

# A Call to Action

RE-INVENTING CREDIT UNIONS  
FOR THE 21ST CENTURY

November 2006



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# FOREWORD



It's timely to publish this important credit union paper "A Call to Action" on the future of credit unions in Ireland.

Its purpose is to present the collective vision of progressive credit unions - a vision that addresses the needs of Irish society in the 21st Century - and to describe how credit unions can achieve this. Conveyed within are key recommendations for the actions that credit unions, together with Government, should take in order to make this vision a reality.

It is a vision that will enable credit unions to excel at their mission of service in a modern and prosperous society that Ireland has so quickly become.

Central to this vision is the re-affirmation of the fundamental and ongoing mission of credit unions to give ordinary people a better deal on financial services. It is a mission just as relevant today as it was 50 years ago when credit unions first started.

While credit union philosophy, ideals and mission remain constant and are not up for debate, many realise the way in which credit unions deliver value to their members and achieve their social objectives must change if they are to prosper in the Ireland of today and tomorrow.

Many will welcome this informative, challenging and thought provoking paper. Its publication is intended to initiate a robust and healthy discussion of the changes required to assure the future of credit unions in Ireland.

For this reason it is being circulated to all who are concerned with the future of credit unions as a "call to action" to commence this urgent and long overdue discussion.

A handwritten signature in blue ink, appearing to read 'Bill Hobbs', with a long horizontal flourish underneath.

Bill Hobbs  
CEO CUDA



# EXECUTIVE SUMMARY

This paper is presented by the Credit Union Development Association, as the product of an extensive process of discussion and consultation which engaged the volunteer leadership and professional managers of its member credit unions, some of whom also belong to the Irish League of Credit Unions. Together, the credit unions in CUDA serve over 15% of the two million credit union members in the Republic of Ireland and hold over 15% of the almost €12 billion the credit union movement holds in assets.

The purpose of this paper is to present the collective vision of CUDA's members, for the future of credit unions in Ireland and to convey their recommendations for the actions that credit unions, together with Government, should take in order to make that vision a reality.

The essence of their message is that the philosophy and ideals of the credit union are just as relevant to modern day Ireland as they were fifty years ago when credit unions first started here. But credit unions must raise their standards and modernise their products, their operations and their systems for governance and internal control if they are to achieve their social objectives in the Ireland of today.

For that to happen, there is also a need for Government to modernise credit union legislation and to strengthen its role in protecting the savings of credit union members.

The fundamental and ongoing mission of the credit union is to give ordinary people a better deal on financial services. The vision is to re-establish the credit union as the very best place for people to save and to borrow, and for credit unions to become the primary source of funding for social finance.

As discussed below, the case for change flows from considerations of both credit union philosophy and sound public policy, as well as from the new realities of the financial industry both in Ireland and internationally.

This paper concludes by discussing the specific reforms that are necessary to achieve the new vision, as summarised in the following recommendations:

1. Credit unions should focus on their core business and offer a wider range of updated savings and lending products that meet the needs of modern consumers.
2. They should adopt market-based principles of pricing to ensure better rates and terms for consumers.
3. Credit unions should become a primary funding source for a specialised social finance facility to be established by Government.
4. Credit unions need to upgrade their IT, operational systems and internal controls to achieve greater efficiency and safety.

5. The credit union model for democratic governance should be improved to meet modern standards of best practice.
6. The credit union movement needs to accept the desirability and inevitability of rationalisation, with fewer albeit larger credit unions in the future.
7. Credit union legislation should be modernised, with effective supervision by the Financial Regulator completely replacing industry self-regulation.
8. Credit union savers should have the same deposit insurance guarantee as bank customers receive through a Central Bank programme.

This paper is submitted to the rest of the credit union movement and to Government with the goal of contributing to a robust and healthy discussion on the need for change, which will assure the continuing success of the credit union ideal in Ireland.



# INTRODUCTION

## A NEW VISION FOR CREDIT UNIONS

Credit unions have succeeded beyond the grandest dreams of their founders a half century ago. First organised in an era when bank loans were out of reach for most people, credit unions were based on the revolutionary idea of ordinary citizens starting up their own bank and sharing in its profits. In communities throughout the country, credit unions took root and prospered, becoming the most trusted source of financial services. Today, nearly half the population are members, making credit unions the largest and most successful voluntary movement in Ireland, with assets of almost €12 billion.

But despite these successes, credit unions are now at a crossroads. Many inside the movement worry that these unique institutions may be facing decline, with a changing society starting to pass them by. Commercial banks now compete avidly for consumer trade, offering 24/7 convenience and attractive rates on both loans and savings. No longer the cheapest source of credit for many households, credit unions have been steadily losing market share for several years, even among their own members.

Only about half of all members actually use their credit union in any given year, and the percentage who borrow is even lower and dropping.<sup>1</sup> Credit union membership is ageing, as younger people go elsewhere for the convenience and accessibility that many credit unions do not provide. The unpaid volunteers who run nearly all but the largest ones are becoming more and more difficult to recruit.<sup>2</sup> Most troubling are recent reports of rising bad debt at some credit unions, prompting the need for assurances from the Financial Regulator that member savings are safe.<sup>3</sup>

Too many credit unions are increasingly finding themselves out of step with overriding public policy objectives which Ireland, as a modern and progressive country, properly demands from anyone offering financial services to the public. Citizens today expect their Government to insist that financial institutions operate in accordance with the highest standards of accountability, transparency, responsible corporate governance, financial prudence and putting the interests of consumers first.

In the face of this, some credit union leaders still cling to models for credit union governance and industry self-regulation that are plainly obsolete in a modern country. As a result, credit union savers lack critical safeguards in the form of regulatory supervision and State-approved deposit insurance that law and public policy require for bank customers.

The member credit unions of CUDA share the conviction that these trends are alarming and cannot be ignored any longer. There is an urgent need for credit unions to modernise their operations – and for Government to modernise how credit unions are regulated and supervised.

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<sup>1</sup> Mintel International Group Ltd., Credit Unions, Irish Series, June 2005, p. 5.

<sup>2</sup> Ibid. p. 11.

<sup>3</sup> At its 2006 Consultative General Meeting, the Irish League of Credit Unions reported that over 70% of its member credit unions had loan delinquency in excess of the 5% safe limit set by the League's standards. The well-publicised financial problems earlier this year at Monaghan Credit Union resulted from excessive loan losses. A run on the credit union was averted by public assurances from the Registrar of Credit Unions that the credit union was solvent and had the means to meet member withdrawals. "Reassurance on credit union" The Irish Times, 29 April 2006.

CUDA member credit unions are both large and small, and they serve both community and employment based memberships. Some of them are also members of the Irish League of Credit Unions. Together, they have about 300,000 members and assets of about €1.8 billion, representing over 15% of both the total membership and assets of all credit unions in Ireland.

The purpose of this paper is to present their collective vision for credit unions – a vision that addresses the needs of Irish society in the 21st Century – and to describe how credit unions can achieve it. Their vision is that credit unions re-establish themselves as the very best place for people to save and to borrow, offering the most advantageous rates and terms available. And that credit unions also become the primary source of funding for social finance that improves the quality of life in this country.

The core values of the credit union are timeless, but the ways in which credit unions put those values into action must be more efficient, convenient and professional. Credit union products and services must be more price competitive. The absolute safety of members' savings must be unquestionable. Credit unions must be operated and self-governed in accordance with the highest standards of best practice. It is imperative for credit unions to modernise and renew their vision if they are to remain relevant and effective in serving the needs of modern consumers.

