Stabilising British Credit Unions

A research study into the international rationale and design of credit union stabilisation programmes.

Paul A Jones
Research Unit for Financial Inclusion
Liverpool John Moores University
March 2010

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Research Unit for Financial Inclusion

Faculty of Health and Applied Social Sciences

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This research report was written by Paul A. Jones, of the Research Unit for Financial Inclusion at Liverpool John Moores University.

The opinions, ideas and recommendations contained in this report are those of the author, based on data generated through the research. They do not necessarily reflect those of ABCUL or of any particular participating organisation.

All case study chapters have been checked and verified by the national credit union organisations concerned.

Executive Summary

The context

At the 2009 AGM of the Association of British Credit Unions, a motion was carried by members asking the Board of Directors to look into the possibility of developing a stabilisation fund for credit unions in Great Britain. This request arose out of widespread concerns in the credit union movement about the ongoing number of credit union failures and out of a desire to assist troubled credit unions. Since 2002, 42 credit unions have been declared in default by the Financial Services Compensation Scheme.

The research

ABCUL commissioned the Research Unit for Financial Inclusion at Liverpool John Moores University to undertake this study into international stabilisation programmes with a view to generating knowledge about assisting credit unions in difficulties. The findings of the research, and recommendations, are those of the author and not of ABCUL.

Why credit unions fail

Programmes designed to stabilised troubled credit unions depend on an understanding of how and why credit unions get into financial difficulties and eventually fail. The research developed an analysis of failure focusing on the immediate causes, the contributory causes and the fundamental causes of credit union failure. Fundamental causes were found to lie in a lack of effective governance and poor management.

Why stabilisation matters

The Financial Services Compensation Scheme (FSCS) guarantees the savings of members in credit unions declared in default up to £50k. However, FSCS has no remit to support or stabilise credit unions in order to prevent failure happening in the first place. Stabilisation matters for, even though members in failed credit unions do not lose their savings, the community that the credit union served loses the benefits of credit union membership and the reputation and credibility of the credit unions generally is called into question.

International approaches to stabilisation

The research study was designed to investigate the dynamics of credit union stabilisation programmes world-wide in order to learn from the experience of the international credit union movement. The aim was to investigate whether the principles of stabilisation could be developed and implemented in Britain.

Internationally there are varying models of stabilisation funds and programmes, which differ in their constitution and their operation. Some of those explored in the report are operated by the Government regulator (United States, Newfoundland and Labrador) and others privately by credit union leagues and associations (Ireland, Poland, Uzbekistan, and Jamaica). The international preference is for greater Government regulatory involvement in stabilisation as a component part of deposit insurance schemes

The principles of stabilisation

Stabilisation programmes are built on number of common principles. These include regulatory compliance, meeting robust performance standards as a condition of entry and of ongoing participation; regular off-site and on-site monitoring, examination and supervision; financial and technical assistance for unstable credit unions targeted at securing recovery; the authority and mechanisms for the responsible authority to intervene; and procedures to instigate credit union mergers or liquidation if required. In addition, all known examples of stabilisation programmes regard stabilisation as a component part of deposit insurance

Stabilisation is complementary to deposit insurance

The principle of protecting members' savings through assisting and supporting credit unions in trouble rather than primarily through compensation pay-outs subsequent to default is fundamental to stabilisation.

Stabilisation depends on effective and enforced regulation, and compliance with compulsory financial and operational standards.

Participation in a stabilisation programme, including access to depositor protection, is dependent on compulsory compliance with regulatory financial and operational standards. In general, stabilisation depends on credit unions achieving and maintaining a key set of ratio targets in areas of capital, liquidity and delinquency.

Stabilisation demands robust monitoring, supervision and examination of credit unions by the regulatory or administrative authority.

In all case studies, the responsible authority carried out continuous off-site monitoring of financial and organisational performance, through statistical ratio analysis of financial data, often using the PEARLS monitoring system, and through the examination of reports regularly submitted by credit unions as a condition of their membership of the programme.

Stabilisation requires the power to intervene when credit unions fall to meet required financial and operational performance targets

Trends in a rise in delinquency, in a decline in bad debt provisioning or in a decline in capital would, in all case studies, merit immediate investigation and action. Even though in most cases, it is credit unions themselves that seek assistance from a stabilisation programme, it is the responsible authority that has the over-riding obligation to intervene not only to stabilise an individual credit union and protect its members' savings, but also to protect the reputation of credit unions as a whole and, importantly, the assets of the stabilisation fund

Stabilisation provides technical and financial assistance to troubled credit unions.

All stabilisation programmes offer troubled credit unions expert technical assistance, advice and financial support to assist them to re-establish themselves as going concerns.

Stabilisation depends on a strategic and monitored "work-out" plan of action to re-stabilise the credit union as a going concern or fit for merger.

Stabilisation intervention into a troubled credit union involves field staff working with credit union directors and managers on a restructuring and rehabilitation plan in order to re-establish a credit union as a viable independent institution or as sufficiently robust to transfer its engagements into another credit union.

Stabilisation is time limited

The time allocated to a restructuring and rehabilitation plan varies from one programme to another. But, in general, at the maximum, a supported credit union would be expected to be self-sustainable within 2 years, and often within a much shorter period.

Stabilisation programmes include actions to merge (transfer engagements) or to liquidate credit unions that cannot achieve independent viability

Stabilisation programmes depend on a rigorous diagnostic of the potential long-term viability of a credit union, and stabilisation is not attempted without recovery being assessed as realistic. For this reason, stabilisation programmes always include the option of assisting credit unions to transfer their engagements or to proceed to liquidation.

Is it time to think about credit union stabilisation in Britain?

The positive impact of credit union stabilisation programmes throughout the world is impressive. Since the creation of such programmes in Ireland, Newfoundland and Labrador, Jamaica, Poland and Uzbekistan, no credit union has failed and no savers have had to be compensated out of the assets of the stabilisation fund.

Stabilisation is often a key critical element of international credit union success, and it is perhaps time for credit unions to consider its desirability in Britain. Certainly, many credit unions would find stabilisation challenging given the need to meet robust financial and operational standards and agree to regular inspection, monitoring and examination.

It is clearly not feasible that a credit union stabilisation programme could be implemented immediately in Britain. Credit unions are the result of a particular historical process of development, and, too many are, as yet, insufficiently robust to participate in a stabilisation programme designed to international standards

In looking to the future, ABCUL does need to have the development of a stabilisation programme on its agenda. For irrespective of the training and support that ABCUL offers its members, on the basis of international experience, it is a stabilisation programme above all that would contribute the most to long-term stable credit union development.

The Cost of Stabilisation

Stabilisation programmes represent a significant financial and resource investment in the safety and soundness of credit unions and in the security of members' deposits. In all case studies, the costs of stabilisation were met by credit unions themselves.

The cost of stabilisation in any particular country is dependent on a range of variables and, consequently, it is not easy to define exactly the cost of stabilisation or to make comparisons between different countries. It is estimated, after comparisons with international examples, that a British stabilisation programme could possibly be established for around £1 million per annum. In fact this compares favourably with £6 million true cost of delivering the Financial Services Compensation Scheme for credit unions in the five years, 2004 – 2009[1]. Initial premiums levied on credit unions could be based on 0.2% of saving deposits.

Recommendations

The report makes a series of recommendations which arise out of the research study and do not necessarily reflect the views of ABCUL. These recommendations aim to promote the principles of stabilisation within the British credit union movement. Numbered examples of the recommendations are as follows:

> **For credit unions**
>
> 3. Boards of directors should ensure accurate and timely monthly management accounts are submitted to all board meetings. They should regularly evaluate progress according to financial target ratios such as PEARLS.
>
> 7. Credit unions should not compromise rigorous financial monitoring, analysis and management through a reliance on the FSCS as a pay-out box in case of failure. Credit unions need to recognise the reputational damage of individual credit union default on the credit union movement as a whole.
>
> **For the Association of British Credit Unions**
>
> 14. In the longer term, ABCUL should negotiate with Government on the creation of a credit union stabilisation agency. This could be a Government sponsored organisation but operated in collaboration with the FSA, ABCUL and the sector. It could be integrated into, or work collaboratively with, the FSCS or its equivalent.
>
> **For Government and the Financial Services Authority**
>
> 17. The FSA should focus their attention on credit unions identified as weak financial institutions and support interventions and remedies to avoid default. This is seen as a much more effective intervention than raising compliance thresholds for all.
>
> 18. The Government should work with the FSA, FSCS, ABCUL and the sector to consider strengthening of the credit union sector through the development of a credit union stabilisation agency.

The report

This research report is offered to the ABCUL board and to the ABCUL membership as a whole on the occasion of the 2010 AGM as a contribution to further discussions on the desirability and feasibility of creation a British credit union stabilisation programme.

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[1] These figures were obtained from FSCS for a Ministerial Briefing in 2009. The £6 million figure includes a net compensation pay-out (after loan recoveries) to depositors in credit unions in default of £2.2 million.

1. Introduction

The ABCUL Board in Annual General Meeting in March 2008, in response to a request from the membership, undertook to explore the possibility of developing a stabilisation fund for credit unions in Britain, and to report on its findings and to give recommendations at the ABCUL AGM in 2009. This research study requested by ABCUL in response to the 2008 AGM motion and conducted by the Research Unit for Financial Inclusion at LJMU, aims to assist the ABCUL Board in its deliberations. The recommendations of the report, however, are those of the author and not those of the Board.

ABCUL members assembled in the 2008 AGM were rightly concerned about the long-term stability of some British credit unions. In the seven year period 2002 to 2009, 42 credit unions[2] failed and were declared in default by the Financial Services Compensation Scheme (FSCS). An unknown number of additional credit unions also failed, but were rescued or transferred (merged) into stronger credit unions, often with the financial support of local authorities, the DWP, regeneration or other external agencies. It can be estimated at least 10% of credit unions have failed since 2002. Whilst not actually failing, it is also well known throughout the credit union movement that there are many credit unions struggling financially which are potentially vulnerable to failure. In this study, the FSCS reported that there are no indications that the rate of credit union failure is reducing, and, given the impact of the recession, there are concerns that it may rise.

It is true that the level of default in most of the 42 failed credit unions has been relatively small, on average £73k per credit union[3]. However, in one case it was a significant £908k. Further, so far, there is no evidence to suggest that the current level of credit union failure has impacted negatively on the good-standing of the credit union movement as a whole. Even the most publicised failures seem to have had only minimal negative impact on the movement. The failure of Streetcred Credit Union in Rochdale, for example, had little or no recorded negative impact on Manchester Credit Union, situated just a few miles down the road, according the reports of its manager. Nevertheless, ABCUL members in the 2008 AGM were not lulled into complacency. It was not difficult for them to imagine how the continuing failure of credit unions could start to compromise the credibility of the movement a whole. The motion at the AGM resulting in this study was timely, for perhaps it is now that the movement needs to think seriously about preventative action to reduce the possibility and the impact of credit union failure.

In many parts of the world, credit union movements, either privately on their own or under the auspices of the Government regulator, have established stabilisation funds and programmes which are precisely designed to protect members' savings by ensuring the safety and soundness of credit unions. In all known cases, these programmes are also linked to deposit protection schemes but, unlike the UK FSCS, they are not established primarily to pay-out compensation to savers in liquidated credit unions declared in default. Neither are they interventions to be activated solely to rescue a credit union after it has

[2] See Appendix 1 for a list of failed credit unions declared in default whose members were compensated through the Financial Services Compensation Scheme.
[3] Figures supplied by the FSCS as part of this study.

failed and succumbed to financial difficulties. Stabilisation is by definition strategic, holistic and preventative. Stabilisation programmes are designed to ensure the financial stability of credit unions, by assisting them when they are in difficulties, but first by ensuring and requiring, under penalty of expulsion, that they operate according to robust business and financial standards, monitored and examined within the programme.

This study explores the operations and dynamics of stabilisation programmes in Canada, Ireland, Jamaica, the United States and Uzbekistan, and is informed through information gained from the stabilisation programme in Poland. It begins, however, with a consideration of the reasons for credit union failure in Britain. The purpose of the case studies is not for information alone, but to learn and to reflect on how the principles of stabilisation could respond to stem credit union failure in Britain. It is important to understand the nature of a problem before exploring the dynamics of a solution.

The research study involved direct consultations and telephone interviews with international credit union personnel connected with the case studies, and also with the World Council of Credit Unions, the National Federation of Community Development Credit Unions (US) and the Polish National Association of Cooperative Savings and Credit Unions. It also involved consultations on the issue with the Financial Services Authority, the FSCS, the Financial Inclusion Team at the Department of Work and Pensions and a small group of credit union managers in the field.

Internationally, the impact of stabilisation programmes within national credit union movements is impressive. Wherever stabilisation programmes exist, credit union failure resulting in a need to pay-out member savings from a compensation fund, rarely, if ever, happens. Corrective action stems failure before it ever results in a credit union being declared in default. Of course, such action may lead to mergers or even the managed closure of solvent credit unions.

The applicability of the principles of stabilisation to the British credit union movement is, however, complex. British credit unions are where they are, as a result of their own particular history and process of development. Despite the advances of the past ten years, many remain small organisations, often run by volunteers, and the rigour of a robust stabilisation programme, if operated according to international principles, would be likely to put too many credit unions immediately out of business.

However, the study does conclude that stabilisation must be on the ABCUL agenda if it looks to the future stability and strength of a credit union movement. Internationally, credit union success has depended significantly on having stabilisation programmes in place. It is a key factor, for example, in the stability of emerging credit union movements throughout the world.

In the meantime, while the credit union movement is as it is in Britain, the study also concludes that much can be done to introduce elements of stabilisation now and in the medium term. The recommendations are commended to the ABCUL Board.

2. Why credit unions fail

Programmes and initiatives designed to stabilised troubled credit unions depend, of course, on a clear understanding of how and why credit unions get into financial difficulties and eventually fail. Consultations with the FSA, the FSCS, and the DWP were designed to throw light on the dynamics of failure and identify the key areas that would be of concern within a programme of stabilisation. The following typology of failure arises out of these consultations.

Of course credit unions that transfer engagements or even close altogether, have not necessarily failed. Transfer or closure happens for a range of reasons. Credit unions may transfer engagements to achieve economies of scale, to reach wider and more diverse markets or for other strategic objectives. Solvent credit unions may close voluntarily because there are no longer directors or staff to run the organisation, or maybe there is no longer a viable common bond or even because the original purpose for the credit union has diminished or disappeared.

In this context, and in regard to the study, credit union failure refers specifically and only to the inability of the institution to meet its liabilities, either to its savers or to its creditors, as a result of sustaining financial loss. Failed credit unions are by definition insolvent institutions having more liabilities (debts) than their total assets. They are in default because assets, even when realised, would be insufficient to pay liabilities. In Britain, the FSCS covers default and compensates savers up to the value of £50,000 per member per credit union.

The immediate cause of credit union failure

Within the research discussions, the immediate cause of credit union failure was identified as financial loss. However, this can occur for a number of reasons, but in Britain financial loss arises predominantly from two main sources: loan delinquency and bad debt, and generating insufficient income to meet expenditure.

- <u>Loan delinquency and bad debt.</u>
    - Loan delinquency and bad debt were regarded in combination as often a primary reason for credit union failure. In Britain, the incidence of bad debt in one way or another always lies behind credit union failure.
- <u>Insufficient income to meet expenditure.</u>
    - If income is too low and/or expenditure too high, the result again is financial loss. An insufficiently profitable lending portfolio together with rising and uncontrolled costs can result in failure. In a number of default cases, income was insufficient because external subsidies and grants had had come to an end. Credit unions that are grant-dependent are vulnerable to failure when support of the funding bodies ceases.

Financial loss in credit unions can also arise from embezzlement and fraud. Of course, there have been occasional incidences of embezzlement and fraud in British credit unions. Yet according to the FSA and FSCS, these are not significant causes of financial loss in British credit unions and any losses sustained are usually covered by insurance. Of course, embezzlement and fraud can undermine the credibility of a credit union as a safe and secure financial institution. This could result in the loss of earned income.

Contributory causes of credit union failure.

Loan delinquency, bad debt, and insufficient income to cover expenditure are the immediate sources of the financial loss that result in insolvency and failure. However, these are themselves products of a range of contributory factors that create the conditions within which they arise. Some of these contributory factors or causes are internal to credit unions and others, whilst others can arise from the external market and economic environment.

The following contributory causes were indentified in the consultation meetings as arising out of the direct experience of the FSA, FSCS and the DWP in dealing with credit unions that have failed or that experience severe financial and organisational difficulties.

Internal contributory causes

In general, it was considered that the most prevalent contributory causes of financial loss in British credit unions so far relate to the internal organisation of the credit union.

- Financial discipline and control
    - Lack of financial discipline. Insolvency often arises from a general failure within credit unions to maintain financial discipline, to operate to high financial operating standards and to meet financial targets.
    - Lack of financial control. Failed credit unions have not been able to control income and expenditure. This is often the result of poor financial systems, a lack of internal controls and poor financial accounting, particularly an inability to master accruals based accounting. Without accruing for expenditure, credit unions often spend funds they do not have. A lack of financial control in managing grants can result in grants running out with costs still needing to be met. In was noted that some failed credit unions had very few available records, including out of date and inaccurate records of members' accounts.
    - Lack of financial information. It was reported that in some of the larger credit unions that have failed, the board and staff did not have the relevant financial information early enough to recognise what was happening in the credit union. There were no financial reports submitted to board meetings or available to the manager.
    - Lack of financial analysis. Over and above a lack of financial information, credit unions fail because of a lack of insight or analysis among board and staff members as to the meaning or interpretation of

financial information. Often with no financial ratio analysis, boards and staff are unable to spot organisational deficiencies in time.

