European Network of Credit Unions

11th February 2015

Submitted electronically
European Banking Authority
Tower 42, 25 Old Broad Street
London
EC2N 1HQ
United Kingdom

Re: Consultation paper: Draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes ("EBA/CP/2014/35")

Dear Sir or Madam,

The European Network of Credit Unions (ENCU) appreciates the opportunity to comment on the European Banking Authority's (EBA) draft guidelines on methods for calculating contributions to Deposit Guarantee Schemes (DGS) in the European Union.[1] Credit unions are consumer-owned, not-for-profit financial cooperatives that promote financial inclusion in financially underserved European communities by offering their members affordable and easily understandable financial products.

European credit unions are subject to the DGS Directive[2] even though credit unions in most Member States are exempt from the CRD IV capital requirements directive under CRD IV Article 2(5).[3] ENCU represents credit unions in Estonia, Great Britain, Ireland, Poland, Romania, and FYR Macedonia with approximately €20 billion in total assets but an average size of only roughly €21 million in assets per institution.[4]

Question 1: Do you have any general comments on the draft Guidelines on methods for calculating contributions to DGSs?

The ENCU supports the concept of creating risk-based levies for DGS fund contributions but we are concerned that the proposed guidelines underestimate the risks posed to DGS funds by large banks and also do not take into account factors that make small financial institutions relatively less risky on a per asset basis than large institutions. Small institutions like credit unions are less risky on a per asset basis than large banks because they have less complex operations and because the large sizes of commercial banks present concentration risks to DGS funds.

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[1] European Banking Authority, *Draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes: Consultation Paper* (Nov. 2014), *available at* https://www.eba.europa.eu/news-press/calendar?p_p_auth=Dfa70b8h&p_p_id=8&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&_8_struts_action=%2Fcalendar%2Fview_event&_8_eventId=887889

[2] *Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes*, 2014 O.J. (L 173) 149, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0049.

[3] *Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC*, Article 2(5), 2013 O.J. (L 176) 338, *available at* http://ec.europa.eu/internal_market/bank/regcapital/legislation-in-force/index_en.htm.

[4] European Network of Credit Unions, "Credit Unions in Europe"; http://www.creditunionnetwork.eu/cus_in_europe.

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Small institutions are also relatively less well able to afford to pay such levies and, for credit unions, the money used for DGS assessments would generally be contributed to the institution's retained earnings but for the DGS levy. This means that a high level of DGS assessments on credit unions could have the unintended consequence of increasing the DGS fund's liabilities.

We urge the EBA to establish a DGS levy system that takes into account the value of an institution's Covered Deposits (CD) relative to the DGS funds' total CD liabilities or the DGS fund's total reserves, and equates lower risk with a lower ratio of these measures.

The ENCU's view on how best to quantify the risks to DGS funds based on institutional size are discussed in more detail as part of our response to Question 5, below.

Question 5: Do you agree with the core risk indicators proposed in these Guidelines? If not, please specify your reasons and suggest alternative indicators that can be applied to institutions in all Member States. Do you foresee any unintended consequences that could stem from the suggested indicators?

The ENCU's comments on the core risk indicators address the following four issues: (a) Ratio of institutional Covered Deposits relative to total DGS fund liabilities or reserves; (b) Return on Assets (RoA) versus additions to retained earnings; (c) Institutional Protection Schemes; and (d) Use of CRD IV risk-based capital and liquidity measures.

a. Ratio of institutional Covered Deposits relative to total DGS fund liabilities or reserves

We urge the EBA to establish a DGS levy system that takes into account the value of an institution's Covered Deposits (CD) relative to the DGS funds' total CD liabilities or total reserves. We believe that consideration of institutional CD relative to the DGS fund's total liabilities or reserves would appropriately place small financial institutions generally in the low risk sector "bucket" discussed in Annex 1 which would have a lower rate of DGS assessment. In the alternative "sliding scale" approach, taking into account the value of an institution's CD relative to the DGS funds' total CD liabilities or total reserves would also appropriately control for the higher-risk business activities of large banks, as well as for the higher concentration risks presented by institutions that are large compared to a DGS fund's total CD exposures or reserves.