The new vision also requires action by Government to modernise credit union legislation and provide credit unions with greater flexibility in how they deliver consumer financial services. But Government also needs to assure that member savings are safeguarded through more effective supervision by the Financial Regulator and by extending to credit union savers the same Central Bank guarantee that covers consumer deposits at commercial banks and building societies.

These recommendations are interlinked and mutually reinforcing. They are not intended as a menu from which alternatives can be picked or discarded. Rather, they are essential components of a comprehensive vision for the future of credit unions. It is a vision that will enable credit unions to excel at their mission of service in the modern and prosperous society that Ireland has so quickly become.

The remainder of this paper will expand on the reasons why these changes are essential and will discuss in detail the reforms that are being proposed.



# BACKGROUND

## UNDERSTANDING THE NEED FOR CHANGE

### 1. Credit Unions in 21st Century Ireland

Credit unions have been the great success story of volunteer, community action in Ireland. But the social, economic and political environment of today is vastly different from what it was when they reached the pinnacle of their success a few years ago. The far more competitive financial marketplace in which they now operate is throwing up challenges that many credit unions are finding difficult to meet.<sup>4</sup>

Most credit unions still manage to pay market-rate returns on savings and therefore continue to grow. But on average they are doing so at the expense of other measurements of their financial health. As shown in the following table, key indicators of financial performance have deteriorated in recent years.

	2000	2001	2002	2003	2004
CU Assets (in millions)	€5,872	€6,791	€8,045	€9,288	€10,869
CU Loan Market Share	8.9%	8.5%	7.4%	6.8%	5.5%
CU Loan / Assets Ratio	65.4%	62.7%	56.3%	53.6%	49.1%
CU Capital / Assets Ratio	11.5%	11.5%	10.1%	10.0%	9.9%

"CU Loan Market Share" means share of consumer loans by all depository institutions.

Sources: 2001-2005 ILCU Annual Reports; Central Statistics Office, 2005 Statistical Yearbook of Ireland.

Data is for Republic of Ireland only.

These numbers show how the credit union share of the consumer loan market has been steadily dropping during a time when consumer borrowing has been booming.<sup>5</sup> Credit unions are finding it harder to lend out member savings, and their loans outstanding have declined as a percentage of their total assets. The resulting impact on earnings has cut into credit unions' ability to increase retained earnings and the other reserves that make up their capital.<sup>6</sup> That capital stands as the most important line of defence to protect member savings if a credit union encounters financial difficulties. Meanwhile, loan quality has suffered, as some credit unions have been tempted into unduly relaxing their credit standards to make up for lost volume. Not captured in the available statistics but also of concern to many observers is that declining margins are also tempting some credit unions into making riskier investments, which they have neither the expertise nor the systems to handle prudently.

<sup>4</sup> Those changes, and their impact on credit unions, are discussed in greater detail in the section that follows.

<sup>5</sup> The decline in loan market share is more acute than these numbers show, since they only compare credit unions with other depository institutions (e.g. banks, building societies). But finance companies and other non-traditional lenders have been taking an ever larger share of the Irish consumer loan market. If their share were added in, the drop in credit union performance would worsen.

<sup>6</sup> If credit unions had maintained the loan to asset ratio they had in 2000, total net income over the past five years would have been about €200 million higher, *ceteris paribus*.

Overall, credit unions in Ireland remain strong and vibrant. Many progressive credit unions are not experiencing the adverse trends described above and are modernising their products and systems. But while some are doing much better than average, others are doing worse. For the movement as a whole to maintain its success going forward, broad reform and constructive change is essential.

The challenges facing credit unions today were best summed up in a recent speech by Mr. Patrick Neary, Chief Executive of the Financial Regulator:

“Many recognise that credit unions are at a crossroads. In the last number of years credit unions have been very successful and have grown very rapidly. However, as documented in the ILCU Rationalisation Committee Report, the Irish experience is beginning to mirror the challenges previously experienced in more mature jurisdictions. These challenges include:

- ‘Decreasing market share’
- ‘Tightening margins’
- ‘Increasing delinquency’
- ‘Inadequate technology’
- ‘Issues with governance’

“Changes in Irish society, the economy and increased competition have all combined to produce a new business environment where credit unions will have to make hard decisions in order to secure the future of the sector.”<sup>7</sup>

Mr. Neary’s analysis was acutely accurate. By contrast, the standard excuses for these trends, as offered by some in the credit union movement, simply do not hold up on analysis.

For example, credit union delinquency rates are explained away as the consequence of credit unions serving the least well-off members of society. It is true that credit unions do serve, and should be proud of serving many people whom the banks just do not want. But that in no way explains why loan quality has been declining. Ireland is getting richer, not poorer.

With nearly half of the population as members, credit unions for the most part serve people who are solidly middle class and who are prospering along with Irish society in general. The problem is that many credit unions are not making enough loans to the more credit-worthy people who are already their customers.

Instead, because of the inconvenient loan process at many credit unions, too many members go elsewhere to borrow. And while credit union rates are excellent for the small loans that no one else will make, larger borrowers can often get better rates and faster service somewhere else. And many of those larger borrowers

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<sup>7</sup> Address by Mr. Patrick Neary, Chief Executive, Financial Regulator, 2006 World Credit Union Conference (Dublin, 28 July 2006)



## BACKGROUND

with good credit records do go somewhere else. Then, in an attempt to keep loan volumes up, some credit unions are easing up on their credit standards and making poor lending decisions. Many of those also lack the necessary systems to keep on top of loan repayments and manage down their delinquencies.

Certainly, there are changes that need to be made in legislation to give credit unions greater flexibility in making prudent loans. In particular, the limitations on longer maturities contained in Section 35 of the Credit Union Act, 1997 should be relaxed for credit unions that meet appropriate regulatory requirements and have the expertise and systems in place to engage safely in longer-term lending. In that regard, it is good that the Minister for Finance initiated an in depth review of Section 35 in consultation with the Financial Regulator and the credit union movement.<sup>8</sup>

Likewise, the recent Ministerial action liberalising limits on credit union deposits was very much a step in the right direction.<sup>9</sup> As discussed below, using deposits rather than shares as the primary vehicle for member savings will greatly enhance the ability of credit unions to employ modern techniques of asset/liability management.

But it is incorrect to blame the decline in key credit union metrics on action or the lack of action by Government or the Financial Regulator. Instead, the central thesis of this paper is that the challenges now facing credit unions result, to a large extent, from the reluctance of many in the movement to accept a fundamental reality: The business model still employed by many credit unions is largely unchanged from the one that was developed – and worked very well – in an Ireland very different from today.

Credit unions got their start in Ireland at a time when basic financial services were unavailable or unaffordable to the great mass of people. Banks served business and the well-to-do, and ordinary people had little or no access to affordable credit.

Much has changed from those simpler times, when a credit union could be started by the leaders of a small community, by the priest, the school teacher and the publican, and run part-time out of the church hall to serve their neighbours in a civic spirit of volunteerism. In those days, people didn't need complicated products or instant access to their money. They just needed a place where they could save, earn a decent return, and get the small loans no banker was willing to make.

