arrears figures reported on the Prudential Return may not fully reflect the actual position; (4) the Reserve figures reported for 2011 may be overstated as some credit unions are likely to wait until year-end to finalise their bad debt provision requirements and investment valuations; (5) the 2010 Credit Union Annual Return does not contain information for a number of credit unions with balance sheets showing significant solvency stress; and (6) that there is a lag in the impact of the difficulties being encountered by credit unions on the reserve position in credit unions.

compared there are no great differences. However, it is worth noting that industrial credit unions are more likely than community credit unions to be either small (have assets of less than €20m) or large (have assets greater than €100m) and that while 9% of community credit unions have assets between €60m and €100m, no industrial credit union falls into these asset size categories. Over the period September 2006 to June 2011 we note a decline in credit union numbers from 425 to 408 representing a fall in the number of industrials from 58 to 48 and in community credit unions from 367 to 360. In terms of credit unions within the respective size bands there is little change over the period, with the exception of the category less than €20m which has seen a drop in numbers of 14 (from 230 to 216).

Table 1 – Asset Categorisation

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010	31 March 2011	30 June 2011
Sector							
Greater than €100m	29	29	28	28	29	30	30
€60m to €100m	35	35	35	35	33	31	31
€40m to €60m	46	47	48	48	51	48	48
€20m to €40m	85	86	82	85	81	83	83
Less than €20m	230	223	225	219	215	217	216
Total	*425*	*420*	*418*	*415*	*409*	*409*	*408*
Community							
Greater than €100m	21	21	20	20	21	21	21
€60m to €100m	34	34	34	34	32	31	31
€40m to €60m	41	44	45	44	47	44	44
€20m to €40m	78	77	73	77	73	75	75
Less than €20m	193	189	193	189	188	190	189
Total	*367*	*365*	*365*	*364*	*361*	*361*	*360*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited); March & June 2011 data is extracted from the Prudential Return (Unaudited).

Table 1 continued – Asset Categorisation

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010	31 March 2011	30 June 2011
Sector							
Greater than €100m	29	29	28	28	29	30	30
€60m to €100m	35	35	35	35	33	31	31
€40m to €60m	46	47	48	48	51	48	48
€20m to €40m	85	86	82	85	81	83	83
Less than €20m	230	223	225	219	215	217	216
Total	*425*	*420*	*418*	*415*	*409*	*409*	*408*
Community							
Greater than €100m	21	21	20	20	21	21	21
€60m to €100m	34	34	34	34	32	31	31
€40m to €60m	41	44	45	44	47	44	44
€20m to €40m	78	77	73	77	73	75	75
Less than €20m	193	189	193	189	188	190	189
Total	*367*	*365*	*365*	*364*	*361*	*361*	*360*
Industrial							
Greater than €100m	8	8	8	8	8	9	9
€60m to €100m	1	1	1	1	1	0	0
€40m to €60m	5	3	3	4	4	4	4
€20m to €40m	7	9	9	8	8	8	8
Less than €20m	37	34	32	30	27	27	27
Total	*58*	*55*	*53*	*51*	*48*	*48*	*48*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited); March & June 2011 data is extracted from the Prudential Return (Unaudited).

3.2.2 Table 2 compares the share of total assets by asset size (June 2011). The general pattern is one in which the more numerous smaller credit unions account for a disproportionately small share of total assets while the few large credit unions account for a disproportionately large share. Despite accounting for more than half of the number of credit unions, those with assets of less than €20m account for just 15% of total assets. Along similar lines, while three-quarters of credit unions have assets of €40m or less, they account for a third of total assets. At the other end of the scale, though small in number, those credit unions that have assets of €100m or more account for just over a third of total assets.

Table 2 – Credit Unions by Asset Size – June 2011

	No. of Credit Unions	% of Credit Unions	Total Assets €m	% Total Assets
Sector				
Greater than €100m	30	7.4%	4,747.20	33.6%
€60m to €100m	31	7.6%	2,370.45	16.8%
€40m to €60m	48	11.8%	2,378.87	16.8%
€20m to €40m	83	20.3%	2,503.33	17.7%
Less than €20m	216	52.9%	2,137.74	15.1%
Total	*408*	*100.0%*	*14,137.58*	*100.0%*
Community				
Greater than €100m	21	5.1%	3,031.16	21.4%
€60m to €100m	31	7.6%	2,370.45	16.8%
€40m to €60m	44	10.8%	2,175.37	15.4%
€20m to €40m	75	18.4%	2,271.85	16.1%
Less than €20m	189	46.3%	2,005.01	14.2%
Total	*360*	*88.2%*	*11,853.86*	*83.8%*
Industrial				
Greater than €100m	9	2.2%	1,716.04	12.1%
€60m to €100m	0	0.0%	0.00	0.0%
€40m to €60m	4	1.0%	203.49	1.4%
€20m to €40m	8	2.0%	231.48	1.6%
Less than €20m	27	6.6%	132.72	0.9%
Total	*48*	*11.8%*	*2,283.73*	*16.2%*

Notes: June 2011 data is extracted from the Prudential Return (Unaudited).

3.3 Income

3.3.1 Table 3 details total income as well as its individual components. The income of credit unions has varied from year-to-year; it peaked in 2007 at €860.4m prior to the onset of the financial crisis and in 2010 stood at €772.42m. The principle component of credit union income is interest income which on average accounts for 71% of total income with investment income, on average, accounting for approximately 27%. Between 2006 and 2009, income from interest payments increased from €572.88m to €613.52m (an increase of 7%) before falling sharply in 2010 to €546.47m (a decrease of 10%). This downward fall between 2009 and 2010 is of such a magnitude that it takes interest income to a level lower than what it was in 2006. It is also clear that this set-back has been felt by credit unions in all of the asset size categories.

3.3.2 Credit union income from investments has been more variable. The best year for credit unions' investments was 2007 when income from this source was €256.95m. Investment income in 2010 was €207.76m, somewhat similar to the 2009 figure and a 19% fall from its 2007 peak. Again all asset size categories have experienced investment income deterioration.

Table 3 – Credit Union Income – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Total Income					
Greater than €100m	€250.34m	€267.86m	€252.97m	€258.58m	€251.02m
€60m to €100m	€148.47m	€164.15m	€153.96m	€157.49m	€132.86m
€40m to €60m	€122.84m	€134.66m	€124.69m	€144.58m	€134.21m
€20m to €40m	€147.73m	€160.53m	€149.45m	€156.19m	€134.47m
Less than €20m	€118.85m	€133.21m	€128.89m	€130.91m	€119.86m
Total	*€788.23m*	*€860.40m*	*€809.96m*	*€847.75m*	*€772.42m*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
 For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.
* Investment Income does not include investment losses.
# Other Income includes Members Deposit and Other Interest Expense and Similar Charges.

Table 3 continued – Credit Union Income – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Interest Income					
Greater than €100m	€171.63m	€172.76m	€179.67m	€180.61m	€173.00m
€60m to €100m	€105.03m	€109.36m	€112.20m	€110.94m	€89.76m
€40m to €60m	€91.16m	€90.97m	€98.30m	€101.58m	€93.28m
€20m to €40m	€111.43m	€114.76m	€114.34m	€117.68m	€98.53m
Less than €20m	€93.64m	€96.32m	€103.51m	€102.69m	€91.90m
Total	*€572.88m*	*€584.17m*	*€608.02m*	*€613.52m*	*€546.47m*
Investment Income*					
Greater than €100m	€82.34m	€97.78m	€73.56m	€69.78m	€76.39m
€60m to €100m	€37.67m	€47.54m	€40.49m	€44.02m	€41.30m
€40m to €60m	€27.57m	€37.53m	€26.72m	€36.37m	€35.72m
€20m to €40m	€32.59m	€43.13m	€32.37m	€34.18m	€30.65m
Less than €20m	€21.07m	€30.97m	€21.99m	€22.87m	€23.70m
Total	*€201.24m*	*€256.95m*	*€195.12m*	*€207.22m*	*€207.76m*
Other Income#					
Greater than €100m	-€3.63m	-€2.68m	-€0.26m	€8.19m	€1.63m
€60m to €100m	€5.77m	€7.24m	€1.27m	€2.52m	€1.79m
€40m to €60m	€4.11m	€6.15m	-€0.32m	€6.63m	€5.21m
€20m to €40m	€3.71m	€2.64m	€2.74m	€4.32m	€5.30m
Less than €20m	€4.14m	€5.93m	€3.39m	€5.35m	€4.26m
Total	*€14.14m*	*€19.32m*	*€6.86m*	*€27.05m*	*€18.22m*
Number of Credit Unions Reporting (I&E)	425	420	418	415	392□

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
□ For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.
* Investment Income does not include investment losses.
# Other Income includes Members Deposit and Other Interest Expense and Similar Charges.

3.4 Costs

3.4.1 Table 4 examines credit union costs by outlining total cost-to-income ratios, bad debt provisions, loans written off and investment losses. Between 2006 and 2010, credit union costs have almost doubled, from €321.51m to €626.77m. This is reflected in a stark increase in the cost-to-income ratio which overall was 49.5% in 2006 but by 2010 had risen to 83.3%. The increase occurred across all size bands, although credit unions with assets in excess of €100m had a consistently lower cost to income ratio than the other size categories.

3.4.2 The increase in costs is primarily associated with increases in both bad debt provisions and loans written off. While both of these costs began to increase in 2008, they grew substantially in 2009 and 2010. In 2008, the credit union sector made additional provisions of €38.28m for bad debts, however, bad debt provisions increased by €157.49m in 2009 and €215.06m in 2010 in recognition of a continued decline in the quality of the loan book. With regard to loans written off, in 2008, this accounted for €41.85m, but rose to €87.95m in 2009 and €107.44m in 2010 (1.7% of gross loans). Again the problem spans all asset categories.

Table 4 – Credit Union Costs – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Total Cost / Income Ratio					
Greater than €100m	35.6%	38.4%	49.8%	54.2%	73.6%
€60m to €100m	44.5%	44.9%	61.6%	72.5%	87.2%
€40m to €60m	40.6%	41.2%	63.2%	70.4%	82.6%
€20m to €40m	44.4%	43.7%	71.3%	72.9%	86.2%
Less than €20m	55.8%	45.4%	60.3%	78.7%	83.1%
Total	*49.5%*	*44.0%*	*62.2%*	*74.4%*	*83.3%*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
* For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.

Table 4 continued – Credit Union Costs – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Bad Debt Provisions					
Greater than €100m	€8.72m	€12.96m	€10.57m	€45.06m	€63.51m
€60m to €100m	€9.36m	€8.63m	€8.78m	€32.86m	€43.58m
€40m to €60m	€3.69m	€2.40m	€6.01m	€26.79m	€36.52m
€20m to €40m	€6.52m	€6.23m	€6.60m	€26.33m	€39.60m
Less than €20m	€3.27m	€5.00m	€6.32m	€26.44m	€31.85m
Total	*€31.56m*	*€35.22m*	*€38.28m*	*€157.49m*	*€215.06m*
Loans Written Off					
Greater than €100m	€11.38m	€9.86m	€11.32m	€22.30m	€29.35m
€60m to €100m	€7.80m	€9.06m	€8.52m	€13.89m	€17.11m
€40m to €60m	€6.45m	€7.92m	€7.25m	€16.99m	€21.50m
€20m to €40m	€6.61m	€7.59m	€7.58m	€17.83m	€20.41m
Less than €20m	€5.47m	€5.68m	€7.18m	€16.94m	€19.07m
Total	*€37.71m*	*€40.11m*	*€41.85m*	*€87.95m*	*€107.44m*
Investment Losses					
Greater than €100m	€0.21m	€0.51m	€25.78m	-€4.98m	€4.61m
€60m to €100m	€0.24m	€2.49m	€15.87m	€4.30m	€2.28m
€40m to €60m	€0.03m	€1.72m	€10.78m	€3.98m	€0.12m
€20m to €40m	€0.31m	€0.69m	€11.04m	€7.10m	€1.06m
Less than €20m	€0.03m	€0.51m	€9.52m	€7.05m	€0.34m
Total	*€0.83m*	*€5.93m*	*€72.99m*	*€17.46m*	*€8.40m*
Number of Credit Unions Reporting (I&E)	425	420	418	415	392*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
* For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.

3.4.3 Investment losses are also detailed in Table 4. This problem reached a peak in 2008 (€72.99m) and since then losses have been reduced; €17.46m in 2009 and €8.40m in 2010. Benchmarking investment losses (Table 4) against investment income (Table 3), it would appear that credit unions with assets less than €60m now have this aspect of their business under control while credit unions with assets in excess of €60m have scope for further improvements.

3.5 Arrears Over 9 Weeks and Provisions

3.5.1 The opportunity is taken in Table 5 to explore in detail arrears over nine weeks (information is also detailed on provisions). There has been a significant increase in the percentage of the gross loan book in arrears over nine weeks. This increase in arrears over nine weeks is associated with more recent years. Over the first three years of the period, the percentage of the gross loan book in arrears was reasonably stable, increasing from 6.3% in 2006 to 6.68% in 2008. However, since 2008 there has been a very dramatic increase in loan book arrears; 9.85% in 2009 to 15.15% in 2010 to 18.69% in 2011. There are currently 98 credit unions each having arrears over 25% of their gross loan books.

