World Council

September 19, 2014

Filed electronically

William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: *Supervisory guidelines for identifying and dealing with weak banks – Consultat*ive *Document* (bcbs 285)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee's *Supervisory guidelines for identifying and dealing with weak banks* consultative document (bcbs 285).[1] World Council is the leading trade association and development organization for the international credit union movement. Credit unions are cooperative depository institutions that operate to promote thrift and financial inclusion. Worldwide, there are 57,000 credit unions in 103 countries with US$ 1.7 trillion in total assets serving 208 million natural person members.[2]

Credit union supervisors frequently apply the Basel Committee's international standards to credit unions, based on their own government's initiative or on advice from consultants engaged by International Financial Institutions (IFIs) such as the International Monetary Fund (IMF) and the World Bank.

World Council supports most aspects of the Committee's proposed *Supervisory guidelines for identifying and dealing with weak banks* guidance. We are concerned, however, that some elements of the proposal could be used to discriminate against the cooperative depository institution model or impose excessive regulatory burdens on credit unions and other smaller financial institutions. We urge the Committee to clarify the final version of this guidance to help avoid such unintended consequences.

Summary of World Council's Comments

1. **Mandatory Demutualization of Credit Unions and Other Mutuals:** We are concerned that the proposed corrective action of "[r]equire changes in the legal structure of the banking group" in Paragraph 116 and "forced restructuring" in Paragraph 191 could be used to discriminate against the cooperative model by requiring mandatory conversion of credit unions and similar mutual institutions to joint-stock companies.

[1] Basel Committee on Banking Supervision, *Supervisory guidelines for identifying and dealing with weak banks -- consultative document* (2014), *available at* http://www.bis.org/publ/bcbs285.htm.
[2] World Council of Credit Unions, *2013 Statistical Report* (2014), *available at* http://www.woccu.org/publications/statreport.

We urge the Committee to clarify that the phrases "[r]equire changes in the legal structure of the banking group" in Paragraph 116 and "forced restructuring" in Paragraph 191 refer to holding company-level reorganizations, such as in the context of spin-offs to raise capital or in the case of insider abuse or other instances of inappropriate control over the banking group, and is not intended to favor mandatory demutualization of credit unions or other mutual institutions.

2. **"Consistency" in the Regulatory Framework, Basel III Risk-Based Capital, and Competition:** We strongly oppose the proposition expressed in Paragraph 12 that "banks, large or small," should necessarily be subject to the same supervisory system, such as Basel III risk-based capital rules, and also strongly oppose Paragraph 12's statement that "[t]o avoid distorting competition, all banks, in general, should be subject to the same supervisory and regulatory framework." By extension, we do not support the statement in Paragraph 6 that "[t]he toolkit described here should be relevant whether the institution is a small local bank or a large international banking group . . ." because too much of the guidance relies upon concepts developed by the Committee specifically for large, internationally active banking institutions.

   We urge the Committee to revise Paragraph 12 to clarify that the "proportionality concept" articulated in the *Core Principles of Banking Supervision* remains in effect in the weak bank context, and also to remove the references to "distorting competition" from Paragraph 12 because these statements are not accurate in the context of large banks' competition with credit unions or community banks, and because competition matters should be outside the scope of this weak banks guidance.

3. **Supervisory Discretion, Rule-of-Law Principles, and Stress Testing:** Many aspects of the proposal suggest giving supervisors broad discretion to require weak institutions to take remedial measures on a case-by-case basis, including the proposed guidance on stress testing in Paragraphs 49 through 59. While we recognize that supervisors must have discretion in this area—every weak bank is weak in its own way—we urge the Committee also to be sensitive to the importance of rule-of-law principles in the depository institution supervisory context and not to encourage supervisors to use broad, ambiguous grants of legal authority to override more specific legal provisions addressing the same subject matter.

4. **Definition of "Weak Bank:"** The proposed definition of "weak bank" in Paragraph 9 is both circular and a truism. We believe that the more detailed guidance in Paragraph 10 regarding what constitutes more fundamental weaknesses would be clearer and of better utility to supervisors than the proposed definition in Paragraph 9.

5. **Tax Rules and Capital Injections in Weak Institution:** We support not taxing stabilization support in the weak institution context, such as with respect to direct capital injections made by private- or public-sector stabilization funds to credit unions in the form of grants. We urge the Committee to clarify that capital injections, including in the form of grants made to credit unions, should not be subject to taxation.