  - Lack of financial planning. Failure is often the result of a lack of foresight and ability to think ahead financially. Failure is the result of not having the skills to understand the financial position of a credit union or the ability to see things getting worse.

  - Low institutional capital and reserves. A key element of poor financial planning is not thinking ahead sufficiently to build up capital and other reserves sufficiently. Credit unions with low capital to asset ratios, and little other reserves, are extremely vulnerable to failure.

- Credit administration and arrears collections**.**

  - Poor credit administration. Imprudent lending and poor management of the loan portfolio can lead to situations that quickly get out of control. Over-exposure on the loan book can result in credit unions suffering significantly if some loans begin to go bad (as a result of unemployment, sickness etc). In some credit unions, it only took two large loans to go bad to de-stabilise the organisation.

  - Ineffective or inexistent debt recovery procedures: Credit unions that have succumbed to financial loss and failure often had poor or no debt recovery procedures in place.

- An appropriate and effective business model

  - Lack of a business model that works. When credit unions operate primarily in the sub-prime market, generating sufficient income to build the business is difficult. Serving high risk, low income members can be demanding in resources for often small financial return. Credit unions that do not serve an economically diverse membership can remain vulnerable and, unless small and totally volunteer run, can find it challenging to balance the budget.

- Business planning

  - No real action or business plan. Many of the credit unions that failed did not have any real business or action plan that was actively used to monitor progress. They did not have the ability to analyse the market and plan against future possible scenarios. The failure to recognise, for example, that the loss of employer support can have a major impact on the profitability of the business, can lead to the failure of an employee credit union.

- Organisational effectiveness

  - Slow response rate to organisational deficiencies. Credit unions that get into difficulties are often slow and inefficient to respond to organisational deficiencies. Systems may not be in place to spot those deficiencies in the first place, but even when made aware of them, credit unions can be slow to take action.

External contributory causes

External factors that can threaten the profitability and stability of credit unions are increasing, particularly as a result of the recession. However, it was noted that there is currently little if any evidence to suggest that external factors alone have ever so far led to credit union failure in Britain. However, external factors can impact negatively on credit unions, as has happened in other countries, and it may be that there are significant uncertainties ahead for British credit unions.

- Changes within the market place
  - Closing markets. A company closing down in an area can adversely affect a credit union. It only takes 20 or 30 borrowers to default on loans for many credit unions to be in serious trouble.
- Changing economic environment
  - Impact of the current recession. At first reported as an opportunity for credit unions, there is now increasing anecdotal evidence to suggest that the recession is beginning to impact negatively on some credit unions. Credit union income is being challenged as people become increasingly reluctant to borrow, as borrowers find it harder to repay and loan delinquency and bad debts rise. In a situation where deposits cannot readily be converted to income generating loans, some credit unions are even turning away deposits as they endeavour to maintain capital adequacy ratios and dividend rates. Diminished returns on liquid and other investments are also impacting on credit unions' bottom line.

Fundamental causes of credit union failure

Lying behind the contributory causes of credit union failure, however, are two major fundamental causes of credit union insolvency and default. It is from these two fundamental factors that all the contributory and immediate causes of failure arise. These are poor governance and bad management.

- Lack of effective governance
  - Lack of board competence. It was stressed in discussions that credit union failure was fundamentally a board issue and that it often arose from a lack of financial and business competency among directors. Credit unions were vulnerable if board members were unable to interrogate financial statements and to question what they are being

told. A lack of director ability and confidence to ask the right questions, to interrogate management and to spot problems as they arose led to severe difficulties within credit unions. Particular difficulties also arise if a board feels overpowered by a forceful manager.

- Lack of confidence in decision making. Credit unions get into difficulties if boards of directors are reluctant to take difficult decisions soon enough. Boards, for example, can find it difficult to take hard decisions on staff redundancies or on dealing with inefficient and unprofessional practice among volunteers.
- Lack of board engagement. Participants also argued that failure arose from a lack of real engagement of board members in the progress and in well-being of the credit union.
- Lack of a commercial culture. On the boards of failed credit unions, there was often an accepted culture and set of attitudes that was not sufficient to maintain the viability of the credit union. Often boards had difficulty in operating to sound commercial principles. *"I have seen over time, a general if not complete, unwillingness of boards to engage with a more commercial approach",* one participant noted.
- An over-reliance on external funding. In failed credit unions there was often a reliance on external funding streams and board members were often very critical when funding was not available or managed as they would have wished. The attitude of many directors can be *"a perpetual looking for grants and saviours (the Council being one)".* Failure can therefore arise from a lack of focus on board responsibility and from an unwillingness to accept responsibility.
- Lack of succession planning. In a number of failed credit unions, board members simply "ran out of steam". In others, directors just grew older and found there was nobody to succeed them. In some cases, directors simply lost heart in the whole enterprise.

- Lack of effective management
  - Lack of management personnel. In many small credit unions, there is sometimes a lack of personnel to manage and control the credit union and often a dependence on one or two key individuals. If these individuals leave or fall ill, the credit union can get into difficulties as there is nobody to do the work. The loss of a good manager, where that person has been the sole leader and driver of the business, can result in the credit union getting into immediate difficulties. In many credit unions, there is no second tier of competent management to take over.

- <u>Lack of financial knowledge and insight among managers.</u> Credit unions fail as a result of poor financial management. If management lacks the financial insight and the skill to read financial trends and the perspicacity and astuteness to spot things going wrong, then credit unions can fail. This is often linked to a lack of financial ratio analysis in a credit union.
- <u>Lack of sound financial processes and procedures.</u> Credit unions that fail, for example, to conduct regular bank reconciliations can get into difficulties easily.
- <u>The lack of qualified and competent staff.</u> Credit unions that are assisting staff members to gain qualifications and thus develop competence in financial affairs are less likely to fail than those that settle for less qualified and competent staff.
- <u>Gatekeeper founder members.</u> Difficulties arise if the founder members of a credit union are not making way for competent managers and financial controllers as the business grows. ‘The person who sets up the credit union is often not the best person to manage its development’, (one discussion group participant).

3. International approaches to credit union stabilisation

The research study was designed to investigate the dynamics of credit union stabilisation programmes world-wide in order to learn from the experience of the international credit union movement. The aim was to investigate whether the principles of stabilisation could be developed and implemented in Britain.

Internationally, however, there are varying models of stabilisation funds and programmes, which differ in their constitution and their operation. Some are operated by the Government regulator (United States, Canada (Newfoundland and Labrador)) and others privately by credit union leagues and associations (Ireland, Poland, Uzbekistan, and Jamaica). The case studies in this chapter have been chosen to reflect the varying models of stabilisation.

Five cases studies were selected; these are the United States, Canada (Newfoundland and Labrador), Ireland, Uzbekistan, and Jamaica. The research was also informed through contact with the National Association of Cooperative Savings and Credit Unions in Poland. However, Poland has not been included as a case study, purely out of a consideration of the length of the report. The principles of the Polish stabilisation programme are reflected in the principles of stabilisation more generally.

In fact, for all their diversity, the principles of stabilisation are remarkably common and consistent throughout the case studies. These principles are brought together in Chapter 4 of the report. In many ways, it is the principles are that are the most important findings of the study, as it is these principles that would inform the development of a stabilisation programme in Britain.

In regard to the various models, however, the international preference, and certainly that of WOCCU, is for greater Government regulatory involvement in stabilisation as a component part of deposit protection schemes. There are moves in this direction both in Ireland and Jamaica, as are noted in the case studies. According to WOCCU, fewer and fewer credit union movements are organising private stabilisation funds and programmes, and in fact, many of these are being wound down as formal Government deposit protection schemes are introduced. WOCCU notes that this is also the case in New Zealand and Trinidad. This is a factor ABCUL would have to consider in any moves to create a stabilisation programme in Britain.

All the case studies were read, reviewed and agreed by the national credit union organisations concerned. The author of the report is therefore assured of their accuracy.

Newfoundland and Labrador, Canada

The Credit Union Deposit Guarantee Corporation

Newfoundland and Labrador is Canada's most easterly province, one-and-three-quarters times the size of Great Britain yet with a population of just 509,677. There are 11 credit unions in the province with 41 branches between them. Combined assets, as of June 09, were C$740 million (£416m). Credit unions range in size from the largest at around C$390 million (£211m) in assets to the smallest credit union with C$6 million (£3.4m).

Credit unions in the province are regulated, supervised, insured and offered technical assistance by the Credit Union Deposit Guarantee Corporation (the Corporation), a provincial Crown Corporation established in 1991. Under the Newfoundland and Labrador Credit Union Act 2009, the Corporation has a responsibility to facilitate the financial stability of credit unions and to ensure that they comply with legislation and implement sound business policies and practices. It has a board of six directors, three are government representatives appointed by the Minister and three are credit union representatives nominated by the credit unions in the Province.

The Deposit Guarantee Fund

The Corporation maintains a deposit guarantee fund, the purpose which is, as is the case with the FSCS in Britain, to pay out the claims of depositors in the case of the credit union liquidation and default. Currently, this fund insures member deposits (savings) up to C$250,000 (£142k) per account type.

However, the guarantee fund is also designed to provide financial and other assistance to credit unions for the purposes of stabilisation when facing difficulties. As guardian of the guarantee fund, the Corporation has the responsibility of doing all in its power to re-establish the stability of failing credit unions so that they have no, or a reduced, requirement to call on the fund assets. The Corporation, therefore, takes a proactive role in the stabilisation of troubled credit unions and is specifically charged under the Act to protect credit union deposits against impairment arising from financial losses and insolvency.

The Corporation has considerable regulatory and financial powers to act in relation to credit unions, beyond those held by the FSA in Britain. It undertakes robust monitoring and supervision of credit unions and carries out regular financial and organisational examinations. When problems arise, it has wide ranging powers to intervene and to act in order to rectify deficiencies and to stabilise failing credit unions. If satisfied that a credit union is failing in any respect, the Corporation has the power to take control of the institution, replace both board members and management, and place the credit union under its own supervision until the problems are resolved.

Although managed by the Corporation, the guarantee fund is financed by credit unions themselves via a series of levies and charges for annual assessment by the Corporation. All salaries and costs of the seven members of Corporation staff are also financed through the fund and the credit union system. Additional income to the Corporation also comes from its role as a master policy holder for credit union insurance. At the moment, the fund has a C$6 million investment profile. If in the case of any particular failed credit union, the fund would be insufficient to meet losses, the Corporation can also approach the Government for loans or for financial support. Any monies borrowed or paid by the Government to the credit union system are ultimately repaid by the credit union system.

Promoting sound business and financial practices for credit unions

The approach taken by the Corporation to credit union stabilisation is primarily preventative. In order to reduce the possibility of difficulties and losses arising in credit unions, the Corporation requires all credit unions to meet statutory financial and organisational standards and these are robustly enforced. Credit unions are required, for example, to have at least a 5% capital asset ratio (2% from share capital and the rest from retained earnings) and at least a 6% liquidity ratio. Any deviation from this standard would result in the Corporation requiring the Board of Directors of the affected credit union to submit a plan that would show when and how the credit union would be back in compliance with the Act and Regulations. The plan would be reviewed by the Board of the Corporation and if approved it would be monitored by the staff of the Corporation. Failure to meet the plan could result in placing the credit union under the Supervision of the Corporation.

The Corporation endeavours to assist credit unions, however, to build their management and financial capacity to meet the required standards, by, as the definition of its role in the Act states, "*promoting the development and implementation of sound business practices and sound financial policies and procedures'* and by *"establishing and implementing loss prevention programmes and controls'.* The Corporation takes a hands-on approach to its involvement in credit unions and is empowered to issue directives in relation to multiple aspects of business and financial practices and procedures. The Corporation can, for example, *"establish terms, conditions, restrictions and limitations in relation to the lending activities of credit unions and the loan policies"* if it judges that these are in the interests of a credit union's stability and financial strength.

Issuing directives is complemented, however, by the role the Corporation takes in board and management training. In interview, one of the Corporation's senior officials stressed that the Corporation's involvement in training is central to its holistic approach to credit union stabilisation. In recent years, in its quest to ensure the stability of credit unions, the Corporation has prioritised, for example, improving credit union corporate governance and has put significant resources into director training programmes and corporate governance conferences. The importance of having qualified trained people on credit union boards, with an ability to hold management to account, is regarded by the Corporation as central to long-term credit union stabilisation.

According to the interviewed official, traditionally credit union losses, for example, have come about through poor lending practices due to incompetent and unaccountable management. Strengthening the capacity of the board to ask the right questions and hold management to account has been seen as critical to long-term success. The official reported that prioritising the development of corporate governance has led to marked improvements in credit union stability and performance in the province.

Monitoring and examination of credit unions

Participation in the deposit guarantee fund entails regular monitoring and examination of credit unions by the Corporation. Even with the vast distances involved in Newfoundland and Labrador, the Corporation keeps a close eye on credit union operations and performance. It has immediate electronic access to each credit union's financial data and conducts detailed financial analysis in order to monitor financial trends. In addition, all credit unions have to submit monthly financial and operational reports to the Corporation. Bi-annually, the Corporation's Auditors conduct an inspection that is over and above the required year-end external audit.

The Corporation monitors credit unions in terms of their performance and their risk of failure. The two areas that merit the highest attention of the Corporation are the quality of the loan portfolio and a credit union's loan portfolio risk assessment. Insufficient lending (a low loan to asset ratio), bad debt and declining capital adequacy are regarded by the Corporation as the major factors which result in credit union failure. The primary focus is on the condition of the loan book and on the reserves made for doubtful debts. Fraud and high expense to income ratios are, according the Corporation, less of a problem among the province's credit unions.

Low loan to asset ratios, increasingly prevalent among credit unions, is a major monitoring concern as it results in a decline in income and in a capacity to retain capital adequacy levels. However, overall, it has been bad debt that has been the primary cause of credit union destabilisation in Newfoundland and Labrador. In recent years, for example, there have been a number of recorded cases of managers making large unauthorised commercial loans on which borrowers subsequently defaulted. It is for this reason that the Corporation keeps a close watch on loan and delinquency ratios. Even though low loan to asset ratios are also a concern, a sudden increase in the value of the loan book is always, for example, according the Corporation's official, a red flag meriting further investigation, for it can mean that large loans have been made without due consideration of repayment.

If there is any cause for concern, either in regard to rising bad debt or a fall in the capital ratio to below 5%, or for any other reason, the Corporation has the power to enter a credit union and undertake a detailed examination and inquiry into its affairs. This is normally conducted by the Corporation's stabilisation team, all of whom are highly-qualified credit union technicians. The team will even go through the individual loans to members and ascertain if any were out of policy or imprudently made. The team will always seek an explanation from management, for example, if any loan was made with a total debt service ratio greater than 40%. Such loans would be judged as very high risk. In most cases, if the ratio of determined high risk loans is greater than 20% of the total loan book, the stabilisation team will demand further action be taken in a credit union. On the recommendation of the team, the Corporation retains the right to close down part or all of the lending operations of the credit union if they are judged as too high a risk and the

Corporation may also require the credit union to set up a reserve to cover potential future losses.

Assisting credit unions under supervision

If the Corporation considers that a credit union is unable to pay its liabilities, or is in financially difficulties or carrying on its business not in conformance with legislation or sound business practices, it has the power under the Act to take control of the credit union and declare it to be under the supervision of the Corporation or of any other appointed agency.

The power of the Corporation to take control of a credit union and to send in a supervisory team to take full responsibility for management and operations is a key characteristic of the Canadian approach to stabilisation. Whilst under supervision, the supervisory team have the power to investigate the credit union's problems, to remove and replace individual members of board and of management, to change policies and procedures, and to direct the staff in the development of a detailed recovery plan.

Under supervision, the team sent in by the Corporation endeavours to re-establish the credit union as a going concern or, if necessary, to arrange an amalgamation with another credit union or to liquidate the organisation. In these circumstances, it is the supervisor, and not the board or the membership, that has the power to *"reorganise, amalgamate, dissolve, wind-up, liquidate or otherwise dispose of the business of the credit union"* (Credit Union Act: 176.i). In nearly all cases, supervision will entail the replacement of the management of the credit union. The supervisor will seek out a new manager and offer the staff team and board technical assistance and training in order to build management and board competence.

The Corporation can use deposit guarantee funds, or borrow additional funds from the Government or other agencies, to provide financial assistance to credit unions. This financial assistance may be given to recapitalise the credit union, purchase or assume its liabilities or assets or for any other reason the Corporation judges appropriate. In one case, for example, a credit union had sustained a C$7 million loss, due in part to the manager extending a C$1.2 Million line of credit to a member involved fraudulently in the promotion of a form of Ponzi scheme. There was also an unauthorized Commercial loan issued to one member for approximately C$2.9 M and it should be noted that the credit union manager also solicited members to borrow from the credit union to invest in the Ponzi scheme. Many of these loans were not qualified and eventually were a loss to the credit union. The credit union recovered some of the losses through its insurance bond but the Corporation had to make up the remainder of the loss, paying C$400,000 a year to the credit union in financial support until the deficit is paid in full,. This credit union was in the end transferred into another credit union, but this transfer was only possible given the financial support of the deposit guarantee fund.