3.5.2 As a whole the credit union sector has increased its provisioning for bad debts from €204.9m in 2006 to €738.41m in 2011. Provisions are set aside to deal with expected losses while reserves are intended for unexpected losses. The 2011 provisions fall short of the total arrears in the sector of €1,051.4m. That said, it is worth noting that in 2006 the amount set aside for provisions was about half of the amount in arrears (€380.44m), and while the nominal sums have increased, in 2011 about 70% of the arrears are provided for[3]. However, while the overall sector may appear to be better prepared to absorb unforeseen losses in 2011 than it was in 2006, what the aggregate does not show is the relationship between provisioning and levels of arrears at the individual

[3] Between July 2010 and March 2011, the Central Bank undertook an inspection of 401 credit union loan books in order to establish the adequacy for provisions for bad and doubtful debts and to identify levels of additional provisions that need to be made by credit unions. The results indicate that 263 (or 66%) of credit unions did not have adequate provisions for bad and doubtful debts on their loan books and had a shortfall of €108m (or 28%) of their provisions.

credit union level. In other words, not all credit unions may be better prepared in 2011 than they were in 2006.

Table 5 – Arrears and Provisions – 2006 - 2011

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010	30 June 2011
Arrears						
Greater than €100m	€99.34m	€105.26m	€126.90m	€176.06m	€251.42m	€283.80m
€60m to €100m	€83.16m	€84.78m	€98.95m	€139.99m	€169.62m	€192.03m
€40m to €60m	€64.61m	€66.17m	€77.43m	€103.24m	€147.88m	€179.42m
€20m to €40m	€72.47m	€70.70m	€77.97m	€118.32m	€151.31m	€225.03m
Less than €20m	€60.86m	€61.61m	€76.81m	€106.43m	€140.06m	€171.17m
Total	*€380.44m*	*€388.51m*	*€458.07m*	*€644.05m*	*€860.27m*	*€1,051.4m*
Provisions						
Greater than €100m	€60.61m	€72.71m	€77.39m	€118.67m	€182.69m	€210.17m
€60m to €100m	€48.62m	€52.93m	€62.26m	€91.81m	€111.57m	€134.45m
€40m to €60m	€30.36m	€37.14m	€45.72m	€72.95m	€100.37m	€121.40m
€20m to €40m	€36.28m	€40.54m	€43.48m	€70.79m	€95.19m	€155.52m
Less than €20m	€29.04m	€33.78m	€40.68m	€65.31m	€87.99m	€116.88m
Total	*€204.90m*	*€237.10m*	*€269.54m*	*€419.53m*	*€577.81m*	*€738.41m*
Average Arrears						
Greater than €100m	5.36%	5.62%	6.38%	9.14%	13.34%	15.46%
€60m to €100m	6.74%	6.43%	7.21%	10.88%	16.88%	19.84%
€40m to €60m	6.07%	5.93%	6.34%	9.17%	14.41%	18.12%
€20m to €40m	5.99%	5.50%	5.99%	9.32%	14.84%	19.35%
Less than €20m	6.51%	6.45%	6.96%	10.13%	15.45%	18.86%
Total	*6.30%*	*6.14%*	*6.68%*	*9.85%*	*15.15%*	*18.69%*
Number of Credit Unions Reporting (Arrears)	425	420	418	415	380	408

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited); June 2011 data is extracted from the Prudential Return (Unaudited).

3.6 Loan-to-asset ratios

3.6.1 In Table 6 the loan-to-asset ratio is documented. On this count Irish credit unions appear to be significantly under-lent. During this period, the loan-to-asset ratio for the sector rose from 47.45% in 2006 to 52.11% in 2008. However, since 2008 this ratio has contracted quite quickly to 47.63% in 2009 and then to 42.45% in 2011. The loan-to-asset ratios of industrial credit unions are somewhat higher than those for community credit unions with the difference becoming quite pronounced in 2010 and 2011. Across the size bands the average loan-to-asset ratio is broadly similar for the sector as a whole. This is also the case for community credit unions. A much greater variability occurs, however, for industrial credit unions.

Table 6 – Loan-to-Asset Ratio – 2006 - 2011

	31 Dec 2006	31 Dec 2008	31 Dec 2008	31 Dec 2009	31 Dec 2010	30 June 2011
Sector						
Greater than €100m	43.02%	45.18%	49.69%	45.43%	43.50%	40.68%
€60m to €100m	45.00%	48.16%	51.21%	45.53%	43.40%	42.41%
€40m to €60m	46.11%	46.45%	50.27%	46.92%	43.99%	41.92%
€20m to €40m	48.26%	50.44%	53.24%	48.35%	45.26%	42.89%
Less than €20m	48.37%	49.89%	52.52%	48.13%	44.57%	42.64%
Total	*47.45%*	*49.15%*	*52.11%*	*47.63%*	*44.46%*	*42.45%*
Community						
Greater than €100m	41.79%	42.69%	47.10%	43.62%	42.12%	39.00%
€60m to €100m	44.60%	47.67%	50.73%	45.05%	42.90%	41.96%
€40m to €60m	47.09%	47.23%	51.11%	47.67%	44.56%	42.26%
€20m to €40m	47.64%	49.40%	52.15%	47.13%	43.82%	41.56%
Less than €20m	48.31%	49.76%	51.96%	47.54%	43.52%	41.61%
Total	*47.31%*	*48.78%*	*51.51%*	*47.02%*	*43.58%*	*41.56%*

Notes: Data is extracted from the Prudential Return for December each year (Unaudited).

Table 6 continued – Loan to Asset Ratio – 2006 - 2011

	31 Dec 2006	31 Dec 2008	31 Dec 2008	31 Dec 2009	31 Dec 2010	30 June 2011
Industrial						
Greater than €100m	46.27%	51.71%	56.17%	49.95%	47.14%	45.07%
€60m to €100m	58.78%	64.85%	67.67%	61.84%	59.58%	57.82%
€40m to €60m	38.02%	34.92%	37.75%	38.68%	37.39%	39.12%
€20m to €40m	55.13%	59.32%	62.09%	59.92%	58.43%	57.52%
Less than €20m	48.75%	50.65%	55.91%	51.86%	51.85%	49.73%
Total	*48.41%*	*51.64%*	*56.19%*	*51.98%*	*51.12%*	*49.16%*

Notes: Data is extracted from the Prudential Return for December each year (Unaudited).

3.7 Dividends

3.7.1 In Table 7 the average dividend rate is detailed. There has been a pronounced decrease in the average size of dividends paid to members since 2007. For the first two years of the period, average dividends to members were just over 2%. However, these fell to 1.94% in 2008, to 1.58% in 2009 and to 0.90% in 2010. It is worth noting that there is an increasing gap between the average dividends of industrial credit unions and those of both community credit unions and the sector as a whole. In 2010, the average dividend paid by industrial credit unions was about 0.63 percentage points greater than that for the sector as a whole and 0.74 percentage points greater than that paid by community credit unions. Furthermore, in 2010, more than 100 credit unions were unable to pay a dividend.

3.8 Liquidity

3.8.1 In Table 8 the liquidity rate is documented. Despite the financial crisis and the challenges that it has posed, average liquidity has remained high and in June 2011 stood at 45.83%. Average liquidity is much higher for small credit unions (51.41% for credit unions with less than €20m in assets) compared to large credit unions (34.5% for credit unions with assets greater than €100m). There has also been a notable drop in the number of credit unions with liquidity of less than the regulatory requirement of 20%. In 2006, prior to the start of the financial crisis, 95 credit unions had liquidity of less than 20% but since then this number has decreased sharply to 43 in 2009 and to 13 in June 2011. Overall it would appear that average liquidity holding is excessively high.

Table 7 – Average Dividends – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Sector					
Greater than €100m	2.61	2.78	2.61	1.90	1.11
€60m to €100m	2.03	2.24	1.91	1.31	0.80
€40m to €60m	2.17	2.42	2.03	1.29	0.85
€20m to €40m	2.15	2.37	2.03	1.41	0.88
Less than €20m	2.09	2.22	1.81	1.71	0.91
Total	*2.14*	*2.31*	*1.94*	*1.58*	*0.90*
Community					
Greater than €100m	2.60	2.80	2.51	1.84	1.03
€60m to €100m	2.01	2.22	1.88	1.26	0.75
€40m to €60m	2.13	2.41	2.00	1.20	0.80
€20m to €40m	2.14	2.32	1.99	1.39	0.78
Less than €20m	2.03	2.13	1.74	1.70	0.77
Total	*2.10*	*2.25*	*1.88*	*1.54*	*0.79*
Industrial					
Greater than €100m	2.66	2.75	2.96	2.08	1.31
€60m to €100m	2.50	3.00	3.00	2.75	2.00
€40m to €60m	2.50	2.58	2.75	2.19	1.31
€20m to €40m	2.18	2.72	2.36	1.56	1.47
Less than €20m	2.45	2.71	2.27	1.79	1.64
Total	*2.45*	*2.72*	*2.42*	*1.84*	*1.53*
Number of Credit Unions Reporting (I&E)	425	420	418	415	392*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
* For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.

Table 8 – Liquidity – 2006 - 2011

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010	31 March 2011	30 June 2011
Number with Liquidity < 20%	**95**	**90**	**108**	**43**	**20**	**17**	**13**
Greater than €100m	8	10	8	2	1	2	1
€60m to €100m	9	5	13	1	1	0	2
€40m to €60m	15	13	14	5	2	0	1
€20m to €40m	24	21	23	8	8	3	2
Less than €20m	39	41	50	27	8	12	7
Average Liquidity	**37.49%**	**34.48%**	**32.90%**	**35.36%**	**41.64%**	**41.05%**	**45.83%**
Greater than €100m	28.93%	28.64%	28.84%	28.67%	31.47%	32.31%	34.50%
€60m to €100m	25.70%	27.32%	26.09%	32.23%	35.77%	36.71%	38.23%
€40m to €60m	27.49%	27.02%	26.04%	31.15%	35.69%	36.55%	41.76%
€20m to €40m	31.29%	29.34%	27.26%	32.60%	36.07%	35.71%	40.66%
Less than €20m	44.78%	39.92%	38.00%	38.71%	47.58%	45.92%	51.41%

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited); March & June 2011 data is extracted from the Prudential Return (Unaudited).

3.9 Reserves Profile

3.9.1 In Table 9 a profile is presented of realised reserves as a percentage of total assets. WOCCU's standard for institutional capital (undivided earnings and regular reserves only) is a minimum of 10% of total assets. Information is presented in terms of reserve to asset categories. As of June 2011, of the 408 credit unions analysed, 352 (86%) hold at least 10% of assets as total realised reserves[4]. There are, however, 56 credit unions (14%) with total realised reserves below

[4] The Regulatory Reserve Ratio requires credit unions to hold a minimum of 10% assets in Total Regulatory Reserves. As of 30 June 2011, 71% of credit unions have reported that they are in compliance with this requirement. The Total Realised Reserve figure above includes any realised reserves that credit unions have reported in addition to the Total Regulatory Reserve. This includes the surplus / deficit that has been reported for the first nine months of the year. The information reported is unaudited and may be impacted by bad debt provisions and investment valuations which many credit unions make at year end.

10% of assets[viii] of which 27 credit unions could be considered to be significantly undercapitalised having total realised reserves of less than 7.5% of assets. These 27 credit unions have total realised reserves of €12.17m against total assets of €609.28m (or 2%). More generally, Table 9 highlights constancy, at least over the last four time periods, in the number of credit unions with total realised reserves of less than 10% of assets (approximately 60 credit unions in each period). This raises questions as to the financial soundness of these credit unions. Having said this, and noting that the March 2011 and June 2011 figures are extracted from unaudited Prudential Returns, it is pleasing to note that the reserve base for the sector as a whole has not been subject to a significant decline.

Table 9 – Reserves – 2006 - 2011

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010	31 March 2011	30 June 2011
Average Reserves							
Less than 7.5%	47	24	15	19	8	22	27
7.5% to 8.0%	19	10	5	4	5	2	2
8.0% to 8.5%	34	15	7	5	5	8	4
8.5% to 9.0%	33	19	18	7	8	9	6
9.0% to 9.5%	34	37	28	12	14	8	5
9.5% to 10.0%	51	28	37	13	14	14	12
Greater than 10.0%	207	287	308	355	338	346	352
Number of Credit Unions Reporting (Balance Sheet)	425	420	418	415	392*	409	408

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
* For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised;
March & June 2011 data is extracted from the Prudential Return (Unaudited).
2006 - 2010 = Statutory Reserves + Realised Reserves - Dividend - Interest Rebate.
2011 = Statutory Reserves + Additional Regulatory Reserves + Other Realised Reserves +/- Surplus/Deficit.