1. Mandatory Demutualization of Credit Unions and Other Mutuals

We are concerned that the proposed corrective action of "[r]equire changes in the legal structure of the banking group" in Paragraph 116 and "forced restructuring" in Paragraph 191 could be used to discriminate against the cooperative model by requiring mandatory conversion of credit unions and similar mutual institutions to joint-stock companies. Credit unions performed better than banks during the global financial crisis and there are many ways to strengthen or, if needed, resolve weak credit unions.

Credit unions performed better than banks during the financial crisis because of their conservative lending and investment profiles and high levels of capitalization compared to banks. In the United States of America for example, the world's largest credit union system, U.S. credit union loan losses between 2008 and 2013 averaged 0.90% of total loans, while loan losses at U.S. banks averaged 1.62% of total loans over the same period.[3] Although there are similar numbers of U.S. banks (currently 6,623[4]) and U.S. credit unions (currently 6,632[5]), between 2008 and 2013 there were 485 failures of U.S. banks compared to 136 credit union failures.[6] Only 26 of these credit unions had over US$ 50 million in assets and, unlike banks, credit unions were not generally eligible for public open bank assistance from the U.S. Treasury's TARP Program.[7] Credit unions in the next two largest systems, Canada and Australia, performed at least as well as the U.S. credit unions during this time period.

There are numerous methods for strengthening and, if necessary, resolving weak credit unions and other mutuals that do not involve demutualization, including issuance of Common Equity Tier 1 (CET1) compliant mutual capital instruments—for instance, the CET1 Core Capital Deferred Shares (CCDS) issued by Nationwide Building Society of Great Britain in 2013[8]—mergers, and purchase and assumption transactions. Further, the performance of demutualized financial institutions as joint-stock companies is mixed at best; for example, all British building societies which have demutualized were either acquired by large banks or failed.[9]

We also note that mandatory demutualization of weak Italian cooperative banks was considered and rejected as a viable solution for strengthening these institutions in the IMF Working Paper *The Reform of Italian Cooperative Banks: Discussion of Proposals*.[10]

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[3] *See* Credit Union National Association (CUNA), *NCUA Proposed Rule: Prompt Corrective Action–Risk-Based Capital* at 9 (May 28, 2014), *available at* http://www.cuna.org/Legislative-And-Regulatory-Advocacy/DownLoads/rcl_rbc_052814/.
[4] "FDIC: Institution Directory;" https://www2.fdic.gov/IDASP/ (last visited Sep. 19, 2014).
[5] CUNA, *Monthly Credit Union Estimates* at 5 (July 2014), *available at* http://www.cuna.org/Research-And-Strategy/DownLoads/mcue/.
[6] CUNA, *NCUA Proposed Rule: Prompt Corrective Action–Risk-Based Capital* at 10.
[7] *Id.*
[8] *See, e.g.*, Our Core Capital Deferred Shares (CCDS) | Nationwide; http://www.nationwide.co.uk/about/investor-relations/capital-securities/ccds-market-data-and-investor-information (last visited Sep. 18, 2014).
[9] *See* "BSA—List of demutualised building societies;" http://www.bsa.org.uk/information/consumer-factsheets/general/list-of-demutualised-building-societies/ (last visited September 18, 2014).
[10] Eva Gutiérrez, *Reform of Italian Cooperative Banks: Discussion of Proposals*, IMF Working Paper WP/08/74, at 3 (2008) ("[W]e propose a reform that includes several elements to improve governance while preserving the cooperative nature

We urge the Committee to clarify that the phrases "[r]equire changes in the legal structure of the banking group" in Paragraph 116 and "forced restructuring" in Paragraph 191 refer to holding company-level reorganizations—such as in the context of spin-offs to raise capital or in the case of insider abuse or other instances of inappropriate control over the banking group—and is not intended to favor mandatory demutualization of credit unions or other mutual institutions.

2. "Consistency" in the Regulatory Framework, Basel III Risk-Based Capital, and Competition

We oppose the proposition expressed in Paragraph 12 that "banks, large or small," should necessarily be subject to the same supervisory system, such as Basel III risk-based capital rules designed for large, internationally active banking groups. The compliance costs of risk-based capital are not justified in the context of small depository institutions which are limited to lower risk investments by law and which are subject to a reasonable leverage ratio requirement (such as 5% or greater capital-to-assets to be adequately capitalized).

We also strongly oppose Paragraph 12's statement that "[t]o avoid distorting competition, all banks, in general, should be subject to the same supervisory and regulatory framework." To the contrary, complex financial regulations like Basel III themselves give large banks a distinct competitive advantage over credit unions and other, smaller financial institutions which are less able to afford the cost of compliance with these rules.

