Effective regulation and supervision of all financial institutions safeguard the stability of a country’s financial system and protect the savings deposits of its people.

Credit unions collectively represent only a small percentage of the financial sector’s total assets in most countries, in part because they focus on providing financial services to poor, low and middle income individuals. They are established at the local level to serve people who otherwise would not have access to financial services. Although their assets may be low by comparison, credit unions serve large numbers of small depositors and, as such, should be regulated and supervised.

While several models of credit union supervision have emerged, World Council of Credit Unions (WOCCU) maintains that the ministry or agency that regulates financial institutions should supervise credit unions through a specialized unit trained in their nature, risks and methodologies.

WOCCU consistently finds that, in addition to stronger financial performance, credit unions supervised by the financial sector regulator enjoy greater public confidence and trust, which results in higher membership and savings growth.

Central banks, ministries of finance, financial cooperative systems and policymakers in countries as diverse as Azerbaijan, Barbados, Bolivia, China, Ecuador, India, Kenya, Lesotho, Malawi, Panama, South Africa, Trinidad & Tobago, Uganda, the United Kingdom and Uzbekistan have called on WOCCU to assist them with developing legislative and regulatory frameworks for credit unions.

The Credit Union Regulation and Supervision technical guide shares lessons from WOCCU’s experience in developing suitable regulatory systems and supervisory frameworks for credit unions.

Core Principles Underlying Credit Union Supervision

- Credit unions are private sector organizations and should operate free of government interference with management.
- The appropriate role of government vis-à-vis credit unions is that of legislator, regulator and prudential supervisor.
- Credit unions should be supervised by a government agency responsible for the financial sector.
What is a Credit Union?

Credit unions, called by various names around the world, are user-owned financial cooperatives that offer savings, credit and other financial services to their members. Credit union membership is based on a common bond, a linkage shared by savers and borrowers that can be based on a community, organizational, religious or employee affiliation.

Credit unions worldwide offer members from all walks of life much more than financial services. They provide members the chance to own their own financial institution and help them create opportunities such as starting small businesses, building family homes and educating their children. In some countries, members encounter their first taste of democratic decision making through their credit unions.

Legislation

Establishing a Secure Legal Foundation

A strong supervisory framework is built upon a secure legislative foundation that is prudential, proportional and predictable.

• Prudential legislation establishes financial standards to which a credit union must adhere to protect the health of the institution and safeguard member deposits.
• Proportional legislation recognizes the risks a credit union presents to depositors and the financial system as a whole and establishes appropriate rules to mitigate those risks.
• Predictable legislation provides a credit union the clarity and certainty it needs to plan and invest for the future.

Legislation that seeks to address the needs of credit unions within a body of law for banks, cooperatives or microfinance institutions (MFI) often neglects to recognize the cooperative governance structure, deposit-taking function and/or scale and scope of credit union operations. Conversely, credit union-specific legislation ensures an appropriate set of financial management disciplines, creates avenues for building and distributing capital, establishes governance controls and sets up a prudential supervisory framework for a large number of small institutions.

Different from Banking Legislation

Legislation intended for commercial banks is generally inappropriate for credit unions whose purpose is to provide cooperative financial services to members who are the depositors, borrowers and owners. Unlike commercial banks:

1. Credit unions are often formed by individuals who lack(ed) access to affordable financial services and have banded together to overcome the market failure. As a result, they have limited ability to raise initial start-up capital.
2. Credit unions do not have the same access to capital markets.
3. As not-for-profit institutions, credit unions should not have external shareholders, rather members who own the institution and receive the financial services provided.
4. Credit unions are governed by a board of directors that is democratically elected from within the membership through a one-member, one-vote process.
5. Credit unions share back-office operations, policies and procedures and cross-guarantee systems with other credit unions to a much greater degree. Legislation should recognize this not as a violation of anti-trust principles, but as credit union cooperation within a non-competitive framework.
6. In best practice, credit unions generally do not “negotiate” mergers in which one party attempts to bid up or receive any price beyond the book value of its outstanding ownership shares.
7. It is best practice for credit unions that voluntarily liquidate to not compensate members beyond the value of their initial shares.
Different from Cooperative Legislation

Most legislation for cooperative societies is limited in scope to addressing the governance, registration and promotion of cooperatives. Cooperative acts generically encompass agricultural, consumer, marketing and production cooperatives. They are inadequate for credit unions because unlike other cooperatives:

1. Credit unions mobilize voluntary public deposits from their members.
2. Credit unions maintain a capital base that is comprised principally of accumulated reserves and retained earnings from operations.
3. Credit unions specialize in financial intermediation, which necessitates adherence to prudential financial standards and supervisory oversight.
4. Credit unions require access to central bank liquidity mechanisms as well as to payment, settlement and clearing networks.

