European Network of Credit Unions

14th October 2013

*Sent via email*
Wayne Byers
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
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**Re: Consultative Document: *Liquidity coverage ratio disclosure standards* (bcbs 259)**

Dear Mr. Byers,

The European Network of Credit Unions (ENCU) welcomes the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultation paper on Basel III liquidity rules. Credit unions are not-for-profit savings and loan cooperatives that promote thrift and financial inclusion, especially in low-income and rural areas. Although European credit unions are not subject to Basel III, Basel III significantly affects the operations of European credit unions' bank counterparties and those bank counterparties' relationships with credit union customers.

We are writing because adoption of the Basel III liquidity rules in the European Union (EU) has resulted in European commercial banks reclassifying bank term deposits made by credit unions from "retail" or "small business" deposits to "wholesale funding provided by other legal entity customers".

This change in deposit classification has negatively impacted EU credit unions' yields on banks deposits, caused some banks to stop doing business with credit unions, and threatens credit unions' ability to promote financial inclusion of the unbanked. Credit unions in the EU have very limited investment powers—limited primarily to investments in banks deposits, loans to members, and government-guaranteed debt instruments—and are small or medium-sized enterprises (SMEs), especially when compared to internationally active banks. EU credit unions' term deposits in banks are "sticky" and stable in large part because credit unions have few other options for investing their money.

We urge the BCBS to clarify as part of its upcoming Net Stable Funding Ratio (NSFR) revision project that credit unions and similar institutions which have very limited investment powers, or are SMEs by financial institution standards, can have their term deposits classified as "retail" or "small business" for NSFR purposes. Without this clarification, we are concerned that more banks will close credit unions' accounts or reduce the yields paid on credit unions' term deposits as Basel III is phased in across the EU.

In the Republic of Ireland, Irish commercial banks are citing the cost of capital the Basel III liquidity rules imposes on "wholesale deposits" as the reason they have reduced the interest that they will pay on credit unions' term deposits from as high as 3% annual interest to as low as 0.6 % annual interest, with an average spread between the yields on "retail/small business" and "wholesale" of 150 basis points. Please see the attached briefing paper from the Irish League of Credit Unions for additional details.

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In Great Britain, at least two large banking institutions have recently announced that they will cease doing business with credit unions. We believe that these institutions have likely made a business decision that holding deposits made by credit unions is too expensive under the new Basel III rules and other regulations.

Credit unions and similar institutions with limited investment powers perform an important financial inclusion role in many Member States and we do not believe that the historical behaviour of credit unions' deposits at banks justifies classification as "wholesale funding provided by other legal entity customers". The reduction in credit unions' interest income impedes their ability to promote financial inclusion and, if not addressed immediately, may threaten the viability of some credit unions and similar financial institutions in the EU.

Unlike hedge funds and similar non-bank financial institutions, credit unions' deposits at banks are "sticky" and stable—there were no runs on European credit unions by their members, or runs on banks by credit unions, during the Global Financial Crisis of recent years—and credit unions have few other options in terms of investing their money. These limited investment options of bank deposits, loans to members, and government-guaranteed debt help reduce credit unions' risk profile but also give credit unions limited options for generating the net income necessary to maintain the credit union as an economically sustainable enterprise, especially when loan demand from members is limited as it is now.

Banks refusing to do business with credit unions at all, as is the case with at least two banks in the Great Britain, raises the possibility of credit unions being unable to find correspondent banks to provide investment, payment, settlement, and liquidity services. Unlike in some cooperative systems, EU credit unions do <u>not</u> have second-level "central" credit unions (i.e. no credit union "bankers' banks") and must therefore rely on commercial banks for counterparty services.

In the Republic of Ireland, for example, there are just under 400 credit unions. Twenty of these have assets in excess of €100 million, 16 have assets between €100 million and €200 million and 4 have assets between €200 million and €350 million. Two-hundred-sixty-one have assets between €10 million and €100 million and 101 have assets below €10 million. With total system assets of approximately €12 billion, the average credit union balance sheet is €30 million. The average lending ratio is 40%, so the average credit union has €18 million on deposit with a number of banks. Most credit unions spread their deposits across 5 or 6 counterparties meaning the average on deposit with each counterparty would be €3 million to €3.5 million if spread across banks equally.

Irish credit unions' bank deposits remained "sticky" and stable during the financial crisis. As shown by the below table, the five most-used bank counterparties in the Republic of Ireland between year-end 2007 and year-end 2012 saw a significant net inflow of deposits made by credit unions, not an outflow of credit union funds.

