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

Re: Consultative Document: *Guidance on the Application of the Core Principles for Effective Banking Supervision to the Regulation and Supervision of Institutions Relevant to Financial Inclusion*

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's consultative document *Guidance on the Application of the Core Principles for Effective Banking Supervision to the Regulation and Supervision of Institutions Relevant to Financial Inclusion*.¹ Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are 57,000 credit unions in 105 countries with USD 1.8 trillion in total assets serving 217 million natural person members.²

1. Credit Unions Are Formal Depository Institutions, Not “Nonbanks”

World Council strongly opposes the Committee's proposal to conflate credit unions and other mutual depository institutions with “nonbank financial institutions” that are “not . . . a formal financial institution” as stated on page 1 of the proposal.

Contrary to the Committee's assertions, credit unions are formal, depository institutions. Credit unions are a type of depository institution that, like a mutual savings bank or building society, is legally able to accept deposits and engage in other banking activities but is not a commercial bank. While credit unions are not called “banks” per se, they are not considered “nonbanks” under any common definition.

We strongly urge the Committee to revise this proposal to exclude credit unions and other depository institutions from the final version of this “nonbank” guidance. We further urge the Committee to use a definition of “nonbank” in the final version of this guidance that means a “non-deposit-taking institution,” which is how the World Bank, the European Commission, United States financial regulators, and others define the term “nonbank.”

¹ Basel Committee on Banking Supervision, *Guidance on the Application of the Core Principles for Effective Banking Supervision to the Regulation and Supervision of Institutions Relevant to Financial Inclusion* – Consultative Document(2015), available at <http://www.bis.org/bcbs/publ/d351.pdf>.

² World Council of Credit Unions, *2014 Statistical Report* (2015), available at <http://www.woccu.org/publications/statreport>.



The World Bank has defined “nonbank” financial institutions in multiple publications as “a financial institution that does not have a full banking license and cannot accept deposits from the public.”³

The European Commission has defined “nonbank financial institutions” to exclude credit unions and other depository institutions even though credit unions and some other types of depository institutions, like postal banks, are not subject to the European Union’s Capital Requirements Directive in most Member States.⁴ The Commission’s definition of “non-bank” is as follows:⁵

“The sector of [Nonbank Financial Institutions] is defined as including insurance undertakings, pension funds and other financial intermediaries (OFIs). The latter group includes financial institutions engaged in the securitisation of assets, securities and derivatives dealers (operating on own account) and specialised financial institutions (e.g., hedge funds, venture capital firms, etc.).”

Similarly, the US Federal Financial Institutions Examination Committee—an interagency committee composed of the Federal Reserve Board, the Treasury Department’s Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Consumer Financial Protection Bureau, and the National Credit Union Administration—defines a credit union as a form of “traditional depository institution” and not as a “nonbank,” for example:⁶

“Certain [Bank Secrecy Act] provisions have been extended to cover not only traditional depository institutions, such as banks, savings associations, and credit unions, but also nonbank financial institutions, such as money services businesses, casinos, brokers/dealers in securities, futures commission merchants, mutual funds, insurance companies, and operators of credit card systems.”

Examples of “nonbanks” according to the US Federal Financial Institutions Examination Committee include only institutions that are legally prohibited from accepting deposits:⁷

- Casinos and card clubs;

³ E.g., World Bank, “Key Terms Defined: Nonbank Financial Institution,” *Global Financial Development Report 2014: Financial Inclusion* (2014), available at <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,contentMDK:23268764~pagePK:64168182~piPK:64168060~theSitePK:8816097,00.html>; Jeffrey Carmichael & Michael Pomerleau, *Development and Regulation of Non-Bank Financial Institutions*. World Bank Publications, at 12 (2002), available at <https://ideas.repec.org/b/wbk/wbpubs/15236.html>.

⁴ Credit unions are exempt from the European Union’s CRD IV pursuant to Article 2(5) of that Directive. See Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance, Art. 2(5), 2013 O.J. (L176) 338, 350 (2013).

⁵ European Commission, *Non-bank financial institutions: Assessment of their impact on the stability of the financial system*, at 2 (2012), available at http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp472_en.pdf.

⁶ Federal Financial Institution Examination Committee, *Bank Secrecy Act Manual*, at 4-5 (2014) (emphases added), available at http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2.pdf.

⁷ *Id.* at 299.



- Securities and commodities firms (e.g., brokers/dealers, investment advisers, mutual funds, hedge funds, or commodity traders);
- “Money services businesses” such as remittance firms, check cashers, or e-money providers.
- Insurance companies.
- Loan or finance companies.
- Operators of credit card systems.
- Dealers in precious metals, stones, or jewels.
- Pawnbrokers.

Unlike “nonbanks,” a credit union charter gives the institution a license to engage in banking activities including accepting deposits, making loans to consumers and businesses, engaging in payments services, investing in financial instruments like debt securities, and selling some types of insurance products like credit life insurance or credit disability insurance.