We believe that equating smaller financial institution asset size with the lower risk sector is appropriate based on safety and soundness reasons as well as on public policy, and is also appropriate because of large banks' de facto public subsidy created by the implicit state-backing of "too big to fail" institutions.

We are also concerned that not taking into account the institution's CD relative to the sector's total CD or the DGS fund's reserves will have the unintended consequence of making it harder for small financial institutions to build capital through earnings retention, and therefore increase the likelihood that these institutions would require assistance from a national DGS fund.

Specifically, we urge the EBA to consider as a core "individual risk indicator" either:

> **(i)** The ratio of the institution's total CD to the national DGS fund's aggregate CD exposure ($CD_{Institution}/CD_{Member\ State\ Total}$); or
>
> **(ii)** The ratio of the institution's total CD to the total reserves of the national DGS fund ($CD_{Institution}/DGS_{Total\ Reserves}$).

Whereas many European commercial banks individually exceed €20 billion in assets (or even €1 trillion in assets)—meaning that the success or failure of a single large bank could in some cases exhaust the reserves of a national DGS fund—the €20 billion in credit union assets in ENCU-member countries is divided among 928 individual credit unions that each have a separate balance sheet, independent management, and succeed or fail on their own. Some credit unions systems also operate their own, private-sector Institutional Protection Schemes (IPS) that seek to resolve weak credit unions without governmental action or funding.

Large banks each individually present a greater risk to the DGS fund than would a similar amount of small bank or credit union assets simply because large banks have many more CD tied to the success or failure of a single institution, and also because large banks typically engage in more complex and risky business activities than small banks and credit unions. Credit unions and small banks primarily engage in low-risk retail banking activities such as consumer lending and deposit-taking, and do not usually invest in complex financial instruments.

Including the ratio of an institution's total CD relative to the DGS's total CD exposure or total reserves as a core risk factor will also help credit unions and other small institutions build retained earnings in order to protect the DGS scheme from losses. As cooperatives, credit unions must build their regulatory reserves using retained earnings and have few other avenues for building regulatory capital.[5]

DGS levies themselves should not undermine the financial stability of any firm as this would be counter-productive to the financial stability aim of the DGS and self-defeating in terms of protecting DGS funds. The moneys credit unions would pay in DGS levies would likely otherwise be added to these institutions' regulatory capital as retained earnings and be used to protect the DGS scheme at the institutional level by lowering the institution's risk of failure. In addition, large banks are better able to afford DGS levies compared to credit unions because of the banks' larger economies of scale.

A tiered DGS levy system with higher marginal rates for larger institutions is also appropriate because small financial institutions often promote financial inclusion in underserved parts of Europe, especially rural areas. Credit unions are often the only financial institutions operating in rural areas because serving these parts of Europe are often not sufficiently profitable for most banks, and without the credit union many rural communities would have no local access to financial services.

We urge the EBA to establish a DGS levy system that takes into account the value of an institution's CD relative to the DGS funds' total CD liabilities or total reserves.

b. Return on Assets (RoA) versus additions to retained earnings

We do not support the use of Return on Assets (RoA) as a core individual risk indicator because credit unions, as not-for-profit cooperatives, do not seek to maximise RoA and generally have lower RoAs than large banks because of their financial inclusion mission and their smaller economies of scale. A high RoA is also only relevant to safety and soundness if the institution's net income is added to its retained earnings. We think that a better measure of how the institution's income affects its risk to a DGS fund would be the ratio of the institution's additions to retained earnings relative to its total assets.