**Table – Counterparty Analysis (5 most used counterparty banks' stocks of deposits by credit unions)**

| **Counterparty- Bank** | **Origin Details** | **September 2012 €'m** | **September 2007 €'m** |
|---|---|---|---|
| Bank of Ireland | Irish based Bank | 1,500 | 700 |
| Allied Irish Bank Group | Irish based Bank | 2,000 | 1,200 |
| Irish Life & Permanent | Irish based Bank | 1,700 | 400 |
| Anglo Irish Bank | In liquidation since early 2012 | 0 | 750 |
| Ulster Bank | part of RBS Group | 700 | 350 |
| KBC Bank Ireland | part of KBC Group | 800 | 0 |

This table clearly illustrates that the credit unions did not move their money away from the Irish banks during the financial crisis as many other non-retail type depositors did at that time. The counterparty table shows a range from €700 million to €2 billion deposited by credit unions in the five most used counterparties as at September 2012. These are totals for 400 credit unions, so the average on deposit by each credit union in each counterparty ranges from €1.75 million in Ulster Bank to €5 million in Bank of Ireland.

We do not believe that the withdrawal of individual deposits of this size is going to create funding problems for these banks even in a crisis. The fact that there was a significant inflow of deposits by credit unions into these banks during the recent Global Financial Crisis also demonstrates these deposits' sticky and stable nature; Irish credit unions nearly doubled their bank deposits during this period in a manner more similar to "retail" or "small business" depositors than to "wholesale" funding sources.

We strongly urge the BCBS to clarify that bank deposits made by credit unions with limited investment powers, or which are SMEs, can be classified under the NSFR as "retail" or "small business" as was the status quo ante in the EU. We are concerned that the cost of Basel III liquidity compliance for banks will lead to credit union consolidation or failures if EU credit unions' deposits remain classified as "wholesale" for NSFR purposes.

Without such clarification, Basel III implementation will negatively impact underserved communities in Europe, especially in rural areas where credit unions are often the only financial institution serving the community, including in Ireland, Poland, Great Britain, Estonia, Romania, and other EU Member States. In Ireland, for example, there are now only four retail banks operating with a branch network, and these four banks are actively reducing the number of branches they operate. The only other financial institutions offering personal savings and loans to consumers are the credit unions, and in many rural areas credit unions are the only remaining financial institutions with local branch offices. The continued existence and operation of a successful and viable credit union movement is vital for the ordinary people of these Member States.

We hope this comment letter and the attached paper assists in your understanding of how the Basel III liquidity rules are negatively impacting EU credit unions' financial inclusion mission and why clarification of the NSFR is needed as soon as possible.

Please do not hesitate to contact either of us or Anne Schneider at +32 2 626 9500 should you have any questions regarding our comments.

Sincerely,

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World Council of Credit Unions

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# Basel III Liquidity Standards–Implications for Irish Credit Unions

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## Background - Irish Credit Unions

Credit unions are not for profit financial cooperatives which are managed by voluntary boards of directors. There are just under 500 credit unions affiliated to Irish League of Credit Unions (ILCU), 400 in the Republic of Ireland and 100 in Northern Ireland. There are 3 million members of credit unions on the island of Ireland out of a total population of 5 million.

Credit unions in the Republic of Ireland are regulated by the Central Bank of Ireland and credit unions in Northern Ireland are regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Credit unions are part of the Irish/UK Deposit Guarantee Schemes and consequently credit unions have the appropriate funds on deposit with the Irish Central Bank and the Prudential Regulation Authority in the UK. Credit unions in the Republic of Ireland are also part of the European Central Bank's Minimum Reserve Requirement (MRR) and consequently have the appropriate funds on deposit with the Irish Central Bank for this.

Credit unions manage personal savings of €12 billion on behalf of their 3 million members. From this €12 billion members savings, loans of €5 billion are outstanding by members and the balance of €7 billion is invested in mainly deposits accounts in banks.

The total savings held by households in Ireland is €92 billion and the total amount of consumer credit advanced to households excluding loans for house purchase is €14 billion. So credit unions represent over 10% of the overall personal savings market and over 33% of the personal lending market in Ireland.

Because credit unions are only 40% lent out, they are very dependent on the interest they earn on the €7 billion surplus funds they have, to break even and to pay dividends, i.e. a return on members savings.

