World Council

March 16, 2018

Sent via email
Governor Katsunori Mikuniya
Chair of the Executive Council
International Association of Deposit Insurers
c/o Bank for International Settlements
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Switzerland
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Re: Research Paper – *Deposit Insurance Fund Target Ratios* (Jan. 2018)

Dear Governor Mikuniya:

World Council of Credit Unions (World Council) appreciates the opportunity to comment to the International Association of Deposit Insurers on the Association's draft research paper *Deposit Insurance Fund Target Ratios*.[1] Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 68,000 credit unions in 109 countries with USD 1.8 trillion in total assets serving 235 million physical person members.[2]

Our comments include research regarding credit union savings guarantee schemes the inclusion of which in the Association's final research paper would provide a fuller picture of deposit insurer practices globally, especially in G20 countries:

(1) the National Credit Union Share Insurance Fund (NCUSIF) administered by the National Credit Union Administration (NCUA) of the United States of America, which guarantees savings held by more than 5,600 federally insured credit unions;

(2) the United Kingdom's Financial Services Compensation Scheme (FSCS) which guarantees the savings held by approximately 450 credit unions in Great Britain and Northern Ireland as well as the deposits of UK banks and building societies; and

(3) Deposit guarantee corporations insuring savings held by credit unions in the Canadian Provinces of Manitoba, New Brunswick, Nova Scotia, Ontario, Prince Edward

[1] International Association of Deposit Insurers, *Deposit Insurance Fund Target Ratios* (Jan. 2018), *available at* http://www.iadi.org/en/assets/File/Public_Consultation/Research_Paper_DIFTR_for_Public_Consultation.pdf

[2] World Council of Credit Unions, *2016 Statistical Report* (2017), *available at* https://www.woccu.org/impact/global_reach/statreport.

Island, and Saskatchewan. These funds insure the deposits of 216 credit unions and *caisses populaires*.

The United States' NCUSIF, the United Kingdom's FSCS and Canadian provincial deposit insurance funds guarantee significant amounts of savings and have proved resilient during stress periods even though they can be structured differently from many of the deposit insurance funds that responded to the Association's survey.

The NCUSIF, for example, is structured using a cooperative model that includes credit unions making at-risk capitalization deposits into the NCUSIF that must be immediately replenished if impaired. As a result, the NCUSIF has been more resilient under stress than the Federal Deposit Insurance Corporation's Deposit Insurance Fund and its predecessor funds. The NCUSIF insures more than USD 1.1 trillion in savings[3] out of the approximately USD 1.4 trillion in total credit union savings worldwide,[4] or more than 78 percent of total credit union savings globally.

The United Kingdom's FSCS operates without a prefunding mechanism and guarantees approximately GBP 2.6 billion (USD 3.6 billion) in credit union savings[5] as well as the UK-based retail deposit accounts held by banks and building societies.

Canadian provincial credit union deposit insurance funds have a relatively wide variety of fund target ratios that range from as low as 95 basis points relative to total insured deposits to as much as 200 basis points relative to the total assets of insured institutions. Credit unions and *caisses populaires* in Manitoba, New Brunswick, Nova Scotia, Ontario, Prince Edward Island, and Saskatchewan have approximately CAD 99 billion (USD 76 billion) in total savings.[6]

In the UK and USA, savings held by credit unions are often confusingly called "shares" or "share accounts"[7] as a legal matter even though these account products are withdrawable, are accounted for as deposit liabilities, and are insured up to maximum