Credit unions are only released from supervision when the Corporation is satisfied that the problem that caused the concern is corrected and the credit union is effectively organisationally and financially stabilised. This is dependent, of course, on the credit union meeting the minimum 5% capital requirement. There is a system of appeal against a supervision order through the courts, but this is rarely taken up by boards or, if taken up, is rarely if ever successful. The cost of contesting supervision alone militates against board action, as does the realisation that without Corporation support the credit union would most likely fail. A forced transfer of a credit union into a stronger credit union was resisted by a small group of members, for example, for nearly three years but the Corporation ultimately won the court case and the merger went ahead. This merged credit union, now operating as a branch of the larger credit union, is very successful and continues to provide a valued financial service to the people and businesses in the community.

Conclusion

The Newfoundland and Labrador approach to the stabilisation of troubled credit unions appears rigorous and robust. It is a holistic approach that turns on a number of factors including the setting of clear and enforceable financial ratio standards, the promotion of sound business and financial practices, regular monitoring and examination by external Corporation technical staff, the availability of a range of powers of intervention and a systematic, top-down approach to assisting credit unions under supervision. As in other countries, credit union stabilisation is linked to the existence of a deposit guarantee fund, and actions taken by the Corporation are as much to protect the assets of the fund as they are of any one particular troubled credit union.

Overall, according to the Corporation official in interview, the credit union system in Newfoundland and Labrador is robust and financially sound. With its growing oil industry, the province seems to have been little affected by the global recession and credit unions have not experienced the downturns experienced in other parts of the world. Yet nevertheless, at the time of writing, three of the provinces eleven credit unions were under supervision by the Corporation. The consistently identified problem, which resulted in the decline of their capital adequacy ratio, was the quality and productivity of the loan book. Poor lending, bad debts and a low loan to asset ratio culminated in a potential for credit union failure.

In Newfoundland and Labrador, credit unions play a significant role within the local economy of the province and, as the Corporation official explained, *"the last thing you want is to close a credit union".* Credit union failure would have a notable impact on the economic life and prosperity of the province. It is for this reason that the state has both implemented the deposit guarantee fund and established a Corporation with wide-ranging powers of intervention. The safety and soundness of credit unions in Newfoundland and Labrador are overseen as much, if not more, by the regulator than by credit unions themselves.

In 1991 when the Corporation was established there were 18 credit unions in the province with approximately C$100 million in assets. 12 of these 18 credit unions were reporting losses. Today, there are 11 credit unions with a combined capital of 4.7%. Based on YTD results, it is expected that all but one credit union will be profitable in 2009. The one credit union that may experience a loss will only have a deficit in the range of C$30,000.

Ireland

Irish League of Credit Unions

The Savings Protection Scheme

Established in 1989, the Savings Protection Scheme (SPS) is owned and operated by the Irish League of Credit Unions (the League) to protect the savings of League-affiliated credit union members in the Republic of Ireland and Northern Ireland. SPS aims to protect member savings by ensuring that credit unions are sound and stable financial institutions and by making financial, technical and other assistance available to support credit unions in trouble.

Prior to SPS, the League had already established a credit union stabilisation fund which, unlike other international case studies in this report, was not linked to a deposit guarantee fund. Even in SPS, which can extend savings protection to each individual member up to a maximum of €13,500 (£10,000), this protection remains discretionary and dependent on the decision of the League Board. The discretionary nature of the guarantee is a consequence, of course, of the size of some of the credit unions in Ireland, the multiple collapses of which could easily exceed the resources of the fund. However, and this is central to an understanding of the nature of SPS, the fundamental approach taken by SPS is not, as with the British FSCS, based primarily on building a financial capacity to pay-out the savings of members in failed credit unions, but rather on working with troubled credit unions that have solvency issues in order to ensure that they do not fail, and fall into default in the first place.

SPS was initially created with a £7 million deposit from the earlier League credit union stabilisation fund, and since has been funded entirely through credit union deposits and League income generating activities. Since a review in 2002, credit unions now pay into the fund 58 cents/pence per € (£) 1,000 of assets per annum up to a maximum deposit of €64,000. The SPS contribution is treated as an expense by the credit union, it cannot be held on the credit unions balance sheet as an asset. The SPS fund has been augmented over the years through its investment portfolio and through insurance income. The SPS fund currently stands at over €110 million.

Structure of the Savings Protection Scheme

SPS was established as a savings and protection trust company limited by guarantee, for and on behalf of the League. It has a board made up of League directors and is constituted with a remit to hold the funds of SPS and to borrow and raise money if required. As an agent of the League, it can make loans to credit unions and to take and enforce security on these. The ability to hold securities was one of the key reasons that SPS was constituted as a distinct entity within the structure of the League, as the taking and holding the securities of its members would have been problematic for the League as an unincorporated association.

SPS enabled the League to create and own a distinct stabilisation fund. However, it operations are fully integrated within the League structure and it acts solely on the directions of an Administration Committee of the League board. It is this committee which has the power to act in relation to stabilisation, within parameters laid down by the League Board. The Committee's role is to control and to oversee the monitoring and support operations of the League in regard to its member credit unions and to ensure that appropriate financial and technical assistance is given to troubled credit unions facing difficulties.

Importantly, the Administration Committee is charged to promote, maintain and monitor the financial and administrative standards, procedures and requirements that credit unions have to comply with in order to remain members of the League and covered by SPS. Originally, all solvent League-affiliated credit unions were grandfathered into SPS, but now they have to maintain rigorous financial and operational standards and procedures both to remain League members and to benefit from the advantages SPS affords. It is this focus on the robust maintenance of operational and performance standards that underpins the League's approach to stabilisation and savings protection. By ensuring that credit unions are stable institutions, operating in compliance with good business practice, the League endeavours to prevent financial difficulties arising and thus resulting in credit unions having no requirement to call on SPS funds in the future.

In the event of a credit union not complying with the required standards and procedures, the Administration Committee has the power to recommend disaffiliation from the League. However, this final sanction remains with the League Board. The Administration Committee has also the power to propose the amalgamation of a credit union if its viability as an independent entity is in doubt, or if it is of benefit to its members.

Conditions for participation in SPS

The range of conditions which are regarded as fundamental to the effective operation of SPS, and to which all credit unions are bound, as a condition both of participation in SPS and of League membership, are set out in the League's publication, "Savings Protection Scheme" (1991). These include the following conditions; credit unions must:

- adopt the registered rules of the League and operate in accordance with them
- make financial and other returns to the League as required.
- *"operate within such standards in respect of operating ratios, identification and control of delinquency, liquidity requirements, bonding and insurance levels and such other areas as may be agreed from time to time by the League*."
- comply with internal control procedures as recommended by the League board
- allow League field officers right of entry into credit union premises to conduct examinations of credit union operations, financial systems and accounts
- allow League representatives to attend and speak at any meeting of the credit union board or any meeting of its members subject to prior notification

- co-operate with the League if it requires the calling of a special general meeting.

It is worth noting in regard to the above that the conditions in regard to financial operating standards, membership of the League and participation in SPS are dependent on credit union's provisioning for bad debt, according to a formula set down by the League, and was traditionally dependent on maintaining a capital to prior year savings ratio of 10% (this was approximately equivalent to an 8% capital to total assets ratio)[4]. Credit unions whose bad debt or capital asset ratio fell below the required level would merit the attention of field staff and would be most probably be recommended for remedial action.

Monitoring and examination of credit unions

The League approach to stabilisation does not depend solely on the setting of financial and operational standards and procedures, but also on rigorous, close and regular examination and monitoring of credit unions to ensure that those standards and procedures are maintained. As the League notes (ILCU 1991),

> *"It is hoped that tighter monitoring procedures by the League will result in problem credit unions being identified at a very early stage and appropriate remedial action taken prior to a need for recourse to the Scheme Fund arising"*

Central to the League's approach to monitoring is the use of the PEARLS financial ratio system. All credit unions must, as part of their membership of the League, submit quarterly returns to the League, the data from which is inputted into PEARLS. This enables League officers to keep a close eye on credit union performance and monitor trends. Trends in a rise in delinquency, in a decline in provisioning for bad debts or in a decline in capital adequacy would merit immediate further attention and investigation by League officers.

In addition to statistical financial monitoring, as a condition of participation in SPS and of League membership, League field officers have a right of entry into credit unions in order to make examination visits. These visits may take place without prior warning being given to the credit unions concerned, which must allow field officers access to the premises and to all credit union documentation and records. It is important to note that monitoring and field staff have an overriding responsibility to protect the SPS fund and equally credit unions have a responsibility to do all in their power to avoid insolvency and having to claim against the fund.

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[4] In August 2009, the Registrar of Credit Unions (RCU) issued a circular regarding the Regulatory Reserve Ratio now required in the Republic of Ireland. With effect from 30 September 2009, all credit unions are required to maintain a Regulatory Reserve Ratio of not less than 10 per cent on an on-going basis. *"A minimum of 8 per cent of total assets must be held in the Statutory Reserve. The remaining 2 per cent of total assets required to meet the Regulatory Reserve Ratio may be held either in the Statutory Reserve or in a reserve account called the "Additional Regulatory Reserve"3, which must be clearly identified as non-distributable"(*RCU 2009)

Monitoring reports are made to the League, and it is the Administrative Committee, which on the basis of field reports and financial statistical data, has the power to take action to support and to assist any credit union in difficulties. On the basis of the recommendations and advice of League officers, the Committee decides on the type and manner of technical and/or financial assistance. The Committee is able to make grants and/or loans to credit unions and seek security on any loans made. The discretion to support or assist any credit union remains with the Administration Committee, and is not the right of any one particular credit union just by virtue of being a League member.

Technical and financial assistance

In the case of a troubled credit union, and on the basis of the Administrative Committee's considerations, the League would make recommendations to the credit union's board in respect of a recovery plan of action and would indicate the technical and/or financial assistance that could be offered the credit union from the League. The League would strongly recommend prompt corrective action and offer assistance to the staff and board in a credit union not meeting financial target ratios. This assistance could involve greater investigative work to explore the causes of financial and operational weaknesses in a credit union and technical assistance in financial and business planning. Field officers would offer to work with the board, the treasurer and staff until the credit union was effectively stabilised.

The recommendations of the League to the board of a troubled credit union could if ignored result in disaffiliation from the League. However, League officers in interview reported that the League's recommendations are rarely implemented through diktat but rather are most often taken up by board and staff members through a process of consultation and negotiation with League officers. In the most troubled credit unions, boards and staff are generally responsive and positive about the proactive support offered by the League to assist in the process of stabilisation.

Only in a few recorded cases has the League taken the lead in enforcing the transfer of engagements of a failing smaller credit union into a larger credit union. But even in these cases the transfer decision was formally taken by the credit union board and not by the League.

In addition to technical assistance, the League can make available financial assistance to help any troubled credit union trade out of any difficulty they may experience. However, since the creation of SPS, financial assistance, either by way of a grant or loan, has only been awarded occasionally and in a small number of cases. A typical example of financial assistance is the support that can be offered to stabilise bad debt. The League can, in the case of rising bad debts and of low provisioning, effectively provide funds to guarantee any of the delinquent loans concerned. Funds made, however, are subject to stringent, legally binding conditions which aim to ensure that the credit union actively manages the guaranteed loans and implements actions both to reduce delinquency and to rebuild the provisioning for bad debts. The stabilisation of bad debt can be a key effective tool to ensure that the credit union remains solvent and in a position to trade.

The lack of call on the SPS fund for stabilisation purposes, however, has led over time to some changes in the use of the fund. The League can now use the resources of the fund to support the business development of credit unions and thus contribute to their long term operational and financial stability. If, for example, the purchase of premises can be seen to be in the long term interests of a credit union, a loan can now be made from the fund for that and similar purposes.

As has been noted already, in the event that a failed credit union is declared in default and unable to meet its liabilities and repay savings to its members, the SPS has the discretionary power to offer financial assistance to compensate each credit union member up to a maximum of €12,700 (£10,000). However, throughout the history of SPS, no claim has ever been made by credit union members for compensation in a failed credit union.

Conclusion

Even though linked, as all case study examples, to a deposit guarantee scheme, the approach taken by the League to protecting the savings of credit union members has been based, not on the capacity to repay those savings in the case of credit union default, but rather on a strategic and holistic approach to ensuring the long-term stability and sound business operation of it member credit unions.

For the League, long-term stability has been as dependent on a strategic approach to the enforcement of clear and operational and financial standards and procedures, as to the regular, rigorous and robust monitoring and examination of credit unions and to ensuring the League's capacity to offer prompt technical and financial support to credit unions when required. The fact that there has never been a claim from members in failed credit unions for compensation highlights the effectiveness of the SPS strategy.

Post scriptum - Deposit Guarantee Scheme for Financial Institutions

At the time of the creation of SPS, and until recently, there was no Government depositor protection scheme, similar to the British FSCS, in either of the Irish jurisdictions that included credit unions. In the Republic of Ireland, there was a Government Guarantee Scheme for Financial Institutions but credit unions were not included. This has now changed, when, in 2008, the Government included credit unions in the Deposit Guarantee Scheme for Financial Institutions which now guarantees members' savings up to €100,000 per depositor. There is still no Government depositor protection scheme for credit unions in Northern Ireland. However, this will change if NI credit unions become FSA-regulated entities and thus will benefit from the FSCS.

In many ways, this is a significant step forward in the protection of credit union members' savings in the Republic and, in the future, in Northern Ireland. For in SPS, not only was the savings' guarantee discretionary, it was relatively limited (even though average savings in Irish credit unions are well below the €13,500 limit). Savings protection also did not extend to credit unions that were not members of the League.

Nevertheless, the introduction of the Deposit Guarantee Scheme for Financial Institutions does leave the League with a challenge. Unlike SPS, but similar to FSCS, the Irish Deposit Guarantee Scheme will have no credit union stabilisation element and is only designed to pay out members savings in cases of credit union default. But clearly, the importance of stabilisation remains and it would seem counter-intuitive, given the Irish experience, to rely on a pay-out system alone for the long term protection of savings.

The League is currently in discussions with the Registrar of Credit Unions both in the Republic of Ireland and in Northern Ireland in order to determine how SPS can be improved or reformed to complement the role of the Deposit Guarantee Scheme, and the FSCS, and to continue to offer technical and financial support to credit unions that are facing difficulties. The issue of how both the state and the League systems are to be funded will be central to these discussions.

Jamaica

Jamaica Co-operative Credit Union League

The Stabilisation Fund

Jamaica's first credit union, The Clerks Credit Union, was established in 1941 with a mission to combat the poverty and usury of the time and to enable people to save and borrow at affordable rates of interest. Perhaps it was because this first credit union lasted only a few years before it was liquidated that the Jamaica Co-operative Credit Union League (JCCUL) has always been conscious of the importance of protecting credit union members' savings first and foremost by ensuring that credit unions are stable and sound financial institutions.

By 1963, JCCUL had created the Co-operative Credit Union Stabilization Society Ltd, which established a savings' protection fund, financed entirely by member credit unions out of their income. This fund offered reassurance to credit union members through its ability to provide financial assistance to any credit union to repay savings in the event of liquidation.

At the same time, and importantly, the Society monitored the performance of its member credit unions to prevent credit union failure happening in the first place.

The Stabilisation Society was closed in 1977 when JCCUL established a new Stabilisation Fund (the Fund), which operates to this day. Like the former Society, the Fund was designed to protect the safety of members' savings by ensuring the financial stability of credit unions. Although not technically a deposit insurance scheme, it would be able to assist in the repayment of members' savings if a credit union is in default on liquidation, but, importantly, it offers a wide range of financial and technical assistance to credit unions in difficulty.

The principle of protecting members' savings through stabilisation rather than through pay-outs subsequent to default is fundamental to the constitution of the Fund. The aim is to ensure that credit unions remain safe and sound financial institutions and that the assets of the Fund are not depleted through pay-outs to failed credit unions. According to JCCUL's literature, the stabilisation fund was established to enable the League to, among other things:

1. *Assure the repayment of money invested in shares of, or deposits with a member society (a credit union) including declared dividends on the shares and earned interest on the deposits in the event of the liquidation of such society, up to the value of the stabilisation fund*
2. *Protect and stabilise member societies in financial difficulties by loans or advances with or without security or grants up to the value of the Stabilisation Fund*

3. *Take any preventative action as in the opinion of the Board may be necessary to avert financial difficulties in member societies or to recoup losses incurred by member societies or their members*

JCCUL insists that all its 46 member credit unions participate in, and contribute to the Fund as a condition of their JCCUL membership, and failure to do so renders a credit union liable to suspension or expulsion both from the Fund and from JCCUL. This Fund is a co-operative enterprise, owned collectively by member credit unions, and operated by JCCUL on their behalf by way of the rules approved by delegates at the JCCUL's Annual General Meeting.

It is financed entirely through the contributions of its members. Each year JCCUL levies a general assessment on all credit unions, the amount being determined by the JCCUL Board, but which does not exceed 0.35% of a credit union's total member deposits and savings. In the rules of the Fund, additional levies can be charged if it falls below 1% of the aggregated deposits and savings in all member credit unions. The Fund aims to stand at 3% of the total aggregated deposits and savings of all participating credit unions. It currently stands at just about 2%.