3.9.2 As of June 2011 unaudited total assets were calculated at €14.138 billion and reserves at €1.86 billion which equates to an average reserve ratio for the sector of 13.2%. The introduction of the Regulatory Reserve Ratio and close management of dividend payments by the Registry of Credit Unions has helped to ensure that reserves have not been significantly depleted to date. Earnings retained for reserves are not then available to pay dividends. However, the payment of nominal dividends or the non-payment of dividends will not be sustainable on an on-going basis.

3.10 Return on Assets

3.10.1 In Table 10 the average return on assets is documented for all credit unions. In the two years preceding the onset of the financial crisis, credit unions enjoyed a return on assets in excess of 3%, reaching 3.5% in 2007. Thereafter credit unions have suffered a sharp decline in their return on assets which by 2010 had fallen to 0.9%. Although not detailed in Table 10, 11% of credit unions reported a deficit in 2009, this increased to 17% in 2010. For the six months to March 2011, 27% of credit unions have reported a deficit. The size distribution detailed in 2010 suggests that credit unions with assets in excess of €100m are able to generate a higher return on assets than credit unions in the other size bands.

Table 10 – Return on Assets – 2006 - 2010

	30 Sept 2006	30 Sept 2007	30 Sept 2008	30 Sept 2009	30 Sept 2010
Sector					
Greater than €100m	3.5%	3.6%	2.8%	2.5%	1.4%
€60m to €100m	3.0%	3.3%	2.2%	1.6%	0.6%
€40m to €60m	3.3%	3.4%	2.2%	1.8%	0.9%
€20m to €40m	3.3%	3.5%	2.6%	1.7%	0.8%
Less than €20m	3.3%	3.6%	2.4%	1.4%	1.0%
Total	*3.3%*	*3.5%*	*2.4%*	*1.6%*	*0.9%*
Number of Credit Unions Reporting (I&E)	425	420	418	415	392*

Notes: All Data extracted from the Credit Union Annual Return for 2006 to 2010 (Audited);
* I&E: For 2010, the data excludes 17 Credit Unions whose accounts have not yet been finalised.

3.11 Financial Projections

3.11.1 In carrying out its work, the Commission benefited from a number of presentations that set out scenarios for the future capital adequacy of credit unions based on specific assumptions. These included the Strategic Review of the credit union sector conducted by Grant Thornton (projections made for 2011 to 2013) and the Prudential Capital Assessment Review (PCAR) undertaken by the Central Bank whereby baseline and adverse loan loss scenarios were applied to assumed financial forecasts (projections made for 2011 to 2013). The Commission, in carrying out its own work, notes that, as of June 2011, the position regarding arrears has increased to €1,051.4m, and that there are now 27 credit unions with total realised reserves to asset ratios of less than 7.5% and, as such, these credit unions can be considered to be seriously undercapitalised. Scenarios provided by Grant Thornton and the Central Bank project that, in the absence of corrective action by the Central Bank and the credit unions, the financial position of a significant number of credit unions will deteriorate markedly between now and 2013, due mainly to rising bad debts, poor governance and inadequate buffers of reserves.

3.12 Summary

From the analysis the following points emerge:

3.12.1 Irish credit unions prior to the financial crisis and economic downturn (indeed for most of the last decade) have been under-lent. The average loan to asset ratio in 2011 was 42.45%, an historic low.

3.12.2 The share of investment holdings in Irish credit unions is high. This adversely impacts upon income generation as the return from investments tends to be lower than interest receivable on loans. This has been compounded by significant losses on some investment portfolios accounted most notably in the 2008 and 2009 returns.

3.12.3 Adverse economic conditions are now translating into significantly higher levels of loan write-offs: a 110% increase between 2008 and 2009 and a further 22% increase between 2009 and 2010. There are also increases in arrears with 98 credit unions each currently having arrears over 25% of their gross loan books. Reassuringly, good practice and regulatory pressures have led to commensurately higher levels of bad debt provisioning.

3.12.4 Since 2007 credit unions have suffered a sharp decline in their return on assets which by 2010 had fallen to 0.9% (with 110 credit unions actually reporting a deficit in the 6 months to March 2011). This has led to a decrease in the average dividend rate (0.9% in 2010); over 100 credit unions did not pay a dividend in 2010.

3.12.5 The adverse economic conditions have resulted in a decline in credit union performance and have made it difficult for credit unions to replenish reserves through retained earnings. In 30 June 2011, 56 credit unions had total realised reserves of less than 10% of assets with 27 credit unions seriously undercapitalised. And while it may not be the same credit unions that are undercapitalised in each time period, there does appear to be constancy to date in the number identified as having total realised reserves of less than 10% of assets. That said the average total realised reserves ratio for the sector has held up well and as of June 2011 was 13.2%.

3.12.6 Despite the financial crisis, average liquidity has remained high and currently stands at 45.83% (in 2011 only 13 credit unions failed in to meet the 20% regulatory requirement). This high level of average liquidity raises a problem in its own right in that credit unions do not aggregate their liquid positions and in consequence do not avail of the higher returns which aggregation can generate. Excess liquidity appears to be more pronounced for smaller credit unions.

3.12.7 The financial profile reveals a commonality of the issues faced by credit unions of all sizes and common bond types. The declining fortunes of the Irish economy have not only put an additional brake on credit union development but arguably have contributed to regression in some credit unions. The Strategic Review of the Credit Union Sector completed by Grant Thornton in January 2011 and the Central Bank's PCAR also envisage a further deterioration in credit union solvency. While the financial challenges now faced by credit unions are evident, they are not insurmountable but do reinforce a clear need to reform how credit unions are governed and regulated.

Chapter 4 - Deposit Protection, Resolution, Stabilisation and Liquidity

4.1 Introduction

4.1.1 This chapter sets out the recommendations of the Commission on Credit Unions with regard to designing a prudential management framework to underpin the future evolution of the sector having regard to its particular ethos and nature and to ensure a stable Credit Union sector.

4.1.2 A prudential management framework for credit unions can arguably be viewed as having, among other things, a series of components[ix]. These include:

a) a regulatory framework (considered separately in Chapter 6) with a view to the protection by each credit union of the funds of its members and the maintenance of the financial stability and well-being of credit unions generally;

b) a deposit guarantee scheme to protect the savings of members up to a statutory maximum;

c) a resolution mechanism to deal with credit unions that are 'not viable';

d) stabilisation support, in certain circumstances and with conditions, for credit unions that are facing difficulties but are otherwise considered 'viable'; and

e) a liquidity support mechanism to facilitate short-term liquidity needs for otherwise sound credit unions.[x]

4.1.3 Deposit Guarantee Scheme, stabilisation and resolution should be handled in a coordinated, holistic fashion and controlled and governed by the Central Bank.

4.1.4 Ultimately the objective of a prudential management framework must be the protection of the financial system (or group of organisations to which it applies) and not the individual entities within that system (or within the group).

4.2 Deposit Guarantee Scheme[xi]

4.2.1 Savings in credit unions are protected up to €100,000 per member per credit union by virtue of the Financial Services (Deposit Guarantee Scheme) Act 2009. The Commission recommends that credit unions remain subject to the general deposit guarantee scheme rather than establishing a credit union-specific scheme.

4.2.2 In return for protection under the deposit guarantee scheme, credit institutions must maintain a Deposit Protection Account at the Central Bank of such amount as may be determined by the Minister for Finance.[xii] The provision that requires credit unions to maintain such an amount at the Central Bank has yet to be commenced. The Commission recommends that this provision be commenced for credit unions.

4.3 'Viable' and 'Not Viable' Credit Unions

4.3.1 Within the credit union sector, it is critical that a distinction can be made between those credit unions that are 'viable' and those that are 'not viable'.[xiii]

4.3.2 When making a determination as to the viability of a credit union, the Commission recommends that a variety of interrelated factors should be taken into account. These factors should include capital adequacy, the dominant factor in determining the viability of a credit union[xiv], as well as, for example, factors relating to loan impairment and delinquency, investment impairment, high and rigid cost base, liquidity and the structure of liquidity, loan-to-asset ratio and governance capacity, and inability to present a feasible plan to restore capital reserves. The tendency for capital to lag behind other indicators of financial viability was noted.[xv]

4.3.3 While some members of the Commission emphasised the need to set out a range of factors related to the determination of viability, the Commission accepts that doing so must not impinge on the independence and ability of the Central Bank to take intervention actions in a credit union based on factors other than those general viability factors listed above at 4.3.2.

4.4 Resolution[xvi]

4.4.1 The development of a resolution regime for credit institutions has been the subject of detailed consideration both in Ireland and in the context of Ireland's international relationships.

4.4.2 Resolution involves bringing, in this case a credit union, to an end of its life in an orderly manner, as provided for in the Central Bank and Credit Institutions (Resolution) (No.2) Bill.

4.4.3 The Central Bank and Credit Institutions (Resolution) (No.2) Bill 2011[xvii] is expected to have completed its passage through the Oireachtas in the autumn session. Under the provisions of this Bill, it is proposed that the assets and liabilities of a financial institution that is under a resolution process can be (1) transferred to another institution or (2) transferred on a temporary basis to a 'bridge bank' with a view to transferring them to another institution, or, under Section 50 of the Bill, it is proposed that a Special Manager may be appointed to manage that business or part of the business with a view to preserving or restoring the financial position of that credit institution, subsidiary or holding company, to wind down that business or part with a view to liquidating its assets and paying off its liabilities and shrinking its business to facilitate its possible liquidation or acquisition, or having regard to any recovery plan for, and any resolution plan for, that credit institution shall otherwise manage that business or part of the business.

4.4.4 In order for the Central Bank to use its powers to seek to make a proposed transfer order or a proposed special management order, the intervention conditions or grounds which are set out at Section 8 of the Central Bank and Credit Institutions (Resolution) (No.2) Bill must be met.[xviii] The Commission recommends that the powers intended to be granted to the Central Bank under the Central Bank and Credit Institutions (Resolution) (No.2) Bill 2011 when enacted, should be considered for those credit unions that meet the intervention conditions or grounds set out in the Bill. The Commission believes that a credit union that becomes, or is likely to become significantly undercapitalised or otherwise meets the conditions or grounds set out in the Bill, as determined by the Central Bank in accordance with the specified criteria, and informed by international best practice (taking account of the significant differences in business models and support structures in other jurisdictions), should enter the resolution process if the conditions or grounds set out in the Bill are met. This recommendation does not impact on the independence and ability of the Central Bank to use the resolution powers set out in the Bill in any circumstances where the conditions or grounds set out in the Bill are met.

4.4.5 Under Section 9 of the Central Bank and Credit Institutions (Resolution) (No.2) Bill it is proposed that a Credit Institutions Resolution Fund be established, and be managed and administered by the Central Bank, to provide a source of funding for the resolution of financial instability in, or an imminent serious threat to the financial stability of, an authorised credit institution. The Fund shall be constituted by the contributions made by authorised credit institutions and by the Minister for Finance. The Commission notes that it is proposed that the Minister for Finance may, at the request of the Central Bank, provide a financial incentive to a credit union to accept the transfer of the assets and liabilities of another credit union. Any such financial incentive provided is a debt due and owing from the transferring credit union to the Credit Institution Resolution Fund. Such funding provided by the Minister for Finance may be recovered, by the Minister, from the Credit Institution Resolution Fund which is to be established under this proposed legislation.

4.5 Steady-State Stabilisation

4.5.1 The Commission recommends that a steady-state stabilisation mechanism is established for individual credit unions and the credit union sector as a whole. It is the Commission's intention that the steady-state stabilisation mechanism apply in certain circumstances and under certain conditions for those credit unions that are facing difficulties but are otherwise considered by the Central Bank to be 'viable'.

4.5.2 In the course of its deliberations, a number of models for stabilisation were put forward by members of the Commission. These included the establishment of an independent statutory based, regulated Credit Union Stabilisation Company with a board of directors to include representatives of the credit union movement; the establishment of a Credit Union Stabilisation Fund with a board approved by the Minister for Finance; and the establishment of an Impaired Asset Agency with a board appointed by the Minister for Finance.

4.5.3 On balance, the Commission recommends that responsibility for stabilisation should rest with the Central Bank as the independent regulator for the sector and the entity with best access to information.

4.5.4 For a credit union identified by the Central Bank as 'viable' but not meeting regulatory requirements, intervention by the Central Bank is required. This might involve the Central Bank requiring the credit union to undertake certain measures to ensure compliance.

4.5.5 For a credit union identified by the Central Bank as 'viable' but undercapitalised, the Central Bank may decide that in addition to the undertaking of specified actions to ensure compliance, financial stabilisation assistance is also required and warranted.

4.5.6 The Commission recommends that the stabilisation actions carried out by the Central Bank will include, among other things, such actions as:

- The provision of technical and financial advice;
- Mandatory changes to governance structures of the credit union;
- Changes to the business, operations, systems and processes within the credit union;
- Capitalisation of the credit union.

4.5.7 On entering a stabilisation process, the credit union will provide the Central Bank with, among other things:

- a plan setting out quarterly targets for the credit union to return to a status of 'viable', as determined by the criteria set out by the Central Bank, at the end of the stabilisation process,
- quarterly reports indicating that the agreed targets have been achieved, and

- any other reports or inspections as requested by the Central Bank.