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<sup>8</sup> Section 35 (2) of the Credit Union Act, 1997 provides that loans with maturities greater than five years cannot exceed 20% of a credit union's loan portfolio and that loans longer than ten years cannot exceed 10%

<sup>9</sup> Credit Union Act 1997 (Alteration of Financial Limits) Order 2006. With this change, the amount that a credit union can receive in the form of deposits from a single member has been increased to €100,000 from €26,000. The limit on the total amount of an individual member's shares and deposits was raised to €200,000 from €64,000. A credit union can now hold total deposits from all members equal to 100% of its shares, up from 75% before. A deposit represents a debtor/creditor relationship between the credit union and the member, and credit unions were already free under Section 31 of the Act to pay different rates of interest, at different times, on different classes of deposit accounts. Shares, on the other hand, represent a member's ownership interest in the credit union and receive dividends out of net earnings at the end of the year. Credit Union Act, 1997, Sections 28-30.

By about 20 years ago, the standard operating model for the credit union had become well-established and successful. At the time that the model was perfected, Ireland was a very different place to what it is today:

#### **Ireland 20 Years Ago**

- Rural and agricultural
- Underdeveloped economy
- Net emigration
- Homogenous society
- Respect for institutions
- Savings ethic
- Patient, relaxed lifestyle
- Volunteerism
- Limited access to credit
- Higher yields on investments
- Irish-owned banking system
- Banking is “clubby”
- Self-regulation of banking

#### **Ireland Today**

- Urban and commercial
- Highly developed economy
- Net immigration
- Multicultural society
- Suspicion of institutions
- Borrowing ethic
- Harried and want it now!
- What’s in it for me?
- Many sources of consumer credit
- Lower yields on investments
- Foreign-owned banking system
- Banking is fiercely competitive
- Government regulation of banking

The reality that must be confronted by credit unions is this: Their products, delivery systems, marketing approaches, and methods of management and governance – all the elements of the credit union business model were designed for an Ireland that barely exists any more. It is not that credit unions failed to change in the past 20 years. It is that Ireland has changed so much more, and so quickly, it has almost left them behind.

The Recommendations section of this paper outlines the changes in credit union operations, governance and regulation needed to adapt the movement for success in 21st Century Ireland. That portion of the paper includes a further analysis of why traditional practices still prevalent in the movement are hindering credit unions in today’s very challenging marketplace.

## **2. The Changing Environment for Financial Services in Ireland**

The financial services industry in Ireland has changed dramatically over the past 20 years, paralleling the remarkable transformation of the Irish economy and society in general. No longer is the credit union the only source of financial services for many people, even in smaller communities. Moreover, the recent growth in sub-prime lending has steadily eroded the credit union share of a market segment which they traditionally dominated.

These changes in Irish consumer banking mirror changes that have occurred in developed economies around the world. The market for consumer financial services in Ireland has evolved to look more and more like it does in the U.K., the U.S., and other prosperous and highly developed countries.



# BACKGROUND

This convergence comes about because of global trends that are reshaping the financial services industry throughout the modern world. These are trends that credit unions ignore at their peril:

**Sophistication:** Today's consumers are much smarter in their understanding of financial services. Their needs are more complex and varied. They are accustomed to having multiple choices and options. They demand convenience and speedy delivery. They are more mobile, they compare rates and fees, and they are much less loyal.

**Automation:** More complex financial products require much more sophisticated technology. Routine transactions are automated to keep down costs, and people's lives have become too busy to spend in a teller queue. Increasingly, people want to do their banking by phone, at an ATM or over the Internet. Service 365/24/7 is now the expected norm.

Nevertheless, people do still value the personal touch, and they want a human being to help them with complicated products or when things go wrong. Credit unions have a unique opportunity to outperform the competition if they retain their ethos of "high touch" while becoming much more "high tech".

**Consolidation:** Complexity requires scale economies to spread the costs of more sophisticated technology. Hence, the competition is merging and getting bigger and bigger. There are fewer but much larger financial institutions. Credit unions do not require the scale of an international commercial bank. But they must candidly recognise that many small credit unions simply cannot survive. Rationalisation of the movement is inevitable, as will be further discussed below.

**Internationalisation:** Banks are not just merging and getting much bigger, they have become multinationals. Given present trends, it will not be long before credit unions are the only 100% Irish-owned financial system in Ireland. This trend is actually an opportunity for credit unions.

**Specialisation:** The large scale now required for banking services to be cost-competitive means that smaller players like credit unions must specialise to survive. It is just not possible for credit unions to be all things for their customers and still give consumers the best deal. However, their basic business of consumer savings and lending can achieve optimal scale at the size represented by today's medium-sized and larger credit unions. If they focus on improving their core business, credit unions can regain their pre-eminence as the best place for consumers to save and borrow.

**Regulation:** As banking institutions get larger, the impact of a bank failure on a nation's economy becomes potentially catastrophic. Moreover, bank failures and scandals of recent years in several countries have thoroughly discredited the concept of bank self-regulation. As a result, political leaders and central bankers throughout the world have come to recognise that the supervision and examination of financial institutions is a vital state function that must be handled by Government. This is now the political reality in Ireland, and it resulted in the creation of IFSRA.

The aspiration to self-regulation is a traditional habit of the credit union movement that must be abandoned. Instead, credit unions should help ensure the absolute safety of member savings by supporting robust and effective supervision by the Financial Regulator. Member savings should be further protected by the same guarantee scheme run by the Central Bank for depositors at commercial banks and building societies. These are key points that are discussed in more detail later in this paper.

### 3. How Credit Unions Have Adapted in Other Countries

Successful credit union movements in other English-speaking countries have responded to these global trends by continuously adapting and modernising their operations so as to remain competitive. Driven by the realities of the global financial marketplace, credit unions in the U.S., Canada, Australia and New Zealand have modernised their products, their systems of management and governance, and their processes for prudential regulation and supervision, and they have done so along the general lines described in this paper.

The credit union movement in Great Britain, which was struggling to grow just a few years ago, started to take off in the late 90's once it began adopting the modern credit union business model advocated in this paper. Membership more than doubled to almost 500,000, and British credit unions now operate with legislation and supervision more advanced than in Ireland. Their members' savings are protected up to £31,700 by the same UK government plan that applies to banks.

	Ireland	U.S.	Canada	Australia
Credit Unions	430	9,015	550	157
Members (millions)	1.9	87.0	5.1	3.6
Assets (€ billions)	€10.87	€567.42	€64.46	€20.92
CU share of deposits	4.7%	6.8%	5.5%	2.5%

Ireland data is for the Republic only, as of September 2004. All other data is as of December 2005.

Sources: ILCU, Credit Union National Association, Credit Union Central of Canada, Credit Union Services Corporation (Aust) Ltd.

With their introduction of a current account equivalent later this year, British credit unions will move ahead of their Irish colleagues in providing advanced services to their members. Those payment services were developed as a joint venture with Britain's Co-operative Bank and will be extended to credit unions in Northern Ireland next year.



# BACKGROUND

Similarly, by adopting a modern business model similar to the one described here, the Polish credit union movement, which was founded less than 15 years ago, has already surpassed Irish credit unions in the range and sophistication of the services that it offers. Polish credit unions now serve over 1 million people and operate the most extensive financial network in that country.

Certainly, credit unions in other English-speaking countries have made their own mistakes, and modernisation was sometimes accompanied by turmoil and division. For example, controversy in the 1960's over a government proposal to insure member savings deeply divided the American movement. Several hundred U.S. credit unions dropped their affiliation with the national trade body, Credit Union National Association (CUNA), over its opposition to the plan.<sup>10</sup> More recently, some North American credit unions have been criticised for weakening their commitment to the credit union ethos and focusing on business clients and high-income individuals.

