Asian Credit Union Forum
Manila, Philippines
8th Sept 2012

Effective Regulation & Supervision

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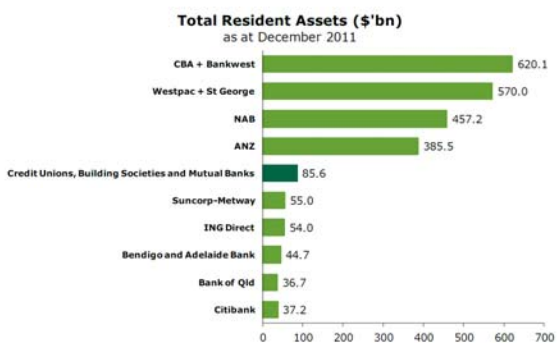
Select Credit Union
Australia

- First credit union in Australia – 1946
- 1956 100 CU's
- 1963 273 CU's
- 1973 833 CU's
- 1978 690 CU's
- 1993 357 CU's
- 2012 104 Mutuals
- Total assets A$85.6 billion
- More than 4.5 million members
- Collectively the fifth largest deposit holders
- High member/customer satisfaction

Definition of a Mutual

- Mutuality defined by economic test (equal share of the surplus upon winding up) and governance test (one member one vote)
- Six Australia credit unions have recently converted to become "Mutual Banks"
- All credit unions, building societies and mutual banks have exactly the same regulatory environment as banks
- Regulated entities are known as Authorised Deposit-taking Institutions (ADIs)



ATM Accessibility @ June 2011	Number of ATMs
CBA/BankWest	3,757
rediATM	3,400
Westpac/St George Bank	2,875
ANZ	2,714

Source: APRA & Cuscal

The mutual sector has the second highest ATM accessibility across the country

Credit Union “Australian Firsts”

- To offer payroll deduction for savings and loans
- To offer free life insurance on loans
- To introduce online computer operations
- To introduce ATMs
- To introduce point of sale machine
- To provide international ATM withdrawals
- First non US financial institutions to join VISA

History of CU regulation

- Up to 78 Registrar of Cooperatives
- 1978-92 Savings Reserve Board
- 1992-98 Financial Institutions Commission
- 1998- Australian Prudential Regulation Authority (APRA)

1978 to 1992

- Department of Cooperatives
- Credit Union Act 1969
- CU Savings Reserve Board
- Performance Indicators set to manage growth as well as profitability
- Reserves to assets ratio min 10%
- Reporting
- One small credit union failure in 1979 – depositors lost 30 cents in the dollar total $150,000

1978 to 1992

- Reserve Board powers
- Circumstances that a CU may be placed "under direction"
  - Trading at a loss, accumulated deficit, not liquid, not sufficient provision for doubtful debts, not complete monthly/qtly reporting.
- CU Savings Reserve Fund
- No deposit insurance scheme in Aust until 2009 (now $250,000 per account)

1992-1998

- Financial Institutions Commission
- Formed to regulate Non Bank Financial Institutions
- 1995 company tax applied to CU's
- Primary Objects – 8% capital adequacy ratio, min 60% of assets in loans to members (or apply for exemption)
- Examples of unexpected outcomes of primary objects

1998 to present

- Australian Prudential Regulation Authority
  - APRA sets legally enforceable "Prudential Standards" for all regulated entities
  - Banks, Mutuals (credit unions, building societies, mutual banks), general and life insurance companies, as well as superannuation (pension) funds
  - APRA's mission: to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions are met
  - Regulation is focused upon depositor protection

Prudential Standards

- Capital adequacy (reserves)
- Liquidity
- Credit quality
- Large exposures
- Outsourcing
- Business Continuity Management
- Audit
- Governance
- Fit & Proper

AUSTRALIA

Prudential Standard APS 110

Capital Adequacy

Objectives and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that authorised deposit-taking institutions maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities.

This Prudential Standard outlines the overall framework adopted by APRA for the purpose of assessing the capital adequacy of an authorised deposit-taking institution.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- have an Internal Capital Adequacy Assessment Process;
- maintain minimum levels of capital, at both Level 1 and Level 2 as appropriate; and
- inform APRA of any significant adverse changes in capital.

