Regulatory Capital for Irish Credit Unions: Time for Change?

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Introduction

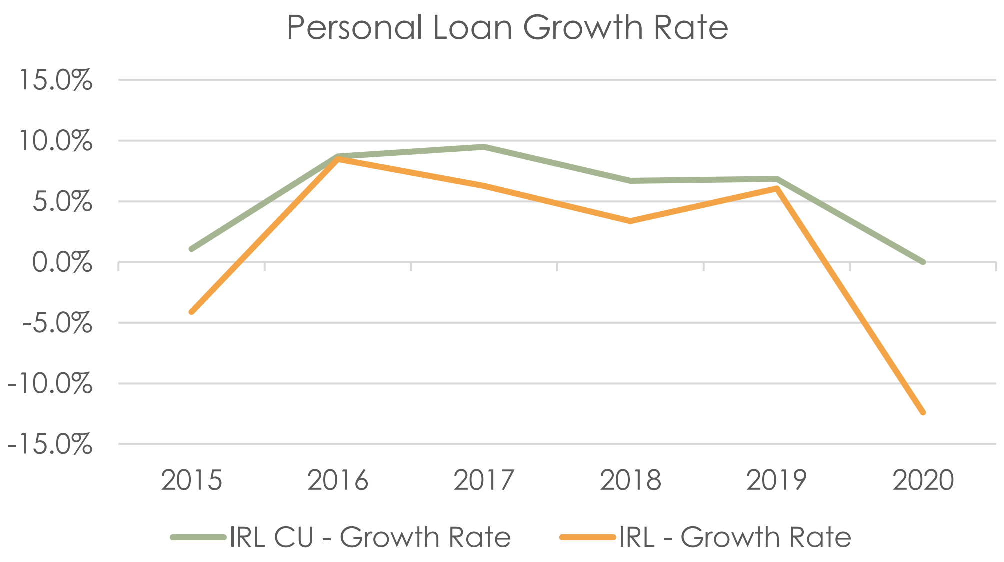
- All papers and materials are available on the CEO Forum Website

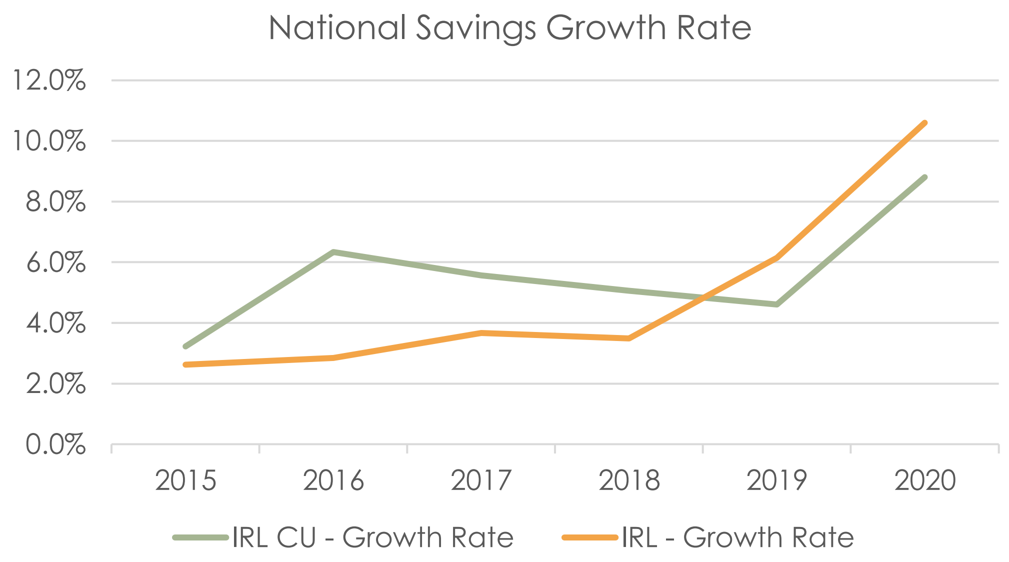
  https://cuceoforum.ie/

- Acknowledgement
  - Lorraine Greville, CFO, Life Credit Union
  - Michael Ahern, CEO, Dubco Credit Union
  - And the many contributors who supported our work