World Council strongly opposes the Committee’s attempt to create a new bifurcation in financial regulation that defines any institution that is not a commercial bank as a “nonbank.” The Committee’s conflation of credit unions, building societies and mutual banks with “nonbanks” is likely to be viewed as a symptom of regulatory capture of the Committee by commercial bankers. The term “nonbank” should only be used to refer to institutions that do not accept deposits, which is how the term “nonbank” is commonly understood and defined.

The Committee should instead be consistent with the “nonbank” terminology employed by the World Bank, the European Commission, the US Government, and others, which recognizes the difference between different types of depository institutions—which include commercial banks, building societies and other thrift institutions, and credit unions—and non-depository “nonbanks” like microfinance institutions, remittance providers, and finance companies.

We strongly urge the Committee to revise this proposed guidance to exclude credit unions and other depository institutions from the final version of this “nonbank” guidance.

2. More Stringent Standards for Credit Unions and Other Mutual Depository Institutions than for Joint-Stock Financial Institutions Are Not Reasonable

World Council opposes the proposed statements in the guidance to the effect that credit unions and similar mutual depository institutions should be subject to more stringent regulatory standards than joint-stock financial institutions or commercial banks. These statements regarding financial cooperatives are not justified by the facts and are not consistent with the Committee’s claim on page 1 that this proposal “is provided to reinforce the important of the proportionate regulation and supervision of such institutions.” The Committee’s proposed statements regarding more stringent standards for cooperative financial institutions should not be finalized.

These aspects of the proposal—whether intentional or not—effectively call for favoritism on the part of supervisors to the benefit of commercial banks and joint-stock microfinance institutions and to the detriment of credit unions and other mutual depository institutions like



building societies and mutual banks. While we agree with the statement in proposed Principle 16 that “[t]he Core Principles do not require compliance with the capital adequacy regimes of Basel I, Basel II or Basel III,” the proposal in several instances argues for supervisory discrimination against credit unions and other mutuals within the category of depository institutions that are exempt from Basel-style risk-based capital requirements. In general, credit unions have a more conservative and lower-risk operating philosophy compared to their joint-stock company competitors.

The Committee should not finalize these arguments urging supervisors to discriminate against credit unions and other mutual depository institutions as a class. Instead, supervisors should address perceived institutional weaknesses on a case-by-case basis to remediate specific prudential concerns related to the assets and liabilities of individual institutions, such as through the creation of special reserves to control individual risks. Supervisory tools like the CAMEL/CAMELS Rating System framework already allow a high degree of supervisory granularity by examining an institution’s capital level, asset quality, management quality, earnings, and liquidity on a case-by-case basis.⁸

The Committee’s proposal to discriminate against credit unions and other mutual depository institutions is also likely to create artificial barriers to market entry for credit unions and similar mutual depository institutions that will reduce consumer choice and financial inclusion. Credit unions exist primarily to promote thrift and to provide their members with loans and other financial services at fair rates; credit unions exist not for profit, not for charity, but for service to their members. (Of course, “not-for-profit” is not the same as “non-profit;”⁹ credit unions need to have positive net income in order to add to their retained earnings—which are owned by the membership—as well as to control for inflation and expand their services to members).

In general this means that credit union membership results in significant savings for consumers compared to doing business with commercial banks. A recent economic analysis conducted by the Credit Union National Association of the United States of America, for example, found that in 2015 credit union members saved on average US\$ 91 per individual and US\$ 173 per household annually by doing business with their credit union, rather than a commercial bank, because of credit unions’ generally better rates on financial products and lower fees than banks offer.¹⁰ Nationally, these benefits resulted in over US\$ 9.2 billion dollars in savings for US consumers last year.¹¹ Of the approximately 6,021 federally insured credit unions in the United States, roughly 38 percent are designated as serving low-income consumers primarily.¹²

⁸ See, e.g., US National Credit Union Administration, “CAMEL Rating System,” Letter to Credit Union 07-CU-12 (Dec. 2007), available at <https://www.ncua.gov/Resources/Documents/LCU2007-12.pdf>.

⁹ Compare “not-for-profit,” *Oxford English Dictionary Online* (2016) (“Designating an organization, corporation, etc., which does not operate for the purpose of making a profit”), with “non-profit,” *Oxford English Dictionary Online* (2016) (“A non-profit-making organization; *spec.* a charity.”).

¹⁰ Credit Union National Association of the USA, *National Member Benefits Report: Year-End 2015* (2016), available at <http://www.cuna.org/memberbenefits/>.

¹¹ *Id.*

¹² US National Credit Union Administration, *Summary of Federally Insured Credit Union Call Report Data: 2015 Q4* (2016), available at <https://www.ncua.gov/analysis/Pages/call-report-data/Reports/PACA-Facts/PACA-Facts-2015-12.pdf>.