But lessons learned from abroad can prevent similar mistakes here, On the other hand, Irish credit unions can also learn much from the success of those many credit unions in other modern countries that have prospered by adapting to modern realities and thereby continue to excel at delivering low-cost, high-quality financial services to ordinary people.

## **4. Accepting the Need for Change**

It is common knowledge that social movements and their institutions do not survive over the long haul unless they keep in tune with changes in the society they serve. To stay relevant and effective, they must continuously revise and adapt the ways and means by which they work to achieve their goals. But it is equally essential that in doing so they remain steadfast and true to their social goals and the core values they represent. Method, technique, style and practice may need to change with the times, but the goals and values that are the soul of a social movement cannot.

Striking the necessary balance is never easy. But change is most difficult for institutions like credit unions that have been highly successful for a long time. Because certain ways of doing business worked well in the past, there is a natural reluctance to let go of them. This is true even in the face of mounting evidence that the old ways do not work so well any more. It is just for this reason that some commentators are now saying that credit unions are victims of their own success.

The fundamental social and economic mission of the credit union is to give ordinary people a better deal on financial services than they can get from the for-profit sector. This was why credit unions were founded. It is a mission just as relevant to the citizens of 21st Century Ireland as it was fifty years ago.

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<sup>10</sup> An agency of the Federal government now insures accounts in American credit unions for up to \$100,000 per member (and up to \$250,000 more for certain retirement accounts).

Equally relevant today are the core values embodied in the co-operative structure of credit unions, values that form their basic philosophy:

- The customers credit unions serve are their members, who are also their owners. There is no tension between producing profits for owners and a better deal for customers because both are one and the same.
- To ensure that they are always guided by their members' welfare, credit unions are governed by volunteers elected from their membership democratically on the basis of one member, one vote.
- Governance by member representatives helps ensure that members are treated with dignity, fairness, honesty and transparency.
- Members share a common bond through their membership and participation in the credit union.
- Because of their ownership structure, it is in the nature of credit unions to encourage thrift and to educate their members in the wise use of their money.

Together with their mission, these philosophical values are the essence of the credit union ethos. They define who credit unions are, and they are not up for debate or compromise.

But these basic values are very different from operational methods and techniques and day-to-day business practices. Credit unions should not confuse "how we've always done things" with what makes up their true philosophy. It is good that credit unions have made philosophy a habit, but not all their habits are philosophical.

For credit unions to achieve their mission in the 21st Century, there are some old habits of doing business, old ways of thinking, that need to be changed. In the pages that follow, a number of those traditional practices will be identified that should be altered or dropped altogether. None of the things that are proposed for change are part of the real credit union ethos and philosophy. They are simply things that worked well in another time.



## THE VISION

### **CREDIT UNIONS AS THE PRE-EMINENT SOURCE FOR CONSUMER SAVINGS AND LOANS**

Fundamentally, the co-operative structure of credit unions creates unique strengths that will enable them to excel at accomplishing their mission for many years to come. But for credit unions to realise on those strengths, they must focus on modernising their core business of savings and lending, so that they conduct it more efficiently and cost-effectively. By doing so, they can offer their members the best rates and terms in the market. They can thereby achieve their basic mission of giving ordinary people a better deal on financial services than is offered anywhere else.

Credit unions will be able to achieve this because the economics of their non-profit structure give them a built-in pricing advantage over other providers of banking services. Since their only owners are their depositors, credit unions do not have a separate group of investors demanding a profit – a profit motive that limits what depositors receive on their savings and what borrowers pay on their loans at other providers. Uniquely in a credit union, all of the profits belong to the depositor-members, and those profits are not subject to income taxes at the credit union level.

Without the cost of paying returns to a separate stockholder group or the expense of income taxes, credit unions have an inherent interest spread advantage over other depository institutions. If they achieve reasonable operational efficiencies, they should always be able to pay consumers more for their savings while charging them less for their loans. This has been the experience of efficient credit unions in other countries where, like Ireland, credit union income is exempt from taxation.

There are two additional efficiencies that flow from credit unions' co-operative philosophy and which also bring them commercially practical, competitive advantages. First, their community-based ownership gives them an intrinsic marketing advantage. They do not need large advertising budgets to reach their members. As locally owned institutions, they can tailor their service delivery to the specific needs and tastes of their own communities. Unlike big banking operations, they are not limited by one-size-fits-all standardization. They can respond to local needs by offering additional services, such as insurance, bill paying and other transaction and group purchasing plans, to their basic business of savings and loans. They can appeal to local civic pride in recruiting the unpaid volunteers who provide their governance. Their members' natural affinity with the credit union is a true business advantage that competitors envy and which gives credit unions genuine cost savings.

Secondly, the credit union commitment to member education gives them unique credibility. It flows naturally from their basic purpose of helping their members get a better deal on financial services. But this member education objective carries its own ethical imperative. A credit union's leaders cannot in good conscience educate their members to use the credit union unless it truly does offer financial products that are superior to the competition.

Credit unions can realise on these advantages if they modernise their business practices and operate with the much greater efficiencies that are required to compete in today's financial marketplace. It is not suggested

that credit unions try to mimic commercial banks or to expand beyond their traditional social role of serving the needs of individuals and their communities. To the contrary, in order for credit unions to consistently achieve their goal of giving ordinary people a better deal on financial services, they should focus on their basic business and get much better at doing it.

The experience of credit unions in other modern countries demonstrates how this can be done. The recommendations that follow are informed by both the successes and failures that credit unions elsewhere have experienced in adapting to change. These recommendations are intended as a roadmap for accomplishing the vision of a re-energised credit union movement in Ireland that builds on its ethical principles and its long history of service over profits.



# RECOMMENDATIONS

## ACHIEVING THE NEW VISION

### **1. Credit unions should provide a full range of updated savings and lending products that meet the needs of modern consumers.**

To truly excel in their core business, credit unions need to begin by offering a much broader array of modern savings and lending products. The traditional share account is manifestly outdated as the primary vehicle for member savings.<sup>11</sup> It is limited by law to paying dividends only once a year, and then only in arrears after the annual accounts are closed. Likewise, members need more borrowing alternatives than the traditional closed-end instalment loan that has been their staple from the beginning.

Specifically, credit unions should:

- Provide a variety of deposit accounts to replace shares as the primary place for member savings. Interest rates on deposits should track the market but exceed what banks are paying. And the exact terms of each account type should reflect its function and usage:
  - Deposits that are used for the members' "in and out" money would pay a low rate of interest and serve as a kind of current account. Indeed, depending on the services it carries for free, this account might not pay any interest at all unless a minimum balance is maintained. This is the account to be used for cash transactions over the counter or at an ATM machine. This is the account for standing orders and direct debits.

It is not suggested that credit unions should offer chequing accounts. But they will be able to pay longer term savers better returns if they pay lower, more appropriate rates on accounts that are used for frequent in-and-out transactions.<sup>12</sup>
  - Regular savings deposits should earn a competitive rate of interest that is calculated and paid at least monthly. Because this account pays a good return, the frequency of withdrawals should be limited to reduce the expense of offering it. Alternatively, fees might be charged if more than a certain number of transactions are incurred during the month.
  - Term deposits for longer-term savings would pay even higher rates on funds that are left for a pre-established period of time. (E.g. six months, one year, etc.) An interest penalty should be charged to discourage early withdrawals. If the member needs cash before maturity, he/she should be able to borrow against the account at a rate that is only a percent or two higher than what the account pays.
  - As permitted by law, credit unions should develop accounts in which savings can be accumulated tax free for retirement.

