

Ewart S Williams: Some thoughts on a new regulatory regime for credit unions

Feature address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Thirty-First Annual General Meeting of the Eastern Credit Union, St Joseph, 18 March 2005.

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I would like to express my sincere thanks to the Board of the Eastern Credit Union for inviting me to address you on the occasion of your Thirty First Annual General Meeting. I am pleased that 2004 was a very successful year and that you have very good news for your membership when you meet tomorrow notwithstanding the low interest rate environment encouraged by Central Bank policy. I am convinced that competition brings out the best in all of us and Eastern Credit Union is an excellent example.

I understand that with us this evening, in addition to Eastern Credit Union members, are stakeholders as well as officials of the national credit union leadership. Accordingly, I would like to take this opportunity to talk a bit about some issues that have been the subject of much public debate in recent months having to do with the prudential supervision of credit unions.

My point of departure will be the Government's stated position to work towards a "single" regulator for the financial system as a whole and the announced decision to bring some credit unions under the regulatory authority of the Central Bank. I will try to touch on some of the problems involved in the approach and give some thoughts on an appropriate regulatory model for the Credit Union movement.

Obviously I am not making official pronouncements here since the choice of regulatory regime is not the call of the Central Bank but of the Government.

But first permit me to recognize the tremendous contribution that the Eastern Credit Union has made to the people of Trinidad and Tobago.

I was pleasantly surprised to read about the origins of the Eastern Credit Union. I grew up in San Juan and I did not realize that Eastern started in my backyardout of the Bermudez Biscuit Factory and the Aranguez Estates. From these modest beginnings in 1973, you now cover the East- West corridor and have expanded to San Fernando and more recently to Tobago. I understand that plans are afoot to expand to central Trinidad.

Your accomplishments have been impressive indeed and the Eastern Credit Union is now a major player in our local financial system. The statistics that I have seen have you moving from an initial membership of twenty-two, and a share capital of \$1 million in 1978, to a current membership of some (103,000) and a resource base of about \$600 million. In terms of assets, Eastern ranks as the third largest financial cooperative in Trinidad and Tobago.

But your influence in the cooperative credit union movement has been greater than could be measured by your financials, as impressive as these are.

Eastern's main contribution has been as an innovator; stretching the boundaries of the cooperative movement, in an effort to better serve its membership. Eastern was the first to move away from the traditional model of share savings and consumer credit to provide a range of product offerings more associated with commercial banks.

Eastern's innovative loan programmes have helped its members construct homes, create and sustain small businesses, purchase land, and pay for advanced level education.

Among credit unions, Eastern has been a pioneer in the introduction of certificates of deposits, loan protection and life savings programmes, and an ATM service.

Reading through the pages of your various annual reports, I was struck not so much by how many of your members you helped to build homes, to buy cars, to start small businesses (and I am not saying that these are not important achievements). What struck me more, as I could read between the lines, was a certain passion for the fundamental principles of pooling, co-operation and mutual support.

I could see this passion and pride in the many references to **La Joya**, this jewel of a facility that so aptly represents your trail-blazing success. I could see this passion for community and mutual support in your education awards; the credit union management courses; the efforts to get youth involved in the movement; and to get members to assist in reducing loan delinquency. I could see the passion for

the co-operative spirit in your alliances with other credit unions to pursue joint activities, and in your strategic partnerships with credit unions in Barbados, Jamaica and Grenada.

That you could be true to your cooperative ideals even while you expand your range of financial services; strengthen your business infrastructure to better compete with the rest of the financial sector; all this, while striving to adhere to acceptable prudential and governance standards; that you can accomplish all these things simultaneously, speaks volumes for the commitment of your management and staff, your current Board of Directors and indeed the entire leadership and membership that built this institution over the last thirty years.

I am sure that there are a few other credit unions which have evolved in ways broadly similar to Eastern and which can boast of their own successes. And I congratulate them all and I urge them to continue their efforts to keep the credit union spirit alive, as they continue to face the challenges emanating from globalization and financial liberalisation and a more secular approach to community.

Ladies and Gentlemen, you know better than I, the tumultuous change that the credit union movement has undergone over the past three decades. The movement saw a period of very rapid growth in the decade to the mid-1980s; this was followed by stagnation up to around the mid-1990s: since then, with the aid of some government support by way of tax credits, the movement has blossomed once more.

To survive, the credit union movement has had to adapt, and this is reflected in the considerable consolidation that has taken place from around 400 credit unions in the early 1980s to about 130 today. Total credit union assets have increased sharply in recent years and are estimated at about \$4 billion currently. The recent growth has, however, been very lopsided and has led to much concentration.