Specifically, we urge the Committee to make the following edits, detailed below, in the final version of this guidance:

a) Governmental Support Initiatives: Page 6, Second Paragraph:

“As a general rule, supervisors should not have responsibilities to promote or develop a sub-sector of financial institutions that they supervise. ~~This is particularly relevant in segments of small deposit-taking institutions such as financial cooperatives, which may be subject to government-supported developmental initiatives.~~ If supervisors also have such developmental responsibilities or objectives, they should clearly publish these objectives (EC 3), and their institutional arrangements should ensure independence between the development function and the regulatory and supervisory functions to reduce conflicts of interest (EC 4).”

We urge this revision to the final version of this guidance because we do not believe that the Committee’s proposal is appropriate for depository institutions of any type, as discussed above in Section 1 of this letter. Also, as discussed below in Section 3 of this letter, this guidance only considers the developing world perspective and is therefore not relevant to credit unions in most jurisdictions for that reason as well.

We also urge this revision because many joint-stock company financial institutions, including commercial banks, benefit from “government-supported developmental initiatives” as well as governmental capital injections and other forms of governmental subsidies (both express and implied). While perhaps not a “developmental initiative” per se, commercial banks have often enjoyed infusions of governmental capital during stress periods, such as the US Treasury’s US\$ 700 billion dollar Troubled Asset Relief Program (TARP), which subsidized the United States’ commercial banking industry during the most recent financial crisis, and similar bank bail-outs in Europe and elsewhere.¹³

It does not make sense to single out credit unions for receiving relatively meagre governmental support in the context of international development projects when commercial banks have recently enjoyed much larger governmental subsidies. Commercial banks have enjoyed much larger governmental subsidies both in terms of transfer payments (such as capital injections) and in terms of other subsidies such as implied governmental backstops that allow large commercial banks to borrow in the interbank market at lower rates than are available to credit unions (since credit unions are not large enough to enjoy an implied governmental backstop and have rarely received such backstops in the past).

b) Initial Capital Requirements: Page 10, Third Paragraph:

“Determining the appropriate minimum initial capital requirement (EC 6) for an institutional type is of particular importance. Lower minimum initial capital requirements for nonbank financial institutions (compared to banks) are most likely

¹³ See, e.g., International Monetary Fund, *Fiscal Implications of the Global Economic and Financial Crisis* (2009) (detailing, by jurisdiction, the trillions of dollars of governmental capital injections and other subsidies that were necessary to recapitalize joint-stock banks during the most recent financial crisis), available at https://books.google.com/books?id=pF8_T81IAwC&dq=government+bank+capital+injection.



appropriate given their typically narrower scope, smaller size, and reduced complexity. However, the threshold should be high enough (i) to support the basic infrastructure needed to operate sustainably, (ii) to ensure that the capital will be adequate to cover unexpected losses from material activities and risks that will be assumed, and (iii) to indicate the minimum financial capacity and commitment of the new entrants. In some countries, in an effort to encourage uptake, the minimum initial capital for a new type of nonbank financial institution has been set too low, leaving the institution with insufficient funds to acquire the requisite operating systems and technology and to absorb the typical initial losses of a start-up. An excessively low requirement can also result in high numbers of relatively weak institutions or institutions engaged in riskier business models. Start-up requirements for financial cooperatives may also include a minimum thresholds such as number of members and for geographical scope. ~~In defining minimum initial capital for supervised cooperative entities, particular attention should be given to regulatory or statutory provisions regarding member withdrawal (with its associated assumption of membership share redemption) (see guidance on Core Principle 16).²²~~

We urge the Committee to delete the references to initial capital requirements for credit unions and similar financial institutions in the final version of this guidance because the Committee does not understand how credit unions have been formed traditionally. Nearly all of the more than 50,000 credit unions in existence today were formed by volunteers with little or no initial capital other than the shares of the members, which were considered at-risk equity. These institutions were usually subject to governmental regulation from their inception but had few start-up costs because they were run by volunteers (who were not paid a salary or wages) and did not have to invest in a branch office or technological infrastructure.

It remains possible today to start a credit union in this traditional way—with little initial capital but also few start-up costs—but for initial capital requirements and other regulatory hurdles such as a minimum number of initial members (since it is difficult for a credit union that does not exist to attract members, since it cannot offer any services until it is created legally).

For these reasons credit unions are exempt from the European Union's initial capital requirement of EUR 5 million.¹⁴ Similarly, the United States of America's Federal Credit Union Act and its implementing regulations also set no initial capital requirement for a *de novo* credit union, only require 7 physical person individuals to form a credit union,¹⁵ and give a *de novo*

¹⁴ See Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance, Art. 2(5), 2013 O.J. (L176) 338, 350 (2013).