Jamaica Deposit Insurance Corporation.

JCCUL's Stabilisation Fund has operated in its present form since 1977. However, it is set to change. Under the Deposit Insurance Act of 1998, the Government's Jamaica Deposit Insurance Corporation (JDIC) operates a Deposit Insurance Scheme which protects deposits and savings in Jamaican financial institutions up to a maximum of J$600,000 per depositor per ownership category in each institution.

Currently this scheme covers commercial banks, trust companies, merchant banks and building societies, but does not cover credit unions. However, it is anticipated that Jamaican credit unions will also be covered by this scheme as soon as the Bank of Jamaica (Credit Unions) Regulations have been enacted.

Participation in the Deposit Insurance Scheme will be compulsory and will involve an additional cost for credit unions. An annual levy will be charged at a rate equivalent to 0.15% of the total value of insurable deposits held by a credit union. It will also require credit unions to meet financial and operational standards of the Regulatory Authorities – The Ministry of Finance and the Public Service (MOFS), The Bank of Jamaica (BOJ), The Financial Services Commission (FSC).

Conditions of membership of JCCUL and the Stabilisation Fund

The operation of the Stabilisation Fund depends on credit unions complying with regulatory requirements and meeting standards of business and financial performance set by JCCUL. The constitution of the Fund stipulates that JCCUL must establish and enforce standards of sound business and financial practice for credit unions, and promote the adoption of credit union policies and procedures designed to control and manage risk in order to limit claims against the Fund. Membership of the JCCUL and of the Fund depends on meeting these required standards.

As a condition of membership, JCCUL credit unions are required to meet a institutional capital to total assets ratio of at least 8%, a delinquency ratio of less than 5% of the loan portfolio and make provision for bad debts according to a detailed formula, which requires 100% provision for loans delinquent for 360 days and over, 60% for loans delinquent greater 180 to 360 days, 30% greater 90 to 180 days and 10% 60 to 90 days. Failure to meet these ratio requirements, which are monitored centrally using the PEARLS monitoring system, would merit the immediate intervention of JCCUL.

Monitoring and examination of credit unions

In the rules of the Fund, stabilisation is inextricably linked to the supervision of credit unions and requires the regular and ongoing monitoring of performance against the set standards. It is for this reason that JCCUL must be in a position to obtain relevant and up-to-date financial and organisational information to assess the risks and threats to member credit unions. It is only by having this knowledge of member credit unions that JCCUL can detect signs and intervene to implement corrective actions in case of difficulty.

In fact, the terms and conditions of the Fund require JCCUL to monitor and examine its member credit unions. JCCUL officers carry out monthly off-site evaluations of credit union financial and organisational performance, through statistical ratio analysis of financial data and through the examination of reports regularly submitted by credit unions to JCCUL as a condition of their membership. These include the balance sheet, delinquency report, liquidity report (all submitted monthly) and the income statement (submitted quarterly).

JCCUL now has a Credit Union Risk and Compliance Unit, which is currently assisting credit unions to prepare to comply with the Bank of Jamaica Standards. It is expected that by meeting these standards credit unions will not pose a threat to the Stabilization Fund.

As part of the terms of JCCUL membership, JCCUL has a right of access to credit union premises and all credit union records. Even though on-site examinations of credit unions were traditionally part of monitoring process, JCCUL no longer routinely carries these out except in cases where its off-site analysis points to a significant problem, as this role is now being undertaken by the Bank of Jamaica. The Central Bank (BOJ) is conducting these examinations with a view to granting licences to credit unions once the Bank of Jamaica (Credit Union) Regulations have been enacted.

Of course, it could also be the case that examinations are undertaken when credit union boards and managers are themselves concerned about a credit union's financial position and invite JCCUL to assist in the investigation and the resolution of a problem.

Assisting credit unions

If JCCUL has a concern in regard to the financial or organisational stability of a credit union, particularly in relation to rising bad debts, declining loan provisioning or weakening capital adequacy, it has the right and the responsibility to implement a programme of corrective action or re-stabilisation. Even though it can be the case that credit unions themselves seek assistance from JCCUL, it is JCCUL that has the over-riding obligation to intervene not only to stabilise an individual credit union but also to protect the reputation of credit union movement as a whole and the assets of the Fund.

The constitution of the Fund allows JCCUL to take any preventative action necessary to avert financial difficulties in credit unions. It can offer management, technical and expert assistance and support to boards of directors and/or managers and staff members. If the required competencies do not reside within JCCUL, it can organise the outsourcing of technical assistance on behalf of the particular member credit union.

JCCUL can also use the Fund to offer financial assistance in the form of loans, advances or grants to a credit union. These may be used to rebuild institutional capital or provision for bad debts or, in fact, for any purpose that JCCUL judges to be in the long term interest of the stability of the credit union.

Normally, assistance is given to credit unions through collaboration and negotiation between JCCUL staff and credit union boards of directors and/or management. However, by virtue of the rules of the Fund, JCCUL has the power to take credit unions into supervision and directly manage and re-organise their affairs. This can only happen with the agreement of the Registrar, who is the existing regulator.

There are a number of circumstances in which JCCUL would take such resolute action but it certainly would be considered if it were regarded as the only means of preventing financial difficulties in a credit union or to recover sustained losses. Once the credit union is taken into supervision, JCCUL has the power to replace both board and staff members and implement longer-term plans of recovery and corrective action.

JCCUL can aim to stabilise a credit union as an independent going concern. However, by virtue of the rules of the Fund and with the agreement of the Registrar, JCCUL also has the power to instigate the merger process by way of transfer of engagement or the amalgamation of a troubled credit union with a stronger credit union; or to assist in the process of liquidation.

With the support of the Fund, JCCUL can assume all or any of the liabilities of a credit union that is in the process of liquidation, transfer of engagement or amalgamation. It can also assume the assets of a credit union that is in the process of transfer of engagement or amalgamation or purchase the assets of a credit union in the process of liquidation up to the value of the Fund.

In respect to the liquidation of credit unions, the reference to *'up to the value of the Fund'* is important. The assistance given to a liquidated credit union in default so that it can pay-out members' shares is not limited to any particular maximum figure, but it is restricted by the size of the fund at any one time.

To date, no credit union has ever failed and been declared in default on liquidation in Jamaica. Therefore no claim for member compensation has ever had to be made from the Fund. The only case of credit union liquidation recorded was a case of voluntary liquidation in which the credit union concerned had sufficient assets to meet all liabilities.

Over the last five years, since 2004, four credit unions have been stabilised and subsequently merged into other credit unions, and one has been stabilised and continues to operate as an independent going concern.

It is also important to note that the constitution of the Fund also focuses on the link between credit union stabilisation and establishing and carrying out technical and advisory programmes for the general welfare of credit unions and the credit union movement in Jamaica. Stabilisation is regarded holistically and is not something that just instigated subsequent to credit union failure.

Implementing a plan of recovery

The intervention of JCCUL into a troubled credit union involves field staff working with the credit union directors and managers to re-establish the credit union either as a going concern or as sufficiently robust to transfer its engagements into another credit union. In the latter case, it is important to sufficiently stabilise the credit union before the transfer, otherwise the transfer could potentially de-stabilise the receiving credit union.

In interview, JCCUL staff indentified that a JCCUL recovery plan would essentially outline the strategies to achieve, among other things, the following:

- *Competent Board of Directors and Committees*
- *Competent management and staff*
- *Adequate capital*
- *Appropriate documented policies and procedures*
- *Effective internal controls*
- *Effective Governance Structure, with proper management reporting and information systems*
- *Adequate risk management oversight (credit, market and operational)*
- *Periodic strategic business planning*
- *Effective internal and external audit functions*
- *Suitable business premises and physical infrastructure*
- *Convenient locations and business hours*
- *A judicious array of products and services to meet members' needs*
- *Cost-effective and competitive pricing of products and services*
- *Adequate liquidity*
- *Full loan loss provision and a delinquency ratio within the standard*

As part of the stabilisation process, with the agreement of the Registrar, JCCUL has the power to insist on the replacement of board members and staff. These would then be replaced by JCCUL staff, or contracted technical advisors, who would work with the credit union to implement the issues above in order to achieve stability within a set time frame. The plan of recovery would be monitored by the Credit Union Risk and Compliance Unit (RCU) of JCCUL.

Future of the JCCUL's Stabilisation Fund

Clearly, there will be a need for JCCUL to re-think the purpose and operation of its current Stabilisation Fund when credit unions come under the new regulatory framework of the Bank of Jamaica, which will include JDIC Deposit Insurance cover.

If things continues as is, not only will the introduction of the Government Scheme result in credit unions paying twice for stabilisation and deposit insurance, there will be the potential for large areas of overlap between the Government scheme and JCCUL's Fund.

As with the JCCUL Fund, the Government's scheme is not designed just to pay-out on credit union liquidation and default, but it aims to engender confidence in the Jamaican financial system though the regular supervision of credit unions by the Bank of Jamaica and by having clearly defined systems for dealing with problems that may arise in financial institutions.

JCCUL has not yet come to a final decision as to the future of the Stabilisation Fund. Options available to the Jamaican credit union movement include:

1. changing the constitution of the Fund so that it could be used to assist credit unions in other ways apart from in time of financial distress.
2. with the approval of the Bank of Jamaica, if and when they become the regulator, retain the fund to assist credit unions in financial distress
3. make cash refunds to credit unions on a pro-rata basis.

The Movement will make the final decision on the future of the Fund when the (Credit Unions) BOJ Regulations are passed.

Conclusion

The approach taken to the stabilisation of credit unions by JCCUL is both holistic and strategic. It does not just depend on the creation of a fund to pay-out the deposits and savings of members in collapsed credit unions in default. Rather, the approach taken is to ensure the financial and operational stability of credit unions by:-

- *the setting of clear and distinct financial and operational standards,*
- *robust monitoring of credit unions to ensure that they are meeting these standards,*
- *regular on-site examinations of credit unions (Now being done by the BOJ)*
- *monthly off-site supervision of credit union. (JCCUL continues this activity)*
- *having powers of intervention into troubled credit unions, with approval of the Registrar, when standards are not being met or they are in evident financial difficulty*
- *having available resources to offer credit unions, with the approval of the Registrar financial and technical assistance to trade out of difficulties,*
- *having, or being able to commission, skilled technical staff to work with credit unions on work-out plans of recovery and*

- *having the wherewithal to monitor the effectiveness of these plans on an on-going basis.*

In addition, this approach is complemented by the powers given to JCCUL by its membership to be proactive to merge credit unions by way of transfer the engagements, or amalgamations or to liquidate them in the interests of the credit union movement as a whole.

The results of this approach are seen in the fact that not one Jamaican credit union has had to call on the Stabilisation Fund to compensate its members after falling into default or has one Credit Union Member lost any money in his/her Credit Union.

United States of America

National Credit Union Administration

The National Credit Union Share Insurance Fund

The independent federal agency, the National Credit Union Administration (NCUA), registers, regulates and supervises federal credit unions. It also operates and administers the National Credit Union Share Insurance Fund (NCUSIF), which protects members' savings and provides credit unions with a range of technical and financial assistance if and when they get in difficulties. The NCUA combines its regulatory and supervisory functions with deposit insurance and actions aimed at the stabilisation of troubled credit unions.

In the US, credit unions can either be federally or state chartered. The NCUA has full regulatory and supervisory responsibility for 5,000 federally chartered credit unions and, in collaboration with state supervisory agencies, also supervises the large number of the 3,800 state chartered credit unions that choose to participate in the NCUSIF. Unlike the FSA or FSCS in Britain, the NCUA is responsible solely for credit unions.

National Credit Union Share Insurance Fund

The National Credit Union Share Insurance Fund (NCUSIF) was first established by the US Congress in 1970. Before that time, a number of trade associations organised private insurance and stabilisation funds but eventually, these were considered insufficiently robust or large enough to handle possible significant downturns within the credit union sector. NCUSIF is backed by the "full faith and credit" of the U.S. Government. However, it is funded entirely by credit unions themselves.

NCUSIF was initially capitalised with the residual funds of the remaining trade association deposit insurance programmes. This amounted to around 0.3% of the totally insured deposits. NCUSIF was re-capitalized in 1985 by each credit union depositing an additional 1% of its insured share deposits into the fund. This has resulted in a fund of around 1.3% of credit union member savings. Credit unions must maintain a 1% deposit of their members' savings with the NCUSIF, adding to the deposit as savings increase. This is recorded as an investment in the NCUSIF and, if the credit union converts to a different financial charter, converts to non-federal insurance, or chooses to voluntarily dissolve and is solvent at the time, the deposit is returned.

For the most part, this 1% deposit has proved effective and sufficient to ensure the operation of the deposit insurance fund. To date, the NCUA has charged only one additional premium, following the failure of three large credit unions in 1992. However, the recent financial crisis and economic downturn will result in credit unions having to make an additional premium contribution of 0.15% of insured deposits to recapitalise the NCUSIF for expected losses relating to natural person credit unions[5] and to repay funds borrowed to establish the Corporate Stabilisation Fund (see below). The stabilisation fund

[5] A natural person credit union is the US designation of a credit union that directly serves individual members. This is in contrast to a corporate credit union that only serves credit unions.

is a co-operative system and, if called upon, has to be recapitalised by credit unions themselves.

Deposit insurance covers all 5,000 federally chartered credit unions, which represent the majority of credit unions in the US and which must by regulation participate in the scheme. NCUSIF also serves a large proportion of the 3,800 state charted credit unions that choose to participate. Currently, NCUSIF provides all members of insured credit unions with $250,000 in coverage for their individual accounts.

A smaller private deposit insurance fund, American Share Insurance (ASI) does exist, which serves around 200 state chartered credit unions not covered by NCUSIF. ASI also provides additional add-on insurance for NCUSIF insured credit unions if they wish to top-up their cover to $500,000 per individual account with Excess Share Insurance (an ASI product).

NCUA monitoring and examination of credit unions

NCUA staff stress that the effective operation of NCUSIF depends on prior rigorous monitoring and on a robust and regular examination programme. Under the Federal Credit Union Act, NCUA examiners have a right of entry into federally chartered credit unions to conduct an examination of the audit and accounts, of policies, operations and internal controls and of credit union governance and management. This normally takes place annually. A similar NCUA right of entry exists to state chartered credit unions that participate in NCUSIF, but this is generally dependent on NCUA examiners being accompanied by state examiners. The NCUA establishes agreements or understandings with individual state credit union supervisors relating to the process of conducting examination and supervisory contacts.

NCUA examinations are risk-focused, and aim to identify and address issues before they become major problems. NCUA examiners concentrate on risk in seven key areas[6]: (1) credit; identifying risk of default on repayments of loans or investments; (2) interest rates; identifying risk that changes in market rates will negatively impact on income; (3) liquidity; identifying risk of an inability to fund obligations as they arise; (4) transaction; identifying risk of fraud or operational problems in transaction processing that could result in an inability to deliver products, remain competitive, and manage information; (5) compliance; identifying risk of violations and non-compliance with legislation and regulation; (6) strategic; identifying risk of adverse business decisions; and (7) reputation; identifying risk of negative public opinion or perception leading to a loss of confidence and/or severance of relationships.

Two areas of risk of central concern to examiners are loan delinquency and capital adequacy. One NCUA official explained that the examination is not an internal audit, but that it does involve such actions as a sample investigation of the loan book including an assessment of loan underwriting. NCUA examiners look specifically for rising trends in delinquency and assess abilities to handle delinquent loans greater than 2 months in

[6] NCUA Letter to Federal Credit Unions. May 2002. Letter No.: 02-Fcu-09. NCUA

arrears. They focus particularly on the incidence of loan modifications (rescheduling) as a typical way of hiding loan delinquency.

The assessment of the capital (net worth) ratio is mandatory. There are certain variables, including the nature and the age[7] of the credit union, but normally a credit union is recognised to be well capitalised at 7% of assets or over, adequately capitalised at 6% to 6.99% but undercapitalised at any net worth ratio less than 6%. A series of mandatory actions under the "Prompt Corrective Action" (PCA) regime must be implemented in any credit union that falls below a capital ratio of 6%, which in all cases includes a net worth restoration development plan to increase capital and restrictions on asset growth and business lending. If the ratio drops below 4%, the credit union is regarded as being seriously under-capitalised and stabilisation assistance is required. If a credit union falls below 2%, it is assessed as critically undercapitalised and must be taken over by the NCUA (conservatorship), merged or liquidated.

Subsequent to the annual examination, the NCUA examiner would normally prepare Documents of Resolution (DOR) which identify and offer possible ways forward to correct unacceptable risk situations. The NCUA has the discretion and authority to provide special assistance to NCUSIF insured credit unions, which are insolvent or in danger of insolvency, and/or whose viability is in question. The aim is to enable their continuation as financially viable, self-sustaining institutions or to assist in merger with, or purchase and assumption by, another credit union. In the case of capital ratio decline, as noted, examiners have no option but to initiate mandatory PCA actions.

The cost of NCUA examinations, as of the NCUSIF, is borne entirely by credit unions themselves. Examinations are chargeable by a fee proportionate to asset size. Credit unions with assets of under $2 million have their fees waived.