As a fallout from the financial crisis there are now only four retail banks operating in Ireland with a branch network and these four banks are actively reducing the number of branches they operate. The only other financial organization offering personal savings and loans are the credit unions. Therefore the continued existence and operation of a successful and viable credit union movement is vital for the ordinary people of Ireland, especially those who live long distances from a bank branch or those who cannot fulfill their financial needs over the internet.

## Classification of Deposits & Relevance to Credit Unions

Heretofore, banks have broadly treated credit union funds as stable deposits which have attracted competitive rates of return. Under Basel III a number of different classes or funding sources are identified. Classes can largely be divided into retail (placed by a natural person) and wholesale (placed by a legal entity).

Based on Basel III criteria, deposits from credit unions fall into the wholesale category Non-Bank Financial Institutions (NBFIs). The implications of this reclassification are:

- **Liquidity Coverage Ratio (LCR)**: The LCR assigns a specific run-off rate to each source of funding. A run-off rate reflects the amount of funding due to mature in next 30 days which is not rolled over and therefore is withdrawn from the bank. The NBFI class attracts a run-off rate of 100%.

- **Net Stable Funding Ration (NSFR)**: In order to establish the available amount of stable funding of a bank, the NSFR assigns a factor to each source of funding, called the availability factor. This factor represents the proportion of the balance today that is expected to be available to the bank in one year in order to fund longer term assets. Accordingly, certain behavioural assumptions are built into the availability factor relating to expectations regarding funding withdrawal. The NBFI class has been assigned an availability factor of 0%.

The most valuable sources of funding are those regarded as most stable and sticky, i.e. those that are unlikely to be withdrawn from the bank. Those funds will therefore have lower run-off rates in calculating outflows for the purposes of the LCR and high availability factors in calculating available amounts of stable funding under the NSFR.

Stable retail funding is perceived as the most valuable source of funding to a bank and is likely to attract the highest deposit rates. Conversely, less stable wholesale funds, perceived as less valuable to banks, will attract lower deposit rates and so deposits from credit unions will no longer be as attractive to the banks, especially those deposits with maturities of less than one year.

Our analysis over recent years, indicates that wholesale deposit rates have been 2% per annum lower than the rates offered to credit unions for similar maturity profiles. With in excess of 60% of the overall balance sheets or €7 billion in surplus funds in credit unions this differential in rates if it were to continue would result in a reduction in income of €140m per annum to credit unions. This would put considerable pressure on credit unions ability to break even, never mind to pay dividends to their members.

The average dividend rate paid to members as a return on their savings has been 1% over the past three years. If a 2% reduction in the income earned on the €7 billion invested surplus funds was to materialise as a result of deposits being reclassified as wholesale then these dividends would be wiped out and credit union members would get no return on their €12 billion savings.

**Grounds for Credit Unions to Seek Reclassification**

The ILCU believes that there are a number of reasons why credit union deposits should not be classified as wholesale NBFI's.

- The €7 billion surplus funds in Irish credit unions is actually owned by the 3 million members who have saved an average of €4,000 each with the credit union. So it's retail money in effect.

- This money has always behaved as if it were retail in that it has been "sticky" and stable. The members have left it with the credit union through good and bad times and the credit unions have left it on deposit with the banks.

- As referred to above there are now only four retail banks operating in Ireland with a branch network. The only other financial organization offering personal savings and loans are the credit unions. This restricts ordinary peoples ability to move their savings from one institution to another and so makes the credit unions deposits with banks very stable.

- There was no run from the credit unions by the members or from the banks by the credit unions during the Global Financial Crisis of recent years.

- Credit Unions have a very simple business operating model compared to other asset managers or pension fund managers or money market fund managers. They are each run by a voluntary board of directors who are not financial market experts. With the small number of deposit taking banks operating in Ireland the deposits are left with the banks even in uncertain times.

- The credit unions are restricted in what they can invest their surplus funds in. They can only invest in Government or Bank bonds or bank deposits. Because of this and the ever declining bond yields over 80% of surplus funds are in bank deposits.

- Basel III provides for certain run-off rates or parameters to be determined at national level.

- In their comments and answers to listed questions from the recent EBA discussion papers, the EBA Banking Stakeholder Group in replying to question 17 felt that it would be appropriate to allow derogations from the application of outflow rates on the basis of uniform strict criteria in some cases such as when the behavior of depositors depends on country-specific factors, like 'historical' preferences or legal frameworks.

We hope this paper assists in your understanding of the issues as they are likely to affect Irish credit unions.

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