¹⁵ 12 U.S.C. §§ 1753 (“Any seven or more natural persons who desire to form a Federal credit union shall each subscribe either individually or collectively before some officer competent to administer oaths an organization certificate in duplicate . . .”), 1754 (“The organization certificate shall be presented to the [National Credit Union Administration] Board for approval. Before any organization certificate is approved, an appropriate investigation shall be made for the purpose of determining (1) whether the organization certificate conforms to the provisions of this chapter; (2) the general character and fitness of the subscribers thereto; and (3) the economic advisability of establishing the proposed Federal credit union.”), available at <https://www.law.cornell.edu/uscode/text/12/chapter-14/subchapter-I>.



credit union up to 10 years to meet the normally applicable 6 percent leverage ratio requirement to be adequately capitalized.¹⁶

We recognize that in some cases a credit union may need a higher level of initial capital based on its business plan, such as if it plans to engage in digital financial services (given the high costs of the required computer and payments systems), and it will need more than 7 members to be able to engage in proper financial intermediation. We believe that these concerns are best addressed by the supervisory agency on a case-by-case basis in the charter application process based on the actual start-up expenses the credit union reasonably expects to incur. In addition, the number of members to be reached by the credit union within its first year of existence should be addressed on a case-by-case basis with the supervisory agency based on the credit union's business plan.

Regarding geographic scope, we support the idea that credit unions should have a large and potentially unlimited geographic area from which to attract new members. This is because credit union "common bond" laws often limit who can join a credit union even though the original purposes of the "common bond"—to create a type of credit enhancement that usually involved the credit union disclosing to its membership the names of members who were delinquent on loans, who would then face peer pressure to pay their arrearage—no longer functions in this manner because of consumer protection laws prohibiting publication of the names of delinquent consumer borrowers.

Credit unions in Australia have largely done away with common bonds and most credit unions in Canada today have common bonds that include anyone who lives or works in the province where the credit union is located. Common bond laws also usually de facto prohibit credit unions from operating on a cross-border basis because foreign consumers would be prohibited from joining the credit union because of its common bond restrictions.

Credit unions typically face problems generating income when their common bond confines their operations to a small geographic area. Such small geographic limits make it difficult or impossible to achieve an efficient level of economic scale. It is essential that credit unions have a large pool of consumers from which to attract new members in order to be able to generate the retained earnings needed to capitalize the institution.

c) Supervisory Corrective and Sanctioning Powers: Page 16, Paragraph 4:

~~"Financial cooperatives may also require specific corrective and sanctioning actions, due to their membership-based structure, as well as their system-based organisation in some countries. For instance, the supervisor may consider restricting new membership in financial cooperatives during the implementation of a corrective measure, or may restrict redemption of shares in case of liquidity shortage or if the capital base is near or below the minimum regulatory requirement. Additionally, the requirement for a financial cooperative to raise additional capital is likely to be more challenging due to its capital and ownership structure. Specialised tools may be used~~

¹⁶ 12 U.S.C. § 1790d(b)(2) ("New Credit Unions"); 12 C.F.R. §§ 702.301-701.307 ("Alternative Prompt Corrective Action for New Credit Unions"), available at <https://www.law.cornell.edu/cfr/text/12/part-702/subpart-C>.



~~in the case of cooperative systems, such as imposing the exit of a financial cooperative from the system to which it is affiliated, which may result in different prudential requirements from those imposed on independent (non-affiliated) financial cooperatives.”~~

We urge the Committee not to finalize the above paragraph because it does not consider the many, effective supervisory tools commonly used to strengthen or resolve problem credit unions and other mutual depository institutions.

Restricting new membership for credit unions during implementation of corrective measures is self-defeating because this would diminish the ability of the credit union to raise new capital in the form of shares or retained earnings. Credit unions in need of increased capital often increase their earnings retention by increasing gross income and also decreasing costs. Credit union shares, with sufficient permanence and loss-absorbability, can qualify as Common Equity Tier 1 capital.¹⁷ Further, credit union capital shares typically qualify as Additional Tier 1 capital even if they do not meet all of the requirements of Common Equity Tier 1 capital.¹⁸

In addition, the Committee’s proposal focuses only on the numerator of the institution’s capital ratio. Credit unions frequently raise their capital ratios through shedding assets (“spinning down”), which increases its capital ratio by decreasing the denominator of that ratio (i.e. institutional assets) even when the numerator of the ratio (i.e. regulatory capital) remains constant. Credit unions can also often increase the numerator of their capital ratios through a Certificate of Indebtedness or similar capital injection.¹⁹ Supervisory mergers or purchase and assumption transactions are also common means of resolving weak credit unions.

We urge the Committee not to finalize this proposed paragraph on supervisory actions because it claims that Supervisors need to treat credit unions and similar mutuals more stringently than joint-stock financial institutions without considering the many supervisory tools available to strengthen or resolve problem mutual depository institutions.

If the Committee does choose to include guidance regarding supervisory actions to strengthen or resolve credit unions and other mutual depository institutions in the final version of this standard, we strongly urge the Committee to include these specific supervisory actions discussed in our comments, including issuances of new shares, increased earnings retention, “spinning down,” Certificates of Indebtedness, and supervisory business combinations with a stronger institution.