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[3] National Credit Union Administration (NCUA), *Industry at a Glance* (Sep. 2017), *available at* https://www.ncua.gov/analysis/Pages/industry/industry-at-a-glance-september-2017.pdf.
[4] World Council of Credit Unions, *2016 Statistical Report* (2017).
[5] "Credit union quarterly statistics - 2017 Q2;" https://www.bankofengland.co.uk/statistics/credit-union/2017/2017-q2 (last visited Mar. 14, 2018).
[6] Canadian Credit Union Association, *National Sector Results: 3rd Quarter 2017*, *available at* https://www.ccua.com/~/media/CCUA/About/facts_and_figures/documents/Quarterly%20National%20System%20Results/3Q17SystemResults.pdf.
[7] *See, e.g.*, 12 U.S.C. 1757(6) ("A [US] Federal credit union . . . shall have the power . . . to accept from its members . . . payments . . . on (A) shares which may be issued at varying dividend rates; (B) share certificates which may be issued at varying dividend rates and maturities; and (C) share draft accounts authorized under section 1785(f) of this title; subject to such terms, rates, and conditions as may be established by the board of directors . . ."), *available at* https://www.law.cornell.edu/uscode/text/12/1757; Credit Unions Act 1979, § 8 ("Subject to sections 9 and 10 below, a [UK] credit union shall not accept a deposit from any person except by way of subscription for its shares.") (emphasis added), *available at* https://www.legislation.gov.uk/ukpga/1979/34/contents.

amounts of USD 250,000 per credit union member per account for the NCUSIF or GBP 85,000 per credit union member for the FSCS.[8]

Although some types of credit union equity shares do qualify as regulatory capital, such as US corporate credit union "Perpetual Contributed Capital (PCC)" shares[9], UK credit union "deferred shares"[10] or Canadian credit union "Common Equity Tier 1" shares,[11] only withdrawable, deposit-like share accounts are guaranteed. Such withdrawable shares are functionally deposits for most intents and purposes.[12]

1. National Credit Union Share Insurance Fund (NCUSIF) of the USA

The National Credit Union Administration (NCUA) of the USA administers the National Credit Union Share Insurance Fund (NCUSIF), which is an instrumentality of the US federal government that is backed by the full faith and credit of the United States. The NCUSIF is *ex ante* funded through a combination of at-risk capitalization deposits and additional equity resulting from levies. The NCUA is also the resolution authority for federally insured credit unions.[13] We urge the Association to include the NCUSIF's operating structure and fund target levels in the final version of this research paper.

This funding combination of a capitalization deposit plus additional equity resulting from levies has made the NCUSIF resilient and stable even during significant financial crises in the United States—such as the Savings and Loan Crisis of the late 1980s and early 1990s and the Global Financial Crisis of the late 2000s and early 2010s—when other deposit insurance funds in the United States had negative equity.

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[8] *See* "Share Insurance Fund Overview;" https://www.ncua.gov/services/pages/share-insurance.aspx (last visited Mar. 14, 2018); "Credit Unions;" https://www.fscs.org.uk/what-we-cover/products/credit-unions/ (last visited Mar. 14, 2018).

[9] 12 C.F.R. § 704.3(c) ("Requirements for perpetual contributed capital (PCC)"), *available at* https://www.law.cornell.edu/cfr/text/12/704.3.

[10] Credit Unions Act 1979, § 7(6) ("If deferred shares are subscribed for in full, the credit union shall transfer a sum equal to the amount paid on those shares to its reserves."), *available at* https://www.legislation.gov.uk/ukpga/1979/34/section/7.

[11] *See, e.g.*, Office of the Superintendent of Financial Institutions, Capital Adequacy Requirement (CAR) Guideline § 2.1.1.1(5) (establishing the regulatory capital requirements for Common Equity Tier 1 capital shares issued by federal credit unions; provincial credit union rulebooks typically have similar provisions), *available at* http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR17_chpt2.aspx#ToC2111Commonsharesissuedbytheinstitutiondirectly.

[12] *See, e.g.*, *Am. Inst. of Certified Pub. Accountants v. Credit Union Nat'l Ass'n*, 832 F.2d 104, 105 (7th Cir. 1987) ("Accountants report deposits in commercial banks, mutual banks, and savings associations as 'liabilities'. Credit unions issue 'shares' to their members, and the shares (on which 'dividends' are paid) represent sums on deposit. The AICPA decided that deposits in credit unions likewise should be called liabilities, no matter how denominated between the credit union and the member-investor.").