NCUA assistance to credit unions in trouble

Under the Federal Credit Union Act, the NCUA has broad and significant powers to intervene in and to assist failing credit unions, as is explained in this extract from the NCUA manual for examiners[8]:

> *"§208(a) of the FCU Act authorizes special assistance for the following purposes:*
>
> *Reopening a closed, insured credit union; preventing the threatened closing of an insured credit union; or assisting in the voluntary liquidation of a solvent credit union;*
>
> *Protecting the NCUSIF or the interest of the members of the credit union; or (1) Reducing risk, (2) averting a threatened loss to the NCUSIF and facilitating a merger or consolidation of one insured credit union with another, or (3) facilitating the sale of assets of an open or closed credit union to an assumption of its liabilities by another person",*

[7] Credit unions under 10 years old are treated flexibly and given additional opportunities to build the capital ratio

[8] NCUA (2009) Manual for Examiners, Chapter 29, page 29-3 2http://www.ncua.gov/GenInfo/GuidesManuals/examiners_guide/examguide.aspx

The NCUA has at its disposal a range of actions to resolve serious credit union problems, as are detailed in the next section. However, NCUA stresses that assistance should not be regarded as a grant, but rather as a temporary arrangement to re-stabilise a credit union, to arrange a merger, or a purchase and assumption or, if needs be, to liquidate without recourse to the NCUSIF. Credit unions receiving special assistance in order to continue operating independently *"must justify receiving the special assistance, and demonstrate that the assistance will help make the credit union a financially viable financial institution"*[9]*. "Viability and the management team's track record"* are the two key factors, according to a NCUA official interviewed as part of this study, that are assessed in determining whether assistance is used to keep a credit union open rather than to seek a combination with another credit union.

NCUA assistance can be either temporary or permanent. Temporary assistance is normally limited to 6 months and permanent to a 24-month 'workout' period. Normally, permanent assistance is not given easily but is dependent on 9 preliminary requirements being met. Before any attempt to stabilise a credit union there is a rigorous assessment of it chances of long-term viability. The 9 requirements are, as listed in the NCUA manual[10]:-

1. *A viable field of membership*
2. *Capable management*
3. *Accurate and current books*
4. *Full and fair financial disclosure*
5. *Proper written policies and procedures (or realistic plan to put them in place)*
6. *Approved net worth restoration plan or risk based plan (including the impact of repayment of assistance)*
7. *Positive track history of financial performance and resolving problems*
8. *Correction of root problems*
9. *System for monitoring on-going performance*

In 2008 and to date in 2009, NCUA has provided $1.1 billion in assistance to 'natural person'[11] credit unions. NCUA officials estimate over the last 5 years 25 credit unions have received assistance through the stabilisation programme, mostly used, however, to facilitate mergers or a purchase and assumption of assets and liabilities.

Measures and actions available to NCUA to stabilise troubled credit unions

NCUA actions in the case of failing credit unions depend entirely on the economic and organisational situation of the troubled credit unions. They can range from the issues of various types of letters of understanding and agreement (LUA) which details action to be taken and support to be given, to taking credit unions into conservatorship, to assigning the credit union to a regional special actions division or to facilitating a merger or purchase and assumption.

[9] Ibid. Chapter 29, page 29-2
[10] Ibid. Chapter 29, page 29-6
[11] A natural person credit union is the US designation of a credit union that directly serves individual members. This is in contrast to a corporate credit union that only serves credit unions.

Conservatorship is perhaps one of the most significant and powerful actions available to the NCUA. It is a virtual take-over of the credit union by the NCUA in the interests of the membership, in which the board is replaced by an appointed administrative board and through which the manager and staff subject can also be replaced if required and if judged as not sufficiently competent to stabilise the credit union. It is not an action that is widely used by the NCUA and one which has to justified and approved by the NCUA board. The aim is to conserve both the assets of the credit union and of the NCUSIF. Once in conservatorship, the credit union must establish a net worth restoration plan, if subject to PCA regulation, or a revised business plan. In both cases, plans must include operational and financial goals and performance benchmarks with target dates. Credit unions in conservatorship are only returned to the members after NCUA board approval and after a further NCUA examination, carried out within 12 months of take-over. Credit unions that cannot be re-established as going concerns after conservatorship are merged with another credit union or liquidated.

Assignment to the special actions division does not result in the same form of take-over as in conservatorship, but it does also enable the NCUA to implement rigorous actions to correct serious problems in short periods of time both to stabilise the credit union and protect the assets of NCUSIF. These include bringing examiners into the credit union with strong technical and decision making skills, and the development of a business plan to achieve profitability within six months of assignment and re-capitalisation to at least 2% within 23 months. The NCUA can also replace the management of the credit union with competent managers.

Whichever course of action NCUA decides to take in responding to the need of a troubled credit union, it has a range of interventions and tools at its disposal. These apply to credit unions re-establishing themselves as independent going concerns or attempting merger with another credit unions. Examples of these interventions include:

- <u>Asset purchase</u> – An asset purchase involves the use of NCUSIF funds to purchase a specific asset. Typically, if a number of large loans that have gone bad and are likely to destabilise the credit union, the NCUA can purchase these loan assets and remove them from the credit unions balance sheet. This is dependent on an assessment of the ability of the credit union to recover.
- <u>Cash payment</u> - NCUSIF funds can be allocated to arrange a merger, for purchase and assumption (see below) or to assist in the liquidation of an insolvent credit union. Cash payments can also be made to assist a poorly capitalised credit union in its recovery plan.
- <u>Charge to reserve</u> – this is non-cash assistance as it allows a credit union to transfer funds from reserves to make up for deficits in undivided earnings, in other words to make up for a loss on trading. Credit unions need the permission of NCUA to make a charge to reserves if it would mean that the net worth capitalisation ratio would fall below 7%.
- <u>Guaranteed line of credit</u> – this is also non-cash assistance whereby the NCUA guarantees credit union borrowing from a corporate credit union or

other credit provider. This can strengthen the liquidity of a struggling credit union in cases where the credit provider would not normally extend a line of credit. Credit unions receiving a guaranteed line of credit must be insolvent or in danger of closing. The guarantee is limited to two years.

- NCUSIF loan – NCUA can authorise a loan to a credit union, which may or may not be subordinated in order to improve liquidity, to recapitalise the credit union (if subordinated) and assist in its long term viability. Such loans must be repaid in full.
- NCUSIF share deposit – NCUA can make a share deposit into a credit union to improve liquidity, build funds for on-lending and income generation, and to assist the long term sustainability of the credit union
- Subordinated loan – NCUA can authorise specific subordinated loans, the repayment terms of which can include 'incentive forgiveness' of a portion or the whole loan repayment, if the credit union meets pre-set, specific and measurable goals and targets. The aim is to restore the profitability of a credit union and to achieve minimum capital requirements.
- Prior-undivided earnings deficit (PUED) – NCUSIF Guaranteed Account - this is non-cash assistance whereby a credit union with a deficit in undivided earnings (a loss) can transfer the negative balance to a PUED – NCUSIF guarantee account. This gives insolvent credit unions a realistic opportunity to recover. However, this measure is limited to 24 months, by which time the negative balance has to be resolved.
- Reduction in earnings transfer – this allows credit unions to transfer less than the regulatory quarterly amount from earnings to capital. This enables credit unions to maintain dividend payments and avoid a significant redemption of shares.
- Temporary dividends – Credit unions with deficits on undivided earnings (i.e. making a loss) cannot disburse dividends on savings without the permission of the NCUA. However, in order to avoid significant share withdrawals, credit unions can be authorised to pay reasonable, market-oriented dividends and transfer the deficit to a PUED –NCUSIF guarantee account.

All interventions aimed at stabilisation depend on the development of a strategic plan of action aimed at establishing the credit union as a going concern. As one NCUA official noted, there needs to a road map to recovery with detailed, achievable objectives. The objectives of a typical road map, or workout strategy, as noted in the NCUA Manual for Examiners[12] include:-

- *Retain capable management and operations personnel, whom the board of directors holds accountable for the results;*
- *Establish basic credit union operations;*

[12] Ibid. Chapter 29, page 29-6

- *Generate current, accurate records including fully and accurately reconciled general ledger accounts;*
- *Meet full and fair disclosure provisions;*
- *Review all expenses and gain operational efficiencies;*
- *Establish the credit union's business strategy for lending and shares, fee income, and operating expenses and incorporate these into a net worth restoration plan or business plan; and*
- *Implement the net worth restoration plan or the business plan with the support of all levels of personnel.*

All actions and interventions are subject to monitoring and follow-up by the NCUA district examiner. Stabilisation is expected to take no longer than 2 years; otherwise NCUA would normally seek a credit union merger or purchase and assumption. If these latter actions were not feasible, the NCUA would pursue the liquidation of the credit union.

Mergers, and Purchase and Assumption

If the credit union cannot feasibly independently continue operations, the NCUA may have no other option but to seek a merger with another credit union or a purchase and assumption. Reports from NCUA suggest that an increasing number of credit unions, given the current economic situation, have to be merged rather than re-stabilised as going concerns.

In the case of merger, the NCUA will act as a facilitator to seek out a suitable credit union to receive the engagements of the failing institution. The NCUA will expect that the receiving credit union undertakes its own due diligence investigation but will assist in an assessment of the business potential of a merger. Under an emergency merger authority, for example, a credit union can accept the engagements of a credit union that serves a different field of membership to its own, a coming-together normally restricted by statute, which would thus open the credit union to a new market and new membership groups. The receiving credit union may also be able to build up assets through a merger or diversify its portfolio of products and services by moving into new areas of operation opened up through the accepted credit union. To assist a merger, the NCUA will be able to offer many of the interventions and actions as detailed above, but, as one NCUA official noted, a receiving credit union may even accept a decline in its own net worth if it sees the merger as an opportunity for growth.

Purchase and assumption (P&A), unlike in a merger, the assuming credit union purchases only specified assets and assumes only certain specified liabilities, which may include share accounts, after the NCUA has places the credit union into liquidation. Assets not purchased and liabilities not taken on, become the responsibility of the NCUSIF. In practice, this enables operations to continue in the area served by the closing credit union without the receiving credit union having to deal taking on the losses of the closing credit union.

Corporate stabilisation fund

Following major losses by some corporate credit unions earlier in 2009, the advent of the NCUA Temporary Corporate Stabilisation Fund (TCSF) needs to be noted within the wider context of stabilisation of the credit union movement as a whole. Created by Act of Congress in May 2009, TCSF guarantees shares held in corporate credit unions (aka central credit unions, credit unions for credit unions that provide short term funds or longer-term investments for credit unions) and has enabled the NCUA to borrow from the US Treasury to stabilise the corporate sector. TSCF has to date prevented a failure in the corporate credit union system, which would have resulted in many natural person credit unions losing their investments and becoming undercapitalised. TCSF is administered by the NCUA but is distinct from the NCUSIF. Natural person credit unions will be subject to an additional NCUSIF premium to cover corporate losses, but nothing like that the premium would have been levied if the corporate sector had collapsed. TCSF lasts for 7 years.

Uzbekistan

Credit Union Association

The Stabilisation Fund

The first credit union in Uzbekistan was licensed by the Central Bank of Uzbekistan in 2002. Over the next six years, with funding from the U.S. Agency for International Development (USAID), the World Council of Credit Unions (WOCCU) worked with emerging credit unions to strengthen their financial management and to build a sustainable national trade association, the Association of Credit Unions (CUA), which would have the capacity to provide member savings deposit insurance and other credit union services.

It was clear to USAID and WOCCU that the credit unions in Uzbekistan were, as in other countries, vulnerable to poor performance and failure. Even though regulated by the Central Bank of Uzbekistan (CBU), the enforcement of regulation tended to be weak and ineffective. There were questions about the quality of credit union governance and financial management and of the ability of many credit unions to control rising bad debts. The CBU did not provide any deposit guarantee scheme and, if the long-term credibility and safety of Uzbek credit unions were to be assured, the newly-formed CUA would itself, have to take the lead, in establishing, in partnership with WOCCU, a private stabilisation programme for its member credit unions.

By 2008, there were 61 licensed Uzbek credit unions with £22 million in accumulated member savings. With technical support from WOCCU, the deposit guarantee scheme, the Stabilisation Fund of the Association of Credit Unions, designed to protect these savings, was launched in 2007.

The principles of stabilisation

For WOCCU, and for CUA, credit union stabilisation is a strategic process designed to ensure the safety and soundness of credit unions. It is not just an intervention brought about after a credit union has failed and succumbed to difficulties. It is also holistic and preventative, and aims to ensure the long-term financial stability of credit unions through assisting them to maintain their solvency, liquidity and reliability, and requiring that they operate to sound business and robust financial standards.

The process of stabilisation is built on number of principles which include effective regulation and regulatory compliance, detailed and robust performance standards as a condition of entry and participation in the scheme, regular off-site and on-site examination and supervision, financial and technical assistance for unstable credit unions targeted at securing their recovery, the authority and mechanisms to intervene in troubled credit unions and policies and procedures to promote credit union mergers or liquidation if required. In addition, stabilisation demands the existence of a deposit guarantee fund with sufficient resources to pay-out depositors in liquidated credit unions in default. However, the process is designed to ensure that eventual pay-outs of depositors in failed credit unions never actually have to take place. Stabilisation protects credit unions but also, and importantly, the assets of the fund that supports them.

The WOCCU approach to stabilisation is therefore more about prevention and the reduction of risk than it is about rescue after credit unions fall into default. In Uzbekistan, the CUA deposit guarantee fund, which currently guarantees deposits up to a maximum of £487[13] per member per credit union, is combined with capital and liquidity funds designed to assist credit unions in times of financial difficulty and with a range of other technical and financial measures to assist credit unions develop as safe and credible financial institutions.

Financing the Stabilisation Fund

Initially USAID and WOCCU supported the capitalisation of the Stabilisation Fund. However, it is now mainly financed through levies on participating credit unions and through retained earnings. In addition, credit unions cover the costs of examination and supervision, are subject to additional charges for particular risks, and pay fees and penalties for incomplete fulfilment of Fund obligations. In 2008, direct contributions by credit unions and retained earnings amounted to 53% of the total capital of the Fund, but this is set to rise over time.

In 2008, capital stood at 19% of all insured savings; however this will decline as more credit unions join the Fund. The aim is that credit unions retain 6% of their deposits in the Fund, which is built up and established through a system of quarterly payments. CUA can make additional levies on credit unions if the Fund declines below a certain set amount or there a deficit in the Stabilisation Fund to pay compensation on deposits in a liquidated credit union.

Conditions of entry and participation in the Stabilisation Fund

Participation in the Fund is in principle compulsory for all CUA member credit unions and is regarded as a co-operative and mutual commitment to protect the savings of members and the reputation of the credit union movement as a whole. However, there are certain rigorous conditions for entry into and participation in the Fund. It is not designed to rescue already failing credit unions, but to offer long-term stability to sound organisations and to assist them if losses and difficulties arise in the future. Credit unions only protected by and benefit from the Fund when they meet and maintain financial and operational standards set by CUA.

In general, credit unions can only be part of the Fund if they have been operating for no less than 12 months, have a history of compliance with CBU legislation and regulation, have a risk rating of 3[14] or better for six months before entry, have an automated accounting system and a track record of submitting financial and other required information monthly no later than 5 calendar days after the close of the month

[13] This figure reflects the low-income economy of Uzbekistan, and arises from a previous insurance limit set by the regulator for banks. This has since been raised for banks and will be raised by CUA for credit unions.
[14] This refers to the rating process and analysis of credit unions performed by WOCCU in Uzbekistan. This rating measures the degree of risk the credit union presents to the credit union network and to credit union depositors. According to the rating, the strength of a particular credit union can be judged. A rating of 5 is very poor and a rating of 1 is very good.

Financial entry and participation requirements are mostly set in terms of meeting a set of modified PEARLS target ratios. Uzbek credit unions wishing to enter and remain in the stabilisation programme, for example, must have a solvency ratio of at least 103% (P6), a net capital asset ratio of 4% (E9), a loan delinquency ratio of 10% or less (A1), and a total operating expenses to average total assets ratio (R9) of no more than 14% and growth in asset and membership annual growth ratios (S9 and S11) of no less than 70%[15]. Apart from S9 and S11, these target ratios are less than PEARLS standards, but still rigorous in comparison with the performance of many British credit unions.

Since 2007, about 15 of the 93 licensed credit unions operating in 2009 have been accepted into the Stabilisation Fund programme, with another 15 on the way to being accepted. This means that about 30% of Uzbek credit unions will benefit from the Fund in the near future. These represent about 50% of the assets of the movement in Uzbekistan. The aim is to progressively recruit credit unions into the Stabilisation Fund; according to WOCCU, long-term success depends on system wide depositor protection and compliance with robust financial and operating standards. Effective stabilisation is required by any credit union movement serving a modern market economy.

Monitoring and examination of credit unions

In the approach taken in Uzbekistan, stabilisation depends not just on the existence of CBU and CUA financial and operational standards, but on compliance with those standards, on the monitoring of compliance, and on enforcement as a condition of participation in the Stabilisation Fund.

The CUA Analysis Department carries out off-site monitoring of participating credit unions. Credit unions must submit monthly all financial data and a series of reports. This data is processed using the PEARLS monitoring system complemented by the use of sophisticated software which tracks inconsistencies in submitted data, checks the accuracy of individual member accounts, monitors trends in lending, savings retention and delinquency and measures the profitability and risk rating of credit unions. The Analysis Department offers feedback, flags up any causes for concern, and makes recommendations to credit unions on a monthly basis.