¹⁷ See, e.g., World Council of Credit Unions, *Credit Union Shares as Regulatory Capital under Basel III* (2012), available at http://www.woccu.org/documents/WOCCU_Credit_Union_Shares_as_Capital.

¹⁸ *Id.*

¹⁹ See, e.g., 12 U.S.C. § 1790d(o)(2)(B) (“[W]ith respect to any insured credit union, [regulatory capital] includes, at the Board’s discretion and subject to rules and regulations established by the Board, assistance provided under section [12 U.S.C. §] 1788 of this title to facilitate a least-cost resolution consistent with the best interests of the credit union system.”).



d) Cooperative Governance: Page 18, Paragraph 3:

~~“The RoP Survey indicated that certain weaknesses in the Board structure and functioning are more common in financial cooperatives and microlending institutions than in banks. Examples included a lack of both fit-and-proper requirements and succession plans for senior management, and failure of the Board to adequately oversee senior management. In small institutions, the chief executive is often also chair of the Board and it is not uncommon for the internal auditor to lack independence. Governance in financial cooperatives poses additional challenges given their membership-based structure, which gives room for conflicts of interest that may lead to poor oversight, excessive risk-taking and frauds.”~~

We urge the Committee not to include the above paragraph in the final version of this guidance because it is not accurate with respect to credit unions and indicates that the Committee does not understand credit union corporate governance.

Specifically, the Committee’s proposed statements in this above paragraph may be accurate about small commercial banks or microfinance institutions, but are not accurate about credit unions. First of all, few credit union chief executives are the Chairman of the Board, since the Chairman and other board members are elected by the members using a one-member-one-vote structure; the chief executive usually does not run in that election because there are typically legal restrictions prohibiting board members from being compensated by the credit union.²⁰ These board members are therefore typically unpaid volunteers—except perhaps for one board member, who is usually the Treasurer—although an increasing number of credit unions are beginning to pay their board members where it is lawful to do so.

Regarding internal auditing, the internal audit function at credit unions is typically performed by a Supervisory Committee elected by membership from individuals who are not members of the Board of Directors.²¹ In this arrangement, the internal auditors do not lack independence, and also have authority to remove credit union officers and directors from office.²²

In terms of fit-and-proper requirements, credit union directors should be able to understand the credit union and its business, and for this reason many credit union directors undergo training after election to the board if they are not already well versed in these issues. But it is also unreasonable to expect that every volunteer director of a small credit union should have the

²⁰ See, e.g., 12 U.S.C. §§ 1760 (“Irrespective of the number of shares held, no member shall have more than one vote.”); 1761a (“Only one board officer may be compensated as an officer of the board and the bylaws shall specify such position as well as the specific duties of each of the board officers.”).

²¹ See, e.g., 12 U.S.C. § 1761d (“The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the board of directors and a summary of the report to the members at the next annual meeting of the credit union; shall make or cause to be made such supplementary audits as it deems necessary or as may be ordered by the Board, and submit reports of the supplementary audits to the board of directors; may by a unanimous vote suspend any officer of the credit union or any member of the credit committee or of the board of directors, until the next members’ meeting, which shall be held not less than seven or more than fourteen days after any such suspension, at which meeting any such suspension shall be acted upon by the members; and may call by a majority vote a special meeting of the members to consider any violations of this chapter, the charter, or the bylaws, or any practice of the credit union deemed by the supervisory committee to be unsafe or unauthorized.”).

²² *Id.*



same level of expertise as the board members of Global Systemically Important Banks since a credit union is much smaller and less complex than the large commercial banks on which the Basel Committee normally focuses its attention. As noted above, it is often illegal for a credit union to pay its directors, which makes it hard to attract and retain outside talent.

The practical result of supervisors insisting on credit union directors having the same level of expertise as the directors of large banks is that it is difficult for credit unions to be able to field a full board, which can result in the credit union being forced to cease operations or to merge with a larger institution. While credit unions ceasing operations would help the commercial banking sector by reducing or eliminating their not-for-profit competition, we do not think that reducing competition in the financial sector is in the public interest or in the interest of consumers. To the contrary, the results of the most recent financial crises—where large, supposedly well-run banks had to be rescued from insolvency by taxpayers and credit unions did not—militate in favor of greater diversity in the financial sector since a larger number of institutions with varying business models typically results in a more stable financial system.

