



FINANCIAL REGULATOR  
*Rialtóir Airgeadais*

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**Address by James O'Brien**

**Deputy Registrar of Credit Unions.**

**INTRODUCTION**

Madam Chairman, members of the executive, ladies and gentlemen, I am delighted to be invited here today to address the Spring Conference of the Credit Union Managers Association.

Managers are important stakeholders in the credit union sector and we always welcome the opportunity to hear first hand what issues are to the forefront in credit unions and what are the day to day challenges. We also welcome the opportunity to consult with and get feedback from CUMA on our regulatory initiatives. Discussions between managers and ourselves at CUMA conferences are always frank – some would even say robust – however this, from our point of view, is all the more valuable for informing our regulatory thinking and policy making.

In my view, the choice of theme for today's conference 'Compliance and Sustainability' could not be better timed as we embark on a strategic review of the credit union sector this year.

I believe that one of the main building blocks for any sustainable credit union model is a strong compliance and governance culture. In this regard, compliance and sustainability are interlinked. Long term sustainability can only be achieved if the governance framework is robust.

Some of what I am going to say today may appear familiar but I make no apologies for re-enforcing the message. We are experiencing an extremely challenging economic and financial period and credit unions must be pro-active in adapting their business to the changing environment. Boards and management will be severely tested as credit unions make their way through these turbulent times.

### ***BUSINESS ENVIRONMENT***

Although credit unions have not escaped the fallout from the financial and economic crisis, the sector overall has, so far, withstood the storm. This is not to say that credit unions have not found 2009 a tough year and it is likely that twenty ten may be even more challenging. The impact of unemployment, public sector pay cuts and poor economic growth on the sector could be significant and credit unions may be facing a time of unprecedented uncertainty.

These are indeed testing times and a question arises - can the credit union sector rise to the challenge? I believe it can. The sector is resilient and has survived tough times before. However, how well credit unions come through this time will firmly depend on the attitude, ability and the willingness of boards and management to adapt to change in their business environment and take the necessary steps to steer their credit unions safely through these relatively uncharted waters.

So where do credit unions need to concentrate their efforts over the next 12 to 24 months? As a guide, I would like to talk about 5 key areas that we will be focussing on over this timeframe. They are:

1. Governance and compliance;
2. Business operations - Lending and Investments;
3. Safety buffers – reserves and liquidity;
4. Regulation; and
5. The strategic review of the credit union sector.

#### ***1. Governance and Compliance***

Turning firstly to governance and compliance. For the credit union sector in Ireland to move successfully to the next stage in its development one of

the key changes required will be in how individual credit unions are governed.

Too often, the same credit unions appear on our radar over and over again. In most cases, we have been working with these same credit unions over a number of years to deal with recurring regulatory issues. A common theme across these particular credit unions is poor governance structures and standards and in some cases a lack of willingness on the part of boards and management to engage with us in a meaningful fashion. On the positive side however, we have found many other credit unions to be extremely co-operative and regulatory matters are resolved quickly in a manner that is satisfactory to all. We want to work with all credit unions in a co-operative fashion. Where there are regulatory issues to be addressed our approach is to be constructive and pragmatic and therefore we would expect boards of directors and management to respond accordingly.

Obstructive and imprudent behaviour by those charged with governance in credit unions is not in the best interests of the members they are serving, nor in the best interests of the credit union sector overall.

Over the past while it has become apparent, that if proper governance is to be achieved in credit unions, the general quality of boards and supervisory committees within the sector must be improved in terms of skills, expertise and competence. The quality of the management teams in credit unions must also be adequate, taking account of asset size and level of risk.

In order to bring this about, we are of the view that the time has now come for a statutory governance framework to apply to credit unions, which would include fit and proper competency based requirements for boards and managers and we intend to include this proposal in the terms of reference for the strategic review – which I will speak about later.

Those credit unions that wish to be ahead should take a critical look to their own governance structures now and where necessary begin the process of improvement and change.

On the subject of compliance in credit unions, let me make the following comments. We regard the attitude by boards and management to

compliance as a yardstick to measure how well credit unions are run and one which is key to making an informed assessment of risk to members' savings. In some credit unions, compliance is seen as optional, where one can pick and choose from the menu to satisfy particular tastes and requirements. We expect full compliance with all legal and regulatory requirements. Our view is that the protection of members' savings must take precedence over all other aims and objectives of credit unions and we expect that diligent boards and management would take the same view. Compliance will continue to be a key focus of our regulatory oversight in twenty ten and beyond.