How were the standards developed?

- APRA chose to apply the Basel Committee on Banking Supervision's capital accords
  - 1988 Basel Capital Accord (Basel I)
  - 2004 International Convergence of Capital Measurement and Capital Standards (Basel II)
- This means that the amount of regulatory capital (reserves) banks and mutuals must hold is based on measurement of risks faced.
- Basel I focused on credit risk while Basel II introduced measures to assess other risks such as operational and interest rate risk.

Basel II Three Pillars

Pillar 1 - Capital
- Credit Risk (IRB, standardised approach)
- Operational Risk (AMA, standardised approach)
- Market Risk (trading activities only - not applicable to CU's)

Pillar 2 - Supervisory Review
- Internal Capital Adequacy Assessment Process – credit concentration risk, interest rate risk, liquidity, strategic, contagion & reputation, regulatory, securitisation

Pillar 3 - Market Discipline
- Consistency of reporting

Capital Adequacy

- Prudential minimum capital adequacy ratio of 12% of risk weighted assets
  - 0% Cash & Government securities
  - 20% High quality cash investments
  - 35% Residential mortgage loans LVR<80%
  - 100% All other loans
- Example for Select Credit Union
  - Reserves ratio calculation \$29m reserves divided by \$300m assets = 9.67%
  - Capital Adequacy calculation \$29m reserves divided by \$143m risk weighted assets = 20.28%

Liquidity

- Sufficient cash available to meet obligations as they fall due
- Prudential minimum 9% of liabilities (CU policy limit generally 13%-15%)
- Must have a liquidity policy and systems in place to measure, report, and manage liquidity
- Must have a contingency plan to deal with a liquidity crisis

Credit Quality

- Risk of borrower default is the single largest risk facing a CU
- A well-functioning credit risk management system is fundamental to the safety and soundness of a CU
- CU's must have credit risk management policies, procedures and controls in place that are appropriate to the complexity, scope and scale of its business

Credit Quality

- Loan approval policies
  - Borrowing limits
  - Capacity to repay
  - Acceptable security
- Collections Activity
  - Regular contact period
  - Agreements / restructures
  - Default notices and transfer to legal agents
  - Repossessions

Credit Quality

- Prescribed Provisioning
  - Personal Loans

Arrears days	Provision percentage
up to 90 days	0%
90 to 180 days	40%
181 to 272 days	60%
273 to 364 days	80%
over 364 days	100%

- General Reserve for Credit Losses
  - required to account for those risks inherent in the business but which cannot be specifically identified (generally 0.5% of risk weighted assets)

Large Exposures

- Exposures to single counterparty or related group of counterparties
  - i.e. loans to members or investments placed with other banks
- Members – 25% of capital (reserves)
- Other banks – 50% of capital
- All exposures over 5% of capital are reportable to APRA each quarter

Outsourcing

- Related to outsourcing of material business activities
- Eg. Central treasury, payments processing, IT system hosting
- Must produce business case, tender, due diligence review, Board approval, ongoing monitoring of performance, and contingency plan
- Specifies the matters that must be addressed in an outsourcing agreement

Business Continuity

- Must identify, assess and manage potential business continuity risks
- Must have a crisis management plan and recovery plan
- Must test continuity plan every year

Audit & Related Matters

- Specifies requirements of auditor
- Auditor must be "fit & proper"
- Must provide auditor to access to all data, information, reports and staff
- Risk management systems description reported to APRA annually
- Annual CEO attestation to APRA that risks identified, risk systems are effective, and accurate information has been reported to APRA

Governance

- The Board is ultimately responsible for prudent management
- Board must have a charter setting out its roles and responsibilities
- Board must document delegations
- Directors must have necessary skills, knowledge, experience
- Must meet with regulator upon request
- Independence criteria

Governance

- Board composition
  - Minimum 5 directors
  - Majority assessed as independent
  - Chair must be independent
- Annual Board and director performance assessments
- Renewal policy
- Remuneration policy
- Remuneration Committee