Background

- The Irish Credit Unions sector is
  - Trusted by members to deliver financial services and described as "*A perfect example of a company that genuinely cares about its customers*"[1]
  - Extraordinarily successful at delivering community financial services [2]

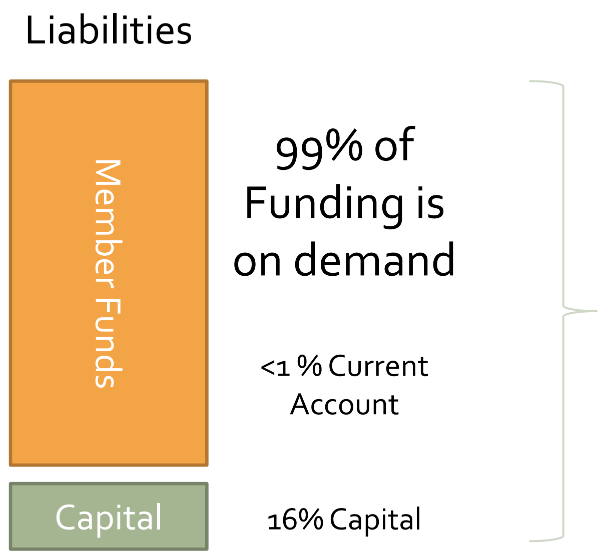




Source: [1] Cxi Report 2017; [2](Central Bank of Ireland, 2020) Financial Conditions of Credit Unions and Statistical release - Credit Advanced to and Deposits from Irish Households;

OBJECTS

- The primary objects of a CU are defined by the 1997 Credit Union Act as amended ("the 1997 Act"), Part II 6(2):
  a) the promotion of thrift among its members by the accumulation of their savings;
  b) the creation of sources of credit for the mutual benefit of its members at a fair and reasonable rate of interest;
  c) the use and control of members' savings for their mutual benefit;



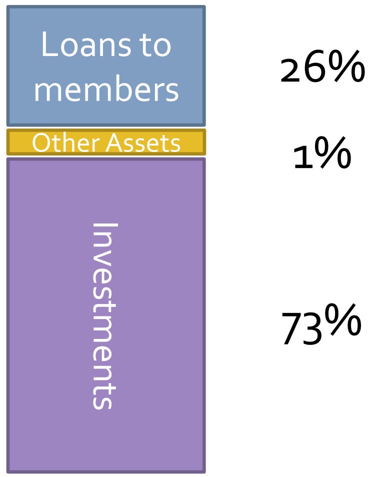
Very low risk funding

€4,500 Average Savings balance
85% of Funding in accounts < €30,000

Simple Business model

- Irish Credit Unions operates a straightforward business model
  - Savings, current accounts and retained earnings
  - Personal Loans; a limited breadth of investments and a small level of SME lending and secured house loans
  - Credit Unions have an average loan to assets ratio of 26.2% as at Sept 2020.

Asset allocation %



Classification

Unsecured personal loans – higher risk
Limited mortgages and SME loans

Limited Investment options – low risk

37% Liquidity on Unattached Savings – lower risk

What is Capital?

- WOCCU Model rules define Capital as
  - Protect members by providing a cushion against economic shocks or unexpected losses
    - Impairment in the assets of the credit union
    - Possible Losses – arising from risky assets of the CU (Loans & investments)
    - Operational risk
    - Other contingencies
  - Support the growth of the credit union
- Regulators impose minimum capital requirements
  - to promote financial stability and
  - to reduce risk-taking

How is Capital Calculated?