According to data available for 2003, the six largest credit unions with assets ranging from \$200 million to \$800 million, account for about one-half of total credit union assets and the largest 17 credit unions account for three-quarters of the industry's 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, 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 thirty-five 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 adequately 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 between 20 and 25 percent. If we calculate this uniformly and according to internationally accepted standards, it is likely to be much higher (the commercial banks have a delinquency ratio of 3 percent);
- (iii) about 40 percent of operating credit unions maintain a capital adequacy ratio of under 10 percent (which is the recommended minimum 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. For various reasons this has not worked out as envisaged.

From my vantage point, the case for stricter credit union supervision is compelling. It is based on the amount of resources now being intermediated and the business models of the larger credit unions which encompass more complex and riskier operations. These factors require that greater attention be paid to risk-management by the unions themselves and that there be a formal supervisory framework for credit unions to protect members' savings and to help maintain the integrity of the financial system. And remember that we are talking about an estimated 500,000 credit union members (about one-third of the population) and largely lower and middle income people.

Some people have argued for self regulation to be done by an organization such as the Cooperative Credit Union League. The fact is, however, that self regulation has never worked on a sustainable basis anywhere because it is usually effective only with those who are inclined to obey the rules – **not for those that need it most**. And, I can assure you that there are credit unions, both large and small, that are not operating in accordance with sound prudential principles.

The case for formal regulation also has to do with the **sustainability of the movement** and with **enlightened self-interest**.

The financial environment is changing very rapidly – more so now than at any period in our history, because of the proliferation of modern information technology. The credit union movement will have to continue changing with the times to meet its members' needs, to fend off competition from other financial service providers and to remain relevant. **The sustainability of the movement will require that credit unions get into increasingly riskier activities to survive and thrive**. In these circumstances, formal, rigorous supervision will become more critical and more urgent.

I should add that it is in everybody's self-interest to have effective formal regulation since poor financial practices by one or two credit unions could undermine confidence in the entire movement and could conceivably have contagion effects on the entire financial system.

I must concede that formal arrangements for the prudential regulation of credit unions are a relatively recent phenomenon. **We, in Trinidad and Tobago, are not alone in lacking adequate credit union legislation**. In fact, data published by the World Council of Credit Unions (WCCU) indicate that only about one-third of 104 member countries surveyed, have credit union-specific legislation. In most developing countries credit unions continue to be regulated under Cooperative Societies legislation.

The **United Kingdom** brought credit unions under the authority of the Financial Services Authority (the regulator for the commercial banks) only in 2002.

In **Jamaica**, legislation shifting the regulation of credit unions to the Bank of Jamaica (the Central Bank) was passed in 2004 but the operating details are still being worked out.

In **Barbados**, starting last year the five largest credit unions accounting for 80 percent of total credit union assets are supervised jointly by the Central Bank and the Registrar of Credit Unions.

Recently, the **Trinidad and Tobago** Government announced the intention to amend the Financial Institutions Act to bring large credit unions under the regulatory control of the Central Bank. The rationale was that that these institutions were essentially conducting business of a "**banking nature**" and should be regulated as banks, while the other credit unions involved in more traditional activities would continue to be supervised elsewhere.

Having examined the FIA, it may indeed be more complicated than originally envisaged to adapt this piece of legislation to the credit unions. Our research shows that legislation intended for commercial banks is generally inappropriate for credit unions, whose purpose is to provide cooperative financial services to members who are their depositors, their borrowers and their owners.

Credit unions are different from commercial banks because of a number of essential features, including:

- their democratic control by members;
- their ownership structure through share contributions;

- their member savings contributions;
- the nature of credit union capital;
- the fact that their surplus is returned to members;

Because of these differences, credit unions have been most successful where they operate under **specific credit union legislation**.

The part of the Government's proposal that prompted the strongest reaction was the proposal to split credit union supervision between two regulators, based on institution size. It is difficult to disagree with the Credit Union League (and many of you credit union leaders) that splitting regulation between two regulators runs the risk of fragmenting the movement and stunting its development.

There was a similar situation recently in Britain. When credit union supervision was transferred from the Registry of Friendly Societies to the newly created FSA, there was considerable concern that small credit unions would not survive under the more robust regulatory regime. The FSA responded pragmatically by adopting a two-tier system which perhaps may fit our circumstances.

It is my view that some kind of two-tier system is an appropriate regulatory approach for credit unions in Trinidad and Tobago. In line with the views of the credit union movement, perhaps it makes sense that all credit unions should be regulated by a single regulator – the Government has assigned the role to the Central Bank. In these circumstances, **the two-track regulatory regime should be based not specifically on size but on the overall level of risk associated with the particular credit union**. In essence, the proposal is for a regulatory regime for credit unions which is essentially riskbased.