Different from Microfinance Legislation

As interest in microfinance has increased in the last decade, governments have enacted legislation for microfinance institutions (MFI). Because credit unions and other MFIs serve the same market—the working poor and others who are traditionally excluded from the financial sector—policymakers often mistakenly assume that microfinance legislation will cover credit union needs as well. While credit unions are a type of microfinance institution, they differ from other MFIs in that:

1. Credit unions intermediate a broad array of financial services beyond credit.
2. Credit unions mobilize voluntary public deposits from their members on a much greater scale.
3. Credit unions have boards of directors elected from within the local membership on a one-member, one-vote basis.
4. Credit unions are community-owned by individuals with equal ownership.
5. Credit unions share back-office operations, policies and procedures and cross-guarantee systems with other credit unions to a much greater degree. Legislation should recognize this not as a violation of anti-trust principles, but as credit union cooperation within a non-competitive framework.
6. In best practice, credit unions generally do not “negotiate” mergers in which one party attempts to bid up or receive any price beyond the book value of its outstanding ownership shares.
7. It is best practice for credit unions that voluntarily liquidate to not compensate members beyond the value of their initial shares.

Uzbekistan

WOCCU Supports Legislation and Builds a Credit Union System

With funding from the Asian Development Bank (1998–2002), WOCCU worked in Uzbekistan to draft and support the passage of a law to authorize the establishment of credit unions. While the law was in development, WOCCU advised Uzbekistan’s Central Bank to develop a supervisory unit and examination process for credit unions. The WOCCU-Uzbekistan program, funded by the U.S. Agency for International Development (2002–08), has since worked with local groups to build a grassroots credit union system. Since 2002, the program has established 58 registered credit unions that offer financial services to 73,000 poor and low-income members in nine regions of the country. Savings grew from zero to US$34.6 million in six years.
Key Elements of Credit Union Legislation

WOCCU’s Model Law for Credit Unions provides a detailed sample of appropriate legislation for credit unions. Key elements of effective credit union legislation include:

- Minimum requirements for organizing and licensing a credit union
- Definition of what constitutes capital in a credit union
- Definition of the powers and permissible activities of a credit union
- Field of membership requirements
- Identification of a supervisory body
- Election process for board members
- Deposit and loan concentration limits for any one member or related group of members
- Recordkeeping and anti-money laundering policies
Regulation

Setting the Rules

Credit unions are financial intermediaries that should be subject to prudential standards. Regulations set forth the application and enforcement of a law. More detailed than legislation, regulations address specific operational, financial and administrative issues.

Regulations establish minimum prudential, operational, administrative, governance, accounting and audit requirements. As in the case of legislation, one set of requirements does not fit all financial institutions. Credit union regulations are likely to differ from those of other financial institutions in the areas of:

- Establishing minimum start-up capital
- Defining what constitutes capital and determining capital adequacy
- Servicing small accounts and loans
- Allowing the use of non-traditional collateral

Minimum Start-up Capital

Credit union regulatory standards include lower initial start-up capital requirements because credit unions are established at the community level to provide a means for low- and moderate-income members to access small savings accounts and loan services. Member shares provide the initial funding base. Credit unions do not have private joint stock capital investors, but instead build their capital from retained earnings over time.

The issue of necessary start-up capital to establish a credit union is one area that significantly diverges from banking regulations. Banks need start-up capital to secure the investors’ stake in the venture and to ensure sufficient funds for operating costs. Community and member interest, as opposed to investor interest, drives the formation of credit unions.

Instead of focusing on start-up capital, key elements for regulators to consider in granting a license to new credit unions are:

1. Submission of 300 signatures from individuals indicating their commitment or intention to become members
2. Presentation of a three-year business plan that demonstrates viability
3. Allowing a grace period to reach capital adequacy ratios and minimum start-up funding (e.g., ranging from US$20,000 to US$50,000)

WOCCU Makes Resources Available

For the past 15 years, WOCCU has provided policymakers, institutional donors, credit unions and governments with free tools to reform and promote effective legislative frameworks and regulatory systems for credit unions and other financial cooperatives. Together, the three tools provide unparalleled technical guidance to anyone interested in advancing the quality of legislation and regulations governing credit unions.

Model Law for Credit Unions

Model Law for Credit Unions (available in English, French, Spanish and Russian) presents 12 key provisions that provide sample text for drafting an entire credit union statute as well as for framing amendments to current laws. Each model article begins with the purpose, recommended content and commentary with rationale.

Guide to International Credit Union Legislation

Guide to International Credit Union Legislation (available in English) is a desk reference and analysis of 50 separate provisions found in existing credit union legislation in 117 countries and political jurisdictions. It enables both law-seekers and lawmakers to review alternative approaches to key legislative provisions affecting credit unions. The analysis includes specific credit union legislation as well as more general legislation, such as cooperative laws.