[13] *See* 12 U.S.C. §§ 1786-1787 (authorizing the NCUA Board to appoint the agency as the Conservator or Liquidating Agent of a troubled federally insured credit union), *available at* https://www.law.cornell.edu/uscode/text/12/chapter-14/subchapter-II.

The NCUSIF has a target ratio range of 1.2% to 1.5% relative to total insured savings, with the NCUA Board setting the Fund's target ratio within that range.[14] The NCUSIF is funded through: (a) federally insured credit unions making an at-risk capitalization deposits equal to 1% of the institutions' insured savings into the Fund; with (b) the additional 0.2% to 0.5% of Fund assets resulting from levies on federally insured credit unions.[15] The NCUSIF's current level of capitalization is 1.46% relative to insured savings.[16]

In addition to the 1% capitalization deposits and additional equity resulting from levies, the NCUSIF also operates an allowance for expected insurance losses that has been written off on an accounting basis. This allowance is not included in the numerator of the NCUSIF's ratio relative to insured savings even though these expected insurance losses have not yet been incurred as an economic matter.

The NCUSIF's allowance for expected insurance losses is reserved for based on the: (i) total assets of federally insured credit unions that have CAMEL ratings of 3, 4, or 5 that are (ii) multiplied by the NCUSIF's recent historical losses on a per-asset basis for federally insured credit unions rated CAMEL 3, 4, or 5, respectively.

When the NCUSIF experiences losses that require levies or replenishment of credit unions' 1% capitalization deposits, the Fund's losses are usually for expected insurance loss expenses rather than for economically incurred insurance losses per se.

Federally insured credit unions' 1% capitalization deposits are treated as an asset on the depositor's balance sheet and must be replenished within one accounting quarter if impaired by losses to the Fund.[17]

The Fund also must be recapitalized up to at least a 1.2% ratio relative to total insured savings (using levies for the 0.2% above the 1% capitalization deposits) within one year of the Fund's ratio being impaired.[18] If the NCUSIF's ratio exceeds 1.5%, however, the Fund must issue a dividend to its member credit unions.[19]

Impairment of credit unions' 1% capitalization deposits held by the NCUSIF and the Fund's additional equity occurred most recently in 2009 with the conservatorship of two central credit unions (i.e. wholesale credit unions that serve other credit unions).[20] The

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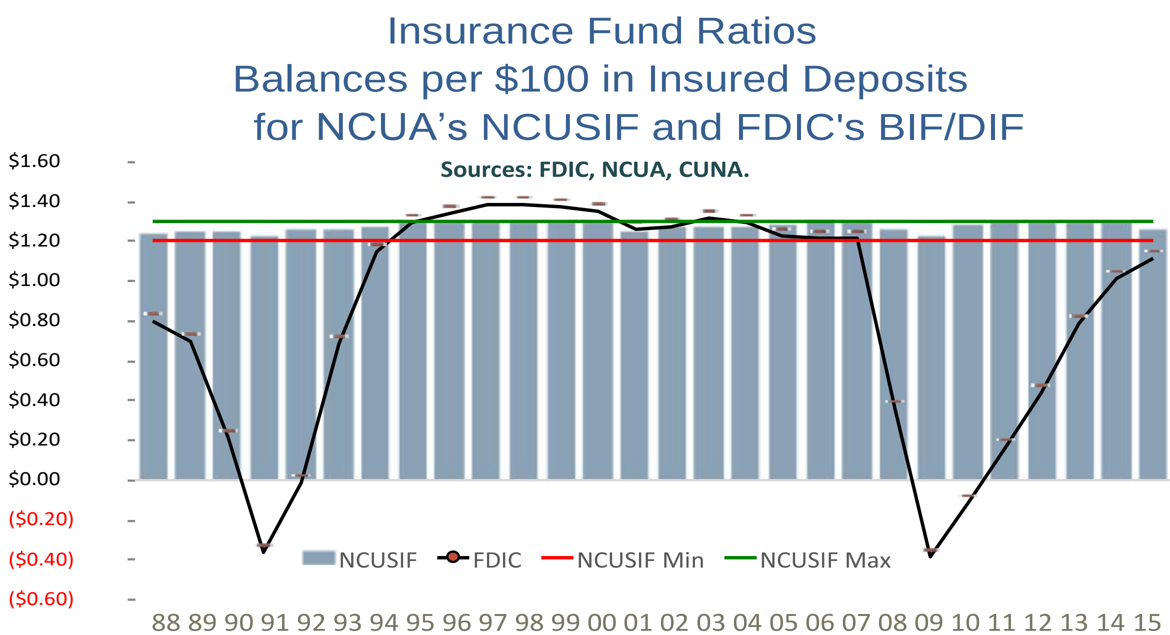
[14] 12 U.S.C. § 1782(c), *available at* https://www.law.cornell.edu/uscode/text/12/1782.
[15] *See id.*
[16] NCUA, *National Credit Union Share Insurance Fund: Preliminary and Unaudited Financial Highlights* (Jan. 2018), *available at* https://www.ncua.gov/services/Pages/share-insurance/Documents/share-insurance-financial-highlights-2018-jan.pdf.
[17] 12 U.S.C. § 1782.
[18] *Id.*
[19] *Id.*
[20] *See, e.g.*, NCUA, Corporate Stabilization Program – Conservatorship of U.S. Central FCU and Western Corporate FCU, Letter to Credit Unions No. 09-06 ("The individual expense for the stabilization