- A capital ratio (also known as 'leverage ratio' in Basel III terms) is calculated by dividing capital by total assets.

$$\text{Capital ratio} = \frac{\text{Capital}}{\text{Total Assets}}$$

- A risk-weighted capital ratio applies a risk percentage to the asset in a calculation based on the credit risk of the underlying asset

$$\text{Risk Weighted Capital ratio} = \frac{\text{Capital}}{\text{Risk Weighted Assets}}$$

Worked example

Assets	€ M [X]
Loans to members	26
Other Assets	1
Investments - High quality liquidity	37
Investment - Long term portfolio	36
Total Assets [A]	100
Comprised of	
Member Funds	84
Capital [C]	16
Capital Ratio [C / A]	16%

Worked Example

Assets	€ M [X]	Weighting [Y]	Risk Weighted Assets [X * Y]
Loans to members	26	100%	26
Other Assets	1	100%	1
Investments - High quality liquidity	37	0%	0
Investment - Long term portfolio	36	25%	9
Total Assets [A]	100		
Risk Weighted Assets [B]			36
Comprised of			
Member Funds	84		
Capital [C]	16		
Capital Ratio [C / A]	16%		
Risk Weighted Capital ratio [C / B]			44%

What is the right level of Capital?

- An unresolved International question for Credit Unions

"The supervisory authority must establish and enforce the rules for an appropriate capital framework with which all regulated institutions must comply. The rules should balance cooperative principles and objectives with the need to protect depositors. Accordingly, supervisory authorities will need to consider what meets the criteria for capital carefully and to ensure that capital instruments are able to absorb losses in the event of failure.

When supervisors choose to align capital requirements of credit unions to Basel standards, a simplified approach may be adopted for small or simple credit unions that are not allowed to hold complex financial instruments.

Extract from International Credit Union Regulators' Network (ICURN) Guiding Principles

Capital in Irish Credit Unions

No minimum | 8% Capital ratio | 10% Capital ratio | 10% Capital ratio plus Operational Risk | 10% / 12.5% Capital plus Operational Risk

1966 ACT

- No Capital requirement
- CU's required to allocate minimum 10% surplus to reserves.
- CU's could reduce allocation if >15% reserves held

1997 ACT

- No minimum capital
- Establishment of the statutory reserve requirement
- Same 10% allocation of annual surplus as previously.

LONGER-TERM LENDING LIMIT REVIEW

- A CU seeking to increase longer-term lending must have a
- Realised capital ratio of >8%
- Statutory capital ratio >6%

SI NO 344/2009

- Increases capital requirements
- Realised capital ratio of >10%
- Statutory capital ratio >8%
- **Includes a provision for Risk Weighted from 2010**

2012 CUCORA ACT

- Establishes an additional operational risk requirement
- In addition to the 10% capital ratio

2019 REGULATIONS

- Establishes a dual ratio of 12.5% for certain Credit Union who engage in House loans