Model Regulations for Credit Unions

Model Regulations for Credit Unions (available in English, French and Spanish) is a supporting piece to the Model Law for Credit Unions and provides sample regulatory text for crafting or amending regulations for credit unions. Complementing this tool is a regulatory matrix that compares credit union regulations from 18 countries.

WOCCU’s legislative and regulatory tools have been implemented in countries as diverse as Belize, Ecuador, Ireland, Kenya, Latvia, Macedonia, Poland, South Africa, Trinidad & Tobago, the United Kingdom and Uzbekistan to improve legislative frameworks and regulatory systems for financial cooperatives and credit unions.

All tools are available for download on WOCCU’s Web site, www.woccu.org.
Capital Adequacy

Capital Defined
A credit union’s institutional capital is comprised of non-distributable reserves that are created or increased by appropriations of retained earnings, capital donations and other surpluses. All forms of capital must be permanent and non-withdrawable. Neither member shares, re-valued assets nor provisions are considered part of institutional capital.

The institution “owns” the capital of a credit union for the benefit of all members, none of whom have any direct claim on it. As such, any credit union that voluntarily liquidates or ceases being a cooperative should donate any remaining net assets to another cooperative or nonprofit agency focused on cooperative development after paying back deposits, shares and external credit.

Regulatory Capital: Credit Union Shares
The mandatory purchase of shares by credit union members creates a membership stake in the institution. Credit union shares are fully withdrawable by the member at par value upon leaving the membership.

When crises occur in credit unions and their surrounding economies, members might withdraw their shares and savings to protect their own assets. It is during such crises that credit unions most need to rely on their institutional capital to cover losses. Because shares cannot be counted on to absorb losses at such times, they are not considered credit union capital, rather a liability.

Shares should be considered capital only if the national law or regulation defines all member shares as “permanent and non-withdrawable.” Where this is the case, members should be advised upon joining the credit union that shares are non-withdrawable.

While not part of institutional capital, supervisors in some developed countries allow credit unions to raise subordinated debt from members and/or non-members with special restrictions on the voting and ownership rights of the debt. The subordinated debt is often long-term with regular payments due to the investor(s). As the debt nears maturity, a progressively greater portion of the debt is no longer considered capital for regulatory purposes. For example, at five years to maturity, 100% of the debt is considered regulatory capital, while at four years to maturity, only 80% is considered regulatory capital. The scale continues to decline at 20% per year.

How Much Capital is Enough?
While start-up capital requirements may be lower in credit unions, greater emphasis must be put on a credit union’s capital adequacy ratio. Just as loan loss allowances serve as the first line of defense to absorb anticipated losses in the credit portfolio, institutional capital protects depositors and shareholders from unexpected losses that result from a credit union’s risk-taking.

In some credit unions, management has less professional training than in other types of financial institutions, coverage is more geographically concentrated, fewer avenues exist to access capital markets, and lending based on non-traditional collateral is riskier. Therefore, a more conservative capital adequacy structure is needed. At the same time, capital standards should recognize that the cost of capital affects the competitiveness of credit unions in the financial marketplace.

Small Accounts and Non-traditional Collateral
Credit unions serve individuals of low- and moderate-income groups by collecting large numbers of small savings and making small loans to many borrowers. As such, credit union regulation and supervisory practices can accept non-traditional collateral and alternative guarantees for small loans. Equally as important, reporting and compliance requirements should take into account the high relative costs of serving large numbers of small depositors.

WOCCU Recommendation
The minimum capital-to-asset ratio for credit unions should be 10% of total assets. Components of capital include retained earnings, donations and statutory reserves. Member shares are not considered capital.
International Credit Union Safety & Soundness Principles

Delinquency: < 5%
Loans that are not paid as agreed are deemed delinquent the day after the first missed payment. The entire outstanding loan balance is then considered past due. Immediate action should be taken to control delinquency and collect when a loan is reported past due. WOCCU recommends that loans past due more than 30 days comprise less than 5% of the total loan portfolio. When a loan becomes delinquent, the credit union should not grant new loans to the same borrower for paying off the outstanding capital and interest.

Loan Loss Provisioning:
35% of Delinquency ≤ 12 Months
Provisions for loan losses are the first line of defense to protect member savings against identified risk. Many countries and credit union systems apply a tiered system of provisioning for delinquency, and standards may vary depending on the level of the credit unions’ technology. The following loan classification schedule should be utilized where provisioning is tiered:

- **Special mention** (one to less than three months)
  10% of the outstanding loan balance
- **Substandard** (three to less than six months)
  35% of the outstanding loan balance
- **Doubtful** (six to less than 12 months)
  65% of the outstanding loan balance
- **Loss** (more than 12 months)
  100% of the outstanding loan balance

In less developed institutions, WOCCU recommends that at least 35% of the outstanding loan balance, not just the missed payment(s), should be provisioned for all loans between one and 12 months delinquent. WOCCU recommends 100% provisioning for loans past due more than 12 months.