CUA also carries out comprehensive, on site examinations, either annually or when need arises. These examinations are comprehensive and thorough, and involve a series of meetings with the board of directors and management. CUA staff examine all aspects of the business, including inspecting accounting and management documentation, verifying internal controls, focusing on the loan portfolio and delinquency and bad debt reports, checking individual savings accounts, and assessing the adequacy of capital and reserves. In many ways, the monitoring examination resembles an independent internal audit through which examiners are particularly checking for risks, deficiencies, losses or fraud which will or might impact on the stability of the credit union.

[15] This indicates the high growth rate of credit unions in Uzbekistan. Credit unions are the only financial institutions authorised to deal in cash without restrictions applied to other financial market participants and are experiencing exponential growth. This high rate is expected to decline in time.

If there are causes for concern, the monitoring and examination process results in the drawing up of a plan of action to correct financial and/or operational deficiencies and to ensure the recovery of the credit union. The Stabilisation Fund may then be used to provide assistance to credit unions, in lieu of proceeding directly to credit union merger, trustee management or liquidation, with the aim of re-establishing the credit union as a financially sound institution.

Action, intervention and recovery

A range of actions and interventions are available to CUA to assist troubled credit unions and support their recovery within the context of a restructuring and rehabilitation plan. CUA can offer technical assistance, advice and financial support to help credit unions re-establish themselves as going concerns. But it also has the capacity to enforce actions and is able to give warnings, impose penalties, restrict credit union operations, suspend or replace management, insist on the re-election of officials, and, in extreme cases, put credit unions into trustee management (a form of conservatorship – see chapter on the US). Whatever action it takes, however, CUA has a close eye both on assisting the credit union and on reducing any potential loss to the Stabilisation Fund.

Financial assistance is dependent on a letter of understanding and agreement (LUA between CUA and the credit union and most financial support is in the form of deposits, repayable to the Fund with interest once the credit union is re-stabilised. CUA can offer liquid cash deposits to enable credit unions fulfil their financial obligations towards their members and third parties, make share deposits with repayment terms that may include “incentive forgiveness” if the credit union meets pre-established goals tied to specific, measurable financial and/or operational performance goals and, in cases of necessity, provide financial cash assistance to pay for exceptional operating expenses such as paying for a capable manager, reconstructing the accounts or assisting the credit union meet dividend and interest payments.

Different financial tools are used for distinct purposes. Liquid deposits are only granted to credit unions that are not in immediate risk of failure, have the resources or cash flow to repay the principal with interest and have a capital asset ratio of at least 3%. Share deposits, on the other hand, can only be used for credit unions that are in immediate risk of failure, are barely breaking even or have negative net income, have minimal resources to repay the principal and interest payments and have a capital asset ratio of less than 3%. Financial cash assistance is used only in exceptional circumstances to turn a failing credit union around with new management or respond to very serious circumstances.

However, in all cases, financial assistance is subject to rigorous terms and conditions. It is dependent on credit unions having identified the source of their financial difficulties, on the loss making activity having ceased, and on the credit union’s management being willing to accept direction and make corrections as determined by CUA. Importantly it is dependent on the credit union being rated at least 4 or having the potential to improve to at least 4 in the following 3 months. CUA do not attempt to stabilise completely failed credit unions.

Financial assistance depends also on capable management being in place, on accurate and up-to-date accounting records, on their being proper written policies and procedures, on the credit union having a written recovery plan, and a positive history of financial performance and problem resolution. If board members or management are unwilling or incapable of solving the financial problems, CUA can request that they be dismissed and replaced. If a credit union manager is dismissed, CUA have a say in the appointment of the new manager and/or request that the credit union is placed in trustee management.

Stabilisation assistance is strictly monitored. CUA's Analysis Department evaluates progress and LUA compliance through monthly off-site PEARLS analysis and as many on-site visits that are deemed necessary. If an examiner detects any negative trends, this is acted immediately and the appropriate intervention initiated.

WOCCU and CUA consider that normally stabilisation assistance should not exceed 18 months. If it appears that a longer time may be necessary, this would demand the approval of the CUA board.

Trustee Management

An option open to CUA in the case of a particularly problematic credit union is to offer to place it into trustee management. Similar to conservatorship in the US, trustee management is a procedure whereby CUA can take possession of a credit union's assets and assume control and operation of the business. Trustee management remains in force until the credit union has the capacity to resume control of business on its own, or until a request is made by CUA for merger or liquidation. Normally, trustee management is instigated initially for a period of 12 months.

Trustee management allows CUA to take an active role in the management of a credit union so that any further financial loss is minimised. According to CUA, it is a useful tool when a credit union board or management continuously fail to comply with agreements; are incapable of coping with severity of the financial problem they face; have performed illegal or unsafe practices that threaten the Stabilisation Fund and/or conceal or refuse to make available the financial and operational records for inspection by an CUA examiner.

In general, according to CUA regulation, trustee management is to be considered if:

- the capital asset ratio is less than 4% and declining;
- the credit union is unable to pay its obligations to depositors and creditors;
- the credit union has experienced losses or potential losses amounting to more than 10% of its institutional capital in each of three prior consecutive quarters and/or more than 50% of its institutional capital regardless of the time period.

Trustee management, however, cannot be imposed and depends on a signed agreement between CUA and the credit union; the sanction, of course, for non-agreement would be an inability to access the required financial assistance from the Stabilisation Fund. The credit union also has to agree that it will pay all expenses associated with the trustee management.

The aim of trustee management is to restructure and reorganise the credit union in order to build its management capacity and to re-establish its effectiveness and financial viability as a going concern. During the period of trustee management, CUA assumes all management responsibilities for the credit union, including responsibility for staffing and for all strategic and operational decisions. At the end of the agreed period of trustee management, CUA submits a report to the credit union board recommending restoration of the credit union to the credit union membership in general meeting, to a newly elected board of directors and new management or an extension of the period of trustee management. If the credit union cannot be stabilised sufficiently, CUA recommends proceeding to a merger or to liquidation.

Mergers and liquidation

CUA has not the power to enforce an involuntary liquidation or merger or revoke a credit union's license. This power only rests with CBU. However the association can recommend member credit unions to proceed with "voluntary" mergers or liquidations if the credit unions wish to retain the benefits of the Stabilisation Fund, to have their member's deposits and to remain in CUA membership. CUA's power of influence, therefore, remains considerable.

According to CUA regulations, CUA would recommend a merger or liquidation if any of the following reasons appertained:-

- a lack of capable or competent management;
- a serious violation of by-laws, regulations, law or an association agreement causing the financial deterioration of the credit union;
- a low credit union rating (rating 5) and no possibility of improving that rating in the next 6 months;
- a capital asset ratio of less than 2%;
- accounting records out of balance and unreconciled for 3 consecutive months;
- the annual audit has not been completed as required by law;
- a net loss over the previous 4 quarters and an inability to reverse the trend;
- incidence of gross negligence, dishonesty and/or fraud;
- credit union management unwilling to accept CUA direction and make the necessary corrections; or
- the field of membership is no longer viable.

Liquidation would only be recommended in the case of an inability to find a suitable merger candidate. The Stabilisation Fund would assist in the process and resources required for merger.

Conclusion

The approach taken in the development of the WOCCU supported CUA Stabilisation Fund was built on a number of clear fundamental principles as noted above. At the heart of these were detailed and robust performance standards as conditions of participation in the Fund, sophisticated monitoring and examination of those standards and the power to take action if required.

The CUA programme is an entirely private scheme, organised by the credit union movement itself. However, it does depend on a good relationship with the regulator, the CBU, and it is recognised internationally by WOCCU that a more formal involvement of Government in stabilisation programmes is to be recommended. The Uzbek programme has been in operation since 2007, and, as yet, no credit union has failed in the system, even though two credit unions have been required to leave. The future of the Fund depends on the stability of credit unions and on minimum claims on Fund resources.

4. The principles of credit union stabilisation

Stabilisation programmes throughout the world aim to ensure that credit unions protect members' savings by ensuring their safety and soundness. Aware of the complex and interrelated nature of the immediate, contributory and fundamental causes of failure (see Section 3 above), all programmes take a long-term and strategic view of stabilisation. None are designed solely to intervene after credit unions have got into difficulties or are on the verge of collapse. The international approach to stabilisation, as highlighted in the case studies in this report, is more about prevention and the reduction of risk than it is about rescue after credit unions have fallen into default.

Stabilisation programmes worldwide differ in their constitution and their operation. Some are operated by the Government regulator (United States, Canada) and others privately by credit union leagues and associations (Ireland, Poland, Uzbekistan, and Jamaica). Even in private programmes, however, there is often strong link with the regulator, either established formally in legislation or through strong established working relationships. In Poland, for example, the role of the National Association of Co-operative Savings and Credit Unions in the regulation, supervision and stabilisation of credit unions is enshrined in legislation[16]. In Uzbekistan, the stabilisation programme depends on a strong link with the regulator, but there it is more informal and negotiated. The international preference, and certainly that of WOCCU, is for greater Government regulatory involvement in stabilisation as a component part of deposit insurance schemes. There are possible moves in this direction both in Ireland and Jamaica, where credit unions have been, in the case of Ireland, or in the process of being, in the case of Jamaica, brought into Government deposit protection schemes. In Jamaica this will entail greater regulatory supervision by the Bank of Jamaica.

Stabilisation programmes also differ in their style and culture of operation. Some are markedly top-down and directive, and in cases of declining net worth or non-compliance with regulation or with the rules of the stabilisation programme, have the power to replace the credit union board and management and to assume control of a credit union until it is stabilised, merged or liquidated. Other programmes, particularly some of those organised privately, are more bottom-up and aim to stress bringing about change through negotiation and influence. However, all programmes, whether Government or private, have robust conditions, standards and regulations for entry and participation. They all continually closely monitor the performance of credit unions against those standards and have powers to take action in cases of impending failure. There are no examples of ad hoc programmes that intervene to rescue credit unions in trouble post factum. All credit unions that benefit from stabilisation have previously been part of a structured, closely monitored and supervised programme.

Despite differences, whether operated by the Government regulator or privately by an association, the process of stabilisation is built on number of common principles that

[16] Act of 14th December 1995 on Co-operative Savings and Credit Unions, Journal of Laws of 4th January, 1996, Warsaw, Poland

include regulatory compliance, meeting detailed and robust performance standards as a condition of entry and participation in the programme; regular off-site and on-site monitoring, examination and supervision; financial and technical assistance for unstable credit unions targeted at securing recovery; the authority and mechanisms to intervene; and procedures to instigate credit union mergers or liquidation if required. In addition, even though there were some counter-examples in the past, all known examples of stabilisation programmes regard stabilisation as a component part of deposit insurance. Stabilisation is a holistic and structured process which endeavours to protect members' savings by ensuring that credit unions are safe and stable institutions. It is holistic insofar as it requires credit union adherence to regulatory requirements, to sound business and financial performance standards and to good governance and effective management.

The key principles of stabilisation arising from the case studies are:

1. Stabilisation is complementary to deposit insurance

In Britain, the FSCS safeguards members' savings by paying out compensation to savers after credit unions have failed and are in default. Stabilisation programmes are also linked to deposit guarantee schemes that pay-out savers in credit unions in default. However, the stabilisation process is designed to ensure that eventual pay-outs of depositors in failed credit unions never actually have to take place.

The principle of protecting members' savings through assisting and supporting credit unions in trouble rather than primarily through pay-outs subsequent to default is fundamental to stabilisation. In Ireland, for example, the Stabilisation Protection Scheme has resulted in no Irish credit union ever being declared in default and no call being made on the fund for compensation. Stabilisation protects the assets of the deposit guarantee fund as much as it protects credit unions themselves.

2. Stabilisation depends on effective and enforced regulation, and compliance with compulsory financial and operational standards.

Participation in a stabilisation programme, including access to depositor protection, is dependent on compulsory compliance with regulatory financial and operational standards. In countries where regulation is weak or 'light-touch', participation also depends on compliance with the robust financial and operational standards of the programme itself. Non-compliance entails either the rigorous intervention of the regulator or expulsion from the programme and the national credit union trade association managing it. From Ireland to Uzbekistan, membership of the national trade association is dependent on compliance with the financial and operational standards designated as the basic requirements of effective performance.

Financial and operational standards vary but are relatively consistent throughout the world. In general, stabilisation depends on credit unions achieving and maintaining a key set of ratio targets in areas of capital, liquidity and delinquency. In the WOCCU-supported programme in Uzbekistan, for example, credit unions wishing to participate in the stabilisation programme must have a net capital asset ratio of at least 4%, a loan delinquency ratio of 10% or less, and an operating expense to assets ratio of no more than 19%.

In Ireland, according to Irish League of Unions' regulations, it has been traditional for credit unions to maintain a compulsory 8% capital to asset ratio in order to remain within the savings protection scheme and the League. In the United States, a series of mandatory actions must be implemented in any credit union that falls below a capital ratio of 6%. If the ratio drops below 4%, the credit union is regarded as being seriously under-capitalised and stabilisation assistance is required. If a credit union falls below 2%, it is assessed as critically undercapitalised and must be taken over by the regulator, merged or liquidated. Financial standards are complemented by business and operational standards with which credit unions also have to comply.

3. **Stabilisation demands robust monitoring, supervision and examination of credit unions by the regulatory or administrative authority.**

Stabilisation depends not just on the existence of financial and operational standards, but on compliance with those standards, on the monitoring and examination of compliance, and on enforcement as a condition of participation in the stabilisation programme.

In all case study examples, the responsible authority carried out continuous off-site monitoring of financial and organisational performance, through statistical ratio analysis of financial data, often using the PEARLS monitoring system, and through the examination of reports regularly submitted by credit unions as a condition of their membership of the programme. In Canada, for example, the regulator has immediate electronic access to each credit union's financial data and conducts detailed and on-going financial analysis to monitor financial trends. The Irish League of Credit Unions has similar access to the data of all member credit unions as a condition of League membership and also monitors PEARLS ratios.

In all cases the responsible authority also had the right of entry into credit unions to conduct on-site examinations of the audit and accounts, of policies, operations and internal controls and of credit union governance and management. These examination visits would normally take place annually or when off-site monitoring indicated a concern. In all case studies, examinations are usually risk-focused, and aim to identify and address issues before they become major problems. In general, the areas of central and most concern to examiners are loan delinquency, fraud, bad debt and any decline in capital adequacy, as the major factors resulting in failure and default.

4. **Stabilisation requires the power to intervene when credit unions fall to meet required financial and operational performance targets.**

Any trends in a rise in delinquency, in a decline in provisioning for bad debts or in a decline in capital adequacy would, in all case study programmes, merit immediate further attention, investigation and action by the responsible authority. In Government schemes such as those in Canada and the United States, the regulator has considerable regulatory powers to act in relation to troubled credit unions, beyond those held by the FSA in Britain. If problems arise, the regulator can issue warnings, impose penalties, restrict credit union operations, enforce a range of corrective actions and can even take complete control of the institution, replacing board members and management, and placing the credit union under its own supervision until problems are resolved.

In private schemes, the responsible authority also has a range of similar powers of intervention, often dependent on the agreement of the regulator but enforceable through threat of expulsion from the stabilisation programme and the national trade association. This is the case in Jamaica where the trade association has the power, with the agreement of the regulator, to take troubled credit unions into supervision and directly manage and re-organise their affairs.

Even though in most cases it will be credit unions themselves that seek assistance from a stabilisation programme, it has to be stressed that it is the responsible authority that has the over-riding obligation to intervene not only to stabilise an individual credit union and protect its members' savings, but also to protect the reputation of credit unions as a whole and, importantly, the assets of the stabilisation fund. The seriousness involved in taking corrective action is directly linked to protecting fund assets, any depletion of which would be a cost to the other participant credit unions.

5. **Stabilisation provides technical and financial assistance to troubled credit unions.**

All stabilisation programmes offer troubled credit unions expert technical assistance, advice and financial support to assist them to re-establish themselves as going concerns. In some jurisdictions, this technical and financial assistance is obligatory (e.g. prompt corrective action in the United States) and in others it is offered through consultation with credit unions boards and management. As mentioned earlier, however, stabilisation programmes reserve the right, in the most problematic cases, to take possession of a credit union's assets and assume control and operation of the business until the credit union has the capacity to resume control on its own.

The availability of financial assistance varies between stabilisation programmes and distinct financial tools are used for different purposes. In the WOCCU-supported programme in Uzbekistan, for example, liquid deposits are only granted to credit unions that are not in immediate risk of failure, and have the resources or cash flow to repay the principal with interest and have a capital asset ratio of at least 3%. Share deposits, on the other hand, are used for credit unions that are in immediate risk of failure, are barely breaking even or have negative net income, and have minimal resources to repay the principal and interest payments and have a capital asset ratio of less than 3%. Financial cash assistance is used in exceptional circumstances to turn a failing credit union around with new management or respond to very serious circumstances.

One financial tool that would be of interest to many British credit unions is asset purchase. In the United States, the regulator is able to purchase the assets of troubled credit unions to assist stabilisation. Typically, if a number of large loans have gone bad and are likely to destabilise the credit union, the regulator can purchase these loan assets, pursue repayments from members itself, and remove them from the credit unions balance sheet. This aims to directly assist the ability of a credit union to recover.