We believe that these proposed statements about making small banking institutions subject to the same rules as the largest banks are not consistent with the Committee's "proportionality concept" articulated in the *Core Principles of Banking Supervision.*[11]

By extension, we do not support the statement in Paragraph 6 that "[t]he toolkit described here should be relevant whether the institution is a small local bank or a large international banking group . . ." because too much of the guidance relies upon concepts developed by the Committee specifically for large, internationally active banking institutions which engage in highly complex and risky financial activities that credit unions do not do. We agree that many elements of the toolkit would be useful in the context of smaller weak institutions under the "proportionality concept," but not when the guidance says that small institutions should be subject to all of the regulations designed to try to keep the world's largest banks from failing despite those banks' excessive complexity and inexorable courtship with undue risk.

Further, this "one-size-fits-all" or "level playing field" regulatory approach would impose outsized regulatory burdens, without meaningful supervisory benefits, on credit unions which are engaged in a traditional community banking model and which do not engage in complex or excessively risky financial activities. These credit unions' permissible business activities are restricted by law primarily to making loans to their natural person members, investing in bank term deposits and government-guaranteed debt, and payments services.

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of the institution, as we found lack of compelling legal or economic support for mandatory conversion to limited company status."), *available at* https://www.imf.org/external/pubs/ft/wp/2008/wp0874.pdf.

[11] Basel Committee on Banking Supervision, *Core Principles of Banking Supervision* at 1, 5, 8, 10-11, 29-32, 74 (2012), *available at* http://www.bis.org/publ/bcbs230.pdf.

Credit unions performed much better than the banking sector during the last financial crisis precisely because their managers' focus was on serving their credit unions' members with fairly priced products through community banking, rather than investing in risky and complex financial products to chase yields (as many banks did). Credit unions' limited rulebooks also prevent the type of regulatory arbitrage—such as banks investing in the lowest quality assets available in each weighting class in order to maximize their return on capital—that Basel I, Basel II, and Basel III have sought to address in increasingly complex ways.

For these reasons the European Union (EU) and many other jurisdictions do not apply Basel III to credit unions and some other types of smaller, less complex financial institutions.[12] Simplicity in an institution's investments and business activities, as is the case for most credit unions, is consistent with less complex regulatory models ("lighter regimes") that are proportional to an institution's actual risks and complexity.

Credit union rulebooks scaled to the credit unions' actual complexity are also a method for avoiding distorting competition in the financial sector, not a source of distortion. In contrast, the "level playing field," where all depository institutions large or small are subject to a single rulebook designed to regulate the largest and most complex internationally active banks, is itself a distortion of competition in the financial sector that favors the largest institutions.

Under the "level playing field" approach to regulation, financial sector competition becomes a game played by titans against Lilliputians with the titans having a distinct advantage because their larger economies of scale make them better able to bear increased compliance costs than their smaller competitors. "One-size-fits-all" regulation imposes artificial economies to scale for financial services and creates state barriers to entry, reducing competition and therefore the surplus available to consumers. These factors combine to give the largest banks a distinct competitive advantage over smaller financial institutions, even though this harms consumers and even though these costly rules are usually designed to reign in excessively risky financial activities mainly practiced by the same large banks.

We urge the Committee to revise Paragraph 12 to clarify that the "proportionality concept" articulated in the *Core Principles of Banking Supervision* remains in effect in the weak bank context.

We also urge the Committee to remove the references to "distorting competition" in the context of from Paragraph 12 because "one-size-fits-all"/"level playing field" regulation itself distorts competition in favor of the largest players, and because competition matters should be outside the scope of this weak banks guidance.

<u>3. Supervisory Discretion, Rule-of-Law Principles, and Stress Testing</u>

Many aspects of the proposal suggest giving supervisors broad discretion to require weak institutions to take remedial measures on a case-by-case basis, including the proposed guidance on stress testing in Paragraphs 49 through 59. While we recognize that supervisors must have

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[12] *See*, *e.g.*, *Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC*, Articles 2(5) ("Scope") (2013), *available at* http://ec.europa.eu/internal_market/bank/regcapital/legislation-in-force/index_en.htm.

discretion in this area—every weak bank is weak in its own way, and early intervention is the best means of preventing serious problems from becoming more serious—we urge the Committee also to be sensitive to the importance of rule-of-law principles in the depository institution supervisory context, and not to encourage supervisors to use broad, ambiguous grants of legal authority to override more specific legal provisions addressing the same subject matter.

Credit unions frequently complain that examiners seek to micro-manage their business model by citing broad legal powers—such as the power to prevent unsafe and unsound practices—that the examiners claim override more specific statutory or regulatory provisions addressing the same issue or activity. In these situations, credit unions have few avenues of appeal except to higher ranking supervisory agency staff because suing the regulator would likely alienate an agency that would still have supervisory authority over the institution, and could sanction the institution for other reasons.