In terms of attacking credit union's membership-based structure and one-member-one-vote election system, this is little different from a joint-stock company where there is no controlling shareholder. For instance, no shareholder of HSBC holds more than 5 percent of its stock. If the Committee's theory that a lack of controlling shareholders results in poor corporate governance, we strongly suggest that the Committee turns its attentions to the corporate governance of Globally Systemically Important Banks before focusing on credit unions and other community-based mutual depository institutions.

e) Components of Capital: Page 22, First Paragraph:

“While EC 1 and EC 2 emphasise the importance of adequately defining the qualifying components of regulatory capital, this task may be particularly challenging for financial cooperatives because of the Basel III capital accord. ~~In general, the capital invested by members is redeemable and usually not considered high-quality capital.~~ Some specific measures may be adopted, depending on the structure, size, and sophistication of a particular cooperative sector: (i) focusing on retained earnings; (ii) restricting redemptions of shares unless capital adequacy ratio is kept at a minimum level equal to or higher than that specified by regulation; (iii) requiring cooperatives to make liquidity deposits in a second-tier entity or to use another comparable facility; or (iv) applying capital adequacy requirements on a group or system basis (eg at the level of a federation or a central cooperative). For the last two measures, the liquidity and solvency of the cooperatives will depend on the liquidity and solvency of the second-tier entity. Consequently, these entities must be well regulated and supervised.”

We urge the Committee to delete the sentence crossed-out above, and to add the underlined phrase, because credit union shares from their inception were at-risk equity and confusion regarding this issue results primarily from a lack of clarity regarding supervisory discretion under the Committee's Basel III standard.

In addition to share capital, credit unions build capital with retained earnings—a form of Common Equity Tier 1 capital—which typically results in credit unions having higher quality



regulatory capital than a similarly sized commercial bank. To the extent that it is difficult for credit unions and similar mutual depository institutions to issue capital instruments, this is the direct result of supervisory confusion regarding the Basel Committee's Basel III capital accord. Specifically, many supervisors claim to lack of flexibility in interpreting the 14 points of Basel III Common Equity Tier 1 in the credit union or mutual context despite the Committee's footnote stating that flexibility for capital instruments issued by cooperatives and other mutual depository institutions is permissible.²³

In addition to making the edits detailed above in the final version of this guidance, we urge the Committee to attempt to resolve the supervisory confusion regarding credit unions shares and similar instruments as regulatory capital by clarifying that national supervisors have discretion with respect to classifying credit union and other mutual depository institutions' capital items.

f) A Proportionate Approach Should Not Result in Higher Capital Levels for Credit Unions: Page 22, Second Paragraph:

~~A proportionate approach does not always result in lower capital adequacy ratios. Particularly with regard to banks and nonbanks engaged in traditional microlending, some factors might justify higher capital adequacy ratios compared to the ratios imposed on diversified financial institutions or institutions not engaged in this type of activity (see description of such factors in Annex E).~~

We strongly disagree with the Committee's claim that small financial institutions should be subject to higher capital levels than commercial banks. The business model of credit unions is very different from that of for-profit banks and other joint-stock financial institutions; credit unions are generally smaller in size, do not pose systemic risks even if the local credit union system is large (since aggregate credit union assets in a jurisdiction are typically spread out over hundreds or thousands of independent institutions), and have less risky business models and lower levels of complexity. In addition, unlike commercial banks, credit unions are member-owned, democratically controlled institutions that operate to serve their members rather than to maximize profits.

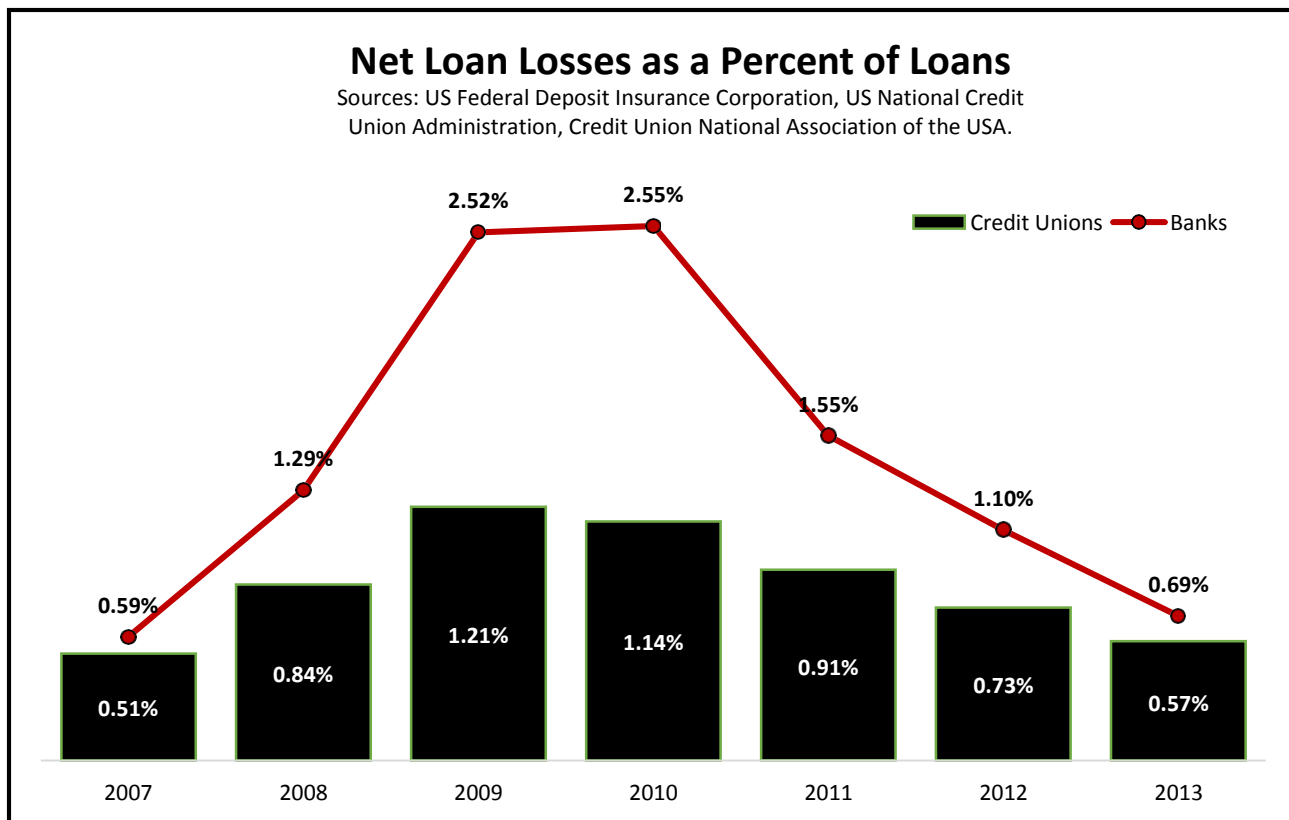
There are no external stockholders in credit unions, and because of that, credit unions are not driven to take excessive risks by the need to maximize profits for investors. Instead, credit unions operate for the purpose of promoting thrift and providing loans and other financial services to their members at fair rates. It does not make sense logically or from a policy standpoint to penalize all credit unions and other mutual depository institutions because of weaknesses in a few cooperative systems—such as cooperative banks in Italy or India—any more than it would make sense to penalize all joint-stock financial institutions for commercial banks' myriad financial losses that have required trillions of dollars in governmental injections of capital and other subsidies to rescue them from their excessive risk-taking.²⁴