## ***2. Business operations – Lending and Investments***

With regard to the business operations of credit unions, we will continue with our strong and close regulatory oversight of the lending and investment functions.

The importance of the credit union sector in Ireland has been brought into focus as the financial and economic crisis has unfolded. On a day-to-day basis, credit unions see the impact on their members and are being called upon to help those in financial distress.

In this regard, unprecedented pressure can be expected to continue from members seeking new loans, or to re-schedule existing loans, as more and more come under financial strain. We fully understand the impact of this pressure on credit unions and the need for member support in these difficult times. However, clear and objective decision-making is required in this regard. Members' savings and the financial position of the credit union must not be put at risk. The financial soundness and long-term sustainability of the credit union must at all times be uppermost in the minds and actions of boards of directors and managers.

This is not a time for any relaxation of lending standards and in some categories, lending criteria must become more restrictive to reflect the increased risk. The decision to lend must be based on conservative estimates of the ability and commitment of the potential borrower to repay. In addition, as many financial institutions are now finding to their cost, the lending decision must never be based on the value of security alone.

Before advancing monies to a borrower, credit unions should avail of all sources of information to ensure that it has the complete financial profile of that borrower to ensure that the risk is fully assessed and understood. The practice of making lending decisions in a vacuum must cease as it defies logic and good business practice. All credit unions should now be using the facilities provided by external credit reference agencies as part of the lending decision process.

In the area of investments, most credit unions are continuing to prudently reduce the risk in their investment portfolios and to a certain extent much of the investment losses have already materialised and been recognised in the financial statements. However, a word of caution, there may still be shocks in some investment portfolios, given the range and type of investment products bought by credit unions over many years. Boards and management must continue to monitor this area closely, on an investment by investment basis and ensure that any deterioration in value is properly reflected in the financial statements. Credit unions should, in the short term, continue to hold surplus funds in deposit accounts only.

### ***3. Safety buffers – reserves and liquidity***

Moving on to the safety buffers – reserves and liquidity.

While the sector overall currently has a reasonable level of reserves, credit unions must continue to remain vigilant, to ensure that levels are adequate. We have been working on building capital and provisioning levels in credit unions over the last 12 to 18 months. The introduction of the Regulatory Reserve Ratio for credit unions in 2009 was a key part of this work. The collaborative approach and input from the ILCU, CUDA, CUMA and other stakeholders, to the consultation process was strongly welcomed by us. While, in the past, many credit unions have looked upon statutory reserves in the negative sense, because they can't be distributed, this attitude appears to be changing and many can now see the need for strong reserves. Reserves are the safety net for the credit union and should be built to (and maintained at) appropriate levels.

We continue to see significant increases in loan arrears and in the levels of re-scheduling across the movement. It is likely that the levels of

arrears in credit unions will continue to rise and subsequently the level of bad debts. Sufficient resources should be made available in the credit control area of the business and it is vital that there is strong oversight of the credit function at this time. Credit unions must continue to make appropriate provisions for bad and doubtful debts that truly reflect the quality of their loanbooks - including those loans that have been rescheduled. Prudent and honest accounting must be maintained and we will not accept any fudging of the position, for that is in nobody's interest. Credit unions must not use practices such as loan re-scheduling, top ups, or share to loan transfers in an attempt to regularise impaired loans. Members putting funds into a credit union have a right to know the true financial condition of the entity to which they are entrusting their savings.

Over the years, credit unions have been able to rely on a stable savings base to fund their operations. Indeed, in more recent years, the high level of savings in the sector has caused difficulties for some credit unions, as they chased high investment returns on surplus funds. However, while in the past savers have been noticeably loyal to their credit union, this strong funding base cannot be taken for granted. Members' savings are likely to become less 'sticky' in the future as credit unions experience increased competition for these funds. It is also likely that members will need to draw down on their savings as finances tighten. Credit unions should prepare for this eventuality. The age profile of savers is also important and the level of dependency on funding from an aging membership should be reduced.

Given that over 80 per cent of overall savings within the movement is unattached, this is an area that credit unions should focus hard on over the next couple of years. Funding and lending projections should be drawn up to ensure that sufficient levels of liquid funds are maintained. We are working closely with those credit unions that have low liquidity in order to ensure that adequate liquidity ratios are maintained across the sector.

You will be aware of our circular issued in January last year requiring credit unions to give priority to the holding of surplus funds in liquid form. That requirement remains in place. In these uncertain times liquidity is all

important and credit unions must be able to meet liquidity requirements as and when required.