1966 — 1997 — 2007 — 2009 — 2012 — 2019

International Capital Experience

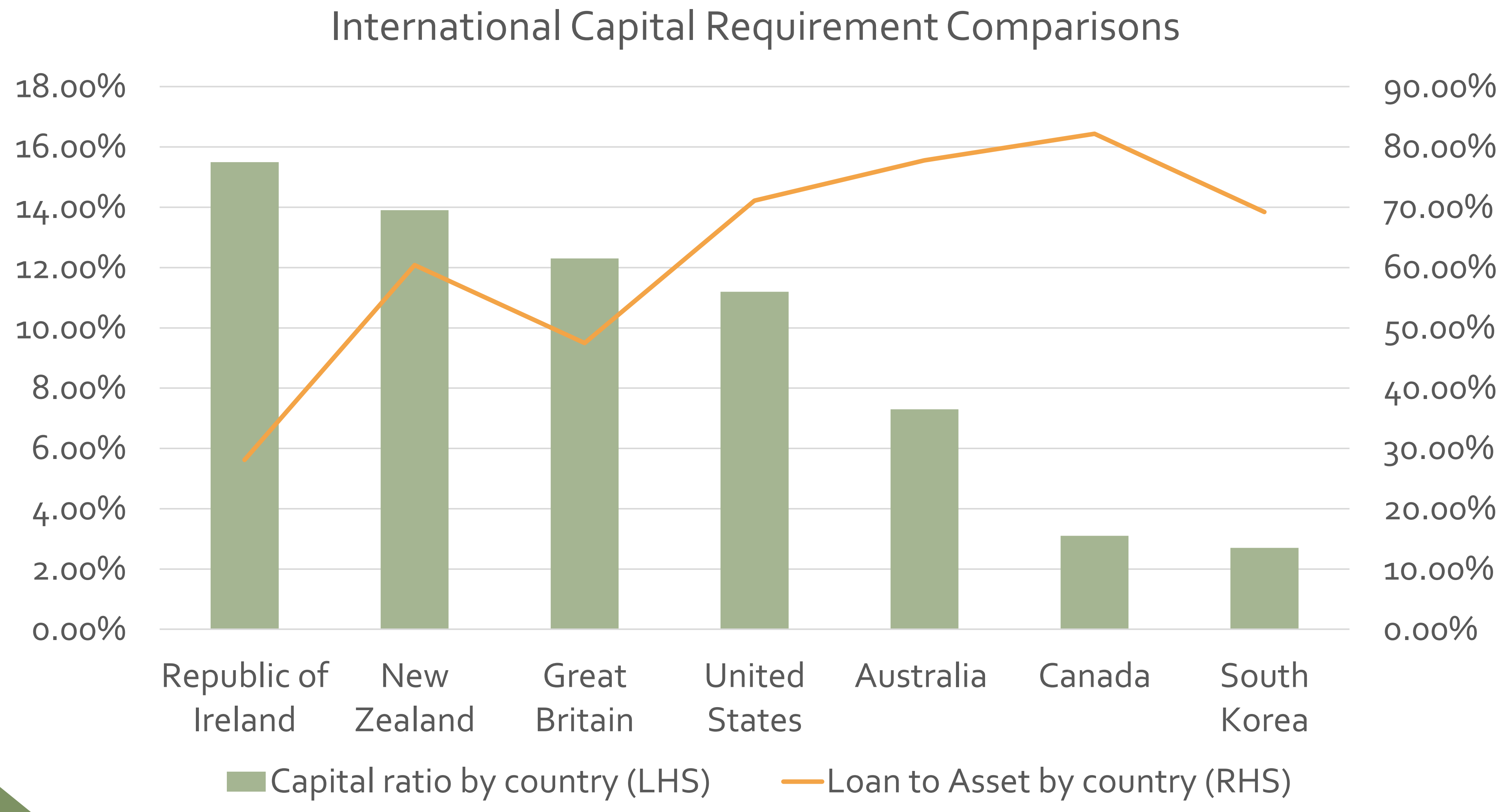
	World Council of Credit Unions	Various international regulatory bodies	Bank for International Settlements
Guidance	Model Rules	National Supervisors	Basel Accord
Minimum Capital requirements	6% Capital ratio	Regulatory capital range from 2% to 10%	10.5 to 13%
Basis for Calculation	Capital ratio	See Over	Risk Weighted Assets
Application	There is no accepted International Standard for Credit Union capital requirements	N/A	Applied Internationally to all complex financial institutions. Acknowledged as not being suitable for most Credit Union systems.
Operational Risk Reserve	N/A	Applied to Irish Credit Unions only	Applied in the Basel III model