²³ See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, at 14-15 & n.12 (2011), available at <http://www.bis.org/publ/bcbs189.htm>.

²⁴ See, e.g., International Monetary Fund, *Fiscal Implications of the Global Economic and Financial Crisis* (2009) (detailing, by jurisdiction, the trillions of dollars of governmental capital injections and other subsidies that were necessary to



Credit unions generally performed well during the recent financial crisis. The comparative performance of credit unions and banks in the United States, for example, during the financial crisis and its immediate aftermath illustrates credit unions' lower level of risk compared to joint-stock banks. During and after the financial crisis beginning in 2008, credit union loan losses, while elevated, peaked at 1.21%, which was less than half the peak level reported by the United States' banking industry. Overall, US credit union loan losses averaged 0.90% between 2008 and 2013, while US banking institution losses averaged 1.62% over the same period, as illustrated by the below chart:²⁵



A similar example of mutual depository institutions' greater resilience and generally lower-risk profile than joint-stock financial institutions are the track records of British mutual building societies versus British joint-stock building societies.

Although mutual building societies are not cooperatives, they are mutual depository institutions with a similar operating philosophy and, over the past 20 years, a number of these institutions in the United Kingdom demutualized to become joint-stock building societies. Today, mutual

recapitalize joint-stock banks during the most recent financial crisis), available at

https://books.google.com/books?id=pF8_T81IAwC&dq=government+bank+capital+injection.

²⁵ Credit Union National Association of the USA, Comment Letter re: National Credit Union Administration's Proposed Rule: *Prompt Corrective Action—Risk-Based Capital*, at 9 (May 28, 2014), available at www.cuna.org/Legislative-And-Regulatory-Advocacy/Downloads/rci_rbc_052814/.



building societies remain an important part of the UK economy—as do credit unions—but none of the joint-stock building societies remain in business after a series of failures and mergers.²⁶

We urge the Committee not to finalize any of these misguided claims about financial cooperatives—detailed above—in the final version of this guidance, including the unfounded argument that credit unions and similar mutual depository institutions require more stringent supervision than joint-stock financial institutions of similar size and complexity. The available evidence indicates that quite the opposite is true: Joint-stock financial institutions are much riskier and likely to experience losses than are credit unions and other mutual depository institutions.

3. This Guidance Only Considers the Developing World Perspective

World Council urges the Committee to state expressly that this guidance is applicable only to informal financial institutions in developing world such as non-depository microfinance institutions.

It is clear from the proposal and its citations that only institutions in the developing world were considered in the development of this paper, and the guidance therefore should not apply in other jurisdictions.

This guidance is not appropriate for credit unions in most jurisdictions, including but not limited to those in Australia, Brazil, Canada, the Caribbean, the European Union, New Zealand, and the United States of America.