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<sup>11</sup> Full implementation of this recommendation will require further liberalisation of the limits on deposits, beyond the recent change described above. Doing so is a key reform that should be included in the overall revision to the Credit Union Act, as discussed in Recommendation 7. But the recent Ministerial order gives credit unions the flexibility to begin using deposit accounts more extensively right now.

<sup>12</sup> As discussed below in Recommendation 4, improved IT will also enable credit unions to handle payment transactions more cost-effectively.

- Reposition the share account as being purely the means by which members have an ownership stake in the credit union. In good years, shares should pay a much better rate than savings deposits. But credit unions need to be straight with their members, making it clear to them that share dividends are not market based, that last year's rate is no indicator of what it will be this year, and that, in any event, no dividend on shares is ever guaranteed.
- Modernise lending products to include open-end loans under pre-approved lines of credit. The current reliance on closed-end loans that must be re-documented each time they are topped up is costly and inefficient. Open-end credit will also make lending more convenient. People go elsewhere for loans (and even pay more) to avoid the inconvenient wait for a loan approval that current practices impose.
- As already noted, the Section 35 limitations on credit union loan maturities should be relaxed for credit unions that meet appropriate regulatory requirements and have the expertise and systems in place to safely engage in longer-term lending.
- Credit unions should partner with high quality, reputable mortgage lenders to finance their members' homes by making long term mortgage loans available at the credit union. Credit unions have missed out on much of the growth in lending over the past few years because of their inability to serve this part of the market.
- Over the longer term, as credit unions develop experience in residential finance, they should obtain legal authority for direct mortgage lending. But they must accept that this change in the law will come at a price: Those credit unions who elect to operate as mortgage lenders must be prepared to accept the higher level of regulation and oversight appropriate to this more complex activity.

Finally, with levels of bad debt creeping up at many credit unions, there is an urgent need for credit unions to improve their credit practices substantially. This does not mean abandoning their commitment to providing loans to the less well-off members of society, to people of good character who cannot borrow elsewhere. But to keep their bad debt manageable, credit unions need to adopt more robust procedures for evaluating loan applications and for promptly following up on late repayments. They need to take advantage of their access to credit bureau services to make sure that loans are not made to people who default on their obligations.

## **2. Credit unions should adopt market-based principles of pricing to ensure better rates and terms for consumers.**

To a significant extent, the difficulties many credit unions have experienced in building loan volume follow directly from their use of one-size-fits-all pricing – not just for loans, but for savings products as well.

For small loans under €1,000 credit unions usually do offer the very best rates available. Indeed most high street banks will not even make small loans except through an overdraft facility. But for borrowers needing larger amounts, credit union rates are often not competitive. When added to the inconvenience of waiting for loan committee approval, many consumers just go elsewhere. Their credit union then finds that it can only charge its higher rates to less creditworthy borrowers. This is the primary cause of rising rates of loan delinquency at some credit unions.



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Meanwhile, to the extent that credit unions overpay interest on accounts used, in effect, as a current account for frequent transactions, they have less earnings available to offer the best rates on their other products.

Thus, just as important as introducing new products is the adoption of correct methodologies for pricing them. This means setting rates at different levels depending on the service involved and rebalancing rates on a regular basis to stay competitive with the market. Because of their inherent cost advantages, as described above, credit union rates should be better in each case than the competition.

But adopting appropriate pricing methodologies will require training and a higher degree of professionalism from credit union personnel. It will also require that credit unions abandon some old ways of thinking that have become confused with their philosophy but which are really just old habits that die hard.

The classic example, which most credit unions have already abandoned, is the idea that 1% a month on the unpaid balance is the rate that must always be charged on every loan. In fact, this is nothing more than a convenience that was inherited from the people who founded credit unions in North America nearly a century ago. Charging one per cent a month was their simple but elegant solution to calculating loan interest with a pencil and paper in the days before electronic calculators and computers: Simply move the decimal point on the principal owed two places to the left and you know how much interest to collect this month.

Fifty or a hundred years ago, 12.68% APR (which is what 1% per month works out to be) was a good rate for people whose only other source of credit was a loan shark. Today, it is actually a rather high rate except for very small loans that no one else makes or for the small minority of members who really are such poor credit risks they cannot borrow elsewhere.

A similar habit that started out as a convenience but is now confused with philosophy is the idea that all loans should bear the same rate regardless of their maturity, their collateral or the risk they present to the credit union. Or the idea that if the credit union does change its lending rate on new loans it must likewise change the rate for loans already on the books.

The foregoing are out-of-date practices that consumers do not expect from other lenders. They prevent credit unions from managing their funds wisely and thereby maximising the overall economic benefit provided to their members.

Finally, credit unions need to break the bad habit of giving away too many of their services for free and earning nearly all their trading revenue off the declining percentage of members who take out their loans. This practice of providing free transaction services and high dividends at the expense of over-the-market rates to borrowers actually discriminates against one group of members in favour of another. Borrowers tend to be younger members, whereas savers tend to be older. (And it is probably no coincidence that those older savers are disproportionately represented on credit union boards.) To speak plainly, this practice violates a fundamental principle of fair treatment to all members.

But also, giving so many low-value ancillary services for free just fritters away the ability of credit unions to stand out in the financial marketplace by offering rates on savings and loans that would really be a better deal for most members.

### **3. Credit unions should become a primary source of funding for social finance.**

As stated in the 2004 report of the Government-sponsored Steering Committee on Social Finance,

“Social finance is repayable financing made available to voluntary organisations which have as their primary objective the development of social infrastructure at local level, primarily in disadvantaged communities.”<sup>13</sup>

Social finance is not “poverty relief” directed at individuals. Rather its purpose is to provide affordable debt funding for community enterprises that can operate on a self-sustaining, commercial basis to create jobs, promote economic development, or otherwise improve social welfare. One example would be a loan of working capital for a community business estate that operates as a nursery for new small businesses. Other examples include finance for job training enterprises, crèches and community recreation centres.

The report recommended that credit unions play a major role in helping to develop a system of social finance, and it invited the credit union movement to suggest how this might be achieved.<sup>14</sup>

There is indeed a very important role for credit unions in funding social finance, a role that flows naturally from their philosophy of community service. That role, however, needs to be carefully designed to integrate prudently with the basic credit union business of savings and lending services for individuals. Credit unions are not social welfare agencies. Effective social finance is a specialised form of commercial lending that requires expertise which credit unions do not possess. But what they do possess is the ability to mobilise the savings of their communities for socially desirable purposes.

Accordingly, Government should establish a special purpose social finance facility with the specialist staff and resources needed to properly underwrite and service social finance loans or provide funding to organisations specialising in providing social finance funding. The facility should be authorised to issue Government-guaranteed bonds into which credit unions could invest excess funds. In this way, credit unions would provide the wholesale funding for social finance lending, but the social finance facility would have the expertise to actually conduct that lending properly.

Capital for this social finance facility should be funded with DIRT that credit unions currently collect and remit to the exchequer. DIRT is computed on dividends and interest paid on the majority of member balances, and at current rates it adds up to over €30 million a year.

<sup>13</sup> Steering Committee on Social Finance, “In the Common Interest - The Case for Social Finance in Ireland” (September 2004), p. 1.

<sup>14</sup> Ibid., p. 6.