It is to be noted, however, that, for the most part, in all case study programmes financial assistance is not be regarded as a grant, but rather as a temporary arrangement to re-stabilise a credit union, or, if needs be, to arrange a merger or liquidate a credit union. Financial assistance is mostly repayable to the stabilisation fund with interest once a credit union is re-stabilised.

6. Stabilisation depends on a strategic and monitored "work-out" plan of action to re-stabilise the credit union as a going concern or fit for merger.

Stabilisation intervention into a troubled credit union involves field staff working with credit union directors and managers on a restructuring and rehabilitation plan in order to re-establish a credit union as a going concern or as sufficiently robust to transfer its engagements into another credit union. In the latter case, it is important to sufficiently stabilise the credit union before a transfer, otherwise the transfer could potentially de-stabilise the receiving credit union.

Each stabilisation team of technicians works with the troubled credit union on a road map to recovery with detailed, achievable financial and operational objectives. This is typically strictly controlled and monitored. In Uzbekistan, the analysis department of the national association (CUA), for example, evaluates progress and compliance on the 'work-out' agreement through monthly off-site PEARLS analysis and as many on-site visits as are deemed necessary. If an examiner detects any negative trends, this is acted upon immediately and the appropriate intervention initiated.

7. Stabilisation is time limited

The time allocated to a restructuring and rehabilitation plan varies from one programme to another. But, in general, at the maximum, a supported credit union would be expected to be self-sustainable within 2 years, and often within a much shorter period. Unless there were exceptional circumstances, credit unions that had not achieved stabilisation within at most a 2 year period would be transferred to another credit union or liquidated. The rigour of stabilisation does not permit the continuance of credit unions that under-perform and risk the assets of the stabilisation fund.

8. Stabilisation programmes include actions to merge or to liquidate credit unions that cannot achieve independent viability.

Stabilisation interventions are, in all cases, demanding in regard to the level of financial and operational performance required of a credit union. The WOCCCU-supported programme in Uzbekistan is typical of stabilisation programmes and recommends a merger or liquidation (in the case of a suitable credit union not being able to be found) if any of the following reasons appertain:-

- *a lack of capable or competent management;*
- *a serious violation of by-laws, regulations, law or an association agreement causing the financial deterioration of the credit union;*
- *a low credit union rating (rating 5) and no possibility of improving that rating in the next 6 months;*
- *a capital asset ratio of less than 2%;*

- *accounting records out of balance and unreconciled for 3 consecutive months;*
- *the annual audit has not been completed as required by law;*
- *a net loss over the previous 4 quarters and an inability to reverse the trend;*
- *incidence of gross negligence, dishonesty and/or fraud;*
- *credit union management unwilling to accept direction and make the necessary corrections; or*
- *the field of membership is no longer viable*.

Stabilisation programmes depend on a rigorous diagnostic of the potential long-term viability of a credit union, and stabilisation is not attempted without recovery being assessed as realistic. For this reason, stabilisation programmes can always assist credit unions to transfer their engagements or to proceed to liquidation.

In the United States, the regulator also has the option of purchase and assumption (P&A), which, unlike in a merger, the assuming credit union purchases only specified assets and assumes only certain specified liabilities, which may include share and loan accounts, after the regulator has placed the credit union into liquidation. Assets not purchased and liabilities not taken on, become the responsibility of the stabilisation fund. In practice, this enables credit union operations to continue in the area served by the closing credit union without the receiving credit union having to deal with the losses of the closing credit union.

5. The cost of stabilisation

Stabilisation programmes represent a significant financial and resource investment in the safety and soundness of credit unions and in the security of members' deposits. In many countries, a strong focus on stabilisation is seen as essential to the effective management and to the long-term credibility of the sector. It was for this reason that, in all case studies, the costs of stabilisation were met by credit unions themselves. These included the organisation and administration of the programme, the costs of supervision, examination and recovery interventions, as well as the capitalisation of the stabilisation fund, Methods of payment varied but were often made up of a mixture of levies, fees and charges, which credit unions were willing to pay for the benefits that accrued to the sector as a whole..

The fact that credit unions themselves were directly responsible for all costs related to stabilisation injected a level of rigour into the monitoring of the compliance of credit unions in stabilisation programmes. Losses sustained by one member credit union were borne directly by the entire body of participating credit unions. Losses and operational costs, therefore, had to be minimised through ensuring that credit unions operated to high performance standards as conditional on their participation in the programme.

The cost of stabilisation in any particular country is dependent on a range of variables and, consequently, it is not easy to define exactly the cost of stabilisation or to make comparisons between different countries. The cost of stabilisation depends ultimately on the way in which programmes are structured and administered. Variable factors include the number of credit unions involved; the way in which they are monitored through onsite or offsite supervisory examinations; the frequency of these examinations and their level of detail; the number of staff employed on the programme, their skill levels, qualifications and experience; the level of operating expenses; the physical infrastructure of the programme including office locations; the level of information technology involved; the funds available to invest in the stabilisation and recovery of troubled credit unions and the conditions of investment interventions and the extent of depositor protection as linked to the fund. However, perhaps the most significant variable is whether or not stabilisation is administered as a stand-alone programme by the industry alone or is organised by, or in partnership with, the Government regulator.

In Ireland the stand-alone Savings Protection Scheme, independently administered through the Irish League of Credit Unions, has built up over the years a stabilisation fund that currently stands at over €110 million. This has been entirely funded through credit union deposits and has been augmented over the years through its investment portfolio and through insurance income. Since 2002, credit unions pay into the fund 58 cents/pence per € (£) 1,000 of assets per annum up to a maximum deposit of €64,000. The cost of stabilisation is covered by this charge and by the return on the SPS capital investment. In the financial year, 2008 – 2009, the Irish League estimated that the fund grew € 8 million, but operating costs of the programme cost up to about € 2 million to supervise 505 participating credit unions (with assets of € 14,000 million)

The situation is somewhat similar in Jamaica where the Jamaica Co-operative Credit Union League had, by year end 2008, built up a stabilisation fund of $767.65 million

(Jamaican) (£5.7 million GBP) in order to protect the $50,400 million assets of its 45 credit unions. The cost of stabilisation is covered by investment income from the fund and also by each credit union paying 0.35% of their total members' savings (shares and deposits) into the Fund at the end of each financial year. At year end 2008, $60.2 million (£450,000 GBP) of incurred expenses were charged to the fund.

It is important to note, however, that in stand-alone programmes such as in Ireland and in Jamaica, the level of depositor protection is much lower than that offered through Government savings protection programmes, such as the FSCS, and is often discretionary. In Ireland, SPS depositor protection was limited to €13,500 (£10,000) at the discretion of the board and in Jamaica the amount of pay-out to depositors in the case of default is limited to the value of the fund and is not set at a predetermined figure. In both countries, however, no credit union has failed and entered into default since the establishment of the stabilisation funds. However, in both countries, recent Government interventions have resulted in credit unions now coming under Government depositor insurance programmes with much higher depositor protection. This will incur a further supervisory requirements and charges on credit unions. In Jamaica, the inclusion of credit unions in the Government depositor protection scheme will involve an additional annual charge of 0.15% of the value of insurable deposits. In Ireland the additional charge is not yet determined.

In the United States, the National Credit Union Administration (NCUA) regulates and supervises federal credit unions and also operates the National Credit Union Share Insurance Fund. Unlike traditionally in Ireland and Jamaica, stabilisation in the US is a Government responsibility. According to NCUA, for the year ending 2008, the total operating costs for the administration of the programme was approximately $180 million (US) for total Assets of $856,600 million (US). NCUA estimated that 62% of the $180 million relates to share/deposit insurance administration (based on a view that 62 percent of the examination time, and the time needed to administer this portion of the examination time, related to insurance and not purely to regulatory responsibilities. Overall, NCUA estimates that the administration of the programme costs 0.02% of the total assets of approximately 5,000 participating credit unions.

How much would a British stabilisation programme cost?

This is not an easy question to answer given all the variables involved. In general, industry stand-alone programmes, as in Ireland and Jamaica, which incorporate independent rigorous supervision for participating credit unions and an independent fund to offer depositor protection in case of default, are potentially much more costly to credit unions than those involving the Government regulator. In fact, internationally there are increasingly moves away from independent industry stand-alone schemes to ones involving the regulator, as is found in the US and Newfoundland and Labrador. In Britain, given the existing involvement of the regulator in supervision and of the FSCS in depositor protection, there would seem to be little reason for the movement, through ABCUL for example, to establish its own stand-alone stabilisation programme. In assessing cost, it would seem favourable and cost effective to consider an approach to stabilisation that involved the FSA, the FSCS and ABCUL as a representative body of the credit union movement.

Clearly there would be organisational, legal and political issues involved in considering a stabilisation agency based on a combined Government and industry approach. However, it is not impossible to imagine the creation of an agency reporting to a board chosen by the FSA, FSCS and ABCUL. This agency could implement a stabilisation programme that would contribute to and strengthen the supervision of the FSA, by working directly with troubled credit unions. It would also support the FSCS by enabling credit unions to avoid failure and default. If a credit union did fail, however, then the FSCS would still ensure member savings were protected.

This combined structure would depend, of course, on the FSA being willing and able to share information obtained through regulatory reports and supervision contacts with credit unions with the agency. Initially, this may be problematic to resolve, but ultimately it is the sharing of information on supervision that would drive down costs considerably. The agency could employ a team of analysts to work with troubled credit unions, either facilitating independent recovery, mergers or controlled closure, and it could be headed up by a manager reporting directly to the agency board.

In order to reduce costs, the team of analysts could work from home, assessing the condition of credit unions through receipt of FSA reports, and monthly or quarterly reports directly received from the credit unions. Costs could be driven down by the electronic filing of financial data, but even on manual systems such analysis would not be impossible. The analysts could also visit credit unions to determine viability, to assure the condition of the credit union and the capabilities of management, and also to work with credit unions to resolve organisational and financially issues.

The costs of the programme, given the variables, are difficult to compute exactly. But with a similar number of credit unions, the situation in Ireland may be an indicator. With a similar number of credit unions, albeit representing €14,000 million of assets compared with £593 million in Britain, the costs of the programme were approximately £1.8 million. It is a fair assumption that the supervision of much smaller credit unions than found in Ireland is a less onerous and speedier task, and so it may be an equally fair assumption to conclude that a British stabilisation programme could possibly be established for around £1 million per annum. In fact this compares favourably with £6 million true cost of delivering the Financial Services Compensation Scheme for credit unions in the five years, 2004 – 2009[17]

An initial funding of the stabilisation programme could very well be by Government grant and a percentage of credit union savings deposits. This could fund the initial administrative costs as well as potential stabilisation requests. Costs would then be funded from the interest received from investments of the initial funding and any subsequent premiums charged, if required. To recoup the full £1 million per annum, initial premiums based on a percentage of saving deposits would be about 0.2%.

[17] These figures were obtained from FSCS for a Ministerial Briefing in 2009. The £6 million figure includes a net compensation pay-out (after loan recoveries) to depositors in credit unions in default of £2.2 million.

6. Is it time to think about credit union stabilisation in Britain?

The positive impact of credit union stabilisation programmes throughout the world is impressive. Since the creation of such programmes in Ireland, Newfoundland and Labrador (Canada), Jamaica, Poland and Uzbekistan, no credit union has failed and no savers have had to be compensated out of the assets of the stabilisation fund. There have been mergers, as a result of persuasion and sometimes coercion, but no credit union has been declared in default and unable to meet its liabilities out of its own assets. In all jurisdictions, the robust financial and operational performance standards demanded by a stabilisation programme, together with expectation of compliance with those standards, have significantly contributed to the strengthening of credit unions.

In 1991 when the stabilisation programme was established in Canada (Newfoundland and Labrador), of the 18 credit unions in the province, 12 were reporting ongoing losses. Today, there are 11 credit unions with a combined capital asset ratio of 4.7%, and it is expected that all but one credit union will be profitable in 2009. The one credit union that may experience a loss will only sustain a minor deficit. With much larger numbers of credit unions, it is a similar story in Ireland and in Poland and other case study areas.

Robust monitoring, supervision and examination against defined performance standards are central to stabilisation and there is clear evidence to suggest that it is these above all that impact on the quality of governance and of management of credit unions. As Wiktor Kamiński, vice-president of NACSCU, the Polish national trade association, noted in reference to the success of stabilisation in Poland:-

> *One of the essential purposes of supervision is to promote high quality of management. Circa 40 co-operative savings and credit unions have already implemented or are at the points of implementation of quality management systems in accordance with standard ISO 9001 – 2000.*

The argument that robust monitoring and examination of credit unions, linked to an accountability for losses, leads to better governance and more effective management may be substantiated to some extent in Britain in regard to the delivery of the Financial Inclusion Growth Fund. The DWP maintains that the credit union Growth Fund loan book is often better managed than the core member loan book as a result of the regular on- and off-site financial monitoring and supervision undertaken by DWP examiners. There is evidence to suggest that there is an increasingly good record of responsible lending and of recovery of Growth Fund loans because of the level of rigorous checking, monitoring and target setting.

Is a British stabilisation programme desirable?

In all case studies, and in other countries such as Poland, structured stabilisation programmes are central to ensuring the stability of credit unions and the safety of their members' savings. In many ways, stabilisation is a key critical element of international credit union success, and it is perhaps time for British credit unions also to consider the desirability of stabilisation, at least in some of its elements. In all case studies, the over-riding impression is of seriousness in regard to credit union accountability and of ensuring that credit unions operate according to rigorous business and financial standards. This is surely an approach that credit unions would want to replicate in Britain.

The argument that the governance and management of British credit unions would be strengthened if greater attention were given to monitoring and evaluating their operational and financial performance, and assisting those in trouble, is convincing. It is arguable that the adoption of a form of stabilisation programme in Britain could potentially result in a leap forward in improving the image and credibility of credit unions nationally. Ongoing reports of credit union failures, in the media and elsewhere, cannot be to the long-term advantage of credit unions.

It is true that most of the 42 credit unions that have failed so far have been relatively small and often very weak local organisations and they have had a marginal negative impact on the credibility of the movement generally. However, one of the failed credit unions was declared in default for £908k, insignificant in comparison with the global banking crisis, but still of significance in a movement endeavouring to establish itself as a trusted and safe section of the financial services industry. A concern must be that if more credit unions fail, and there is no sign of the rate of failure diminishing, that this might eventually impact on the credibility of the sector as a whole. This would particularly be the case if several high profile credit unions failed in a row, perhaps under the added pressure of the recession and the current financial situation.

It is true that the FSA does react to credit unions in difficulty and talks to credit unions about possibilities and options, sometimes in relation to merging with a neighbouring credit union. The FSA is often more open to stabilisation than it is to forced closure if at all possible. It is even ready to engage with a credit union that is technically insolvent and, if such a credit union can show that it has a plan to trade out of its insolvency and the capacity and resources to make it happen, the FSA is often ready to support recovery.

However, what the FSA does not have is the resources or the remit to take an active role in the stabilisation process of credit unions as a whole. For some larger credit unions, the FSA does conduct ARROW [18] monitoring and examination visits which include risk assessments to identify deficiencies. However, these visits involve only a few of the larger credit unions, as these are of much greater economic significance. However, even when problems are identified, the FSA does not have a team of technicians to send in to assist credit unions and has no financial resources to support a rehabilitation plan.

Even prior to credit unions getting into difficulties, and in order to avoid default, for most credit unions, the FSA does not currently have the resources to push hard on financial monitoring, on examining their business planning, and on ensuring that they have the capacity and competence to operate effectively. The FSA tends to fight fires, rather than monitor closely the operations and performance of individual credit unions and hold them to account for failure to conform to good business practice and to regulatory requirements. The FSA does not always have the resources to fully monitor and assess

[18] The FSA "Advanced Risk Recognition Operating FrameWork" (ARROW)

the information submitted in quarterly and annual returns, except in regard to those credit unions that have already become insolvent.

It is equally true that the Financial Services Compensation Scheme does not have the remit or the responsibility to engage with credit unions in trouble. It deals only with credit unions after the fact of failure in order to pay out savers and sometimes other creditors.

There are factors at play currently within the British credit union movement, however, that may suggest a growing desire for the creation of some form of stabilisation programme. Certain sections of the movement argue increasingly for wider credit union conformance to robust financial and operational standards. Credit unions endeavouring to operate to high financial and operational standards often feel compromised by the poor performance of other neighbouring credit unions. The movement's prior and mostly overwhelming desire for 'light-touch' regulation is perhaps beginning to give way to a more pragmatic view of the value of collective conformance to more robust financial and operational standards as a precondition of a heighted brand image within the nation at large.

Given the current constraints and remit of both the FSA and FSCS, however, if a stabilisation programme were a desired objective, it would be credit unions themselves, under the auspices of ABCUL that would have to take the lead to make it happen.

Is a British stabilisation programme feasible?

Even though there may be some emerging signs within credit unions of the desirability of creating a British credit union stabilisation programme, the feasibility of doing so is much more problematic. There are at least three major challenges to creating a stabilisation programme: who would run it?, who would pay for it?, and is the British credit union movement sufficiently mature enough to benefit from it?