Loan Charge-offs: >12 Months
Loans more than 12 months past due should be written off the credit union’s books as a loss on a quarterly basis. Although a loan may be written off the books, the credit union should still seek to collect payment for the outstanding balance.

Institutional Capital: 10% of Assets
Institutional capital is the second line of defense to protect member savings. Each year, a portion of the credit union’s earnings should be set aside in reserves to cover losses from unforeseen or catastrophic problems. Since institutional capital is collectively owned by the membership with no individual direct claims, the reserves allow the credit union to support high rates of return on savings, maintain low costs on loans, create additional reserves and/or invest in new services. To ensure capital adequacy, WOCCU recommends credit unions maintain a capital level of 10% of total assets.

The Basel Accord requires institutions to maintain a capital level that is 8% of risk-weighted assets. In markets where credit unions are prudentially supervised and regulators have the capacity to generate a risk-weighted asset-to-capital calculation, credit unions may consider utilizing a risk-weighted assets standard equivalent.

Non-earning Assets: ≤ 5%
Assuming they meet capital targets, credit unions should limit non-earning assets, such as land, buildings, vehicles, furniture and cash, to a maximum of 5% of total assets.

Pricing: Entrepreneurial Rate
Credit unions should offer competitive, entrepreneurial pricing that covers all costs. WOCCU recommends that credit unions earn sufficient income on loans and investments to cover the cost of funds, operating costs, provisions for loan losses and the accumulation of reserves (or institutional capital).

Efficiency: Operating Costs ≤ 5% of Average Assets
Credit unions should maintain efficiency by limiting operating costs to 5% of average assets.

Liquidity:
(Liquid Assets - Short-term Payables)/Total Deposits = 15%
To meet the demands of loan disbursements and savings withdrawals, WOCCU recommends credit unions maintain 15% of withdrawable savings in easily accessible instruments and accounts.

Diversification:
No Loan > Lesser of 10% of Assets or 25% of Institutional Capital
Credit unions should limit the risk of concentrating the loan portfolio in one or a few related loans. WOCCU recommends the maximum amount of related aggregate loans or credits be the lesser of 10% of the credit union’s total assets or 25% of its institutional capital.

Non-financial Operations: Not > 5% of Total Assets
Credit unions specialize in financial intermediation and should not focus resources on non-financial operations, such as retail store operations. WOCCU recommends the sum of non-financial investments not exceed 5% of total assets.

External Credit:
% of Total Assets, Depending on Capital Level
Borrowing by the credit union is limited to a percentage of total assets, depending on the level of capital reserves. The table below shows acceptable leverage limits.

<table>
<thead>
<tr>
<th>Net Institutional Capital¹</th>
<th>Acceptable Level of External Borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 8% of total assets</td>
<td>0% of total assets</td>
</tr>
<tr>
<td>8–10% of total assets</td>
<td>Max 5% of total assets</td>
</tr>
<tr>
<td>Greater than 10%, not exceeding 12% of total assets</td>
<td>Max 10% of total assets</td>
</tr>
<tr>
<td>Greater than 12% of total assets</td>
<td>Max 15% of total assets</td>
</tr>
</tbody>
</table>

¹ Net institutional capital is institutional capital less any current deficiencies in loan loss provisioning divided by total assets.
In June 2004, the Basel Committee on Banking Supervision issued its International Convergence of Capital Measurement and Capital Standards: A Revised Framework, also known as Basel II. Banking and credit union systems around the world are implementing and evaluating the applicability of Basel II to their environments. A departure from the original Basel Accord, Basel II incorporates qualitative analysis and market forces in addition to the original quantitative standard of maintaining 8% capital-to-risk-weighted assets. The three “pillars” of Basel II are:

Pillar I: Minimum Capital Requirements
At its core, Basel II defined a standardized approach for calculating the capital-to-asset ratio of a financial institution. In the calculation set out in pillar I, an institution’s credit risk, market risk and operational risk are measured to assess capital adequacy relative to the standard of 8% capital to risk-weighted assets.

Pillar II: Supervisory Review Process
Pillar II addresses the qualitative supervisory review process of financial sector supervision. It sets supervisory guidelines for analyzing risk according to the Basel Committee’s Core Principles for Effective Banking Supervision.

Pillar III: Market Discipline
Pillar III sets out a market discipline framework that details what information should be disclosed and made public regarding the capital structure of a financial institution. Although credit unions should fully disclose timely and accurate financial information to members on a regular basis, much of pillar III is geared toward publicly traded banks. Basel II specifically recognizes that some of its disclosure requirements may not be relevant or material for all financial institutions.