COUNTRY CAPITAL REQUIREMENTS

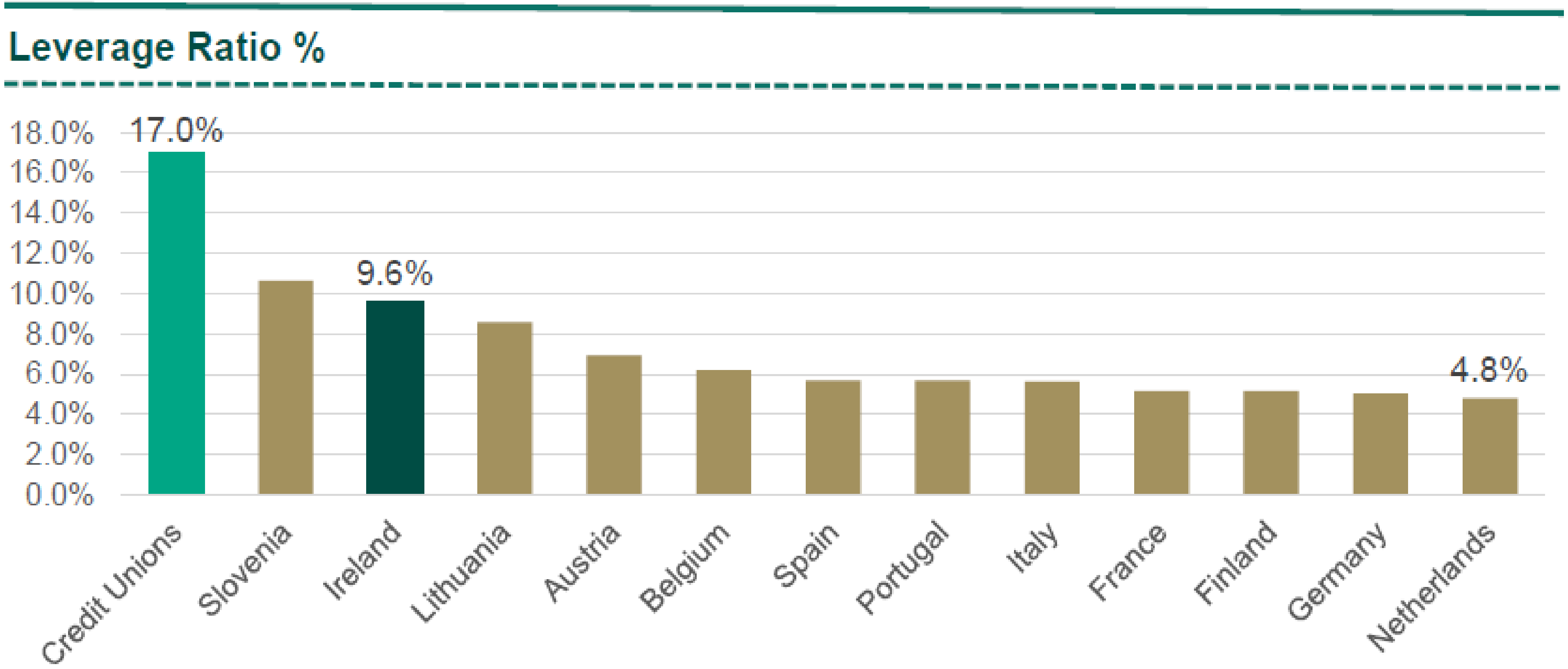
Institution	Leverage Ratio	Risk-adjusted capital ratio	Capital ratio by country	Loan to Asset by country
Republic of Ireland	10%	N/A	15.5%	28.1%
Great Britain	3% - 10%	N/A	12.3%	47.5%
Australia	3% Basel III	10.5% - 13.0%	7.3%	77.8%
Canada	3% -5%		3.1%	82.2%
British Columbia	N/A	10%		
Ontario	4%	8%		
Manitoba	5%	8%		
Saskatchewan	5%	8%		
United States	6%	8%	11.2%	71.1%
South Korea	2%	N/A	2.7%	69.2%
Japan	N/A	8%	N/A	46.3%
New Zealand	N/A	10%	13.9%	60.4%

Source: Derived from the 2019 WOCCU statistics publication

International Comparison



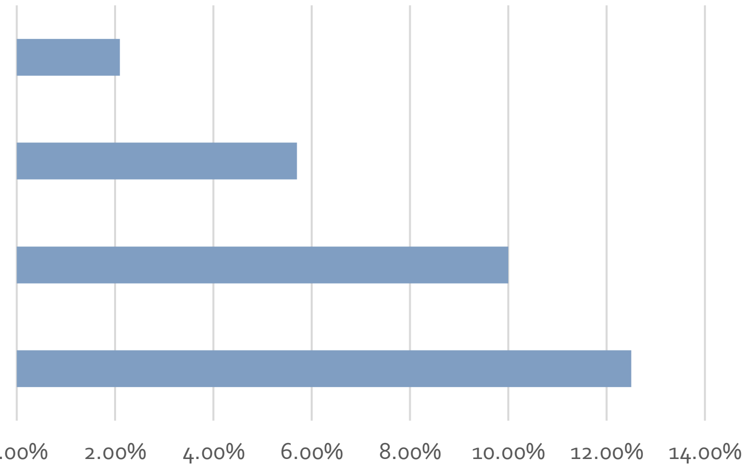
Banking Comparison



Source: Department of Finance (2019)