However, on a positive note, forthcoming consultation on regulation associated with the impending changes in legislation gives the credit union movement an opportunity to seek a more robust regulatory regime. It is perhaps time for credit unions to actively seek minimum capital requirements for credit unions, below which they cannot operate, and also for effective action to enforce regulatory compliance throughout the movement. Standards and compliance with standards is fundamental to stabilisation.

The introduction by ABCUL of centralised back office services also reinforces a greater expectation of conformance to financial and operational standards. Back office services, of whichever form and extent, will demand credit unions meeting a range of performance standards necessitated by collective and collaborative approaches to financial and operational management and business delivery.

<u>Who would run a credit union stabilisation agency?</u>

As has been seen in the case studies, stabilisation is a holistic process involving regulatory compliance, meeting performance standards, monitoring, examination and supervision; financial and technical assistance; the authority and mechanisms to intervene; mergers or liquidation, and savings protection. In Britain, many of the regulatory and compliance factors are the responsibility of the FSA, savings protection is the remit of the FSCS, technical assistance and monitoring could relate to the role of ABCUL and, of course, many elements do not yet exist in this country. Currently, the FSCS does not have the funding or the option to stabilise credit unions, and stabilisation is not currently within remit of FSA

However, it is to be noted that the special resolution objectives in regard to stabilisation powers, the bank insolvency procedure, and the bank administration procedure, as detailed in the Banking Act 2009 can, under the Act, become applicable by order made by statutory instrument to credit unions. Significantly, the way is now open for Government to take a much greater role in credit union stabilisation.

Clearly, it would be unrealistic and inappropriate to consider that ABCUL could implement a stand-alone stabilisation programme. Internationally, the trend is towards much greater Government regulator involvement and away from free-standing private trade association schemes. Free standing private schemes are only applicable in countries where regulation is weak or near non-existent. But ABCUL could certainly have a role in the development of a Government sponsored scheme.

For, in order to bring together the various elements of stabilisation, there would need to be the creation of new entity or credit union stabilisation agency. This agency could unite, in one organisation, in whichever way, the current and future roles and remit of the FSA and FSCS, and engage the trade association in the delivery of stabilisation measures. A collective collaborative approach would be required if stabilisation was to be both a holistic and strategic intervention.

The creation of a new stabilisation agency would, of course, depend on political will to bring it about, and it is not easy to see that political will existing at the moment. The political will to create a new agency would certainly be dependent on an estimation of the impact of credit union failure more generally within the national economy.

Currently the sums involved in credit union failure have been relatively modest and it would probably be argued by politicians that a stabilisation programme is not necessary given the low levels of loss that are involved. Even though of significance to credit union members, as one group participant put it, it is often regarded that so far *"most credit union failures are a flash in the pan".* It was noted by the FSCS that often it does not even receive compensation claims from members in credit unions in default.

However, times are changing and credit unions are strengthening, and it may be that the FSA itself could be re-organised under a future Government administration. If the FSA is re-organised, it might be the time for ABCUL to begin to argue for a credit union stabilisation agency, given that stabilisation world-wide is seen as central to long-term sustainable development. Of course, there would be legal issues to be faced and complexities to be managed, but a stabilisation agency could be a medium to long-term goal for ABCUL.

<u>Who would pay for a stabilisation agency?</u>

By any standard, establishing a stabilisation fund to recapitalise and to assist troubled credit unions, as well as to pay for the staffing, operation and administration of a stabilisation, would undoubtedly be expensive. The argument was expressed several times in the course of the research, by Government officials and others, that it is still probably cheaper just to pay-out compensation to failed credit unions than to operate a stabilisation programme to international standards. The cost of setting up of an examinations and monitoring department alone for over 450 credit unions, for example, would be significant.

However, as was explored in the previous chapter[19], even though with so many variables the exact cost of a stabilisation programme is hard at this stage to delineate, it still may be a reasonable to estimate that a British stabilisation programme could possibly be in established initially for around £1 million per annum. This compares favourably with the current costs of the credit union section of the FSCS. Since 2002, the FSCS has paid out £3.53 million in compensation to credit union members in failed credit unions and recovered a total of £1.04 million, a net cost therefore of £2.49 million. However, to this figure, must be added the administrative costs of the FSCS itself. As noted in Chapter 5, for the five years, 2004 – 2009[20], the true cost of delivering the Financial Services Compensation Scheme for credit unions was £6 million.

The question arises as to how this cost of £1 million per annum would be met. As argued in Chapter 5, an initial funding of the stabilisation programme could be by Government grant and a percentage of credit union savings deposits. Costs would then be funded from the interest received from investments of the initial funding and any subsequent premiums charged, if required. In the previous chapter, a premium of around 0.2% of savings deposits was estimated. This compares with 0.35% of savings deposits in Jamaica and 0.58% of assets in Ireland.

Are British credit unions ready for a stabilisation agency?

Internationally, stabilisation programmes are rigorous and make demands on member credit unions. In this way, they aim to improve the governance and management of credit unions and keep members' savings safe. However, the British credit union movement is currently made up of many small, often volunteer-run, organisations, the majority of which would find it impossible to meet the basic entry requirements of a stabilisation programme. Not only would the financial ratios of many credit unions fail to reach the required standard, many would not have the administrative systems to participate in a stabilisation programme effectively. There are still a significant number of credit unions, for example, that operate manual accounts. Electronic accounting is a prerequisite of stabilisation and many credit unions would find this problematic.

Overall many credit unions would find stabilisation challenging. In any stabilisation programme, credit unions would have to meet stringent and robust financial and operational standards. They would have to expect regular inspection, monitoring and examination to ensure stability and to avert failure. They would be obliged to participate in

[19] Chapter 5. The cost of stabilisation.
[20] These figures were obtained from FSCS for a Ministerial Briefing in 2009. The £6 million figure includes a net compensation pay-out (after loan recoveries) to depositors in credit unions in default of £2.2 million for the five year period. .

the PEARLS monitoring system, and to meet minimum capital requirements as well as target ratios in loan delinquency and bad debt, provisioning, liquidity and solvency from which they would not be allowed to deviate.

The stabilisation agency would have the powers to intervene and to access all premises and books of the credit union, and would need to act immediately when certain financial ratio thresholds were reached. Decisions would be taken by the agency about financial and technical assistance to credit unions in difficultly, and credit unions would not be able to be stabilised just because they found themselves in trouble. Viability and track record would have to be taken into account. Stabilisation assistance would depend on robust business planning targeting growth and recovery. Work-out plans would be monitored and penalties would be set for not meeting targets. There would be time-scale for stabilisation, which if not met would result in mergers or liquidation.

Financial assistance to troubled credit unions would be a particular challenge for many credit unions. This would not necessarily be given in the form of non-repayable grants. Financial assistance would be forms of repayable loans and deposits that would have to be repaid with interest within a given period of time. Stabilisation investment would not be the free-money and the rescue cash investment of the past.

An even greater challenge for credit unions would be the power of a stabilisation agency to change or influence the composition of the board and of management. This would surely be a critical and problematic issue for the movement as a whole. On the one hand, it seems self-evident that a stabilisation programme cannot invest in a failing credit union that continues with an ineffective board and poor management, yet, under current legislation, it is uncertain that powers to change boards and management could exist, as credit unions are legally a mutual and subject to the decisions of the members. This would be a legal issue that credit unions collectively would have to campaign to resolve. Currently the FSA can remove the approved person's status of an individual, but training and competence requirements are not criteria for removing approval. The FSA can try to remove people under 'fit and proper' person criteria, yet currently there is always the opportunity of appeal, the time of which would compromise the recovery of a credit union.

The introduction of a credit union stabilisation programme into Britain based on international principles would be a major culture shock for many credit unions. In fact, stabilisation would necessitate an even greater cultural change within the credit union movement than that brought about at the time of the introduction of the FSA regulatory regime. Credit unions out of compliance with the robust standards and the rules of the programme would have to expect to be closed or merged, or eliminated from the programme.

It is surely the case that a major obstacle in the way of any stabilisation programme being implemented in Britain in the foreseeable future would be the number of credit unions unable to meet its basic requirements. Ironically, maybe the British credit union movement is just not yet stable enough to benefit from more effective stabilisation.

7. Conclusion

It is clearly not feasible that a credit union stabilisation programme could be implemented immediately in Britain. Credit unions are the result of a particular historical process of development, and, collectively, are, as yet, insufficiently robust to participate in a stabilisation programme designed to international standards. There are just too many credit unions that could not meet the basic standards for entry and participation.

A further obstacle, of course, is the expense of a stabilisation system. If a stabilisation programme was replicated along international lines, it would be credit unions themselves that would have to cover the cost through a system of charges and levies. Undoubtedly, this would prove an additional financial burden on the movement.

For Government to become involved, according to both the FSA and FSCS, credit unions would have to be much more significant financial institutions within the national economy to merit the major financial investment required to implement an effective programme. Credit unions, even the largest, are just too small. FSCS pay-outs are a cheaper option and will be so for some considerable time.

However, that said, the study has demonstrated the central importance of stabilisation to credit union success world-wide. It is for this reason that WOCCU prioritised the development of stabilisation programmes in the emerging movements of Uzbekistan and Poland. For it is the rigour of stabilisation which results in good governance and effective management and therefore is the ultimate protector of members' savings.

In looking to the future of the British movement, ABCUL does need to have the development of a stabilisation programme on its agenda. For irrespective of the amount of training and support that ABCUL offers its members, on the basis of international experience, it would be a stabilisation programme above all that would contribute the most to long-term sustainable and stable credit union development.

But even in the future, stabilisation is not a role that ABCUL could or should take on alone. Internationally, there are moves away from stand-alone trade association schemes in favour of those involving the regulator and Government savings (deposit) protection schemes. It could be, however, that in any future re-organisation of the FSA and of the system of banking regulation there would be an opening to campaign for a stabilisation programme, operated by Government but in collaboration with ABCUL. Certainly stabilisation will be an issue as ABCUL develops its central services and finance facilities.

In the meantime, this study recommends that ABCUL begins progressively to introduce its members to the principles and practices of stabilisation. Immediately, for example, it could insist, as a condition of membership, that all credit unions submit monthly reports to be included in the PEARLS monitoring system.

The recommendations, in fact, itemise a number of suggestions of how ABCUL could introduce elements of stabilisation to credit unions. This, it is suggested, will in itself promote the strengthening of the movement, even though it would have to be accepted that the rate of mergers and closures would probably increase as a result. However, those credit unions that remained would be much stronger and stable organisations.

8. Recommendations

The following recommendations arise out of the research study and do not necessarily reflect the views of ABCUL. These recommendations aim to promote the principles of stabilisation within the British credit union movement.

For Credit unions

1. Any deviations from regulatory requirements, including the non-submission of quarterly and annual returns, should be regarded with extreme seriousness by all credit unions.
2. Credit unions should inculcate a culture of transparency in financial accounting and of robust monitoring of financial performance. They should welcome the opportunity to benchmark their own financial performance against that of other credit unions.
3. Boards of directors should ensure accurate and timely monthly management accounts are submitted to all board meetings. They should regularly evaluate progress according to financial target ratios such as PEARLS.
4. Credit unions should recognise that world-wide standards of capital requirements are higher than FSA requirements for Version 1 credit unions. Version 1 credit unions should seek to exceed the minimum capital standards set by the Financial Services Authority. If the capital ratio falls below 3%, credit unions should seek immediate technical assistance and instigate a plan of recovery.
5. Based on trend information provided by financial ratio analysis, troubled credit unions should always act early to prevent default and be ready to seek help from other credit unions, the trade association, the Financial Services Authority or any other credit union support organisation.
6. Credit unions with capital/asset ratios of less than 3%, and find that they cannot improve this ratio over three successive quarters, should seek financial assistance to merge with another credit union.
7. Credit unions should not compromise rigorous financial monitoring, analysis and management through a reliance on the FSCS as a pay-out box in case of failure. Credit unions need to recognise the reputational damage of individual credit union default on the credit union movement as a whole.

For the Association of British Credit Unions Ltd (ABCUL).

8. ABCUL should campaign for effective, enforced yet proportional regulation of the credit union movement.
9. ABCUL should offer advice and support to those troubled credit unions whose future lies in dignified closure or in seeking a merger. ABCUL should communicate the message to its members that, in circumstances of severe financial difficultly, closure or merger can be in the best interests of credit union members and of the credit union movement as a whole.

10. ABCUL should continue to offer the PEARLS monitoring system and input data monthly as a service to its members.
11. ABCUL should ensure that it has access to expert and skilled technical and business analysts able to assist troubled credit unions. The costs of these analysts could be rechargeable to credit unions.
12. ABCUL should encourage credit unions with capital/asset ratios of less than 3%, and which find that they cannot improve this ratio over three successive quarters, to seek financial assistance to merge with other credit union.
13. ABCUL should ensure that credit union participation in any future back office initiative is dependent on rigorous financial monitoring and on the meeting of existing regulatory requirements.
14. In the longer term, ABCUL should negotiate with Government on the creation of a credit union stabilisation agency. This could be a Government sponsored organisation but operated in collaboration with the FSA, ABCUL and the sector. It could be integrated into, or work collaboratively with, the FSCS or its equivalent.

For Government and the Financial Services Authority

15. The FSA should more effectively monitor credit union performance through quarterly and annual returns and increasingly enforce credit union compliance with existing regulatory requirements.
16. The FSA should work with credit unions to ensure their submission of accurate quarterly returns. Credit unions should receive feedback on any difficulties or deficiencies noted by the FSA in quarterly returns.
17. The FSA should focus their attention on credit unions identified as weak financial institutions and support interventions and remedies to avoid default. This is seen as a much more effective intervention than raising compliance thresholds for all.
18. The Government should work with the FSA, FSCS, ABCUL and the sector to consider strengthening of the credit union sector through the development of a credit union stabilisation agency.
19. The Government should create a credit union stabilisation fund to support the mergers of credit unions, so that they do not have to call on the assets of the FSCS as failed credit unions. This fund could be used to purchase the bad and unproductive assets (loans) of troubled credit unions before a merger.

Appendix 1. Credit unions in default 2002 - 2009

	CREDIT UNION	DEFAULT DATE
1	Thameswood Credit Union Limited	12-Sep-02
2	Cathall Community Credit Union Limited	25-Mar-03
3	Fairswan Credit Union Limited	25-Mar-03
4	Guide Post & Scotland Gate Credit Union Limited	25-Mar-03
5	Tendring Dial Credit Union Limited	26-Mar-03
6	Leasowe Credit Union Limited	8-May-03
7	Leicester City Council Employees Credit Union	8-May-03
8	Shepherds Bush Social & Welfare Credit Union Limited	25-Sep-03
9	Croydon Branch Union of Communication Workers Credit Union Limited	15-Oct-03
10	Ruabon Cefn & District Credit Union Limited	15-Oct-03
11	Dudley Estate (Newcastle) Credit Union Limited	14-Jan-04
12	Dalston Social & Business Credit Union Limited	14-Jan-04
13	Raffles Area Credit Union Limited	15-Jul-04
14	Employee Credit Union (Luton Borough Council) Limited	15-Sep-04
15	Hackney South Credit Union Limited	8-Nov-04
16	Greater Pollokshaws Credit Union Limited	20-Jun-05
17	South Airdrie Credit Union Limited	5-Apr-06
18	Money Tree Credit Union Limited	17-Aug-06
19	Furness Credit Union Limited	25-Sep-06
20	St Columba's (Bradford) Save & Credit Union Limited	13-Oct-06
21	Sheldon Credit Union Limited	28-Nov-06
22	Breightmet Credit Union Limited	18-Dec-06
23	L27 (Liverpool) Credit Union Limited	24-Jan-07
24	Skelmersdale Credit Union Limited	23-Apr-07
25	Clydesdale Credit Union Limited	1-May-07
26	Fleetwood and District Credit Union Limited	12-Jun-07
27	Ferries Credit Union Limited	02-Jul-07
28	Corby Community Credit Union Limited	25-Jul-07
29	Streetcred Credit Union Limited	23-Oct-07
30	Caia Park (Wrexham) Credit Union Limited	21-Dec-07
31	Edmonton Credit Union Limited	28-Jan-08
32	Rotton Park & Winson Green Credit Union Limited	3-Mar-08
33	Peterlee Credit Union Limited	25-Mar-08
34	Inner Preston Credit Union	16-May-08
35	Khalsa (Bradford) Credit Union Limited	3-Oct-08
36	Polmaise Community Credit Union Limited	24-Nov-08
37	South West Durham Credit Union Limited	11-May-09
38	St Brendans Credit Union	28-May-09
39	Irvine North Credit Union Limited	09-Jul-09
40	Eastbourne Community Credit Union Limited	15-Jul-09
41	Hull Northern Credit Union Limited	18-Aug-09
42	Derby City Credit Union Limited	18-Aug-09

Research Unit for Financial Inclusion

Paul A Jones is a senior researcher in the Research Unit for Financial Inclusion. His research interests are in the fields of credit union development, co-operative and social enterprise, money and debt advice and financial services for people on low incomes.

The Research Unit for Financial Inclusion (RUFI) is situated within the Faculty of Health and Applied Social Sciences at Liverpool John Moores University. It undertakes academic, action and evaluative research in a wide range of areas related to the development of financial services for lower income households. RUFI has a particular expertise in research aimed at strengthening credit union capacity and effectiveness.

For further information on RUFI see:

http://www.ljmu.ac.uk/HEA/financialinclusion/index.ht