Economics of Credit Union Regulation

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Economics of Regulation

- Rationale for regulation
- Types of regulation
- Principles of good regulation
- UK Credit Unions (Structure and Regulatory Framework)
- Irish Credit Unions (Structure and Regulatory Framework)
- Some Final Questions?

Rationale for regulation

- Financial sector regulated more severely than other sectors because in finance market failures can have devastating consequences.
  - This financial crisis was triggered by problems in the U.S. subprime mortgage market, but led to the biggest drop in global trade since the 1930s.
- Two drivers of market failures in finance which require regulation:
  - asymmetrical information and social externalities.

Rationale for regulation

- Asymmetric information (rationale)
- Buyers purchase a small number of financial products – a mortgage, life-insurance, a pension – each may have life changing impact. Buyers only discover if it is a bad product after the transaction has occurred.
- An important function of financial regulation is to balance the interests of unsophisticated consumers of financial products and their sophisticated sellers.
  - The consumer protection focus of regulation is carried out through rules on how products are sold, who sells them and, sometimes, what can be sold.

Rationale for regulation

- Social externalities (rationale)
  - A social externality occurs when the overall consequence of an activity is not captured by the private interests of those involved in the activity.
- Financial institutions lend to each other, thus the failure of one can undermine others. The costs of a failure to the economy may be far in excess of the costs to the shareholders of the failed bank or members of a failed credit union.
  - This is a social externality.
- The regulatory response to this social externality is to provide insurance for savers and to require institutions to require them to hold greater capital than they would otherwise hold.
  - This response has not addressed interconnectedness directly; instead, it has sought to secure each individual element in the system.

Types of regulation

- Structural (or systemic) regulation
  - This regulation is concerned mainly with the safety and soundness of the financial system.
    - deposit insurance
    - lender of last resort

Types of regulation

- Prudential regulation
  - This regulation is concerned mainly with consumer protection.
  - It relates to monitoring and supervision of financial institutions
  - Various regulatory instruments, such as capital, leverage and liquidity requirements

Types of regulation

- Conduct of business regulation
  - This regulation focuses on how financial institutions conduct their business
  - It relates to information disclosure, fair business practices, competence, etc.
  - It focuses on establishing rules to minimise the risk that:
    - Consumers receive bad advice
    - Frauds and misrepresentation
    - Employees and financial advisor act incompetently

Principles of good regulation

- There are eight principles of good regulation

i. Efficiency & economy
ii. Sustainable growth
iii. Consumer responsibility
iv. Senior management responsibility
v. Recognising the differences in the businesses carried on by different regulated persons
vi. Openness and disclosure
vii. Transparency
viii. Proportionality

Principles of good regulation
Innovation?

- The desirability of facilitating innovation in connection with regulated activities:
- This involves, for example allowing scope , where appropriate, for different means of compliance so as not to unduly restrict market participants from launching new financial products and services.

UK Credit Unions (2015)

	UK	England	Scotland	Wales	N. Ireland
Credit unions	500	222	101	19	158
Adult members	1,667,114	736,910	330,764	65,210	534,230
Assets (000’s)	2,847,807	786,322	540,292	41,386	1,479,806
Loans (000’s)	1,297,640	456,267	290,162	22,579	528,631
Income (000’s)	188,407	77,111	32,091	5,145	74,059
Expenditure (000’s)	137,243	61,249	24,521	4,692	46,780
Capital (000’s)	326,986	86,360	54,822	4,956	180,845

UK Credit Unions (2015)

	UK	England	Scotland	Wales	N. Ireland
Members/Credit unions	3,334	3,319	3,274	3,432	3,381
Assets/Credit unions	5,695,600	3,542,000	5,349,400	3,432,100	9,365,900
Loans/Assets (%)	45.6%	58.0%	53.7%	54.6%	35.7%
Capital/Assets (%)	11.44%	10.98%	10.15%	11.98%	12.22%
Expenditure/Income (%)	72.84%	79.43%	76.41%	91.12%	63.17%

UK Credit Unions

- Credit unions have been subject to many regulatory changes in recent years - relaxation of the common bond, extending loan periods, increasing the interest charged on loans increased 1% to 2% in 2005 to 3% in 2012.
- As of 2016 - credit unions carrying out additional activities in investments, lending, mortgages and transactional accounts were required to satisfy the following criteria
  - Credit unions should establish, implement and maintain an up-to-date financial risk management policy statement approved by the governing body
  - credit unions must ensure that its governing body monitors and assess the risk associated with the carrying on of such activities on at least a monthly basis.
  - Indicative ratio which credit unions engaged in additional activities were suggested

Additional Activities

Ratio	Investment	lending	Mortgages	Transactional accounts	Ratio (%)
Capital/Assets	Y	Y	Y		10
Borrowings/Assets	Y	Y	Y	Y	≤ 5
Shares/Assets	Y	Y	Y	Y	$70\ to\ 90$
Bad debt write-offs/Loans		Y	Y	Y	≤ 10
Net assets/shares +juvenile deposits		Y	Y	Y	≥ 105
Bad debt (>3 months arrears)/Loans	Y	Y	Y	Y	≤ 20
Non-earning assets/Assets	Y	Y	Y	Y	≤ 10
Net zero cost funds/Non-earning assets	Y	Y	Y	Y	≤ 200
Loan income>12 months/Total loans		Y	Y	Y	≤ 6
Net loans/Assets			Y	Y	

UK Capital Requirements

- Capital requirements calibrated to asset size and activity mix
- A credit union having fewer than 5,000 members and total assets below £5m, must have a capital-to-total assets ratio of at least 3%;
- Credit union with 5,000 or more members, £5m or more in assets (or both) must have a capital-to-total assets ratio of at least 5%;
- Credit union with 15,000 or more members, and /or above £10m in total assets must have a capital-to-total assets ratio of at least 10% (8% capital + 2% capital buffer). (*** previously 8% risk adjusted capital before 2016 new regulations)
- 10% capital to asset ratio for credit unions engaged in ‘additional activities’ to take the form of a minimum 8% plus a 2% buffer which can be used in periods of stress.

