# Ewart S Williams: The role of credit unions in the emerging financial landscape

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at a Breakfast Seminar hosted by CUNA Mutual Group/CUNA Caribbean and the Trinidad and Tobago Unit Trust Corporation, Port of Spain, 6 November 2003.

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Thanks for inviting me. Let me give my belated congratulations to you Mr. Chairman on your celebration of Credit Union month in October. I read with interest the many accolades that you received, and deservedly so, for the sterling contribution that the credit union movement has made towards encouraging the practice of thrift, self-help, and cooperation among its members and towards promoting the development of co-operative ideals.

As I reviewed the history of the credit union movement in Trinidad and Tobago I could not help but be impressed by the **resilience** of the movement and its ability to survive and prosper through good times and bad.

I noted, for example, that the period of the first economic boom, between 1973 and 1983, was one of very rapid growth for the credit union movement reflecting the registration of new credit unions. The growth of credit union resources was flat in the late 1980's and early 1990's, a period of economic decline, when many credit unions either collapsed or were merged. In 1986, the Government introduced tax incentives to help boost savings in credit unions and in 1993 a Task Force was established to examine the conditions of some specific credit unions and to provide proposals for generally strengthening the sector.

**In recent years**, the credit union industry has been going through **further adaptations** to cope with the changing financial environment. While there has been growth in the last few years, it has been lopsided way. Some institutions that have adapted to cope with the new market reality have prospered, while many of those that have remained in the traditional mould have languished.

**What is the picture today?**

According to the available data:

- We now have about **130** operating credit unions from about **400** in the early 1980s.
- Total assets of the movement are now estimated at around $3 billion which is a fairly sizable sum and makes the credit union movement a very important part of the overall financial system.
- Interestingly, the 6 largest credit unions, with assets from about $200 million up to about $750 million accounts for 50 percent of total credit union assets and the largest **17** account for three quarters of the industry assets.
- The smaller institutions raise resources from shares and savings deposits and make small loans for consumer purposes; these are essentially run as co-operative societies and are based on principles of volunteerism.

In the case of the large credit unions, we have a new paradigm involving products and services more readily associated with the commercial banks.

These larger credit unions, in addition to shares and savings deposits, now offer certificates of deposits, make mortgage and commercial loans, provide credit and debit cards to be used in automatic teller machines and also provide cambio and travel agency services.

The expansion of the credit union sector over the last 35 years has taken place in the absence of an appropriate legislative framework. As you know, the present legislation, covering the credit union movement {The Co-operative Society Act} dates back to 1971 and does not address prudential issues. In an attempt to fill this gap, the Co-operative Credit Union League, over the past few years, has been promoting a system of prudential management based on adherence to the “PEARLS” system, which provides guidelines for capital adequacy, liquidity and non-performing loans.

The League's efforts have had mixed results. The preliminary data that I have been able to muster suggests:

(i) that about 40 percent of the operating unions maintain a liquidity ratio below the 10 percent suggested in the PEARLS system;

(ii) that non-performing loans in the industry average a relatively high 20 percent;

(iii) that about only 40 percent of operating credit unions maintain a capital adequacy ratio of under 10 percent, which is the recommended ratio.

The need for the stricter regulation of credit unions was recognised several years ago. Indeed the 1993 Task Force Report recommended amendments to the Co-operative Act:

(i) to provide for the regulation and supervision of credit unions by a new supervisory agency responsible to the Minister of Finance;

(ii) to give the regulator power to make regulations with respect to prudential criteria for credit unions;

(iii) to grant full enforcement powers which should include the removal of directors and the suspension of a license to operate.

Later in 1996, an IDB project implemented with participation of the Credit Union League initiated a review of the regulatory framework and established the Credit Union Supervisory Unit within the Ministry of Finance with responsibility for the development and implementation of a system of surveillance for credit unions. It is not clear what is the status of the new draft legislation which was prepared in the context of the project.

From my vantage point, and let me emphasise that these are my views, and not official government policy.

The **sheer volume** of resources being intermediated by the credit unions as well as the rapid changes taking place in the more aggressive segments of the sector underscore the critical need for stricter regulation **to protect the funds of their members and more generally to help in maintaining the soundness of the financial system**. The lower interest rate environment which is promoting greater competition within the financial sector, in my opinion, adds to the urgency for tighter regulations.

But getting the right regulatory framework for the credit union is not that easy.

It is indeed ironic that the main strengths of credit unions constitute unique challenges for supervision and regulation. For example, in traditional credit unions there is a collective ownership by all members, who technically have equal voting rights, regardless of the size of their monetary investment. Control is therefore not legally vested in any one person or group of persons by virtue of their having more at stake. All this is particularly true for the smaller community or employment-based credit unions. Larger credit unions tend to operate with shares and savings of their members as well as from the general public, **in much the same way as banks or non-banks**.

This dichotomy, in my personal opinion, makes a strong case for a two-tier regulatory system of the type that is common in several Latin American countries.