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Conservatively assuming a 10% capital level for the special purpose facility, dedicating credit union DIRT collections for this purpose could be leveraged into over €300 million of additional financing each year for social projects that meet the facility's criteria. Using Government guaranteed bonds would lower the cost of these funds while giving credit unions a safe way to invest member savings that are not needed for member loans.

This proposal would give credit union savers the ability to invest in a socially responsible way by putting their funds in the credit union. Indeed, credit unions might promote a special deposit account to be used explicitly for that purpose. In this way, Government would be able to utilise credit unions' skills in raising member savings on a very cost-effective basis, while encouraging credit unions to remain focused on their core business of serving individuals.

This proposal would put credit unions at the heart of Government's social finance policy. Unlike commercial banks which are increasingly foreign-owned, credit unions are uniquely positioned for this public service because they are Irish-owned and controlled institutions with a fundamental commitment to the welfare of the communities they serve.

#### **4. Credit unions need to upgrade their IT, operational systems and internal controls to achieve greater efficiency and safety.**

Providing a modern range of savings and lending products requires a substantial upgrade to credit union IT systems. Perhaps the most unfortunate fallout from the failed ISIS initiative was that fear of another failure has deterred credit unions from improving their information technology. Compared with credit unions in other advanced countries, Irish credit unions spend too small a percentage of their overheads on data processing.<sup>15</sup> This is a false economy that drives up other costs by limiting flexibility and increasing reliance on manual processes.

Updated IT will also give their members the convenience that consumers expect these days. Members should have access to their funds 365/24/7 via ATM machines. They should be able to manage their accounts over the Internet and use the credit union for standing orders and direct debits.

As already noted, credit unions also need to upgrade their loan underwriting and collections processes. They need to employ more sophisticated tools for asset/liability and investment analysis and for monitoring legal compliance. All credit unions should have disaster recovery plans that are regularly tested. At least the largest credit unions should have internal audit capabilities that include appropriate systems for assessing and managing risk and for testing the sufficiency of internal controls.

More efficient and effective operations will require more substantial expenditure for staff and volunteer training. Credit union people will need that training to manage a more complicated and sophisticated business than they have had in the past.

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<sup>15</sup> Irish credit unions dedicate only about 1% of their expense budgets to IT. Among U.S. and Canadian credit unions the figure is about 5%.

But this is the price credit unions must pay to maintain the success they have already achieved. Because credit unions hold a substantial share of all consumer savings in this country, they can no longer get by with anything less than the most robust systems in place to assure the absolute safety of their members' money. Credit unions in other developed countries have made this step upward, and they can here as well.

### **5. The credit union model for democratic governance should be improved to meet modern standards of best practice.**

When credit unions were very young and very small, they could not afford to hire paid staff. Their operations depended on the labour of volunteers. So it was natural that volunteer directors and committee members also served as their unpaid workforce. Volunteers were at the same time company directors, senior managers and the lowest level staff handling the most mundane clerical tasks.

This was a necessity of the time, but its legacy has been a confusion of roles that today leaves many credit unions, even relatively large ones, with governance systems that are not up to the requirements of the sizable institutions they have become and the substantial role they perform in the economy.

The larger credit unions of today need to be managed by full-time professionals with the training, experience and skills required for any other institution that is holding people's money. The current practice confuses the very different roles of non-executive directors and of executive management. It results in part-time volunteers making management decisions and performing management roles for which they are neither trained nor qualified. Indeed, it creates a basic conflict of interest for volunteer directors to serve both as management and also as the overseers of management.

The current model worked when credit unions were simple in their operational profile, and it may still be the only model feasible for credit unions that are too small to afford staff. But for medium-sized and large ones it represents poor practice and is in need of replacement.

Adopting an appropriate model for governance in no way diminishes the importance of volunteer directors and committee members. To the contrary, it restores them to their proper function of high level oversight as representatives of the members whose interests they are there to advance and protect. Fundamentally, volunteers serve as the "conscience of the credit union." Their crucial leadership role is to establish the business goals and policies that advance the credit union ethos of fairness to members and service over profits. Directors should not be distracted from their real job by dealing with day-to-day operational decisions and routine personnel matters.

Instead, management of the credit union (including managing the hiring, evaluation and discipline of staff) is the responsibility of a professional chief executive. The CEO, in turn, should be supported by a full-time management team of qualified professionals with specialist skills in finance, operations, compliance, marketing and so on.



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The leadership job of the board of directors is to focus on formulating and directing the strategic governance of the credit union, to establish and regularly review its top-level policies, to hire and supervise the chief executive, to set financial and other goals, and to monitor management’s performance in achieving those goals. These are the essential functions of top level governance in a financial institution. They deserve the undivided attention of the board, whose energies should not be wasted on day-to-day decisions which staff are paid to make.

There are two additional and very important advantages to this model of governance. The first is that it prescribes roles for volunteers that can be fulfilled without an undue commitment of time. By adopting a modernised model of board governance, credit unions discover that the challenge of recruiting capable directors diminishes considerably.

Secondly, and even more importantly, effective governance is indispensable to attracting and retaining professional managers with the talents and skills that are needed to run excellent credit unions. Highly capable people gravitate to organisations where roles are well defined: Where directors establish clear policies, expectations and goals, where results are objectively measured and rewarded – and where directors then get out of the way and let managers manage to achieve those goals to their best professional ability. Excellence in the board’s governance of the credit union is key to excellent performance by its CEO and staff.

## 6. The credit union movement needs to accept the desirability and inevitability of rationalisation.

In the U.S., where nearly 90 million people belong to credit unions, there are 3 credit unions per 100,000 of population, and the average credit union has assets equivalent to €63 million. In Canada, those numbers are 1.7 per 100,000 and €117 million. In Australia they are 0.8 per 100,000 and €133 million.

	Ireland	U.S.	Canada	Australia
CU members / total population	48.2%	29.4%	15.7%	17.9%
CU assets / members	€5,782	€6,522	€12,703	€5,810
CUs / 100,000 population	11	3	1.7	0.8
Average assets / CU (millions)	€25	€63	€117	€133
Average members / CU	4,372	9,651	9,227	22,930

Ireland data is for the Republic only, as of September 2004. All other data is as of December 2005. Sources: ILCU, Credit Union National Association, Credit Union Central of Canada, Credit Union Services Corporation (Aust) Ltd.

By contrast, in Ireland there are 11 credit unions for every 100,000 people, and the average credit union has less than €25 million in assets.

These comparative figures suggest why many in the movement are questioning whether there are too many credit unions and suggesting that a period of rationalisation may be inevitable.

The credit union movement in Ireland should be realistic about the future for its smallest credit unions. In every other English-speaking country where credit unions have been successful, the total number of credit unions peaked at about the same stage of development as they have reached here and then began declining, even though the number of credit union members continued to grow.

In the U.S., for example, the movement reached a maximum of over 24,000 credit unions in 1973, but that was at a time when only one American in seven was a member. Today the U.S. has about 9,000 credit unions, but their average assets are close to 50 times greater and nearly one third of Americans belong. Canada and Australia had similar experiences.

In all these countries, the decline in the total number of credit unions was mostly the result of small but healthy credit unions merging into larger ones. The office of the merged credit union often stayed in place as a branch to serve the local community.

There are three reasons why the number of credit unions should be expected to decline here as well. First, the smallest credit unions, which have no employees and in which volunteers do all the work, are finding it hardest to recruit the volunteers they need. This is understandable. When credit unions were the only reasonable source of credit for most people, there was a powerful civic incentive for volunteers to donate time to credit union service. That incentive is considerably lessened today.