Should a Credit Union System Apply Basel II?

The existence of prudential supervision in a country should be the first consideration when determining if credit unions should apply Basel II. Lack of prudential supervision is most typically a concern in developing countries.

To help supervisors determine if they should apply Basel II to credit unions in their jurisdictions, WOCCU recommends the following decision process:

Apply Basel II to Credit Unions if...
Strong, prudential risk-based supervision already exists.
AND
Credit unions compete directly with banks that have adopted Basel II.
AND
Credit unions and their supervisors understand the rationale and process of how to calculate the “standardized approach” under pillar I.

Do Not Apply Basel II if...
Credit unions are not prudentially supervised. In such instances, resources are better spent on ensuring strong examination and oversight.
OR
Strong supervisory oversight exists, but credit unions and/or supervisory staff would have difficulty understanding, calculating and applying the capital-to-risk-weighted asset ratio under pillar I.
OR
Credit unions do not compete directly with banks that adhere to Basel II, in which case the focus should be on creating a strong risk-based supervisory system.

In the appropriate environment, Basel II implementation may help establish regulatory neutrality and introduce a risk-sensitive capital and management framework for credit unions. However, prior to applying Basel II in any country, the credit union sector should have the opportunity to comment on the new regulatory requirement and complete a quantitative impact study to understand the potential ramifications of applying Basel II.
Governance
Governance matters in all financial institutions. In credit unions, good governance is an essential component of success.

Historically, credit unions have had untrained volunteers involved in making technical decisions and taking managerial actions. Credit unions that operate at a small community or closed group level often depend upon volunteers to conduct daily operations and fulfill governance functions. As credit unions grow, they engage in more sophisticated operations and should evolve to depend less on volunteers in operational matters and more on paid professional staff.

The volunteer role is then reserved primarily for the board of directors and supervisory committee. Once a credit union makes the transition to professional management and staff, governance problems occur if and when board members continue to engage in operational decision making rather than in planning and oversight.

Regulations establish defined roles and responsibilities as well as controls for conflicts of interest. They provide two critical sets of guidelines: one that specifies the prudential disciplines of sound management and another that lays out proper rules of institutional governance.

Prudential disciplines constrain the behavior of boards of directors and managers within boundaries that protect member savings and the financial viability of the credit union.

Rules of governance establish systems for internal control and oversight to address problems before external supervision is required. They include role and fiscal responsibility guidelines for the general assembly, board of directors, internal auditor and management.

Regulations can also identify proper criteria for board members. These requirements may include a specified level of education or management experience in a financial institution. Alternatively, regulation may require that board members complete formal training in financial institution management and supervision to maintain their board seats.

Regulations may stipulate that when credit unions grant loans directly to board members, supervisory committee members, general managers or their relatives, the board of directors must approve the loans according to terms no less and no more favorable than for other credit union members of similar financial standings. A director applying for a loan must abstain from the decision making and may not be physically present during the approval process. Loans to directors, managers and their relatives must be externally examined at least once a year to verify that they fall within the policies of the credit union, do not receive special treatment and are not delinquent. If a director’s loan becomes delinquent, he or she must resign from the board.

Bolivia
Credit Union Governance

As part of its credit union strengthening programs in Bolivia (funded by USAID, 1989–2009), WOCCU advised the Superintendency of Banks in developing credit union-specific regulations and in the creation of a non-bank supervisory department within the Superintendency. Below are the key governance provisions in the regulations.

• Credit union regulations in Bolivia require the general assembly to elect the board of directors for a period of no more than three years. No board member can serve more than two consecutive terms.

• Credit unions cannot grant loans to members of the board, supervisory or credit committees during their terms. Outstanding loans upon election retain their original conditions but may not be restructured. Loans to executives or related groups must be paid in full before the parties assume their duties.

• The general assembly can remove members of the board or supervisory committee for the following reasons:
  - Absence from three consecutive or five non-consecutive meetings
  - Negligence, irresponsibility or abuse of power
What to Include in Regulations
Regulations are rules to implement legislation. Historically, credit union legislation has been too general and has fallen short of protecting the financial health of the institutions or safeguarding member deposits. The same is true of traditional credit union regulation. Effective credit union regulations should include the following six components.

1. **Accounting and audit regulations** establish standardized accounting procedures and a chart of accounts, set consistent dates for the fiscal year, stipulate required reports and formats and establish audit standards.

2. **Prudential regulations** establish financial standards intended to safeguard member deposits. These financial standards address: the definition of institutional capital and capital adequacy requirements, asset classification and loan loss provisions, liquidity requirements, delinquency controls, external borrowing limits, allowable investments, ownership limits on fixed and non-earning assets and liquidity requirements.