In the typical Latin American system one tier of the regulatory regime pertains to the small "closed type" credit unions that continue to rely on volunteers to manage and run the operations and that provide traditional basic services. The other regulatory tier pertains to the "more open credit unions" which have a more diversified resource base and are involved in a wide range of services, basically operating like banks.

In applying this model to Trinidad and Tobago, I could envisage a regulatory regime for these closed-type operations that would continue to be based on prudential criteria although these should be less rigid. For instance, these small credit unions should be required to have some minimum capital requirements (but this should be **'real'** capital devoted solely to meeting losses).

Even these small credit unions should **continue to meet modest liquidity ratios** and should **be required to make provisions for delinquent loans**. Very importantly, they should be required to submit information about their operations at least on a quarterly basis and **should** be subject to closer monitoring if they do not meet the specified standards.

These small credit unions could be monitored and supervised by a strengthened unit in the Ministry of Co-operatives.

**In my view, the larger “open-style” credit unions should in fact be subject to a regulatory regime pretty similar to that which obtains for the banks and non-banks.** This more stringent regime should place emphasis on good governance and risk management structures.

For instance, their supervisory regime should clearly define and distinguish between the roles of the Board of Directors and Management, and should require that Directors assume a purely oversight function to ensure that the appropriate risk-management policies are in place.

Because of the diversity of services being offered these larger credit unions should be required to have professional management that meet fit and proper criteria and possess the technical ability to conduct credit risk analysis. They should be subject to higher levels of capital adequacy, liquidity, loan loss provisions and more ambitious delinquency standards. They should operate under clear rules establishing ethical standards of behaviour and controls for insider loans to avoid conflict of interest.

For convenience these larger credit unions could be, in the first round, supervised from the Ministry of Finance pending consideration of a broader Financial Supervisory Authority with responsibility for the supervision of all financial institutions.

Because of the unavailability of data I am unable to say whether any of the large credit unions would be able to meet the current standards that have been established in the banking and non-banking sector.

For the record, the delinquency ratio for commercial banks now averages around 3 to 4 percent; and for non-banks only slightly higher. While the stationary minimum capital ratio for commercial and non-banks is 8 percent, the actual capital ratio for banks now averages about 20 percent and is even higher for non-banks. The liquidity ratio currently averages about 30 percent for banks and about 35 to 40 percent for non-banks.

I recognise that this is a very ambitious proposal which may not find favour with some current industry players who would argue that they have been operating successfully without strict regulation. **My point is that these large credit unions are now intermediating** significant resources and assuming sizable risks and their operations can have contagion effects on the rest of the financial system.

Let me make a few general observations on some of the issues that credit unions would need to grapple with in the context of Trinidad and Tobago’s march to developed-country status.

There is an issue, for instance, whether credit unions should not help their members become not only savers but investors - for instance through pooling resources for investment in equities or in the government fixed income securities. Of course, some of these investments carry risks and members would need to be advised and be agreeable to such investments.

There is clearly the issue about the role of credit unions in providing credit to small and medium sized industries, an area which will be critical to the achievement of sustained growth in employment in Trinidad and Tobago. There is an argument that given the movement’s connection with the small man and with groups that have been deprived access to normal banking services, the entry of credit unions into micro finance is a logical and natural step.

And honestly, I believe that a way can be found to involve the credit union movement in this area without incurring excessive risks.

The fact of the matter is that, in general, lending to many small and medium sized enterprises carry higher transactions cost and greater risks and inadequate security. In many countries in Latin America and Asia, governments have intervened to mitigate these risks through credit guarantee schemes. Such schemes seek to help overcome the problem of loan applicants who have good projects, are creditworthy but cannot offer adequate collateral to satisfy normal requirements of the lending institutions.

The objective of the guaranteed scheme, which could be financed by government with grants and low cost loans from multi-lateral agencies, is to share the risks with the lending institution (in this case, the credit unions) so that if the borrower defaults the lender will be compensated for all or part of the loss involved.

In our case I can envisage a **partnership** between institutions like NEDCO and the Business Development Corporation, providing the technical assistance, project management and consultancy services, on the one hand, with resources from the credit union movement backed up by government credit guarantees on the other. There are a number of best practice arrangements to reduce the risks of abuse of these subsidised arrangements, but perhaps that’s a discussion for another time.

I would like to end with the following concluding remarks:

Firstly, because the credit union movement is now intermediating significant financial resources and assuming greater risks, it would have to contend with higher regulatory standards.

Secondly, the credit union movement needs to pay greater attention to improving its systems for co-operative governance, risk management and information disclosure.

Thirdly, the movement needs to expand the range of investment opportunities that are available to its membership if it is to maintain a competitive position in the current financial market place.

Fourthly, developing strategic alliances with institutions involved in the provision of financial services to small and medium sized enterprises should be a goal that the credit union movement should embrace.

Finally, let me congratulate Cuna Mutual Group on its sterling contribution to the credit union movement in Trinidad and Tobago and let me wish this new initiative and this new partnership all the best.