Secondly, it is inevitable that the compliance burden on credit unions will increase over time. Even for small credit unions that keep their operations simple, Government can be expected to raise the bar in terms of reporting requirements, record keeping, training and systems of internal control. All consumers deserve financial services that are delivered in a safe and reliable fashion, and the members of small credit unions are no exception. It will be difficult for a credit union to absorb the resulting costs of compliance unless it can spread those costs over a sufficiently large asset base.

But most important, it will not be possible for small credit unions to offer the service levels that today's consumers are demanding. The best strategy for many will be to join forces through mergers that can give the surviving credit unions the scale they need going forward.



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This is not to suggest that any credit union should be forced to merge or close, so long as its members are satisfied and want it to stay that way, and, just as importantly, as long as it can maintain the safety of its members' money.

Nevertheless, consolidation is inevitable and should be facilitated and not resisted by public policy. Rationalisation is a good thing when the result is a stronger credit union movement that can better meet the needs of modern society.

## **7. Credit Union legislation should be modernised, with supervision by the Financial Regulator replacing self-regulation.**

For credit unions to achieve the new vision outlined in this paper, Government will need to update the ways in which they are regulated and supervised. In the first instance, several of the reforms described in this paper require enabling amendments to the Credit Union Act, 1997. The case for liberalising sections 27 (deposit limits) and 35 (lending limits) has already been described. Sections 48 to 50 place cumbersome conditions on the introduction of new services, denying credit unions the ability to respond quickly in meeting new member needs. Other amendments are necessary, for example, to modernise the rules for credit union governance and to ensure necessary flexibility for credit union mergers.

But more broadly, the time has come for a root and branch review of the entire Act. The present law is far too detailed and prescriptive. It spells out too many specifics that are best left to the judgment of the credit union's duly elected board of directors and, under the board's oversight, to its management team. The 1997 Act should be replaced with a new law that meets modern standards for credit union legislation in advanced countries.

The need for Governmental action goes beyond revisions to primary legislation. A modern and progressive credit union movement also requires the Financial Regulator to have in place a robust system for credit union examination and supervision, to assure the public that credit unions are operated in a safe and sound manner.

Forward thinking credit unions accept the reality that, in return for more liberal lending limits and the power to offer a full range of deposit services, they must accept levels of regulatory oversight commensurate with the more complex nature of those services. Such enhanced regulatory requirements might include, as appropriate, additional reporting standards, requirements for internal policies and controls, minimum standards for the systems that support these new products, etc.

Progressive credit unions also accept that this heightened level of supervision is the role of Government, through the Financial Regulator. The reality of today is that self-regulation of financial services is no longer suitable for a modern economy. The tendency of some credit union leaders to oppose effective Government oversight is counterproductive, and it should stop.

Hence, the credit unions who have prepared this paper endorse the following comments made by the Chief Executive of the Financial Regulator in the same speech quoted above:

“So it can be seen that quite a number of credit unions can no longer be regarded as small organisations which are only required to balance their books and produce a small surplus from their operations. Faced with increasing competition from other financial institutions, some credit unions are moving into areas of business that require more specialist skills and attract increased risk. This strategic shift has increased the risk profile of these credit unions and it is vital that the regulatory regime be given the ability and flexibility to adjust itself accordingly to cater for this increasing risk in the sector.

Indeed, it is notable that the recently published “Report of the Consumer Consultative Panel on the Performance of the Financial Regulator” recommends that the Financial Regulator should act with a sense of urgency to address regulatory issues that have arisen from changes in the credit union business environment.”<sup>16</sup>

Credit unions can point with pride to the fact that never in their history has a member lost money because of a credit union failure. Historically, the system of self-regulation operated by the Irish League of Credit Unions (ILCU) worked well. It was appropriate in the past when the credit union movement was small and struggling to grow.

But credit unions are now too large a percentage of the financial services and banking industry for their activities to avoid regulation that meets standards of international best practice. The inherent conflict of interest involved when financial institutions regulate themselves has led to the abandonment of banking self-regulation throughout the modern world. For credit unions to cling to this approach risks loss of their credibility as safe places for people to keep their money and to conduct their most important financial transactions.

This was recognised correctly by Government and the Oireachtas in firmly rejecting self-regulation when a new regulatory regime for credit unions was enshrined in the 1997 Act. That decision was ratified three years ago by transferring credit union regulation and supervision over to the new Financial Regulator. Progressive credit unions support the Financial Regulator’s efforts to upgrade its capabilities, and they agree that it should have the resources it needs to perform its duties effectively.

The failure of a single credit union could have disastrous implications for all the rest. Hence, preserving the safety of member savings is of paramount importance to all credit unions. Effective supervision by the Financial Regulator should be welcomed and not resisted.

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<sup>16</sup> Mr. Patrick Neary, Chief Executive, Financial Regulator, 2006 World Credit Union Conference (Dublin, 28 July 2006)



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Nevertheless, it is important that credit unions continue to be separately handled by a dedicated team within the Financial Regulator and not folded into the same area responsible for the mainstream banking sector. Thus, it was sound public policy to maintain the Registrar of Credit Unions and his staff as a separate unit within the Financial Regulator when IFSRA was set up. This separate status needs to be preserved and enhanced. Thus, responsibility for enforcing credit union compliance with consumer protection regulations should also be combined under the Registrar. Having a separate area for all credit union regulation assures that specialists who understand and respect the unique ethos and objectives of credit unions are responsible for their regulatory oversight.

This is not to suggest that credit unions should enjoy a “lighter touch” from the Regulator if that means they do not get the supervision required to protect members’ savings or their rights as consumers. But it is not appropriate for community based organisations that operate on a not for profit basis to be regulated in the same way as commercial banks. Thus, for example, the Regulator might well conclude that it should press a commercial bank to improve its profits, since profits affect a bank’s ability to raise outside capital. But, so long as a credit union’s reserves are sufficient and it is operating prudently, its board of directors may very appropriately decide that it can keep its profits low in order to give its members better service levels or better rates. Unlike a commercial bank, the basic objective of a credit union is to maximise service, not profits.

Moreover, the regulation and supervision of credit unions should not be a one-size-fits-all proposition. It is likely that some credit unions will choose to stay with the current, more simplified model for their operations and services. Although the regulatory requirements for all credit unions will inevitably increase over time, small credit unions operating under the traditional model do not need the same level of regulatory supervision as larger ones offering a modernised range of products and services.

The answer is to establish a two-tiered system of supervision. Only those credit unions that elect to offer advanced services would be subjected to the additional level of oversight those activities warrant. Smaller, traditional credit unions would continue to operate under the same basic regime that is presently in place.

Fundamentally, credit union regulation should recognise the difference between members as owners of the credit union and members as consumers of its services. So long as a credit union operates safely and soundly within the Regulator’s established prudential norms, regulation should defer to the rights of member-owners, through their democratically elected directors, to determine each credit union’s goals and objectives, what products it should offer and how it goes about carrying out its business.

But in modern Ireland, it is the role of the State, through the Financial Regulator, to protect the interests of members in their capacity as consumers. Consumer rights should never be subordinated to the institutional self-interests of credit unions or their trade bodies.

## 8. Credit union depositors deserve the same protection as bank customers receive through a Central Bank guarantee.

The Credit Union Act, 1997 introduced a new statutory requirement that all credit unions participate in a “savings protection scheme” approved by the Registrar “to protect, in whole or in part, the savings of members of a credit union in the event of insolvency or other financial default . . .”<sup>17</sup>

In so doing, Government and the Oireachtas recognised that credit union savers, like depositors in banks and building societies, deserve to be protected from loss in the event of a financial institution’s failure.