Fit & Proper

- Fitness – must possess skills, experience, knowledge
- Propriety – must show honesty and integrity
- Fitness and propriety must be assessed upon appointment and then annually
- If not fit and proper cannot be a director
- Responsible persons – directors, senior managers, external auditor

Fit & Proper

- Objective tests
  - Not disqualified by prudential or corporate regulator
  - No criminal history (police checks obtained)
  - Not a current or former bankrupt
  - Material qualifications verified
- Subjective tests – “Required Competencies”
  - Understand the role of a director
  - Capacity to make an effective contribution to the Board
  - Knowledge of CU, financial services industry, regulatory environment
  - Ability to read and understand financial statements
  - Capacity to undertake continuous professional development
  - Ability to evaluate, form conclusions and make good judgements (and ask questions)

Reporting

- Credit unions provide detailed statistical reports to the regulator on a strict quarterly basis
- Regulator analyses trends and exceptions – may request further information or may cause inspection
- Accuracy of reports must be verified by CU external auditors on regular basis

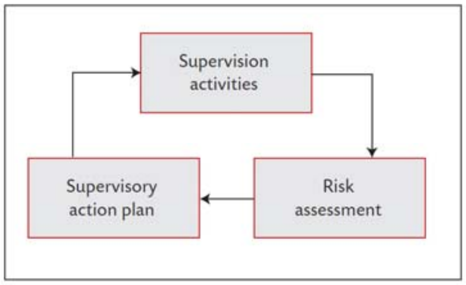
Inspections

- Regulator (APRA) conducts supervisory inspections on annual or as required basis
- APRA conducts separate projects as appropriate – eg residential mortgage stress test
- Format of Credit Union Inspections
  - Risk Assessment
  - Loans audit
  - Significant matters
  - Board interview (interrogation!)
  - Other matters

Rating system

- PAIRS (Probability and Impact Rating System) used by APRA supervisors to classify regulated financial institutions in two key areas:
  - The probability of failure;
  - The impact of failure on the Australian financial system

Supervision Process



Effective Regulation

- Prudential Standards
- Credit Union policies & procedures
- Quarterly financial reporting to regulator
- Annual regulator inspection
- External audit
- Internal audit
- Prudential audit

Self Regulation

- Industry support system – Credit Union Financial Support System (CUFSS)
- Primary objective of CUFSS is to "promote financial sector stability"
- CUFSS monitors member credit unions using a series of performance indicators

CUFSS Ratio Analysis

	May-12	All CU's	$200m - $500m	CUFSS PI's
Interest Margin	2.86%	2.62%	2.88%	n/a
After Tax ROA	0.48%	0.57%	0.44%	0.25%
Capital Adequacy	19.53%	16.40%	16.94%	13.00%
HQLA	16.50%	15.47%	16.12%	13.00%
Expense to Income	78.56%	75.42%	81.74%	80.00%
CUFSS Delinquency Ratio	0.45%	0.88%	1.14%	2.00%
Commercial Loans Ratio	0.34%	3.01%	8.11%	10.00%

Non performing Credit Unions

- Internal reporting and governance
- External audit
- Industry self regulation - CU Financial Support System
- Prudential Regulator (APRA)
- Supervisory directives (increased capital, liquidity, board renewal)
- Orderly exit – merger

Regulation from a Management viewpoint

- Benefits
  - Depositor protection, consumer understanding, image, reputation, standardised processes, non-performing credit unions cannot hide
- Costs
  - User pays, internal compliance costs, defensive focus, no new entrants, taxation? demutualisation?

Final Observations

- Is there an optimal level of regulation?
  - National development goals?
  - The size and complexity of the organisation and/or industry?
  - The desired level of national financial competition?
- Are your CU's an important alternative for consumers?
- Complicated prudential regulation may inhibit national development

Final Observations

- Are your CU's financial institutions or development organisations?
- Donor funded microfinance v regulated self help cooperative
- Regulation is concerned with depositor protection
- Consumers need to be confident that savings institutions will not fail