We urge the Committee to state expressly that this guidance is limited to informal financial institution in the developing world—for which this guidance is clearly intended—by revising the final sentence of the first paragraph on page one to read as follows by inserting the text underlined below:

“This Guidance is intended to help supervisors respond to changes and innovations in products, services, and delivery channels of financial institutions working to reach the approximately 2 billion adults who do not have an account at a formal financial institution (referred to in this Guidance as “unserved and underserved customers”) in the developing world.”

²⁶ See, e.g., Andrew Campbell & Judith M. Dahlgreen, *Demutualization and risk: the rise and fall of the British building society, in Complexity and Crisis in the Financial System: Critical Perspectives on the Evolution of American and British Banking*, at 149-63 (Matthew Hollow, Folarin Akinbami & Ranald Michie eds., 2016)

(“This chapter charts the development of the mutually owned building society in the UK as a means of providing a small and simple range of financial services to consumers in the nineteenth, twentieth and twenty-first centuries. The decline of the size of the sector in the late twentieth century is described, and this is identified as an unforeseen consequence of a small legal change in the Building Societies Act 1986 which permitted conversion of a mutual building society into a registered limited company with a share capital. The large number of consequent conversions and takeovers is noted. A legal change which was motivated by a desire to increase competition for consumers, in fact resulted in a reduction in competition and in the removal from the marketplace of financial services providers who had a simple and distinct product offering and ethos.”), available at <https://www.elgaronline.com/view/9781783471324.00016.xml>.



4. Proposed Definition of “Cooperative Financial Institution” Includes Non-Cooperatives

The Committee should not attempt to regulate financial institutions that it does not understand. The Committee’s proposal to include several types of mutual depository institutions that are not cooperatives within the definition of “Cooperative Financial Institution” in Annex C of the proposal shows a lack of understanding of credit unions and other mutual depository institutions.

Specifically, the Committee believes that “building societies” and “mutual banks” are cooperatives even though they are not structured as cooperatives. Unlike cooperatives, mutual building societies and similar types of mutual thrift institutions do not typically issues shares or follow cooperative principles. The Committee should look to the International Co-operative Alliance’s cooperative principles²⁷ and the International Accounting Standards Board’s IFRIC No. 2 standard²⁸ to inform itself about what forms of corporate organization are cooperatives and which are not.

While mutual building societies and similar mutual thrifts are mutual depository institutions, they are not cooperatives and should not be included in the definition of “cooperative financial institutions” for that reason.

5. Credit Unions Are for Everyone

Credit unions are for people of all walks of life. This includes people of modest means as well as employees of international organizations, government workers, small business owners, doctors, nurses, teachers, factory workers, farmers, police officers, firefighters, pilots, flight attendants and many other professions that are neither poor nor underserved.

As not-for-profit cooperatives seeking to intermediate between net savers and net borrowers (as a bank does), credit unions’ efforts to promote thrift include providing all of their members with financial services at fair rates. In many cases these credit union members are not poor and may be a credit union member even if they also do business with a commercial bank (since credit unions typically offer better rates than banks do). It is also difficult or impossible to intermediate financially when a credit unions’ members are all very poor, since the credit union in that situation does not have a significant deposit base to use to fund its loan book and would have be externally dependent on either subsidized donor funding or high-cost bank loans for on-lending purposes, like non-depository microfinance institutions.

Since credit unions emphasize savings and financial education for their members, credit union members typically build wealth over time and often cease to be poor even if they were poor when they first joined the credit union. As noted earlier, in the United States roughly 38 percent of credit unions are designated as serving low-income individuals primarily; the other 62 percent

²⁷ See International Co-operative Alliance, “Co-operative identity, values & principles”; <http://ica.coop/en/whats-co-op/co-operative-identity-values-principles> (last visited Mar. 31, 2016).

²⁸ International Accounting Standards Board, *Members’ Shares in Co-operative Entities and Similar Instruments*. IFRIC No. 2 (2004).



are not.²⁹ Consumers should have access to credit union services regardless of the individual's personal wealth or income level so that all consumers can get a fairer deal on financial services than banks offer, and also because having net savers as credit union members is necessary to fund the institution's loan book.

Credit unions' business model does indeed help promote financial inclusion, however, credit unions' typically successful efforts to serve the underserved does not mean that they are "not . . . a formal financial institution" or only serve the poor, as the Committee claims in the proposal.

We urge the Committee not to finalize its claims that credit unions and other mutual depository institutions exist only to serve the poor and the unbanked because these claims are not factually accurate.

Conclusion

World Council appreciates the opportunity to comment on the Basel Committee's consultative document on the *Guidance on the Application of the Core Principles for Effective Banking Supervision to the Regulation and Supervision of Institutions Relevant to Financial Inclusion*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael S. Edwards".

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

²⁹ US National Credit Union Administration, *Summary of Federally Insured Credit Union Call Report Data: 2015 Q4* (2016), available at <https://www.ncua.gov/analysis/Pages/call-report-data/Reports/PACA-Facts/PACA-Facts-2015-12.pdf>.