Fund, however, was able to return to above its 1.2% ratio floor that same year, after these institutions' troubled investments in mortgage-backed securities had been sequestered using a good bank-bad bank structure funded with a temporary stabilization mechanism designed to hold these investments to maturity in order to capture their cash flows and spread out resolution costs,[21] as is illustrated by the below chart.

The chart below includes the NCUSIF's ratio relative to insured deposits from 1988 to the end of 2015, based on data from the NCUA and the Credit Union National Association (CUNA) of the USA.

The chart also includes the fund capitalization ratios of the Federal Deposit Insurance Corporation's (FDIC) Bank Insurance Fund (BIF)/Deposit Insurance Fund (DIF) over the same period. (The DIF is the successor deposit insurance fund to the BIF that resulted from the combination of the BIF with the FDIC's Savings Association Insurance Fund (SAIF) in 2006.)



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action should be calculated based on insured shares of $100,000 in two parts: (1) Multiply insured shares as of December 31, 2008, by 0.30% to arrive at the projected premium expense. (2) Multiply insured shares as of December 31, 2008, by 1% to arrive at the NCUSIF Deposit. Multiply the NCUSIF Deposit by 69% percent to arrive at the revised impairment expense. Previously, this was estimated at 51% of the deposit."), *available at* https://www.ncua.gov/regulation-supervision/Pages/policy-compliance/communications/letters-to-credit-unions/2009/06.aspx.

[21] *See, e.g.*, NCUA, Board Action Memorandum, "Closing the Temporary Corporate Credit Union Stabilization Fund and Setting the Normal Operating Level" (Sep. 28, 2017), *available at* https://www.ncua.gov/About/Documents/Agenda%20Items/AG20170928Item4a.pdf.

As the chart illustrates, the NCUSIF did not fall below its minimum ratio of 1.2% for more than a few months even during periods when the FDIC's BIF or its successor, the DIF, had negative equity in the early 1990s and the early 2010s.

The NCUSIF has consistently maintained readily available funds to pay for insurance losses in large part because the 1% capitalization deposit approach provides a system of *ex ante* funding that includes quick replenishment of losses without creating excessive procyclical costs on regulated institutions. While the NCUSIF's 1% capitalization deposit approach can be viewed as heterodox relative to many of the examples included in the Association's draft research paper, the NCUSIF's proven track record of solvency with high levels of capitalization relative to its insured deposits is palpable.

World Council believes that the NCUSIF's cooperative structure using at-risk capitalization deposits that must be quickly replenished in the event of losses to the Fund has been the key factor in maintaining the NCUSIF's high level of capitalization relative to insured savings even during major financial crises. We urge the Association to include the NCUSIF's operating structure and fund target levels in the final version this research paper.