4.5.8 The Commission recommends that a statutory fund, to be controlled and governed by the Central Bank, is established to finance stabilisation actions and that the necessary financing of that fund be sourced from the credit union sector.[xix] [xx] The Commission also recommends that the provision of any funding from this Fund to a credit union is wholly dependent on that credit union's compliance with stated terms (such as those set out at 4.5.4 and 4.5.5).

4.5.9 The Commission recognises that there is a risk that some credit unions may seek to continue in a stabilisation process for a prolonged period of time. To remove this risk, the Commission recommends that the stabilisation process be time limited, that is, it lasts for a specific period of time after which the credit union is either determined to be viable (meeting all regulatory requirements and no longer requiring intervention by the Registrar) or the credit union enters the resolution process. In the case of a credit union that fails to comply with the conditions of the stabilisation process or any instructions issued by the Registrar as part of the stabilisation process, that credit union should enter the resolution process[xxi].

4.5.10 In making this recommendation, the Commission is aware that the European Commission may be concerned about the application of state aid rules. The Commission recommends that clarity should be sought from the European Commission in relation to any potential state aid concerns and it should be made clear to the European Commission that its recommendation is what it believes to be in the best interests of the credit union sector in Ireland and how best to develop the sector.

4.5.11 The Commission recommends that the Credit Union Act 1997 be amended to allow for the establishment of a credit union stabilisation oversight committee. It is the intention of the Commission that such a committee will focus on how the Central Bank has implemented its own rules and procedures in making stabilisation decisions and taking stabilisation actions and that the committee will report its conclusions to the Minister for Finance and the Governor of the Central Bank. The work of the committee will focus on those decisions that have been taken and the committee will not in any way interfere with the independent authority of the Central Bank to act as it sees fit within the statutory framework. The Commission recommends that the Minister for Finance appoint seven people to the committee taking cognisance of the representative nature of the appointees, the volunteer ethos of the sector and representative bodies.

4.6 Liquidity

4.6.1 Liquidity pressures on credit unions have eased somewhat since the last review of liquidity in 2009. This is in part due to work done by credit unions with the Central Bank to improve liquidity levels, which now stand well above minimum requirements (average liquidity currently stands at 45.83%). It appears that – coupled with the liquidity controls already in place – a simple mechanism, with a straight-forward administrative structure may be the way forward.

4.6.2 There have been some limited bilateral liquidity arrangements between Irish credit unions, but on a small scale. The complex issues involved in providing bilateral liquidity, including assessment of collateral and risk management, suggest that this option offers only limited scope for providing sector-wide liquidity.

4.6.3 While credit unions are eligible for participation in Eurosystem monetary operations, the expertise, systems and collateral requirements involved effectively rule out this avenue as a viable option for most credit unions.

4.6.4 As noted in Chapter 3, liquidity shortfall is not a pressing matter for most credit unions, indeed the problem for many now appears to be one of excessive liquidity holdings. The Commission will examine liquidity during the second phase of its work and will investigate the potential for a suitable approach to addressing the issues around liquidity.

Chapter 5 - Governance of Credit Unions

5.1 Introduction

5.1.1 This chapter sets out the recommendations of the Commission on Credit Unions with regard to the governance of credit unions to underpin the future evolution of the sector having regard to its particular ethos and nature and to ensure a stable credit union sector.[xxii] [xxiii]

5.1.2 The issue of governance of credit unions is at the core of strengthening the regulatory framework and setting out a strategy for the future evolution of the credit union sector. Strengthening the governance of credit unions will not only be crucial to addressing the issues that currently exist in the sector but also for providing for a healthy and stable sector into the future[xxiv].

5.1.3 The safe and sound operation of each credit union is the responsibility of its democratically elected officials and management. All credit unions should be required to have robust governance arrangements. In particular, there should be a clear organisational structure with well defined, transparent and consistent lines of responsibility. Moreover, the roles, responsibilities and accountabilities of the board of directors, approved officers, management and committees should be clearly set out by each credit union.[xxv]

5.1.4 While a clear organisational structure is important, such a structure will only serve its purpose when all elements of the governance structure are active in carrying out their roles in a competent manner to ensure the prudent and ethical operation of credit unions.

5.1.5 As credit unions operate in a regulated environment, they should be subject to rules, policies, prudential standards and supervisory activities in order to ensure effective democratic governance of all credit unions in accordance with best international practice. Adherence to standards of governance, fitness and probity and competency must be adequately monitored and the Central Bank must have the powers to sanction failure by a credit union to achieve appropriate standards. It is the Commission's intention that a statutory governance framework, which clearly sets out governance requirements for credit unions, should be developed.

5.2 Governance - Structures

5.2.1 While the Commission will consider a wide range of governance-related issues in the second phase of its work, the recommendations in the Interim Report set out the key aspects of governance that should be introduced now as a matter of priority.

Risk Management and Compliance

5.2.2 A key component of the operational management of a credit union is risk management and compliance. The Commission recommends that credit unions should be required to establish and document robust governance arrangements for risk management. It is the intention of the Commission that these governance arrangements include a clear organisational structure with well defined, transparent and consistent lines of responsibility and effective risk management processes and procedures, and that the governance of credit unions include effective processes to identify, manage, monitor and report the risks to which a credit union is or might be exposed.

5.2.3 The Commission recommends that it be mandatory that credit union appoint a risk management and compliance officer. It is the intention of the Commission that this officer would be responsible for identifying, managing and monitoring the risks faced by the credit union and for ensuring that the credit union maintains a culture of risk awareness, identification and management that is embedded at every level of the organisation. It is the Commission's intention that the risk management and compliance officer should also be responsible for oversight of the credit union's compliance program.

5.2.4 The Commission recommends that the credit union's annual report should be required to include a risk management and regulatory compliance statement.

Internal Audit Function

5.2.5 A robust internal audit function is essential to the successful governance of any financial institution. The Commission recommends that the Credit Union Act 1997 be amended to insert a provision requiring each credit union to develop an internal audit function to provide for the independent internal oversight of the governance of credit unions. It is the Commission's intention that credit unions will develop an internal audit function, including an internal audit committee, that will contribute to safeguarding the assets of the credit union by evaluating and reporting on the effectiveness of risk management, internal control and governance processes to address weaknesses which can cause financial instability. It is the Commission's intention that the internal audit function will report directly to the board of directors on a quarterly basis or as otherwise required.

5.2.6 The Commission is keen to avoid any confusion between this new internal audit function and the existing role of the Supervisory Committee. The Supervisory Committee has an important role to play in overseeing the performance of the board and is accountable to the membership on how it performs this role. The roles and responsibilities of this committee are provided for under Sections 59 and 60 of the Credit Union Act 1997. In light of the ever-growing complexity and technical detail facing credit unions in their day-to-day operations, the Commission recommends that responsibility for examining the books and documents of the credit union, including an inspection of securities, cash accounts and all records relating to loans[xxvi], and for a comparison between the pass-book or statement of account of a sample of all members of the credit union should cease to be a function of the Supervisory Committee[xxvii] and instead come under the internal audit function.

5.3 Governance – Individual Requirements

5.3.1 This section deals with a number of issues regarding the individuals who hold positions of responsibility within the governance structure of a credit union.

Fitness and Probity

5.3.2 The Standards of the Fitness and Probity regime set out by the Central Bank require that a person in carrying out their functions is competent and capable, acts honestly, ethically and with integrity and is financially sound.[5]

5.3.3 The Commission notes that the Central Bank has published Regulations and Standards of Fitness and Probity under Part 3 of the Central Bank Reform Act 2010 and that the Act gives the Central Bank wide ranging powers to set statutory standards of fitness and probity across the financial services industry, to investigate and where appropriate remove or prohibit certain position holders and to approve or veto the appointment of certain people to certain positions. The new regime will apply to two main groups of staff. Controlled functions are

[5] Central Bank of Ireland, 2011, *Fitness and Probity Standards (Code issued under Section 50 of the Central Bank Reform Act 2010)*.

positions from which individuals can be temporarily or permanently removed or prohibited from taking up in the future. Pre-approval controlled functions are a subset of controlled functions requiring the Central Bank's approval before people can take up those positions.[xxviii]

5.3.4 The Commission recommends that Part III of the Central Bank Reform Act 2010 be commenced for credit unions providing the Central Bank with the powers to set out the Regulations and Standards of Fitness and Probity for the credit union sector. The Central Bank has undertaken to hold full and meaningful consultation with the credit union sector prior to finalising the regulations and standards of Fitness and Probity. The Commission notes that the Central Bank Reform Act 2010 allows for a fitness and probity regime to be introduced on a phased basis to allow institutions, in this case credit unions, adequate time to introduce the necessary internal controls and procedures to comply with the regulations and standards of Fitness and Probity.

Minimum Competency Requirements

5.3.5 The governance of credit unions could be improved through the appointment of officers with specific expertise in key areas of the credit union.

5.3.6 The Commission notes that the Central Bank has published a revised Minimum Competency Code which enhances the minimum professional standards for all persons who provide consumers with financial advice and products or who undertake certain specified functions.

5.3.7 The Commission recommends that the Central Bank is provided with the powers to set out a Minimum Competency Code for the credit union sector that would take account of the voluntary ethos of credit unions. The Central Bank will undertake full and meaningful consultation with the credit union sector prior to finalising the Minimum Competency

Code for the credit union sector. The Minimum Competency Code for the credit union sector should be introduced on a basis to allow credit unions adequate time to be in a position to comply with the Code.

5.3.8 It is the intention of the Commission that all directors, following their election or re-election to the board of a credit union, should be required to undertake training to provide them with a clear understanding of their significant responsibilities as a credit union director and that all credit union officers should undergo ongoing training and up-skilling and that all directors should be required to undertake a minimum number of formal training hours each year.[xxix]

Issues for the Second Phase: Implementation

5.3.9 The Commission has made a number of recommendations in this chapter, many of which will require legislative or other policy changes. When it comes to rolling these changes out for credit unions on the ground there will be a requirement for the Central Bank to develop more detailed guidelines, regulations and other provisions to give them real effect. Those implementation issues will be examined further in the second phase of the Commission's work.

5.3.10 In phase two of its work, the Commission will discuss further the general point of how the fitness and probity regime and minimum competency requirements will be introduced. During this phase of its work, the Commission will consider how the role of credit unions' nominating committees can become more focused on succession planning for all key positions and for ensuring that there are sufficient numbers of people nominated for election to the board of directors who meet the criteria required under Fitness and Probity and Minimum Competency regimes.[xxx]

5.3.11 During the second phase of its work, the Commission will consider how the implementation issues surrounding the recommendations on risk management, compliance and the internal audit function, in particular, taking into account differences in size, complexity and risk profile of the credit union.

Chapter 6 - Regulation of Credit Unions

6.1 Introduction

6.1.1 This chapter sets out the recommendations of the Commission on Credit Unions with regard to the regulation of credit unions to underpin the future evolution of the sector having regard to its particular ethos and nature and to ensure a stable credit union sector[xxxi].

6.1.2 The Minister for Finance asked the Commission on Credit Unions to provide a recommendation on the application of the Central Bank (Supervision and Enforcement) Bill 2011 to credit unions. The Commission recommends that the powers and functions intended under the Central Bank (Supervision and Enforcement) Bill 2011 be applied to credit unions. The Commission notes that there is an urgency to the issues involved. However, the Commission could not, at this time, arrive at a single position as to the statutory mechanism for applying these powers and functions to credit unions.

6.1.3 As with other financial institutions, credit unions depend on public confidence for their success. Members need to be assured that their savings are safe.

6.1.4 Since the enactment of the Credit Union Act 1997, the credit union sector has changed significantly. Credit unions have grown both in terms of the size of their assets and the associated risks.

6.1.5 A new regulatory framework is required in order to underpin the development of the sector and to bring the risk profile of some credit unions into balance with their current capabilities as financial institutions and to realign the overall risk profile of the credit union sector to a more manageable and sustainable level that is consistent with the ethos of the sector. The new regulatory framework should be built around the principles of responsibility, accountability, prudence, compliance and transparency.

6.1.6 The Commission notes that in making regulations, the policies and principles should be set out in primary legislation with the relevant standards and procedures to be dealt with in Central Bank regulations. When setting out a new regulation, the Commission recommends that the Central Bank undertake a Regulatory Impact Analysis in line with existing requirements and best practice. The Regulatory Impact Analysis should be cognisant of the new regulation's impact on the development of credit unions.

6.2 Regulation

6.2.1 Credit unions are private organisations owned by their members but because they provide financial services it is appropriate that they are regulated. The State should operate a strong system of oversight that maintains the safety and soundness of the sector and that protects the savings of credit union members.