Asset comparisons

House loan/mortgage assets	Capital Requirement
European bank mortgages[1]	2.1%
Irish bank mortgages[1]	5.7%
Irish credit union house loan requirements [1]	Minimum 10%
Credit unions (extended house Loan limits – CU Total Assets €75 -100M)	Minimum 12.5% [3]



[1] Banking capital requirement apply to the mortgage asset only. Lower capital requirement apply to other asset classes (liquid assets for example)
[2] Credit unions are excluded by regulation from mortgage lending such as 'buy to lets', 'residential investment properties', 'holiday homes' and 'SME business premises.
[3] The increased capital requirement of 12.5% applies to the credit unions total assets and not on specific house loan assets.

Conclusion I

- Capital Requirements in Irish Credit Unions are
  - Overly conservative compared to international comparisons
  - Excessive compared to the Irish and European banking context
  - Unjustified relative to the risk profile of the Irish credit union balance sheet, and are
  - Putting credit unions at a competitive disadvantage relative to competing financial institutions.

Alternatives Considered

EXERCISE #1

Basel III

Application of Risk Weighted Capital requirements

SOLUTION #1

ALR

Application of an Asset Linked Capital ratio

SOLUTION #2

QAR

Application of Capital ratio on Qualifying Asset

ALTERNATIVES CONSIDERED

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Basel III - Overview

Eur'000s	2020		
Balance Sheet Data as of 30th September	As is (A)	Risk-Adjusted assets (A*B)	Risk Weightings (B)
Total Assets	172,963	85,047	49%
Less Collateral (Pledged Shares)	10,148	7,611	75%
Net Assets (C)	172,963	77,436	
Total Capital (D)	24,403	24,403	
Capital Ratio (D/C)	14.11%	31.51%	
Impact on assets for capital calculation of weighting		-51%	
Increase in capital available		124%	
Capital Ratio		14.10%	
Basel III Risk-Weighted Ratio		31.50%	

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Asset Linked Ratio "ALR"

- The working group proposes calculating regulatory capital requirements based on the underlying asset class
  - We graded the capital requirements linked to the underlying asset class
    - 8% applied to unsecured personal & SME lending and other assets classes.
    - 5% applied to other investments and secured loans.
    - 2% on high-quality liquid assets (HQLA) including cash or liquid bank deposits < 90 days, deposits with the Central Bank or sovereign debt.
- Encourages asset allocation decisions towards lower risk classes
  - Improves protection for members by prioritising Credit Union investment decisions into safer assets
- Higher-risk asset classes (potentially higher returns), then higher capital requirements
  - Focus on risk / return and capital requirements
  - Higher Risk = Higher Capital requirements

ALR Calculation

2020 Year-End CU Balance Sheet	€ Millions	Existing requirement	Asset linked ratio	ALR requirement €M
Loan Assets				
Short Term Loans to members	5,404	10%	8%	432
Less Provisions	-517	10%	8%	-41
Less Savings attached to loans	-540	Excluded	8%	-43
Net House loans (2.2% assumed)	112	10%	5%	6
Net SME Lending (1.8% assumed)	92	10%	8%	7
Total Loan Book	5,090			

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Total Loan Book	5,090			0
Cash, CB Deposits & HQLA	3,399	10%	2%	68
Investing Activities				0
Sovereign Debt (8% assumed)	766	10%	2%	15
Investment assets	8,805	10%	5%	440
Total Investments	9,571			0
Other Assets	1,360	10%	8%	109
Total Assets	**19,420**			

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Investment assets	8,805	10%	5%	440
Total Investments	9,571			0
Other Assets	1,360	10%	8%	109
Total Assets	**19,420**			
Total Capital	3,010			
Resultant Capital Requirement		**1,942**		**993**
Resultant Capital buffer		1,068		2,017