2. <u>Financial Services Compensation Scheme (FSCS) of the UK</u>

The United Kingdom's Financial Services Compensation Scheme (FSCS) guarantees savings held by credit unions in Great Britain and Northern Ireland. While we recognize that the FSCS is not *ex ante* funded, and therefore does not have a target deposit insurance fund ratio per se, we urge the Association to include the FSCS as part of its research because it is the savings guarantee scheme for a major economy that has paid out billions of pounds without creating excessive procyclicality even though it is not pre-funded.

Including the FSCS in this research paper would create a fuller picture of the range of practices used by deposit insurers globally. FSCS was established in 2001 pursuant to Part XV of the Financial Services and Markets Act 2000[22] as an entity "independent of the government and the financial industry"[23] and has consistently maintained readily available funds to pay for insurance losses even though it is not pre-funded. The FSCS can make levies for: (a) management expenses; and (b) compensation costs, such as for deposit insurance loss expenses. The UK's bank levy also creates funding which can be used by the UK Government to finance deposit compensation in the event of a bank failure on an *ex post* basis.

[22] Financial Services and Markets Act 2000, §§ 212-224, *available at* http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf.
[23] "About FSCS;" https://www.fscs.org.uk/industry/about-fscs/ (last visited Mar. 14, 2018).

The FSCS assesses levies on credit unions and other UK insured depository institutions pursuant to the Bank of England-Prudential Regulation Authority (PRA) Rulebook[24] and policy statements. The PRA is the primary resolution authority for credit unions and other depository institutions in the UK, but the UK Financial Conduct Authority (FCA) is responsible for maintaining the credit union's registration.[25]

The PRA Rulebook and PRA policy statements, as well as the Financial Conduct Authority's Rulebook and policy statements, regulate the FSCS's annual levies in order to reduce pro-cyclical effects (with interim liquidity, if necessary, provided from the FSCS's commercial borrowing facility operated by the FSCS and HM Treasury[26]). FSCS pays compensation to most depositors within seven days with nearly all other depositors' claims paid within 20 days.[27]

In 2015/2016, for example, the FSCS received GBP 750 million (roughly USD 1 billion) "in relation to the costs of the legacy banking failures."[28] For 2017/2018, the PRA's Policy Statement PS6/17 establishes a maximum FSCS levy for: (a) "FSCS management expenses of [GBP] 69.2 million [approximately USD 96 million] to cover the FSCS's ongoing operating costs . . ."; and (b) "an unlevied contingency reserve of [GBP] 5.3 million [USD 7.4 million] which allows the FSCS to levy additional funds at short notice in the event of a significant unexpected event, without the need for further consultation by the PRA and the FCA."[29]

While the FSCS, as a non-pre-funded savings guarantee scheme, is heterodox compared to many of the funds included in the Association's draft paper, the FSCS has succeeded as a savings guarantee system in terms of consistently maintaining readily available funds to pay for insurance losses without imposing excessively procyclical costs on regulated institutions.

We urge the Association to include the UK's FSCS in the final version of the Association's research paper to provide a fuller picture of the range of practices currently used by deposit insurance systems around the world.

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[24] PRA, *Credit Unions Rulebook* (2017), *available at* http://www.prarulebook.co.uk/rulebook/Content/Part/320139.
[25] *See* Credit Unions Act 1979, § 20 ("Cancellation or suspension of registration and petition for winding up"), *available at* https://www.legislation.gov.uk/ukpga/1979/34/section/20.
[26] *See, e.g.*, PRA, "Financial Services Compensation Scheme – Management Expenses Levy Limit 2017/18," Policy Statement PS6/17, at 7 (Mar. 2017), *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2017/ps617.pdf?la=en&hash=E605A85F2612C9160886C12347F119DEF4F3D794.
[27] FSCS, *FSCS Annual Report and Accounts 2015/16* (2016), at 28, *available at* https://www.fscs.org.uk/industry/publications/annual-reports/annual-reports-archive/.
[28] *Id.* at 35.
[29] PRA, "Financial Services Compensation Scheme – Management Expenses Levy Limit 2017/18," Policy Statement PS6/17, at 5.