6.2.2 As credit unions are not all the same with some capable of more sophisticated financial behaviour than others, the Commission recommends that the regulation of Irish credit unions should be based on the complexity of their business model and the level of risk undertaken by the credit union[xxxii]. The Commission notes that it is proposed under Section 42 of the Central Bank (Supervision and Enforcement) Bill 2011 that when making regulations under Section 40 of this Bill the Central Bank shall have regard to the need to ensure that the requirements imposed by the regulations concerned are effective and proportionate having regard to the nature, scale and complexity of the activities of regulated financial service providers or the class or classes of regulated financial service provider to whom the regulations apply. In the second phase of its work, the Commission will consider further the risk-based model of regulation as well as the information technology requirements associated with such a model.

6.2.3 The Commission notes that under Section 32L of the Central Bank Act 1942 (as amended by the Central Bank Reform Act 2010) the Central Bank must publish an Annual Performance Statement and that the Central Bank must specifically report on the work done by the Registrar of Credit Unions and the Governor or Head of Functions may be called before an Oireachtas Committee to discuss the report. Under Section 32M of the Central Bank Act 1942 (as amended by the Central Bank Reform Act 2010) there is a provision for an international peer review of the Central Bank's performance. This is important given the powers, responsibilities and objectives of the Central Bank to administer the system of regulation and supervision of 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 well-being of credit unions generally as well as the stability of the financial system overall.

Inspections and Investigations

6.2.4 The Commission recommends that the Central Bank should have the powers to conduct inspections and investigations in credit unions or appoint authorised persons to conduct such inspections and investigations.

6.2.5 The Commission notes that Part 3 of the Central Bank (Supervision and Enforcement) Bill 2011 sets out a comprehensive authorised officer regime for the Central Bank to apply to regulated financial service providers. The Bill, as published, proposes to amend section 90 of the Credit Unions Act to apply Part 3 to credit unions. The Commission notes that Section 53 provides that the Central Bank may use its information gathering powers to co-operate with overseas regulators.

Power to Make Regulations and the Prudential Rule Book

6.2.6 The legislative framework should provide the Central Bank with the powers to make regulations that set prudential controls, limits, standards and requirements for credit unions.

6.2.7 Regulation should be conducted in a manner that is reasonable, appropriate and transparent. To ensure that regulation is so conducted, regulation should be based on written rules and prudential standards and that it should to the extent practicable prescribe outcomes rather than methods. The written rules and prudential standards should be sufficiently detailed so that credit union officials are clear as to what actions they are required to take and what actions they are prohibited from taking. However, the rules and prudential standards should only restrict credit unions to the extent necessary to maintain their prudential soundness and as otherwise required by law and should not be so detailed as to interfere unnecessarily with the responsibility of those officials to exercise their own judgement and discretion in managing their credit union for the benefit of their members.

6.2.8 To this end, the Commission recommends the introduction of a Prudential Rule Book that would set out in detail what is required in each of the relevant areas. The Rule Book should include prudential controls, limits, standards and requirements on key areas, including: capital; lending; investments; borrowing; members savings; liquidity; governance; risk management systems and controls; fitness and probity; operations; consumer protection; administration; supervision; and enforcement. The statutory basis of the Rule Book should give the necessary authority to the rules while the detailed contents would remain a matter for the Central Bank following full and meaningful consultation between the Central Bank and credit union movement stakeholders.

6.2.9 The Commission notes that Part 6 of the Central Bank (Supervision and Enforcement) Bill 2011 proposes to provide extensive regulation-making powers for the Central Bank. The Bill also proposes to provide for consultation prior to the making of Central Bank regulations, and for the regulations to be effective and proportionate having regard to the nature, scale and complexity of the regulated financial service providers – including credit unions – affected.

Provision of Reports and Disclosures

6.2.10 The Commission recommends that the Central Bank should have the ability to require credit unions to provide information, including regulatory returns submitted on a periodic basis and to review and analyse financial and statistical reports from credit unions in whatever form it requires as well as having these reports independently verified where it considers this necessary.

6.2.11 The Commission notes that Part 2 of the Central Bank (Supervision and Enforcement) Bill 2011 is based on a similar UK provision which could be used to allow the Central Bank to require a credit union to prepare and pay for an independent expert report on a regulatory matter. These reports could be used for diagnostic, monitoring and compliance purposes, including stress tests for example. There are safeguards to ensure that the provision is used in a balanced and proportionate way, with due regard to the cost burden involved.

6.2.12 The Commission notes that Part 4 of the Central Bank (Supervision and Enforcement) Bill 2011 proposes to provide protection from civil liability and victimisation for whistleblowers. The provisions are flexible enough to provide for protections outside the strict employer/employee context. The Bill also proposes to provide for a mandatory disclosure regime for those performing pre-approval controlled functions (senior or influential positions within financial service providers); failure to disclose could be grounds for an investigation and action under the fitness and probity regime.

Administrative Sanctions

6.2.13 The credibility of a regulatory regime rests in part on its ability to enforce its rules. At present, credit unions are not subject to the administrative sanctions regime that applies to other regulated financial service providers.

6.2.14 The Commission recommends that the administrative sanctions regime should be extended to credit unions, in particular, the Central Bank should have available as a sanction the power to (a) revoke registration, (b) remove or suspend employees, officers and directors who commit prescribed contraventions, (c) impose fines and (d) suspend the board of directors. The Commission notes that sanctions will be subject to the independent Irish Financial Services Appeals Tribunal process as is the case with other regulated financial service providers.

6.2.15 The Commission notes that Part 7 of the Central Bank (Supervision and Enforcement) Bill 2011 makes provision for new enforcement measures. These include warning notices to alert the public to firms operating without authorisation; restitution orders; and the payment of investigation costs by those convicted of an offence.

Regulatory Direction

6.2.16 The Commission notes that Part 5 of the Central Bank (Supervision and Enforcement) Bill 2011 proposes to provide the Central Bank with the power to issue regulatory directions. This is a central provision in the Bill and proposes to allow for prudential regulatory interventions by the Central Bank across the range of its responsibilities in specified serious circumstances. The direction may require the entity to take certain actions or suspend certain activities.

6.3 Risk

6.3.1 Under each of the headings in this section, it is understood that (a) the Central Bank is responsible for setting the requirements that credit unions must meet, (b) that these requirements may be set for individual credit unions, categories of credit unions or the credit union sector as a whole and (c) that each credit union is responsible for developing appropriate policies and contingency plans and putting in place robust systems and procedures.

Risk Management Systems

6.3.2 The Commission recommends that the board of directors of each credit union should be required to take the lead in establishing a strong risk management culture[xxxiii].

6.3.3 The Commission recommends that in accordance with the prudential rules and standards established by the Central Bank, each board of directors should be required to develop, maintain and review on a regular basis risk management systems appropriate to the size of the credit union and the complexity of its operations.

6.3.4 The Commission recommends that the risk management system should include a Risk Management Plan that fully documents the policies and procedures covering all aspects of the credit union's operations as well as the appropriate controls for managing risk within the credit union.

6.3.5 The Commission recommends that each credit union should be required to put in place appropriate processes, procedures, systems, controls and reporting arrangements to monitor compliance with all legislative and regulatory requirements under the relevant Acts.

6.3.6 The Commission recommends that credit unions' internal audit and supervisory committees should be required to engage more closely with the Central Bank, especially in relation to the early reporting of serious issues.

Lending Risk

6.3.7 Lending risk is a very significant risk for credit unions.

6.3.8 To protect members' savings and the financial stability of the credit union, the Commission recommends that:

a) the board of directors of each credit union should be required to adopt and implement policies on lending,

b) each credit union should be required to implement procedures and systems to manage credit risk and that these should provide for greater risk transparency to ensure enhance loan management and reduce bad debt,

c) each credit union should be required to review their loan book on a regular basis, to verify the adequacy of the provision for bad and doubtful debts and that any resulting adjustments to the provision are incorporated into the regular management accounts and credit unions should have a clear, robust and effective approach to handling loan arrears, and

d) each credit union should be required to focus on those forms of lending that they are capable of undertaking and avoid areas which require expertise they do not possess.

Liquidity and Funding Risk

6.3.9 It is important that credit unions keep a proportion of their total assets in liquid form in order for them to be able to meet liabilities as they arise, to fulfil members' withdrawal requests within expected timeframes and to meet requirements in the event of pressure arising from unexpected events[xxxiv].

6.3.10 The Commission recommends that each credit union should be required to:

a) develop liquidity policies,

b) implement procedures and systems to identify, measure, monitor and control liquidity risk and to manage liquidity on a day-to-day basis in accordance with regulatory standards, and

c) carry out regular liquidity stress tests that include an assessment of a 'worst case' scenario and identify contingency measures available to offset the impact should such a scenario occur

Investments Risk

6.3.11 When investing surplus funds, credit unions must prioritise the security of members' funds ahead of maximising returns.

6.3.12 The Commission recommends that each credit union should be required to:

a) develop an investment policy setting out a statement of risk tolerance adopted by the board of directors and enumerate the investment instruments that management is authorised to purchase,

b) implement systems and reporting arrangements to identify, measure, monitor and control investment risk and assist with the day to day management of the investment function,

c) adopt and regularly review a written policy on asset/liability management (ALM), and

d) credit unions should not be permitted to assume sovereign risk outside those jurisdictions identified by the Central Bank or to make investments that are not denominated in prescribed currencies.

Savings and Borrowings

6.3.13 The Commission recommends that each credit union should be required to adopt policies in relation to savings and borrowings that consider the funding requirements of the credit union and are consistent with the credit union's liquidity management policy and ensure that the credit union does not become too dependent on external funds to fund daily operations or long-term needs.

Operational Risk

6.3.14 Operational risk is inherent in all products, activities, processes and systems, of a credit union. The effective management of operational risk must always be a fundamental element of a credit union's risk management system.

6.3.15 The Commission recommends that (a) the Central Bank set the operational requirements that credit unions must meet and (b) each credit union's risk management and compliance officer should be required to develop appropriate operational risk polices and risk measurement metrics as well as strong internal controls, processes and systems in place to mitigate operational risks, with regard to:

(i) Records
(ii) Information Systems
(iii) Insurance
(iv) Business Continuity
(v) Audit
(vi) Abuse of Financial Services
(vii) New Products
(viii) Conflicts of Interest
(ix) Related Party Exposures

6.3.16 To protect against operational risks, the Commission recommends that each credit union should be required to hold reserves in addition to the minimum reserve requirements.

Issues for the Second Phase

6.3.17 Credit unions need to have adequate capital reserves[xxxv]. In the second phase of its work, the Commission will discuss further the issues relating to regulatory reserve, risk-weighting and the role of capital reserve as a trigger for stabilisation or resolution intervention by the Central Bank.

6.3.18 The Commission notes that, in 2010, Section 35 of the Credit Union Act 1997 was amended. The Commission understands that there are concerns about the impact of Section 35 and will revisit this issue during the second phase of its work.

6.3.19 During the second phases of its work the Commission will examine the issue of 'social lending' and will consider the development of services and products to meet the needs of low income groups.

Chapter 7 - Conclusion

7.1 This report sets out a range of recommendations are intended to strengthen the credit union regulatory framework and provide for more effective governance and regulation. The recommendations in this interim report will inform the proposed credit union legislation that is to be laid before the Oireachtas by end-2011. The recommendations in this interim report are the outcome of the Commission's deliberations, a process that was informed by members presenting their points of view and engaging in debate, through presentations from relevant authorities and cognisance of international best practice and the outcomes of academic research in the relevant areas.

7.2 While this interim report and the resulting proposed legislation will make a significant contribution to the necessary reform and development of the credit union sector in Ireland, the work of the Commission is not complete. In the second phase of the Commission's work, it will turn its attention to setting out a strategy for the future evolution of the credit union sector by seeking to define the role of credit unions in the context of a restructured financial services sector, proposing a model for modern credit unions and defining the structure and parameters within which financially viable credit unions will operate, and examining options for restructuring the credit union sector, including proposals made by the Central Bank. The Commission will also examine and make recommendations regarding options for shared services between credit unions and the leveraging of appropriate IT infrastructure and management information systems. Furthermore, the Commission will examine the issue of 'social lending' and will consider now credit unions can play a role in providing financial services and products to meet the needs of low income groups.

7.3 The credit union sector in Ireland plays a crucial role in helping to meet the financial, economic and social needs of many people. It also has a crucial balancing influence on the market behaviour of other financial services providers. Recent adverse financial and economic conditions in Ireland, allied with internal governance weaknesses in some credit unions and the absence of an appropriate statutory regulatory framework, have contributed to the significant issues facing the sector. However, while the challenges faced by the credit union sector are significant, they are not insurmountable. A strengthened and re-vitalised sector can be in a position to play an increasing role in the retail financial landscape of the future.

This report does not impact on the independence of the Central Bank in the performance of its statutory functions and this report is without prejudice to the performance by the Central Bank of its statutory functions.