UK Liquidity Requirements

- All credit unions must now hold liquid assets of at least 10% of total relevant liabilities, Bank of England (2016).
- Definition is the same for all credit unions irrespective of activities
- *Historically, Version 1 credit unions could hold liquid assets of 5% so long as the quarterly amount reported was not less than 10% on two consecutive quarters.*
- For the purposes of the calculation only those assets will count as liquid which can be realised for cash at short notice, and within at most eight days.

UK Lending Requirements

- There are different lending requirements on credit that do and don’t undertake any of the additional activities. There are differences in the lending requirements depending on the capital position of the credit union
- For a credit union satisfying the additional activity requirements the outstanding balance of a loan to a member, must not exceed 1.5% of total non deferred shares in excess of that member’s attached shares; and
- In addition a single large exposure must not exceed 25% of the credit union's capital.
- The aggregate of all large exposures must not exceed 500% of the credit union’s capital
- A *credit union* must not enter into a *regulated mortgage* for a term of more than 25 years.
- PRA was proposing to bring in a £500,000 absolute lending cap but didn’t after consultation

Irish Credit Unions (2015)

Asset Range	Number	Assets €m	Average asset size €m
€100m or Greater	37	6,111.9	165.4
€60m to €100m	38	2,975.4	78.3
€40m to €60m	37	1,796.5	48.6
€20m to €40m	75	2,194.8	29.3
Less than €20m	130	1,435.7	11.1
Total	**317**	**14,514.2**	**45.8**

Irish Credit Unions (2015)

Asset Range	Member Loans €m	Share (%)	Deposits and Investments €m	Share (%)
€100m or Greater	1,060.9	25	3,141.1	75
€60m to €100m	706.2	25	2,117.3	75
€40m to €60m	404.1	24	1,257.2	76
€20m to €40m	551.2	27	1,480.9	73
Less than €20m	363.6	28	925.7	72
Total	**3,086.0**	26	**8,922.3**	**74**

Irish Credit Unions (2015)

Asset Range	Cost to Income Ratio (%)	Liquidity Ratio (%)
€100m or Greater	51.2	34.8
€60m to €100m	56.1	35.1
€40m to €60m	62.6	35.7
€20m to €40m	60.0	36.4
Less than €20m	68.0	46.6
Total	**56.9**	**41.9**

Irish Credit Unions

- A review of Irish credit unions in 2012 has resulted in a new Credit Union Act, the establishment of a Restructuring Board to facilitate credit union amalgamations and a range of new regulatory requirements on credit unions.
- The 2012 Review also envisaged emerging a variety of business models of different levels of complexity which would be accommodated within a tiered approach to regulation based on the nature, scale and complexity of a credit union.
- The tiered regulatory approach has not happened.
- The result has been a ‘one-size-fits-all’ framework which arguably has resulted in small credit unions being subject to a much larger regulatory requirement than expected and which has also arguably hampered the development by larger credit unions of more sophisticated business models.

Ireland Capital and Liquidity Requirements

- Credit unions of all sizes are subject to the same liquidity and capital requirements.
- Credit unions are required to maintain a liquidity ratio of at least 20%. The liquidity ratio is defined as the total amount of liquid assets of a credit union expressed as a percentage of its unattached savings.
- Credit unions are required to maintain a regulatory reserve ratio (capital ratio) of at least 10%.

Ireland Lending Requirements

- Concentration limits - personal loans; commercial loans (no more than 50% of RR); community loans (no more than 25% of RR); house loans; loans to other credit unions (no more than 12.5% of RR).
- Large exposure limit to a borrower or connected borrowers also linked to RR (10%)
- Maturity limits >5 years cannot be more than 30% of the gross loan book (but Central Bank can approve up to 40%)
- Maturity limits >10 years cannot be more than 10% of the gross loan book (but Central Bank can approve up to 15%)
- Maturity limits credit union shall not make a loan to a member for a period exceeding 25 years

Over regulation?

- A number of reports (KPMG, 2014) suggest that the relentless introduction of regulation may have taken many EU economies beyond the point where the cost of regulation exceeds the benefit
  - Up to a point regulation promotes economic growth because the negative impact of regulation on economic growth in normal times is more than offset by avoiding the severe cost of financial crises. But there is an inflexion point beyond which the negative impact of regulation on economic growth in normal times begins to exceed the benefits of regulation.
- It is suggested that Basel 3 reforms have moved regulation to a ‘tipping point’ where more regulation damages the economy with the net impact of regulation on growth being negative.

Over regulation?

- McKillop and Quinn (2016) find that Irish credit unions have moved from a position of increasing returns to scale, to constant returns to scale and now to decreasing returns to scale.

Sample Period	Global Returns to Scale
2002-2008	1.080
2002-2009	1.061
2002-2010	1.022
2002-2011	1.018
2002-2012	0.981
2002-2013	0.973

Over regulation?

- Credit unions are relatively homogeneous - why is the UK regulatory environment more permissive than in Ireland?
- Is there a link between the severity of the financial crisis and the tightness or otherwise of regulation?
- Is there a link between regulatory confidence and permissiveness?
  - Confidence in the organisations under supervision
  - Confidence in the supervisory abilities of those undertaking regulation and supervision
- Is there a link between fear of reputational damage and permissiveness?
- Is there a link in the manner in which all stakeholders engage with one and other?