3. Canadian Provincial Deposit Insurance Funds

Credit Union Deposit Guarantee Corporations (CUDGCs) established by Canadian provinces have played an important role in the functioning of the Canadian credit union system for over sixty years. As financial cooperatives that are owned by their customers, credit unions emphasize controlling risks and protecting their member-depositors against losses. Credit unions in Canada pro-actively created their provincial deposit insurers in the 1950s before legislation required mandatory deposit insurance for financial intermediaries.

As the table below shows, CUDGCs' fund targets are at least 100 basis points in each province for which we have data, with many setting higher targets. (We have included British Columbia and Alberta for illustrative purposes notwithstanding that the Association's research paper already includes information on these provinces' credit union deposit guarantee funds.) Moreover, most deposit insurers have exceeded their target by a significant margin. Only British Columbia and Ontario were somewhat below their targets in 2017. The Canadian credit union system also differs from other financial intermediaries in that credit unions are required to maintain an amount equal to 6% to 10% of their liabilities in liquid instruments held by a central credit union. This provides additional protection that is not reflected by the size of the deposit insurance fund.

Province	Deposit Insurer	Guaranteed fund target	Actual size of fund	Year
British Columbia	Credit Union Deposit Insurance Corporation of British Columbia	1.05% to 1.35% of credit union system deposits and non-equity shares. Current target point is at 1.1%	0.995%, CAD 58.2 Million	2017
Alberta	Credit Union Deposit Guarantee Corporation of Alberta	1.4% to 1.6% of deposits and borrowings, target: 1.5%	1.56% (CAD 329 million)	2016
Saskatchewan	Credit Union Deposit Guarantee Corporation of Saskatchewan	1.4% to 1.6% of total deposits	1.62% (CAD 5.8 million)	2016
Manitoba	Deposit Guarantee Corporation of Manitoba	95 - 115 basis points of insurable deposits	109 bps of insurable deposits (CAD 286.3 million)	2016
Ontario	Deposit Insurance Corporation of Ontario	100 basis points	82bp of deposits, $248.4 million	2017
Prince Edward Island	Prince Edwards Island Credit Union Deposit Insurance Corporation	2% of total assets	1.69% (CAD 1.4 million)	2016
Nova Scotia	Nova Scotia Credit Union Deposit Insurance Corporation	1% of total assets	1.15% (CAD 27,8 million)	2016
New Brunswick	New Brunswick Credit Union Deposit Insurance Corporation	Minimum 1.5% of total assets	2.22% (CAD 7.1 million)	2016

These funds' structures have proven to be very robust. To the best of our knowledge, no Canadian credit union member has ever lost a dollar of his or her deposits.

Given this track record, we believe that the Canadian example strongly supports insurance target ratios of no more than 100 basis points. A 100 basis point target ratio is also consistent with the Canadian Deposit Insurance Corporation's target ratio which, since March 31, 2017, is set at a minimum target of 100 basis points and is currently at 52 basis points of insured deposits.

A higher fund target ratio would require levies that could erode the ability of credit unions to build capital through earnings retention, resulting in generally less well capitalized institutions that would be more susceptible to failure and, by extension, more likely to have depositors that make claims on deposit insurance funds. Lower regulatory capital levels would also make it more difficult for credit unions to provide credit to their local communities, especially vis-à-vis small- and medium-enterprises and physical persons who are underserved by commercial banks.

We urge the Association to include the deposit guarantee corporations of the Canadian Provinces of Manitoba, New Brunswick, Nova Scotia, Ontario, Prince Edward Island, and Saskatchewan, as well as the US's NCUSIF and the UK's FSCS, in the final version of this research paper.

World Council appreciates the opportunity to comment to the International Association of Deposit Insurers on its draft research paper *Deposit Insurance Fund Target Ratios*. 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 General Counsel
World Council of Credit Unions