#### **4. Regulation**

On the subject of regulation - it has been said that the regulation of businesses existed in the ancient early Egyptian, Indian, Greek and Roman civilizations. So it's not something new! However we often get the feeling that credit unions view regulation as something that is imposed on them alone - a cross they have to bear! Of course this is not true and all credit unions must come to realise that regulation acts as a protector for their members and that regulation is not simply an 'administrative burden'.

The regulatory framework can also be seen to act as a protection for boards. The framework sets out the rules by which directors can determine how they can comply with their legal and regulatory responsibilities and directors should embrace the 'protective cloak of regulation' for their own sake as well as that of their credit union.

There is a global reform effort underway to address the flaws and weaknesses exposed so clearly in the global financial regulatory system. The overall objective is to create a more resilient financial system that can withstand unexpected shocks like those we have seen over the past 18 months to 2 years. At a high level, what is envisaged is a financial system that is underpinned by better (though not necessarily more) prudential regulation and increased supervisory engagement and challenge and one that has stronger levels of capital and liquidity. At this high level, we would concur with this approach and credit unions can expect that, as their business model becomes more complex, regulatory oversight will increase commensurate with their risk profile.

You will be aware of the recent announcement regarding the new structure of the Central Bank and where the regulation of credit unions sits within this new structure. In this regard, you will note that there is no change to the current supervisory arrangements and that credit unions will continue to be supervised by the Registrar of Credit Unions in a

separate regulatory stream to that of other financial institutions. Whilst there is a change in reporting arrangements, this is a reflection of the growing importance of credit unions in the overall financial system and the need for increased oversight.

### ***5. Strategic Review of the credit union sector***

Turning now to the strategic review of the credit union sector. The current business model and governance arrangements in the credit union sector have, up to now, produced certain advantages for credit unions. However it has become increasingly clear that changes are required in how credit unions operate which will enable the sector to progress to the next stage of its development. The current regulatory framework for credit unions is outdated and requires significant change. Indeed, credit unions themselves have been seeking change in the legislative framework for some time now.

As you will be aware, the Minister for Finance has requested the Financial Regulator to arrange for a strategic review of the credit union sector to be carried out. This process is in train and the review will involve an examination of the structure, operation, regulation and legislation of the sector. The terms of reference will be wide ranging and it is intended that the outcome of the review will advise and inform an assessment of the future strategic direction of the credit union movement and make recommendations as to the operational model, legislative framework and regulatory controls necessary to protect and sustain the sector into the future.

A key focus of the review will be on how to protect the strengths of the movement while having an enabling legislative and regulatory system that allows credit unions to develop in a prudent manner. It is intended that there will be wide consultation with all stakeholders in the sector during the review to ensure that all views are considered in the work.

Credit unions should not be fearful of this review. We all want modern, well-regulated and financially sound credit unions that operate in line with

best international standards and offer members a real alternative to other financial institutions. However, this can only be achieved through a robust legal, regulatory and operational framework allied with strong internal governance.

I believe that this is a valuable opportunity to design a sustainable credit union business model and regulatory structure to support the strategic development of the sector over the next 10 to 15 years. This opportunity should not be wasted. It should be grasped with both hands and internal politics should not be allowed to get in the way of progress. All stakeholders will need to show strong leadership in this regard.

### **CONCLUSION**

So in conclusion.

Credit unions will continue to find the going tough over the next couple of years and there will be significant demands on boards and managers. Boards and management must have (and if not acquire) the necessary skill sets, expertise and competence to deliver the sector through what is going to remain a challenging time for the foreseeable future.

The strategic review offers the opportunity to develop a sustainable operational and enabling regulatory model for credit unions. Those credit unions that will perform stronger in this new environment will be those that embrace regulation have adopted good governance frameworks, are pro-active in managing business difficulties and can adapt strategies, policies and practices accordingly. Robust risk management and compliance policies will also be key features in these credit unions.

Credit union directors should be confident to embrace change for the good of their credit unions and the sector overall. Now is the time for boards and management to step up to the plate, take a critical look at their credit unions, recognise problem areas where they exist and take the hard and perhaps difficult decisions to make the necessary improvements.

The credit union sector has survived through many difficult economic times in the past. The inherent strengths of member loyalty, volunteer commitment, ethos of co-operation and self help culture will stand it in

good stead in the current difficulties. There is no reason why the credit union sector cannot successfully come through the present financial and economic challenges in good shape, provided the movement faces up to the need to implement the operational and regulatory changes necessary to allow the sector to develop and secure its future. The future shape of the credit union sector depends on that response.

Thank you for your attention. If you have any questions I would be happy to answer them.