3. **Operational regulations** include record preservation, disaster preparedness and security requirements, as well as anti-money laundering and terrorist financing restrictions.

4. **Administrative regulations** include requirements for chartering and licensing credit unions, completing mergers and voluntary and involuntary liquidation.

5. **Enforcement regulations** identify the supervisory authority and define administrative actions, sanctions and the deposit insurance structure.

6. **Consumer protection regulations** identify fair and forthright requirements for accepting deposits, making loans and collecting loans. They also establish clear and standardized guidelines for publishing interest rate information.

Reform
How to Register Existing Credit Unions Under a Strengthened Regulatory Framework
A new law or set of regulations should define licensing requirements. To receive a license, credit unions must comply with:

- Standardized accounting and reporting
- External audit
- Capital adequacy (capital reserves/assets)
- Fully funded provisions for loan losses
- Liquidity standards
- Limits on non-earning assets
- Internal controls
- Credit, collections and savings policies

During the transition period of reform, credit unions will require time and restructuring to meet the new standards. The government often needs time as well to expand its regulatory capacity for credit unions.

Registering existing credit unions under a strengthened regulatory framework may take five or more stages to complete.

**Stage 1: Taking Stock of Existing Credit Unions**
The regulator may undertake a survey to determine the number of existing credit unions in each province or state by issuing a call for all credit unions to register directly with the regulator. The call should specify the reports, data and forms credit unions must submit with their application for registration, as well as the process for review and response to applications. Applications should include the credit union’s location and contact information, names of directors and managers and audited financial statements.

As part of the transition, registered credit unions may also have to apply for a license. Applications for licenses require more detailed financial statements, portfolio quality analyses and financial indicators.

In addition to collecting information, the regulator conducts regional workshops for the credit unions to explain the new regulatory framework, supervisory process and licensing standards, including:

- Required application materials and documentation
- Process to obtain a license
- Standardized chart of accounts
- Reporting requirements
- Qualifications and standards
- Time frame and deadlines
Stage 2: Application Review and Sorting
The regulator receives and evaluates each credit union’s application for registration, organizing them by asset size, range of services or size of membership to reflect risk presented to the financial system.

If not set out in the law, the regulator establishes deadlines by which credit unions must meet standards and criteria to register. Deadlines generally begin with the largest credit unions followed by the others, in a sequence according to the capacity of the supervisory body.

Stage 3: On-site Examinations and Diagnostics
The on-site examination for licensing includes two components: institutional and financial. In the institutional component, the examiner assesses the adequacy of management systems, policies and procedures, information systems and internal controls. In the financial component, the examiner evaluates financial soundness, capital position and loan portfolio quality. Use of a financial analysis tool such as WOCCU’s PEARLS Monitoring System enables the examiner to identify the strengths and weaknesses of a credit union by analyzing three-year trends in the balance sheets and income statements.

Fundamental to the credit union diagnostic is verification of the loan portfolio classification to calculate delinquency, sufficiency of provisions for unrecoverable loans and institutional capital to determine solvency and financial viability.

The examiner also evaluates on what basis the credit union calculates interest and dividend rates and whether the rates are adequate to cover operational costs, provisioning requirements and capital reserve requirements. The examiner also assesses how surpluses are distributed and/or capitalized, whether the credit union maintains liquidity for deposit withdrawals and how management deals with non-performing assets.

Once the on-site examination is complete, the regulator’s criteria or regulations will determine which credit unions:
1. Receive a license
2. Must implement a workout/stabilization plan to meet the conditions for licensing
3. Cannot meet licensing requirements and need to undergo a merger
4. Must be liquidated

Stage 4: Granting a License
The regulator registers and licenses credit unions that meet the minimum regulatory standards. Credit unions are required to adhere to prudential standards set out in the regulations and meet reporting requirements to maintain their license.

Once the license is granted, the regulator continues to conduct off-site and on-site supervision, which involves the continuous monitoring of the credit unions’ financial position and performance through regular reports and visits to the institutions as necessary to ensure compliance.

Stage 5: Workout, Merge or Liquidate
Credit unions that do not meet the licensing criteria may need assistance to establish and implement workout or stabilization plans to achieve the required changes in policy, financial goals and financial condition. The regulator’s decision to license the credit union is then contingent upon the achievement of the targets set out in the workout plan.

Credit unions can enter into agreements with the regulator or a technical assistance provider such as WOCCU to implement workout plans. Such agreements establish performance targets the credit union must achieve within set timeframes. They also specify the assistance and training that a technical team will provide to support the stabilization effort.

Credit unions must make the necessary changes in policies, procedures and systems to achieve the plan’s targets and meet licensing criteria. Personnel training then emphasizes the development of specific and necessary management techniques to support the changes.

