Credit Unions – A Changing Environment

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Introduction

Credit unions are recognised as non-profit organisations with the principal activities of accepting shares and deposits from members, providing savings facilities and making loans available to their members at reasonable rates of interest. They are considered to be the people's bank of choice and in the past have assisted those who may have found it difficult to get a loan from the larger banking institutions indeed this is a valuable service they still provide today. The larger credit unions are steadily expanding their range of activities from the fundamental facilitation of savings and loans and into the mainstream financial services sector.

Regulation of Credit Unions

Pursuant to the provisions of the Central Bank and Financial Services Authority of Ireland Act, 2003 (the "CBFSAI") the Financial Regulator through the Registrar of Credit Unions (the "RCU") is now the regulatory authority with responsibility for credit unions. Prior to this, the regulation of credit unions was overseen by the Registrar of Friendly Societies. The RCU draws up rules under which credit unions must operate which are similar to the codes of conduct and handbooks drawn up by the Financial Regulator for credit institutions, stockbroking firms and others.

The principal legislation under which credit unions are regulated is the Credit Union Act, 1997 (the "Act"). The Act sets out the statutory framework within which the RCU must regulate the industry. There are strict rules regarding permitted investments by credit unions on behalf of their members which must be adhered to. Section 43 (1) of the Act provides that a credit union may only invest funds which are surplus to its operating requirements and thus not immediately required for the purposes of the credit union. Section 48 of the Act permits a credit union to provide, as principal or agent, additional services of a description that appear to the RCU to be of mutual benefit to its members. There are some restrictions on the type of additional services that a credit union can provide which include but are not limited to; additional services which must not involve any risk to the assets of the credit union or the funds of its members; and the investment in certain financial products by a credit union may only be made if this is included in its objects clause. The objects clause may be amended by the members of a credit union to include certain types of investments. When a new objects clause has been passed by the members, it must then be approved by the RCU in accordance with Section 48 (4) (b) of the Act.

New Opportunities and Challenges

The movement of credit unions towards mainstream financial services has marked a significant growth in the credit union sector with assets exceeding €13 billion as at 31 December, 2005. It has also led to an increase in consumer awareness and confidence in this sector which has been reflected in credit union membership figures of over two million people in 530 credit unions nationwide. Credit unions are unique and play an integral role in Irish urban and rural society with a presence in virtually every community in the country and have contributed greatly to the transformation of the Irish economy by playing a major role in the success of the 'Celtic Tiger'.

The sustained growth of the credit union sector has been widely acknowledged by traditional financial institutions many of which are now specifically tailoring financial products such as tracker bonds and mortgage related products to attract both credit unions and their individual members. The RCU facilitates this expansion beyond the historical limits of credit unions by allowing them to create alliances with financial institutions and permitting them to act as agents enabling the credit union to offer their members a broader range of financial products.

The members and the credit unions have in turn become increasingly more sophisticated in terms of the financial products they invest in, which has contributed to an increase in pressure both internally and externally for sustained performance. Some credit union members have substantial savings of €50,000 or more, which have to be remunerated through dividend payments. This could lead to pressure on the boards of credit unions to deliver high returns and could result in an increase in risk taking in terms of investment decisions to meet these high expectations.

Many large credit unions are faced with the external pressure of competition with large mainstream financial institutions most notably the banks as in many cases they are now both offering similar products. To sustain the growth the boards of credit unions must have diverse investment knowledge and experience. This coupled with the fact that credit unions are financial co-operatives operating on a non-profit basis and managed by voluntary boards elected by the members, make it an extremely challenging environment. The legal responsibility to manage risk and ensure the safekeeping of members' funds rests with the boards of credit unions which must also set out its business strategy. The complexity of the strategy chosen will determine the level of regulatory oversight applicable to the specific credit union. Needless to say credit unions adopting a more aggressive investment strategy will be subject to greater regulation and oversight than those which continue to provide only small loans and/or savings facilities.

The movement into diversified financial product offerings has brought as expected, the credit union sector under the spotlight of the RCU which has issued prudential guidance on investments by credit unions and on the required governance of this practice. The fundamental principle of the RCU with respect to investments made by a credit union is that they cannot involve any risk to members' savings. Under the RCU's guidance note a credit union must have a written investment policy in place which has been approved by its board of directors, and the board must also appoint an investment committee to discharge this policy.

Credit unions are now required to make quarterly prudential reports available to the RCU so that it may identify areas of risk within the industry. This new reporting requirement stems from the Irish League of Credit Unions (the "ILCU") report on poor lending practices across many credit unions. This report indicated that some credit unions had been granting larger and longer term loans which had subsequently not been repaid on time or at all, leading to a serious risk of jeopardising the members' interests in the credit unions concerned.

The Credit Union Advisory Committee (the "CUAC") which has a statutory role defined in the Act also plays a part in the regulation of credit unions by advising the Minister for Finance on many issues relating to the credit union sector. The members of the CUAC have extensive knowledge and experience in the area of credit unions and are dedicated to assisting in the development framework for credit unions. The CUAC is currently reviewing the Minister for Finance's submission to them regarding a revised investment framework for credit unions. Their findings and advice to the Minister for Finance will be fundamental in shaping the credit union investment framework which is expected to include a best practice guideline for prudent and responsible implementation of the current investment rules.

Conclusion

In conclusion, the credit union sector is extremely diverse in terms of size and range of financial activities which is not appropriately reflected in either the Act or the regulatory environment. The movement towards more diverse financial services and products for many large credit unions has also led to increased regulatory oversight including in some cases an obligation to comply with the new Minimum Competency Requirements and the Consumer Protection Code issued by the Financial Regulator in July of this year. Such regulatory requirements and codes are applicable to credit unions when they provide a service for which they are required to be authorised by or registered with the Financial Regulator under specific legislation other than the Act. In the case of smaller credit unions, the increased regulatory requirements have led to a greater administrative burden although the new electronic prudential reporting mechanism should decrease this once installed in all credit unions. Credit unions and their members should recognise that strong prudential standards are a prerequisite to the sustained growth, reputation and development of the sector. A strong regulatory reputation although sometimes difficult and onerous to comply with represents a competitive advantage and will undoubtedly lead to increased consumer confidence in the credit union sector which will enable it to sustain its growth for many years to come.

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