Appendix 1 – Commission on Credit Unions -Terms of Reference

Having regard to the commitments

- in the Programme for National Government 2011-2016 to review the future of the credit union movement and to make recommendations in relation to the most effective regulatory structure for credit unions, and
- under the EU/IMF Programme of Support for Ireland to 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 and to make recommendations to the Minister on legislation to be submitted to the Oireachtas by end-2011; and

taking into account

- the not-for-profit mandate of credit unions, their volunteer ethos and community focus, paying due regard to the need to fully protect depositors' savings and financial stability,
- the comprehensive strategy to enhance the viability of the credit union sector prepared under the EU/IMF Programme of Support for Ireland;
- international best practice in the structure, organisation and regulation of credit unions or analogous entities; and
- the strengths and weaknesses of the sector as set out in work done in the Strategic Review of the Credit Union Sector in Ireland;

the Commission on Credit Unions is invited to:

1. **Define the role of credit unions in the context of a restructured financial services sector.** This will focus on the credit union as a cooperative, owned and run by its members and providing its members with the financial services that they require. Consideration will also be given to the role of the credit union in relation to the community in general. In particular, the objects of a credit union as set out under section 6 of the Credit Union Act 1997 will be examined including the function of the common bond in the context of modern financial services systems. The Commission should also consider the question of the prudential supervision of loan societies and credit cooperatives registered under the Friendly Societies Act 1896 and the Industrial and Provident Societies Act 1893 that engage in taking deposits from and providing loans to their members and make recommendations in this regard.

2. **Propose a model for modern credit unions and define the structure/parameters** within which financially viable credit unions will operate. At the same time, the Commission will examine how credit unions may continue to provide the services required by their members while meeting regulatory requirements sufficient to protect the savings of depositors and the financial stability of the credit union sector as a whole. This should examine how the size of a credit union, the variety and complexity of the services it provides and the competencies of its management and staff

influence its viability. The question of credit unions competing with the larger financial institutions should be studied.

3. **Options for restructuring** The Commission will make recommendations on the possibility of voluntary consolidation or restructuring of the credit union sector over time, recognising the need to maintain local presence and taking into account the not-for-profit mandate, the volunteer ethos and community focus of credit unions. In this consideration, due regard must be given to the need to protect depositors savings and financial stability. Central Bank of Ireland proposals in relation to possible restructuring of some credit unions should be examined and recommendations made to the Minister for Finance as these may arise over the term of the Commission. The Commission is required to engage with the Department of Finance, make recommendations and exchange information on legislative proposals during the course of its deliberations.

4. **Shared services** The Commission will examine the options for groups of credit unions to share services on a formal basis and the extent to which this model is appropriate. The Commission should consider which services are most suitable for delivery by a separate entity, e.g. purchasing, auditing, compliance, credit control, legal, marketing, human resource management, administration and training. Progress in relation to the introduction of modern information technology and management information systems for and in credit unions will be examined and recommendations made in this regard.

5. **Determine and set out the basic governance and regulatory requirements that must be met.** The Commission will focus on a set of benchmarks that credit unions should meet if they are to be registered to operate in the State. These benchmarks should include capital requirements, sizes of loan books and of loans, competencies of directors and staff, investments policy, fitness and probity and governance standards. Recommendations will be made in relation to management reporting arrangements both internally and with the Registry of Credit Unions.

6. **Make recommendations for legislative change.** The Commission will examine the existing legislation and in particular the Credit Union Act 1997 and make recommendations on changes required to implement their findings. The Commission should make initial recommendations required to strengthen the regulatory framework of credit unions by 30 September 2011. A final report should be submitted to the Minister for Finance by 31 March 2012.

Appendix 2 – Public Consultation Request

The Government has established a Commission on Credit Unions.

The Commission is to review the future of the credit union movement and make recommendations in relation to the most effective regulatory structure for credit unions. This review will take into account their not-for-profit mandate, their volunteer ethos and community focus, while paying due regard to the need to fully protect depositors savings and financial stability.

A copy of Commission's Terms of Reference is available on the Department of Finance's website:

http://www.finance.gov.ie/documents/publications/reports/2011/creditunion.pdf

The Commission on Credit Unions is seeking views on the following:-

(i) Given the present restructuring of the financial services sector in Ireland how might the role currently discharged by credit unions change in terms of, for example, service provision and support to local communities?

(ii) Is the present credit union operating model appropriate for the Irish movement in the future? If changes are required what form should they take?

(iii) Recognising the need to maintain a local presence and taking into account the not-for-profit mandate, the volunteer ethos and community focus of credit unions is there a need for credit union consolidation and / or restructuring? If so, how might this be achieved?

(iv) What are your views on modern information technology and management information systems for and in credit unions as currently implemented? What changes are required?

(v) Is it appropriate for credit unions to share services on a formal basis and, if so, how might this be implemented? Which services (and why) are most suitable for delivery on a shared basis?

(vi) What are your views on governance standards within the credit union movement? What changes are required?

(vii) What are your views on the regulatory requirements presently placed on credit unions? What changes are required?

(viii) What are your views of the role of credit unions in the support of financial inclusion?

(ix) What are your views on existing legislation and in particular the Credit Union Act 1997? What changes are required?

More generally, the Commission welcomes contributions (over and above those sought in the questions above) that will facilitate the good functioning of the Irish credit union movement in the future.

Contributions on all or some of the above can be submitted by post or email to:

> Secretary to the Commission on Credit Unions,
> Commission on Credit Unions,
> Department of Finance,
> South Block,
> Government Buildings,
> Dublin 2.
>
> CCU.Submissions@ccu.gov.ie

Submissions should be made **by 25 August, 2011.**

In making a submission, please state if the views expressed are personal or are being made on behalf of an organisation.

If views of an organisation are being submitted, it should be made clear which organisation is represented.

Submissions will be subject to the provisions of the Freedom of Information Acts.

Except where it is indicated that the submission is to remain confidential, submissions will be published on the Department of Finance website.

Appendix 3 – Summary of Feedback from the Public Consultation Process

(i) Given the present restructuring of the financial services sector in Ireland how might the role currently discharged by credit unions change in terms of, for example, service provision and support to local communities?

- Credit union sector has withstood the recession relatively well.

- Development of the sector is essential and welcome but it must not be at the cost of loss of identity.

- There is a need to involve younger people in credit unions as members and on board and committees.

- Develop into the third pillar of the financial sector.

- Provide education programmes and workshops for local communities on credit management, develop stronger links with MABS and Citizens Advice; an annual social audit to reflect credit union's place in the community.

- Extend opening hours.

- Examination of costs of providing services.

- Expansion of services to include the full range of personal financial services, debit and credit cards, on-line services, ATM, paypath, provision of loan services and insurance products. Support local businesses through, for example, a loan guarantee scheme.

- Credit unions to connect to banking payments network.

- Central register of loan defaulters to be available to credit union boards.

- Shared services between credit unions.

- Better debt collection.

- Representative bodies to continue functions but not to become involved with the functions of the Registrar.

(ii) Is the present credit union operating model appropriate for the Irish movement in the future? If changes are required what form should they take?

- Credit Unions are of the utmost importance to their local communities.
- It is important that credit unions maintain local operations.
- There have been difficulties in some credit unions.
- There is a need for change and development.
- Shared services centre, improved co-operation, greater collaboration and sharing of resources.
- Access to a central pool of information and training for board members (minimum level of training requirements for directors).
- Develop new services and ways of providing them.
- Keep business model simple – avoid large loans.
- Change scope of supervisory committee especially in the area of risk analysis.
- Set out duties and responsibilities of employees and accountability mechanism.
- Postal votes for AGMs.
- Multi-tiered model of credit unions based on level of service.
- Credit union movement bank / building society employing expert staff to co-exist with the current credit union structure.
- Regulatory staff to spend time working in a credit union for experience.
- Investment services provided by NTMA.

(iii) Recognising the need to maintain a local presence and taking into account the not-for-profit mandate, the volunteer ethos and community focus of credit unions is there a need for credit union consolidation and / or restructuring? If so, how might this be achieved?

- Hub and spoke model.
- Centre of excellence.
- Shared services.
- Stabilisation protection, statutory stabilisation scheme.
- Re-evaluate the current Common Bond and expand the scope of the Common Bond, Single Common Bond for all members.
- Review recruitment strategy.
- Retention of certain committees at local levels.
- Reduce the size of boards.
- Re-structuring from bottom-up and on voluntary basis.
- Consolidation on voluntary basis only.
- Transfers of engagement have negative overtones.
- Need to lessen negative impact of amalgamations on volunteers.
- Tiered system of credit unions.
- Role for local government and other organisations in assisting local credit unions.

(iv) What are your views on modern information technology and management information systems for and in credit unions as currently implemented? What changes are required?

- The Regulator should make known to providers at the beginning of the year the IT requirements so that the systems can by updated.

- Single software system provided by a host service and standard specifications.

- Single central system is not required.

- Current systems currently underutilised.

- Provide the regulator with prudential returns electronically.

- Working groups required to assess each system and audit current systems.

- Access to a clearing house.

- Shared services.

- Central management for future development of the systems.

- Education and advice to smaller credit unions in evaluation of their needs.

- Auditing and compliance functions should remain specific to each credit union due to requirement for transparency.

(v) Is it appropriate for credit unions to share services on a formal basis and, if so, how might this be implemented? Which services (and why) are most suitable for delivery on a shared basis?

- Full co-operation between credit unions is crucial – other credit unions have shown the benefits of co-operation.

- Shared services would reduce costs – most cost efficient way of doing business.

- Scope for shared services in the areas of: information technology, auditing, legal services, training, credit control management, debt collection, purchasing, compliance, marketing, centralised database of members.

- Provide a ‘common bond of services’.

- In keeping with operating principle of co-operation.

- Standardise policies.

- Credit unions will need to agree the services to be shared and shown that benefits will accrue.

(vi) What are your views on governance standards within the credit union movement? What changes are required?

- Present governance structures have served the credit union movement reasonably well, though mistakes have been made.

- Governance structures are out-dated and not fit-for-purpose in the more complex regulatory environment.

- Essential to provide confidence to the public that the sector is managed well – should no longer be able to claim 'I am only a volunteer'.

- Change should be driven by the sector.

- Training and on-going training of board members and officers.

- Introductory seminars for new directors.

- A responsible attitude, common sense, community focus.

- Clear roles and responsibilities of board of directors, supervisors, managers and staff.

- Too much time spent by boards on day-to-day issues and not enough on strategic and long-term issues.

- Improved Supervisory Committee involvement.

- Create an internal audit function.

- Fitness and Probity and Minimum Competency Requirements should be developed.

- "Grandfathering" should be permitted.

- Good competent governance and regulation are in the best interest of the members and credit unions.

- Wrong to impose any regime of competence on serving or potential directors.

- Limits on the number of consecutive terms on board and the number of key positions can hold on board.

- Representative bodies should provide suitably qualified people to give advice and information on particular issues (legal, financial, regulatory).

- Role of professional managers needs to be recognised in legislation.

- Lack of operating guidelines and loose regulatory framework meant that boards were making decisions where the risks were not fully indentified or understood.

- The Central Bank should produce a rule book.

- Useful to measure and monitor key performance indicators (e.g. PEARLS).

(vii) What are your views on the regulatory requirements presently placed on credit unions? What changes are required?

- Regulation should be fair, transparent and proportionate and reflect the business model – involves a two-way communication process.

- Criteria being applied by the regulator must be clear so that credit unions know what they have to achieve.

- Credit unions want to comply with regulation – ensure that changes are flagged well in advance.

- Regulator should be open to reasonable debate with the movement.

- Should allow for the extension of credit union services and outlets.

- Current regulations too severe and good members are being affected in an unfair manner – one-size fits all approach does not fit with ethos of the credit union movement.

- Knee-jerk reaction / Rushing to put new regulations in place but the 'old regulations' were not adhered to and the light regulatory approach is now gone.

- Registrar is attempting to micro-manage individual credit unions.

- Regulation attempting to make up for failures of past.

- Attempting to impose regulations on credit unions more appropriate to other financial institutions.

- People need to be given time to meet the requirements.

- Capital requirements should be risk based and not an arbitrary percentage of assets.

- Credit unions should be encouraged to maximise loan books.

- Regulation of lending practices should be done on an agreed basis between the regulated and the regulator.

- Regulation of credit unions must be distinct from the regulation of other financial institutions.

- Risk is inherent in the lending process, needs to be agreed acceptable level.

- Regulation on rescheduling is too restrictive.

- Sector needs to be shielded from the tendency of EU rules and directives being applied to the it almost by default.

- Regulation of the sector should no longer rest with the Central Bank and an independent credit union regulator reporting directly to the Minister for Finance should be appointed.

- Over regulation will drive out the volunteer from the movement.

- Over emphasis on accreditation and formal learning should be avoided.

- Issues around amalgamation and transfers of engagement need to be reviewed.

- Move toward principle-based legislation away from prescriptive nature of current legislation.

- Regulator's office needs greater resources.

- Inconsistency in decisions being handed down by the Regulator's office.

- There should be an equivalence in terms of regulation, supervision and governance rules between credit unions and other financial services providers.

(viii) What are your views of the role of credit unions in the support of financial inclusion?