Regulators evaluate the credit unions’ viability and growth potential and determine which institutions may consider merging based on criteria such as size, financial condition and growth potential. Credit unions that decide to merge in order to comply with the new regulations may also receive technical assistance.

Credit unions that cannot meet the conditions for licensing and do not demonstrate potential for a successful merger must stop receiving deposits and liquidate. The regulator identifies the conditions of liquidation, including procedures for:

- Notifying members
- Assuming or acquiring the assets and liabilities
- Disposing of assets
Supervision

Enforcing Standards
The government agency responsible for supervising the financial sector should supervise all credit unions in a country to ensure the safety of member deposits. The financial sector supervisor should create a specialized unit trained in the nature, risks and methodologies of credit unions and other non-bank institutions. Credit unions, for example, have higher transaction costs relative to a bank that serves big business and wealthy individuals because credit unions focus on the retail market, offering small savings and providing both secured and unsecured loans.

Credit union examiners need to be well-trained and have at their disposal the tools and power to be effective enforcement authorities. They must have a reporting and monitoring system that gives them the ability to complete off-site examinations and identify problems that warrant an on-site field examination.

Regulations must clearly describe the actions examiners may take to resolve problems in weak institutions. Prompt corrective action includes administrative actions, sanctions, de-licensing, removal of management/officers and liquidation. Outlining progressive disciplinary steps in the regulation ensures that all parties are aware of the consequences of poor financial and/or fiduciary management.

Models of Supervision
Different models of credit union supervision have evolved around the world. Each model has strengths and weaknesses, depending on the perspective of the supervising agency, the credit union and the depositor.

Confidence is one of the most important ingredients for successful financial intermediation in any country. Selecting a supervisory framework that provides the highest degree of consumer confidence will ensure that individual depositors and national economies alike can reap the long-term benefits offered by credit unions.

Predominant models of supervision are as follows.

Direct Supervision of All Credit Unions
Direct supervision of all credit unions by a prudential government regulator with the statutory responsibility of regulating credit unions ensures uniform standards of competition in the market, eliminates the chance for regulatory arbitrage and promotes greater consumer confidence.

PEARLS Monitoring System
Protection, Effective financial structure, Asset quality, Rates of return and costs, Liquidity, Signs of growth

WOCCU’s PEARLS Monitoring System combines a powerful relational database with a proven methodology for measuring financial performance and operational efficiency. PEARLS provides credit union managers, directors and supervisors with concise, easy-to-read reports that reveal institutional trends and identify strengths and weaknesses. It also offers a strategic business planning tool to guide managers in planning for the future and implementing change as necessary.

The PEARLS Monitoring System includes:
• Monitoring tool with PEARLS financial ratios
• Ranking tool for comparing credit unions
• Business planning tool to create strategic plans that help improve performance

The PEARLS software assists credit unions with meeting institutional goals and complying with regulatory standards. The software also carries out a business planning function that plans and shows the impact of growth and expense decisions on the credit union’s financial condition, as well as on its attempt to achieve international standards.

Find out more about the PEARLS Monitoring System at www.woccu.org/pears.
Great Britain and Canada
Supervising the Whole Lot Without Bankrupting the Treasury

Great Britain’s Financial Services Authority (FSA), which regulates the entire British financial services sector, began supervising all credit unions in Great Britain in 2002. Credit unions represent a very small share of its responsibility—about 520 firms of approximately 20,000. It allocates five positions to the direct supervision of credit unions, with support from others as necessary. FSA established prudential norms for all credit unions and requires them to submit quarterly and annual reports; it only carries out regular examinations at the largest credit unions, visiting others infrequently either to address issues or conduct thematic research. FSA charges each credit union an annual fee based on the value of its assets to cover all the costs associated with supervision. FSA also provides assistance and guidance to credit unions, including offering “surgeries” of up to one hour at convenient locations. FSA seeks to offer each credit union a surgery at least once every three years. These surgeries are free.

In the Canadian province of Ontario, the Deposit Insurance Corporation of Ontario (DICO) supervises approximately 200 credit unions across a vast geographical expanse. DICO determined it was not feasible to follow the traditional method of employing a base of examiners in the capital city. Instead, while only six staff perform off-site monitoring and problem resolution in the main office, the primary on-site examiners are accountants in small-to-mid-size firms who have completed DICO’s “certification” training at their own expense. In addition to its own staff, DICO hires these certified individuals to complete on-site credit union examinations. To mitigate potential conflicts of interest, the individual or firm may not work as a consultant or auditor with the credit union under examination for a period of three years. The certification arrangement provides the degree of professionalism and technical skill DICO needs to supervise 200 credit unions at a reduced cost to them.