Yet today, nearly nine years after passage of the law, the €12 billion in savings held by Ireland’s two million credit union members still lacks this consumer safeguard. Although ILCU has long operated its own “Savings Protection Scheme” (SPS), the Registrar has declined to approve it as qualifying under the Act. Now the League’s SPS is embroiled in litigation brought against ILCU by the Competition Authority, which challenged the League’s policy of restricting SPS participation to its own member credit unions. The High Court ruled against ILCU in October 2004, and the League’s appeal is now pending in the Supreme Court.<sup>18</sup>

Meanwhile, the League and the Registrar are apparently deadlocked in negotiations over how the League will need to modify SPS in order to get the Registrar’s statutorily required approval. At issue are questions of governance and control and the fact that SPS funds are not segregated from the League’s general assets and thereby ringfenced from any other claims. The latter is of concern since ILCU has been rightly criticised for using SPS funds to bail out its ill-fated ISIS project and to finance the purchase of its headquarters building.

The lack of State-approved protection for credit union savers has gone on for too long and should be corrected. Resolution of this issue should no longer be delayed by considerations that arise from the League’s self-interest. Instead, the obvious solution is readily at hand. Only a simple amendment to existing law is needed to include credit unions under the compensation scheme that already exists for the customers of banks and building societies.

Under that scheme, which is administered by the Central Bank, each individual depositor will be compensated for 90% of losses from a bank failure, up to a maximum of €20,000. The plan is paid for by the banking industry at no cost to taxpayers. Every bank is required to set aside funds at the Central Bank equal to 0.2% of its deposits, solely to pay depositor claims if the bank fails. If that is not enough, any remaining claims are paid for pro rata by the other banks and building societies, in proportion to their size.<sup>19</sup>

<sup>17</sup> Credit Union Act, 1997, sec. 46 (2).

<sup>18</sup> The Competition Authority v. John O’Regan and ors, [2004] IEHC 330.

<sup>19</sup> European Communities (Deposit Guarantee Schemes) Regulations, 1995.



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Covering credit union savers through this same arrangement would require only a few strokes of the legislative pen. Credit unions would then pay their share of the Central Bank scheme's cost, and their members would enjoy the same insurance protection that all consumers of banking services in this country deserve.

The reality is that, even if the League agreed to necessary changes in the governance, funding and operation of its SPS, that scheme is an inferior mechanism for protecting Irish consumers. ILCU now states that its SPS is not deposit insurance after all, and that the SPS does not guarantee any reimbursement to savers if a credit union fails. Instead, ILCU characterises the SPS as a "stabilisation fund" from which discretionary assistance can be given to a credit union in trouble.

Thus, in reporting on delegate comments at its 2006 Consultative General Meeting, the League states as follows in one of its recent publications, "There seemed to be poor understanding of the nature of the current SPS and it was clarified that no non-discretionary guarantee exists under it, but that it is a stabilisation scheme primarily and protects savings on a discretionary basis."<sup>20</sup>

Even more limiting, the "discretionary" assistance available through the League SPS is capped at only €12,700 per member.<sup>21</sup> Even when the League exercises its discretion to grant assistance, credit union members get far less protection than the €20,000 per depositor maximum guaranteed by the Central Bank .

In any event, because of disastrous experiences with privately-run plans in other countries, international best practice recognises that true deposit insurance is best run by a government or quasi-government body, such as the Central Bank.<sup>22</sup>

For example, the 1990 collapse of a credit union league-sponsored savings protection scheme in the U.S. cost the State of Rhode Island over \$450 million. Even though there was no legal necessity for Government to bail out that programme, angry voters demanded compensation from the state, under whose laws the affected credit unions were registered. During the crisis, massive runs on credit unions throughout Rhode Island forced its Governor to declare a financial emergency and order the 45 credit unions covered by the scheme to suspend operations for several weeks. Some credit unions that were completely sound before the panic never re-opened.<sup>23</sup>

It is important to note that the Central Bank scheme was designed to meet the minimum standards for depositor protection specified by the EU.<sup>24</sup> For valid reasons relating to their non-profit mutual structure, Irish and UK credit unions are generally exempted from European banking rules. Nevertheless, in 2000 the British government wisely

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<sup>20</sup> Irish League of Credit Unions, *CU Focus* (Summer 2006) p. 10,

<sup>21</sup> *Ibid.*

<sup>22</sup> Financial Stability Forum, Working Group on Deposit Insurance, "Background Paper" (2000), p. 8; Garcia, "Deposit Insurance and Crisis Management" (2000) IMF Working Paper, p. 9.

<sup>23</sup> Federal Deposit Insurance Corporation, "Managing the Crisis: The FDIC and RTC Experience" (2005)

<sup>24</sup> Deposit Guarantee Schemes Directive (94/19/EC)

brought credit unions in England, Scotland and Wales into the same deposit insurance scheme it had set up for banks. It did this as a matter of sound public policy, recognising that credit union savers should have the same protection as bank customers. We understand that some Northern Ireland credit unions are also interested in joining the UK plan, but ILCU has not pursued that obvious solution for its NI members.

Notwithstanding the issues discussed earlier in this paper, the great majority of credit unions continue to operate carefully and safely. Likewise, the Irish banking system is strong and secure, yet Irish law, along with the rest of Europe, requires deposit insurance to protect against the remote but serious event of a bank failure.

We don't buy insurance for our homes because we expect them to burn down. It is simply imprudent not to have that security in place. Credit union savers lack the protection they deserve and which the law requires. There is no good reason to delay it any longer.



## CONCLUSION

Credit unions owe their historical success to a passionate commitment to the core values of individual member ownership and democratic control, of volunteer leadership, and of service before profit. In the ever more complex and competitive financial services market of the 21st Century, consumers have an even greater need for a true “people’s bank” which they own and trust and which is dedicated to advancing their welfare over making profits.

These credit union core values will never go out of fashion. But what has gone out of fashion is the way in which too many credit unions still operate. The old ways of doing business worked well in the past. They were brilliantly designed for an Ireland that no longer exists. Credit unions can celebrate the success of the old ways, but now it is time to move on. The credit union mission, which remains constant, is too important to be held back by nostalgia.

Credit unions have an excellent future in Ireland, but only if they modernise themselves for today’s business and social environment. If they do so, this great social movement will survive and thrive in the 21st Century and continue to accomplish its important mission of service.

CUDA is pleased to submit this paper to Government and to the rest of the credit union movement as a call to action, with the conviction that the reforms being advocated are urgently needed. The objective is to inform and inspire a serious discussion of the need for change among credit unions and with Government and other stakeholders.

# APPENDIX

## CUDA CREDIT UNIONS

Blanchardstown & District Credit Union Ltd

Bray Credit Union Ltd

Comhar Linn INTO Credit Union Ltd

Coolock Artane Credit Union Ltd

Dubco Credit Union Ltd

Dundalk Credit Union Ltd

Dundrum Credit Union Ltd

Greystones & District Credit Union Ltd

Lucan & District Credit Union Ltd

Newbridge Credit Union Ltd

Prison Service Credit Union Ltd

St Agnes' Credit Union Ltd

St Anthony's & Claddagh Credit Union Ltd

St Joseph's Aviation Credit Union Ltd

St Mary's Navan Credit Union Ltd

Tullamore Credit Union Ltd