- Credit union accounts should be accepted for payment of social welfare and pension payments.
- Prevent people turning to money lenders.
- Revised payment schedule should be allowed.
- Look humanely at members personal situations and cater for their needs.
- Letting people down when they most need help of credit union.
- Provide services to those who do not have bank accounts.
- The regular savings principle has its roots in self-help.
- Develop closer relationship with MABS and Society of St. Vincent de Paul.
- A Rabobank model and abolishing the common bond would undermine the operating principle of social responsibility and the concept of local people pooling their resources for mutual benefit.
- Lack of trust in banking sector, opportunity to develop this further.
- Develop existing and new products to help those most in need of support in managing their financial affairs.
- Some members also use money lenders.
- Credit unions should not be confined in role of financial inclusion – this is the responsibility of a wide group of stakeholders.
- A social lending product that is easily accessible and designed to compete with the sub-prime market needs to be provided through the credit union.
- Credit unions should avoid the perception that they give ‘soft’ loans.
- Credit unions must not become over-identified with poverty.

(ix) What are your views on existing legislation and in particular the Credit Union Act 1997? What changes are required?

- The Act has served the movement well and the core of it should be retained.

- Strengthen volunteer involvement in credit unions and recognise the role credit unions play in their committees – promote sustainable community development.

- Change should be incremental and not overly influenced by the current economic crisis.

- Act should be overhauled in its entirety – existing legislation is too prescriptive – new legislation should enable credit unions to evolve towards new business models and not be regulated out of existence.

- Built-in obsolescence – monetary limits should be alterable by Ministerial order.

- Credit unions have been included in a raft of new legislation aimed primarily at banks and utilising such legislation will be to the detriment of the movement.

- If credit unions to be exempt from prudential regulation common to other financial services providers there needs to be a clear statement as to the rationale for the exemption.

- Common bond should be updated – restrictions on accepting members is difficult to manage and can undermine confidence.

- Should allow for the establishment of federated structures / alliances within the credit union movement and the development of a central co-operative banking mechanism for credit unions.

- Review and define the roles and relationships of boards, management, staff, supervisory committee (supervisory committee to operate as an audit committee) and other committees (including employee participation) to allow for modern governance standards reflecting the variety of business models.

- Regulation should be enabling and proportionate to the risk inherent in the business model.

- Legislation should address risk management and compliance.

- Lending rules and procedures requires streamlining.

- Need a fit for purpose statutory stabilisation scheme.

- Statutory basis for savings protection scheme and deposit guarantee scheme (a reduced deposit guarantee scheme).

- Allow credit unions to provide the *basic payment accounts* proposed by the Steering Group on Financial Inclusion in the 2011 report.

- Legislation in relation to debt collect should take account of the social element of lending by credit unions.

- Update the sections relating to reserves.

- The Registrar to produce a handbook on how legislation and directives apply to credit unions.

- Review rules around amalgamations and transfers of engagement.

- EC (Consumer Credit Agreements) Regulations, 2010 – extend the limited application indefinitely.

- Include social lending.

- Ensure that credit unions can compete in order to maintain their viability.

Proposals to change the 1997 Act:

- Section 17 – provisions relating to non-qualifying members are unnecessarily discriminatory and impractical.

- Section 21 – retain in any new Credit Union Act.

- Section 23 – retain in any new Credit Union Act.

- Section 24 – strengthen the provision to safeguard those members who lack the capacity to deal with their affairs.

- Section 32 – Remove attachment of all savings to a member's loan - makes the operation of services impractical; should facilitate members wishing to withdraw some of their committed savings.

- Section 35 – too blunt an instrument and lending restrictions should be reviewed; should reflect a more realistic and member-centred method of treating loan re-scheduling process; reduce maximum loan to €30,000 or 0.25% of total assets, whichever is greater.

- Section 36 – remove the need for board approval.

- Section 44 – make mandatory a special fund from the annual operating surplus with a specific allocation dedicated to a social finance / lending provision.

- Section 48 - allow credit unions to offer a full range of financial services and products, overhaul the lengthy and protracted mechanism for introducing new services and introduce an appeals process.

- Sections 58 – 62 – remove the overlap in functions of auditors and supervisors.

- Section 84 – Clearly defined role for the Registrar of Credit Unions, should operate in transparent manner, need to restrict the power of the Registrar and should have to report annually to an Oireachtas committee, put in place an appeals process, must give recognition to the representative bodies by name and require consultation; powers should be given to the representative bodies to monitor and discipline credit union boards.

- Sections 90 - 94 – Inspectors reports should be given to the credit union along with all working papers.

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[i]Endnotes

It could be argued that it has been the drive to maximise shareholder value and director bonuses which has encouraged other financial institutions to engage in risky investment and unsafe lending practices resulting in the present financial turmoil. Brunnermeier (2009) provides an excellent overview of the crisis.

[ii] Credit unions may provide a competitive discipline to mainstream financial institutions in local markets for financial services, and may mitigate against the abuse of market power by large banks. Evidence from the US suggests that banks offer higher deposit rates in markets where there is a significant credit union presence (Tokle and Tokle, 2000; Hannan, 2003). No comparative evidence is available for Ireland. However, competition assessments of the highly concentrated retail banking market in Ireland suggest that there are significant demand and supply side barriers to competition (Competition Authority, 2005). These barriers are not likely to have declined since the onset of the financial crisis and the exit of foreign banks (including Bank of Scotland (Ireland)) from the sector.

[iii] This classification typology was developed by Ferguson and McKillop (1997, 2000).

[iv] MacPherson (1998, 1999) also partitions the dynamics of credit unions into three stages of development: (1) the formative stage, (2) the national stage and (3) the international stage as does Richardson (2000a, 2000b). The latter views the three distinct phases to be characterised by dependence and poor image in the first phase, independence and good image in the second, and interdependence and excellent image in the final phase.

[v] McKillop et al. (2006: 66-68) note that this penetration rate is likely to be an overestimation as people may be members of more than one credit union. For instance, in Offaly and Monaghan, the number of members of credit unions in both counties is greater than the population of each county.

[vi] Demutualisation is not necessarily a bad outcome if the economic and social functions which credit unions originally evolved to provide are now provided efficiently and effectively by other suppliers (or if the evolution of credit unions has taken their focus away from their original social objectives). Even if this is the case, demutualisation involves significant wealth redistribution, and thus warrants attention. Davis (2001 and 2007) summarises many of the theoretical arguments for and against credit union demutualisation using as a backdrop Australian credit unions.

[vii] The name Irish League of Credit Unions was adopted in 1972.

[viii] The Regulatory Reserve Ratio, requiring credit unions to maintain a minimum of 10% of assets as total regulatory reserves, was introduced with effect from 30 September 2009. Transitional arrangements were provided for credit unions that could not meet the minimum Regulatory Reserve Ratio at that date. Such credit unions must achieve the Regulatory Reserve Ratio within the shortest timeframe possible, but not later than the timeframes and percentages set out below:

- 30 September 2011 – Regulatory Reserve Ratio of at least 8½ per cent;
- 30 September 2012 – Regulatory Reserve Ratio of at least 9 per cent;
- 30 September 2013 – Regulatory Reserve Ratio of at least 10 per cent.

[ix] Jones (2010) argues that “stabilisation programmes are built on a number of common principles. These include regulatory compliance, meeting robust performance standards as a condition of entry and of ongoing participation; regular off-site and on-site monitoring, examination and supervision; financial and technical assistance for unstable credit unions targeted at securing recovery; the authority and mechanisms for the responsible authority to intervene; and procedures to instigate credit union mergers or liquidation if required. In addition, all known examples of stabilisation programmes regard stabilisation as a component part of deposit insurance.”

[x] The Commission notes that there are elements to this framework other than those listed here.

[xi] After Canadian credit unions first adopted deposit insurance in 1970, only credit unions in the US subsequently emulated them with the establishment of the National Credit Union Share Insurance Fund (NCUSIF) in 1971. Post 1995, however, deposit insurance for credit unions has grown rapidly. Much of this growth was concentrated in Europe. There, for example, Irish credit unions voluntarily established their in-house Savings Protection Scheme (SPS) in 1989. In Poland, the Czech Republic and Lithuania, credit unions have been legally required to adopt deposit insurance since 1996, 2000, and 2001 respectively. British credit unions joined the Financial Services Compensation Scheme (FSCS) in July 2002 and Latvian

credit unions were included within their state deposit guarantee system in January of 2003. More recently the financial crisis has seen almost blanket coverage of financial institutions, irrespective of their form, with deposit insurance. By 2009, almost 100 countries had introduced a deposit guarantee scheme (Alessandri and Haldane, 2009).

[xii] Under the Financial Services (Deposit Guarantee Scheme) Act 2009, the Minister for Finance has discretion as to the rate specified for a particular class of financial institution.

[xiii] The Commission notes that the issue of credit union viability should be viewed not as a discrete point but as a spectrum of differing degrees.

[xiv]

In the US the National Credit Union Administration (NCUA) was formed to charter and supervise federal credit unions. In assessing credit union viability two areas of particular concern to the NCUA are loan delinquency and capital adequacy with credit unions classified in terms of their capitalisation. Five categories of capitalization, in terms of the ratio of net worth-to-assets are used: 'well capitalized' greater than 7%; 'adequately capitalized' between 6% and 6.99%; 'undercapitalized' between 4% and 5.99%; 'significantly undercapitalized' between 2% and 3.99%; and 'critically undercapitalized' less than 2%. Credit unions classified as 'well capitalized' are free from supervisory intervention under the Prompt Corrective Action (PCA) system. Credit unions classified as 'undercapitalized' or below are required to take progressively more radical steps to restore net worth to adequate levels. If a credit union's capital falls below 2% it is deemed to be 'not viable' and must be either taken over by the NCUA (Conservatorship), merged or liquidated.

In recognition of the time it takes for a new credit union to accumulate net worth, a less stringent system is applicable to credit unions less than 10 years old, and with assets of less than $10 million: 'well capitalized' greater than 7%; 'adequately capitalized' between 6% and 6.99%; 'moderately capitalized' between 3.5% and 5.99%; 'marginally capitalized' between 2% and 3.49%; 'minimally capitalized' between 0% and 1.99%; and 'undercapitalized' less than 0%.

[xv] US Government Accountability Office (GAO) (2011) analysed the effectiveness during the financial crisis of PCA capital triggers for US banks. It concluded that while the PCA framework provides benefits, such as facilitating orderly closures and encouraging banks to increase capital levels the effectiveness of PCA is limited because of its sole reliance on capital, which can lag behind other indicators of bank health. That is, problems with the bank's assets, earnings, or management typically manifest before these problems affect bank capital. Once a bank falls below PCA's capital standards, a bank may not be able to recover regardless of the regulatory action imposed. GAO tested other financial indicators, including measures of asset quality and liquidity, and found that they were important predictors of future bank failure.

[xvi] Academic research on credit union failure is limited. Part of the reason for this is that in many countries only a small number of credit unions fail. Rather than permit a credit union to fail there is a tendency for the poorly performing credit union to transfer its engagements to another credit union. This tendency can be viewed almost as an extension of cooperative principles. Research that is available indicates that both microeconomic and macroeconomic factors are important. Wilcox (2005) in an analysis of US credit unions argues that just two macroeconomic factors, the unemployment rate and the prior year's real interest rate, may account for over half of the variation of National Credit Union Share Insurance Fund, (NCUSIF) loss rates from 1971-2004. Referring to microeconomic factors Gordon (1987) suggests that small less well capitalised credit unions are more likely to fail. Other important determinants of failure include: a lack of trained managers; weak lending and collection operations; poor record keeping; and closures of sponsoring companies. Smith and Woodbury (2010) in a comparative study of banks and credit unions suggest that credit unions are far less exposed to fluctuations in the business cycle and as such are much more able to withstand macroeconomic shocks to their balance sheets. For more details on these studies see McKillop and Wilson (2011).

[xvii] The recommendations by the Commission relating to the Credit Institutions (Resolution) (No.2) Bill 2011 are based on the Bill as published on 24 May 2011.

[xviii] 8.—(1) The intervention conditions are fulfilled in relation to an authorised credit institution if—

(a) either condition A or condition B is fulfilled,

(b) conditions C and D are both fulfilled, and

(c) the Bank has consulted the Minister.

(2) Condition A is that the Bank has serious concerns relating to the financial stability of the authorised credit institution concerned and—

(a) has directed that credit institution to take particular action to address the Bank's concerns, and the Bank is satisfied that—

(i) the credit institution has failed to comply fully with the direction, or

(ii) the credit institution is incapable of taking the necessary action to so comply within the period specified 40 by the Bank in the direction,

or

(b) is satisfied that, having regard to the urgency of the situation or for any other reason, its serious concerns cannot be adequately addressed by such a direction.

(3) Condition B is that the Bank is satisfied that there is a present or imminent serious threat to the financial stability of the authorised credit institution concerned or the financial system in the State.

(4) Condition C is that the Bank is satisfied that the authorised credit institution concerned has failed or is likely to fail to meet a regulatory requirement imposed by law or a requirement or condition of its licence or authorisation.

(5) Condition D is that having regard to the purposes of this Act, any guidelines issued by the Bank under section 88 and such of the matters set out in subsection (6) as appear to the Bank to be relevant in the circumstances, the immediate winding-up of the authorised credit institution concerned is not in the public interest.