The greatest deterrent to implementing this framework is the actual and perceived cost in countries that have hundreds or thousands of credit unions to supervise with scarce public resources. Supervisors need to be able to charge for their services, leverage technology, utilize a risk-based supervisory structure and, most importantly, use alternative methodologies for conducting exams, especially in small-to-mid-size and low-risk institutions.

Direct Supervision of the Largest Credit Unions
In some countries, the financial sector regulator directly supervises only the country’s largest credit unions, based on asset size or deposit base. This model emerged in Latin America in the mid-1990s and is now utilized in Bolivia, Chile, Colombia, Ecuador and El Salvador. In some instances (e.g., Bolivia, Ecuador and El Salvador) smaller institutions that the regulator does not oversee receive limited non-prudential oversight from another government agency not responsible for banking matters. In other cases (e.g., Chile and Uruguay) a ministry responsible for other non-bank institutions, such as mortgage brokers, insurance and money transfer firms, supervises the smaller institutions.

This type of direct supervision extends the technical expertise in central banks to credit unions and focuses resources on the largest institutions, which could present systemic problems if they failed. This framework requires fewer resources from the supervising agency but creates regulatory arbitrage. It also divides the credit union sector into two, with differing compliance, service offerings and interests. The effect of this bifurcated supervisory framework is confusion among depositors about which credit unions are supervised (and sound) and which are not. The confusion can lead to a lack of confidence in all credit unions.

Delegated Supervision
Delegated supervision occurs when the government formally assigns supervisory enforcement power via law or regulation to a third party, most often the credit unions’ national association or an arm of the association. If delegated to the national association, this model can help ensure closer feedback between the credit union and its supervisor compared to direct supervision by the government agency regulator.

This model benefits the government in the short run by allowing it to avoid the financial cost of supervision. It benefits the national association by providing an income stream. In addition, credit unions benefit from the more collegial relationship with a supervisor whose responsibility is to ensure the sector’s growth and promotion.
Successful delegated supervision requires 1) strong management of the conflict of interest where the supervisor is the primary advocate for credit unions and governed by the organizations it supervises and 2) the development of strong technical capacity in the delegated entity.

Restructure Ministry of Cooperatives
As governments recognize the need for prudential, credit union-specific supervision, some have restructured the ministry of cooperatives to become the prudential credit union supervisor. There are several financial and technical weaknesses in this model. Most ministries of cooperatives are under-funded, especially compared to central banks and/or superintendencies of banks. A lack of funding makes it difficult to attract and retain individuals with the necessary financial and technical expertise. And finally, through international training and exchanges, banking sector supervisors generally have greater access to newer supervision techniques and technologies.

### United States

**Size of Sector Permits Unique Two-Pronged Supervision Framework Funded by the Credit Unions**

Although it represents only 6% of the U.S. financial system’s total assets, the asset base of the U.S. credit union sector is sufficient to support a supervisory framework in which government regulators safeguard member deposits at both the federal and state levels. The National Credit Union Administration (NCUA) supervises all federally chartered credit unions, while state-level departments of financial institutions supervise state chartered credit unions.

Each state regulator has its own state law as it pertains to credit union regulation. Most state regulations are very similar to the federal regulations.

With approximately 8,300 credit unions of dramatically different sizes across 50 geographically expansive states, U.S. regulators have devised an efficient framework focused on keeping member deposits safe and placing the least financial burden on the credit unions. State supervisors are financed by examination fees levied on credit unions generally according to asset size. Credit union examination fees and operating income from the deposit insurance fund finance the federal regulator. In the case of NCUA, many examiners work out of their homes to maintain proximity to credit unions and decrease overhead costs.

With few exceptions, the federal and state-level regulators maintain consistent prudential and management standards using the CAMEL rating system, in which examiners supervise credit unions using a risk-based approach. Examiners review quarterly reports and monthly financial statements submitted by the credit unions to identify risk areas. Examiners determine the frequency of on-site examinations according to the level of risk presented and/or sudden or large changes in operating environments for credit unions. As a general rule, examiners review credit unions on-site at least every 18 months.

At the federal level, well-capitalized and well-run credit unions (as determined by their standardized CAMEL rating) with profitable earnings qualify for risk-based scheduling of examinations. Risk-based scheduling allows NCUA to shift resources as necessary to focus on credit unions that pose a risk to the deposit insurance fund. Regulators examine problem institutions with either semi-annual or quarterly on-site contacts. Quarterly call reports and monthly financial statements determine trends depending on the severity of the problems and risk of loss to the deposit insurance fund.
International Credit Union Regulators’ Network

Each year, WOCCU brings together more than 100 policymakers in regional and global regulators’ roundtables to build capacity among supervisors and help shape effective standards for credit unions. In 2007, more than 20 financial cooperative regulators formed the International Credit Union Regulators’ Network and appointed WOCCU as its secretariat.