ALR Progressive and Sustainable

- Capital requirements increase progressively as the Loan to Asset ratio increases
  - resulting in a 14% increase in capital on 60% loan to asset ratio
  - capital remains static under existing capital requirements
- Sustainability is improved
  - 62 % reduction in the time to build capital levels in the current economic environment

	€ M
Total Assets	19,420
6% Growth in credit union assets 2020	1,165
Resultant Capital requirements	
10% ratio requirement [A]	117
ALR Capital Requirement [B]	45
Income generated by new assets	9.9
Years to accumulate capital requirements	**Years**
Current capital @ 10%	11.7
Asset linked ratio	4.5

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Qualifying Asset ratio "QAR"

- Simplified approach where capital requirement excluded on assets with no or immaterial risk:

Asset Class	Qualifying or non-qualifying
Loans (netted of attached shares and provisions)	Qualifying
Investments (non-sovereign)	Qualifying
Fixed assets	Qualifying
Other assets	Qualifying
Sovereign debt	Non-qualifying
Deposits with the Central Bank	Non-qualifying
HQLA (< 90 days)	Non-qualifying
Cash	Non-qualifying

$$\text{QAR ratio} = \frac{\text{Capital}}{\text{Total Qualifying Assets}}$$

QAR Calculation

2020 Year-End CU Balance Sheet	€ Millions	Qualifying Yes/No	Qualifying Assets
Loan Assets			
Short Term Loans to members	5,404	Yes	5,404
Less Provisions	-517	Yes	-517
Less Savings attached to loans	-540	Yes (currently excluded)	-540
Net House loans (2.2% assumed)	112	Yes	112
Net SME Lending (1.8% assumed)	92	Yes	92
Total Loan Book	5,090	Yes (adjusted)	4,550
Cash, CB Deposits & HQLA	3,399	No	0
Investing Activities			
Sovereign Debt (8% assumed)	766	No	0
Investment assets	8,805	Yes	8,805
Total Investments	9,571	Yes (adjusted)	8,805
Other Assets	1,360	Yes	1,360
Total Assets	**19,420**		**14,715**

QAR Calculation

2020 Year-End CU Balance Sheet	€ Millions	Qualifying Yes/No	Qualifying Assets
Loan Assets			
Short Term Loans to members	5,404	Yes	5,404
Less Provisions	-517	Yes	-517
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Investment assets	8,805	Yes	8,805
Total Investments	9,571	Yes (adjusted)	8,805
Other Assets	1,360	Yes	1,360
Total Assets	19,420		14,715
Qualifying Asset ratio			8%
Resultant Capital Requirement			**1,177**
Total Capital			3,010
Capital Buffer			1,833

Conclusion II

- The Asset linked ratio ALR is recommended by the CEO Forum
- Basel III is overly complex and is generally not recommended for Credit Unions
- QAR is overly simple and does not recognise the risk inherent
- All calculations produced results that demonstrate Irish Credit Unions are conservatively capitalised

STRONG IRISH CREDIT UNIONS

- Credit unions have evolved their governance frameworks considerably
- (ICURN, 2019) highlights the emerging risks to credit union capital and acknowledges that the Irish credit union sector operates a "simple business model" and is "well capitalised by any measure".
- The (Credit Union Advisory Committee, 2016) opined:

> **"That it is clear that a strengthened regulatory framework as recommended by the (Commission on Credit Unions, 2012), is now in place".**

- Capital change is now overdue that supports these investments

	10 % Capital Ratio	Basel III 11.5% Risk Weighted	ALR Model	QAR Model @ 6%
Total Assets	19,420			
Total Capital	3,010			
Risk Weighting of Asset	N/A	49%	N/A	76%
Capital Requirement	**1,942**	**1,094**	**993**	**883**
Capital Buffers	1,068	1,916	2,017	2,127
Resultant Capital % Total Assets	10.0%	5.6%	5.1%	4.5%

SUMMARY

- The ALR model is recommended because it:
  - Enhance the viability of credit unions
  - Prioritises investing in safer assets over investing in riskier assets,
  - Strengthens credit union risk management frameworks,
  - Improve credit union risk profiles.

- It will not solve the overall business model challenge
  - it does provide time for the business model to be further developed