(6) The matters referred to in subsection (5) are the following:

(a) whether the authorised credit institution concerned is of systemic importance to the economy of the State;

(b) whether the failure of that credit institution would be likely to contribute to instability of the banking system or serious damage to the financial system in, or the economy of, the State;

(c) the importance of ensuring the depositors of that credit institution will continue to have prompt access to their deposits (whether in that credit institution or elsewhere);

(d) the importance of maintaining public confidence in the financial system in the State;

(e) the importance of maintaining continuity of banking services to that credit institution's customers;

(f) the terms of any resolution plan for that credit institution;

(g) any other matters that the Bank considers relevant, in the particular circumstances, having regard to its duties and obligations.

[xix]

In the US the NCUSIF was initially capitalised with the residual funds of the trade association deposit insurance programmes. This amounted to around 0.3% of the totally insured deposits. The NCUSIF was re-capitalised in 1985 by each credit union depositing an additional 1% of its insured share deposits into the fund. This has resulted in a fund of around 1.3% of credit union member savings. Credit unions must maintain a 1% deposit of their members' savings with the NCUSIF, adding to the deposit as savings increase. This is recorded as an investment in the NCUSIF.

[xx] Partly due to the restrictions on their activities, US credit unions have, in general, withstood the current financial crisis better than many of their banking counterparts (Klinedinst, 2010). This can be gauged through examination of coverage ratios (total equity divided by insured shares or deposits). Coverage ratios were 1.29% and 1.22% in 2007 for the NCUSIF and FDIC respectively; 1.26% and 0.36% in 2008; 1.30% and -0.39% in 2009; and 0.24% and -0.28% in 2010. The sharp fall for the NCUSIF in 2010 was due primarily to heavy losses at some corporate credit unions, requiring the creation of a Corporate Stabilization Fund. Hampel (2010) estimates the cost to the NCUSIF in 2010 of corporate stabilization was around $8.1 billion and that without this adjustment the coverage ratio for 2010 would have been 1.30%.

[xxi] Jones (2010) notes that in the US credit unions receiving stabilisation assistance in order to continue operating independently "must justify receiving the special assistance, and demonstrate that the assistance will help make the credit union a financially viable financial institution". NCUA assistance can be either temporary or permanent. Temporary assistance is normally limited to six months and permanent to a 24-month workout period. Normally, permanent assistance is not given easily but is dependent on nine preliminary requirements being met. Before any attempt to stabilise a credit union there is a rigorous assessment of its chances of long-term viability. The nine requirements are:

11. A viable field of membership
22. Capable management
33. Accurate and current books
44. Full and fair financial disclosure
55. Proper written policies and procedures (or realistic plan to put them in place)
06. Approved net worth restoration plan or risk based plan (including the impact of
1repayment of assistance)
67. Positive track history of financial performance and resolving problems
78. Correction of root problems
89. System for monitoring on-going performance

[xxii] While there are many definitions of governance, at its most fundamental, corporate governance is about aligning the actions and choices of managers with the interests of shareholders (Core, Guay and Larcker, 2003; Leighton and Thain, 1997). A good governance structure will allow the organization to achieve its desired results and to do so in the right way, that is, in a way that is consistent with the normative values of the organization; something that is of particular importance to co-operative organisations. There are two basic issues that need to be addressed, a need to decide where the organisation is going (setting the organisations goals, objectives and mission) and to decide how the organisation will get to where it wants to go (setting out the strategic plans, policies and structures) (Lowndes and Skelcher, 1998; World Council of Credit Unions, 2005).

[xxiii] Corporate governance in publically trade companies has been widely studied. These studies have focused attention on issues such as excessive executive power, shareholders' inability to oversee and control management, the weak regulatory regimes of national governments, and corporate social responsibility (Spear, 2004). While less attention has been paid to corporate governance in the non-profit co-operatives and credit unions sectors, the paucity of study in this area should not be taken as a measure of the importance of examining governance in these sectors. The co-operative and credit unions sectors have a very different ethos to publically trade companies but they face similar challenges in the area of governance, in particular, the need to ensure director and board competency and effective member control over management. That said, governance approaches developed with the corporate sector in mind may be inappropriate for the co-operative context. While Axworthy (1990) acknowledges that there are questions about whether or not the research on private corporation directors can be applied in a co-operative context, he notes that the duties are essentially the same. Axworthy goes on to identify four fundamental differences between co-operatives and corporations and these may impact on governance and how directors perceive their role: co-operatives are member-owned, they do not exist solely for the purpose of making profit, they are democratically controlled and their directors are elected and not necessarily versed in business.

[xxiv] Ketilson and Brown (2011) argue that the co-operative sector faces significant governance challenges emphasising that "for co-ops, governance concerns extend beyond the need for ethical accounting practices and sound board structure; co-op governance must also address issues of member engagement and democracy."

[xxv] As the credit union grows and engages in more complex and sophisticated operations, so too does the need for higher qualified staff. From the perspective of corporate governance, the growth of credit unions has meant that the board of director's control over the credit union has diminished as the operation of credit unions becomes the responsibility of professional management and staff (Sibbald et al., 2002). Furthermore, boards of directors of co-operatives are less likely than the boards of publicly traded corporations to monitor or replace management (Rasmusen, 1988; Fama and Jensen, 1983). A further impact of the professionalisation of the day-to-day operations of credit unions is paid staff seeing volunteers as 'enthusiastic amateurs' committed to the traditions of the movement and a diminishing of the highly personal nature of service (Sibbald et al., 2002; Black and Duggar, 1981; D'Amours, 1998). The challenge in the relationship between owners and managers (the principal-agent problem) is how the owners can ensure that managers will make decisions aligned with the owners' best interests. There is a danger that managers will make decisions in their own personal interest rather than in line with the mission of the organisation and that they will make choices based on securing their own positions in the organisational structure (Williamson, 1963, 1964; Labie and Perilleux, 2008; Leggett and Strand, 2002). Branch and Baker (2000) suggest that these problems can arise in credit unions when there is: a lack of clear rules separating decision oversight from decision making, an unqualified person in a position of decision oversight, inadequate management competitiveness, a failure of the membership and board to exercise fiduciary responsibilities and the one-person one-vote system.

[xxvi] Section 60 (1) (b) of the Credit Union Act 1997 (unofficial consolidated version).

[xxvii] Section 60 (1) (c) of the Credit Union Act 1997 (unofficial consolidated version).

[xxviii]

The Regulations identify 42 senior positions as Pre-Approval Controlled Functions.

[xxix] Board development refers to building a board of directors that is capable of carrying out its roles and responsibilities in an effective and efficient manner, three key components to board development are: recruitment, education, and evaluation. The continuing training and education of directors is relevant for all directors, regardless of their skills, expertise, or experience and is critical for the success of credit union boards. One of the first educational experiences that new directors should have is an orientation exercise

that introduces them to the credit unions affairs and other board members. Hoyt (2003) argues that director orientation is an effective and efficient way for new board members to learn key board practices, processes, and policies. Furthermore, Hoyt suggests that boards should demonstrate their commitment to director training and education by allocating the financial and time resources that allows directors to take advantage of such opportunities. She also argues that training and education activities should aim to develop individual and group capacity in strategic areas.

[xxx]

Given the importance of the board of directors, the selection of directors is a critical factor in determining how effectively a corporation is governed (Mace, 1971; Andrews, 1987; Eaton, 1990; Wood, 1992; O'Neal and Thomas, 1995; Van der Walt et al., 2002; Leighton and Thain, 1997; Biggins, 1999; Grady, 1999). Best practices literature highlights the importance of formalised recruitment strategies and processes, including building a demographic profile of the board, identifying gaps in skills, knowledge, expertise, or demographic characteristics, and communicating these gaps to members, staging information sessions outlining the roles and responsibilities of board members, conducting interviews with potential candidates, and having existing directors who are not up for re-election endorse certain candidates prior to board elections. Vafeas (1999) notes that the quality of a board of director's monitoring effectiveness is determined by the quality of the directors that are appointed (Branch and Baker, 2000; Biggins, 1999; Grady, 1999; Hautaluoma et al., 1993).

The introduction of nominating committees to selection processes has been an important innovation in corporate governance in that it introduces greater independence from the existing board and improves board quality (Leighton and Thain, 1997; Verespej, 1994; Clarkham, 1992; Vafeas, 1999). However, the democratic election of credit union boards poses challenges for the ability of directors to fulfil their role. While volunteer non-professionals may be responsive to local community and social issues they may not have the required financial and business expertise to direct a financial institution. The democratic governance of credit unions relies on those with the appropriate business acumen and management skills being elected to decision making positions and runs the risk that unqualified people may be elected (Branch and Baker, 1998, 2000; Westphal and Zajac, 1995; Stone, 1991). Goth's (2006) survey of credit unions in Ireland and Canada found that for over 66% of respondents the board's skill requirements and organisational needs had 'little' or 'no influence' on the selection criteria for directors and only 1% reported that it 'greatly' impacted on the process. This goes very much against the view that as credit union membership grew, board members with more managerial and professional qualifications would be recruited (Dart et al., 1996; Mathiasen, 1990; Wood, 1992).

[xxxi]

Ralston (2001) argues that regulation imposes a number of restrictions on the portfolios of financial institutions including controls on capital, liquidity and asset composition. These controls are aimed at containing the rate of institutional failure and inspiring confidence in a stable financial system. At the same time, however, these restrictions should not impede the efficiency of financial institutions as the ideal regulatory system requires a balance between preventing market failure and allowing financial markets to perform efficiently.

[xxxii]

Frame et al. (2001) examine differences in institutional risk profiles of US credit unions delineated by membership type and membership expansion via select employee groups (SEGs). A cross-sectional statistical model is specified that examines risk variation relative to the type of common bond and the breadth of the credit union's membership. They find that occupational credit unions have a unique risk profile relative to other common bonds. This includes a greater exposure to concentration risk, which is hedged by holding greater proportions of capital. They also find that as more SEGs are added, credit unions tend to increase their loan-to-share ratios and decrease their capital ratios. The number of SEGs and the proportion of loan delinquencies are positively related which suggests that the informational advantages associated with the common bond become diluted as new groups are added.

[xxxiii]

Rauterkus and Ramamonjiarivelo (2010) examine the impact of US credit union risk characteristics and macroeconomic events on deposits. Looking at a sample of US credit unions from 2004-2008 they find that credit union depositors do not consistently punish credit unions by deposit withdrawal for risky behaviour. Furthermore, they find that credit union deposits increase in times of economic uncertainty and suggest that this indicates that there is a group of people that consider credit unions a safe haven during an economic crisis. The authors state that this sheds a whole new light on the importance of credit unions.

[xxxiv] Pana and Mukherjee (2010) examine the level and determinants of liquidity created by US credit unions. The authors show that the level of liquidity increased by 50% over the 2000 to 2008 period, reaching a level of $318 billion in 2008 and that the contribution of large credit unions to aggregate liquidity has increased over time, while the role played by medium and small credit unions has diminished. The authors also consider the role of capital in influencing liquidity creation. The results suggest that higher levels of capital reduce the ability of US credit unions to create liquidity. Furthermore, capital levels exceeding minimum

regulatory requirements undermine credit unions' incentives to monitor borrowers and extend loans. Consequently, the choice of increasing the relative weight of liquid assets at the expense of investments in loans results in a lower level of liquidity created.[xxxv]

Capital regulation is now applied to credit unions in most countries. The US regulator, the NCUA (2005, p.2) summed up the importance of capital regulation as follows: "Meaningful capital standards are important in protecting the federal insurance funds, taxpayers and the stability of the financial system. NCUA also recognises the importance of institutions in managing capital levels to ensure the efficient use of capital in the economy, to optimise the performance of an institution with appropriate leveraging, and to achieve strategic objectives in providing low-cost services and meeting the service needs of members." Only a small number of papers attempt to assess the extent to which capital regulation affects the behaviour of credit unions. Jackson (2007) assesses the evolution of capital ratios for US credit unions over the period 1990 to 2006. Jackson reports that the capital level of US credit unions stood at 11.6% at the end of 2006, more than four percentage points higher than the legislatively mandated level of 'well capitalized' and exactly four percentage points higher than US credit union capital in 1990. He concluded that the industry capitalization rate in 1990 was perhaps a bit too high, and that the credit union industry in 2006 was less risky than it was in 1990. Goddard et al (2010) examine the determinants of US credit union capital-assets ratios between 1994 and 2009 (a period before and after the implementation of the capital adequacy regulatory framework in 2000). In the first instance they find that the average capital-assets ratio increased by about three percentage points between 1994 and 2007, but has subsequently fallen by about two percentage points between 2007 and 2009 since the onset of the financial crisis. The 2000 regulatory framework also appears to have been effective in increasing the speed at which 'undercapitalized' credit unions take action to increase their capitalization in order to surpass the regulatory minimum threshold. They also find that credit union capital buffers tend to vary pro-cyclically with capital accumulated during economic upturns and depleted through write-offs during downturns. This confirms the view that in the absence of an option to raise new capital in the form of equity, credit unions manage their capital cautiously over the course of the business cycle.