And what's the rationale?

Clearly there are different levels of risk attached to different types of activity that credit unions carry on. The regime could be designed to take account of these different levels of risk. It will need to be sufficiently flexible to accommodate the position of small credit unions while at the same time responding effectively to the situation of large ones. The larger credit unions are likely to engage in a wider range of activities, many similar to those provided by the commercial banks. This will expose them to greater risk and a higher level of supervision. If smaller credit unions are engaging in risky activities, they should also be subject to the more robust supervisory framework.

I said earlier that the Co-operative Societies Act was not a prudential tool and that the FIA was not suited to the credit unions. It is my view that the **draft Credit Union Supervisory Bill** which was prepared in the Ministry of Finance (under the IDB project) may be a useful starting point for new credit union legislation. I noticed from its website that the Credit Union League had an opportunity to comment on the draft bill and had many concerns. I understand this and I agree that the current draft needs much work to be workable; but it's a good starting point. For one thing, the regulatory responsibility will need to be shifted from a proposed Regulatory Authority to the Central Bank.

Without getting into details, it is my view that appropriate credit union legislation will need to address the following areas, particularly with respect to the higher-risk (let's call it, Class A credit unions):

- (i) It would need to define the classes of business in which credit unions could operate and perhaps require that credit unions receive approval from the regulator before entering new classes of business.
- (ii) It would need to give the regulator authority to examine the business and affairs of a Credit Union at least once every 18 months to ensure compliance, and to certify that it is in a sound financial state.
- (iii) As in the case of institutions under the FIA and the Insurance Act, the legislation will need to provide for on-site supervision in which the risk management and governance systems (the higher risk) of credit unions will be assessed.
- (iv) The Act will need to specify prudential criteria on capital requirements, liquidity, investments, and lending limits, as well as reporting requirements. These prudential criteria and reporting requirements, could also, in principle, be tailored to meet the two-tiered risk-based categories in which the credit unions fall.
- (v) It would need to give the regulator enforcement powers to compel compliance with the legislation. These powers could range from "close monitoring", to removal of officials, and suspension of the credit union's charter. The regulator will need to have these powers so

that problem and/or insolvent credit unions could be managed and closed, if needed, to protect members' deposits and the integrity of the credit union system.

If we are to take a more holistic approach to strengthening the credit union movement, in order to support the new regulatory framework, we would also need to look at the developmental aspects of the movement, including the supporting mechanisms. Thus, for instance, and perhaps over time, we would need to give some thought to a **strong effective Stabilisation Fund** – my understanding is that there are currently two such institutions (the Credit Union Stabilisation Cooperative Society and the Central Finance Co-operative Society). I would imagine that there is need for a strong institution capable of providing liquidity and investment support as well as training and various forms of technical assistance to individual credit unions.

Moreover, in order to help the credit unions compete on broadly similar terms as the banks, for instance, one may also need to give thought to a **deposit insurance and a complaints mechanism** for the credit unions, similar to the Deposit Insurance Corporation and the Financial Services Ombudsman Scheme.

These are just some preliminary thoughts which would need to be developed in greater detail and refined.

I am aware that there is ongoing work to strengthen the present Co-operatives Act. This is important and the new provisions should be complementary and not overlap with any new credit union legislation.

To provide credibility to this regulatory approach there would need to be a process of intense dialogue between all the stakeholders – the Ministries of Finance and Labour and Co-operatives; the credit union movement; the Credit Union Co-operative League; and the Central Bank. The role of the Ministry of Labour vis-à-vis the credit unions in particular and the co-operative movement in general will need to be clearly defined. It is my view that the Ministry could still have an important developmental role. There would also need to be a role for the Credit Union League in helping to prepare its membership for the new regulatory environment.

I hope that these ideas contribute something to the ongoing debate about how to preserve the ideals of the credit union movement, help the movement adapt to and thrive in the rapidly changing financial environment, whilst we administer effective supervision to maintain a strong and robust financial system.

I also want to underscore, contrary to the views that have been expressed in the media, the Central Bank recognizes the important contribution that credit unions have made to our society. The Central Bank also expects the credit union movement to continue to play a critical role in our diversified financial sector. We feel strongly, however, that to achieve this, more robust regulation and supervision are urgently needed.

Let me end by again thanking the Eastern Credit Union for inviting me. **I trust that with your commitment and team spirit you will continue to lead the way to positive change.**