The approach of citing general, ambiguous grants of legal authority to override more specific legal provisions is inconsistent with statutory interpretation principles that have existed since Roman times, such as *generalia specialibus non derogant* ("the general does not detract from the specific"), *lex specialis derogat legi generali* ("specific laws detract from general laws"), *expressio unius est exclusio alterius* ("the express mention of one thing excludes all others"), and the rule against surplusage.

In addition, from a Public Choice Theory standpoint, a supervisor operating for the public good is generally biased in favor of regulatory intervention when faced with the decision of whether or not to intervene. This is because, out of all possible future alternatives, the supervisory agency would likely face the strongest criticism in the alternative of: (a) the agency failing to intervene at an early date; and (b) the institution later failing (whether or not earlier supervisory intervention would have prevented the failure).

Similarly, there is little incentive for supervisors to design a stress test that would less serious than a worst case scenario (which is, of course, the point of stress testing). Such stress tests are obviously important for Global Systemically Important Banks (G-SIBs) because they are highly complex, difficult to understand from a supervisory standpoint, and are, by definition, too big to fail. Without stress testing, how and why a G-SIB could fail may not be knowable in advance.

Stress testing of smaller, less complex institutions than G-SIBs, however, is very expensive and risks creating overly pessimistic scenarios, typically based on the darkest days of the last financial crisis, which are not likely to happen and would take limited resources away from other compliance areas that are more likely to cause problems.

Further, based on overly pessimistic stress tests, supervisors may require smaller institutions to take ad hoc actions intended to remediate unlikely problems based on a worst case scenario (or a worse-than-worst-case scenario) and, in the process, limit the smaller institution's ability to earn sufficient yield to remain a sustainable enterprise.

We urge the Committee to be sensitive in this guidance to the importance of rule-of-law principles and not to encourage supervisors to use broad, ambiguous grants of legal authority to override more specific legal provisions addressing the same subject matter.

4. Definition of "Weak Bank"

The proposed definition of "weak bank" in Paragraph 9 as "one whose liquidity or solvency is impaired or will soon be impaired unless there is a major improvement in its financial resources, risk profile, business model, risk management systems and controls, and/or quality of governance and management" is both circular and a truism.

We believe that the more detailed guidance in Paragraph 10 regarding what constitute more fundamental weaknesses would be clearer and of better utility to supervisors than the proposed definition in Paragraph 9.

5. Tax Rules and Capital Injections in Weak Institution

We support not taxing stabilization support in the weak institution context, such as with respect to direct capital injections made by private- or public-sector stabilization funds to credit unions in the form of grants. We therefore support the statement in Paragraph 19 that "[n]eutral tax rules that allow asset transfers and other transactions in a bank resolution without distorting or offsetting the corrective nature of these measures" to the extent that this applies to credit union stabilization assistance.

Many credit union federations operate stabilization funds which are capitalized completely with private-sector funding from credit unions. Federations use these private-sector stabilization funds to address weaknesses in the credit union sector without public support. Public-sector credit union stabilization funds are also usually capitalized via assessments on credit unions, not with money from taxpayers. Capital assistance from these stabilization funds is often in the form of grants.

Some jurisdictions, however, have sought to impose corporate income tax on these stabilizations funds' capital injection grants to credit unions. Taxing stabilization grants made by private-sector or public-sector stabilization funds to credit unions distorts and offsets the corrective nature of these grants because the income tax reduces the grant's effectiveness by the amount of the tax. For example a grant of EUR 100,000 to the credit union that is subject to a 30% income tax becomes only EUR 70,000 in injected capital. The reduction in the amount of capital injected to pay tax also likely increases the liability of the applicable government savings guarantee scheme in an amount that exceeds the amount of the tax collected.

We therefore urge the Committee to clarify the third bulletpoint in Paragraph 19 to read as follows:

> "Neutral tax rules that allow asset transfers and other transactions in a bank resolution without distorting or offsetting the corrective nature of such measures, including exempting capital injections from taxation."

Conclusion

World Council appreciates the opportunity to comment on the Basel Committee's proposed *Supervisory guidelines for identifying and dealing with weak banks* guidance.

While we support most aspects of this proposed guidance, we urge the Committee to consider seriously our suggestions regarding clarifications and other improvements to the draft guidance, especially with respect to how this guidance will be applied by supervisors of credit unions, other mutual depository institutions, and smaller, less-complex banking institutions in general.

If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and Chief Counsel
World Council of Credit Unions