The use of RoA as a risk measure could make credit unions appear more risky than they are objectively simply because credit unions' mission is to serve their members (since a credit union can only do business with its members, who also are the credit union's owners) and because they do not seek to maximise profits at

[5] *See, e.g.*, Bank of England-Prudential Regulation Authority, Credit Unions Sourcebook (CREDS) § 5.2 ("Components of capital"), *available at* http://fshandbook.info/FS/html/handbook/CREDS/5/2.

consumers' expense. Small financial institutions like credit unions can also face challenges in achieving a high RoA because of their smaller economies of scale and relatively higher expenses for personnel costs and real estate compared to other expenses (e.g., every credit union must have at least one compliance officer and branch office regardless of its asset size).

Credit union rulebooks also play a role in limiting credit unions' RoA in ways not faced by banks. For example, credit union rulebooks often include caps on the interest rates credit unions can charge (such as no more than a maximum three percent interest per month), and credit unions face restrictions on with whom they can do business in the form of "common bond of association" laws.[6] These laws typically limit who can join the credit union to persons who live or work in a local geographic area (such as one or more towns or cities) or who are members of a particular association or employees of a particular government agency or business. Despite these restrictions not found in the banking rulebooks, credit unions and other small institutions nonetheless contribute importantly to financial inclusion and the resilience of the banking sector in general primarily because of their small size and orientation towards local communities.

Further, as noted in the proposed guidelines, a high RoA often indicates unsustainable institutional growth and increased risk to the DGS fund, but the proposal does not provide a clear definition of what constitutes an "unsustainably high" RoA. Without a clear definition of "unsustainably high" RoA, national supervisors are likely to struggle to decide how much RoA is too much during boom periods when many financial institutions are experiencing unsustainable profits and expansions, which would under-price the risk these institutions present to a DGS fund. An institution's income included in RoA also may be spent on dividends or used to finance expansion and therefore may not be available to cover losses, unlike retained earnings.

We think that a better measure of how the institution's income affects its risk to a DGS fund would be the ratio of the institution's additions to retained earnings relative to its total assets:

$$\frac{\text{(institution's additions to reserves of retained and undivided earning during the reporting period)}}{\text{(institution's total assets)}}$$

We urge the EBA to remove RoA from the final version of the guidance, or at least to move RoA from the Annex 2 "Description of core risk indicators" to the Annex 3 "Description of additional risk factors".

We also urge the EBA to revise the guidance to include the ratio of an institution's additions to reserves relative to its total assets as a core individual risk indictor instead of RoA, or at least include this ratio in the Annex 3 "Description of additional risk factors".

c. Institutional Protection Schemes

We urge the EBA to include as a core individual risk indictor the institution's membership in a private-sector Institutional Protection Schemes (IPS). Section 13(1) of the DGS Directive mentions IPS expressly as a risk-mitigating factor and credit union IPS funds play an important role in preventing credit union failures at no cost to government. We therefore urge the EBA to include IPS membership in the Annex 2 "Description of core risk indicators" instead of the Annex 3 "Description of additional risk indicators".

[6] *See, e.g.*, HM Treasury, *The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011* § 12 ("Common bonds")*, available at* http://www.legislation.gov.uk/uksi/2011/2687/made.

Credit union associations often operate private-sector IPS that are funded by their member credit unions and act as "stabilisation funds" to help resolve weak institutions without governmental assistance from a DGS fund or other source. For example, the Irish League of Credit Unions (ILCU) operates its own internal stabilisation fund for affiliated credit unions in the Republic of Ireland and Northern Ireland called the Savings Protection Scheme (SPS). The SPS has given support to a number of credit unions over the years without the use of public moneys.

We believe that private-sector IPS fund memberships for credit unions and similar IPS fund membership should be considered as a factor reducing risk to DGS funds in all Member States where such IPS funds exist.

d. Use of CRD IV risk-based capital and liquidity measures

Credit unions in most Member States are exempt from the CRD IV under CRD IV Article 2(5) and therefore are not subject to the CRD IV's risk-based capital measures, the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR) and other CRD IV-based ratios. We believe that credit unions calculating Risk-Weighted Assets, the LCR, the NSFR, et cetera, solely for purposes of DGS levy classifications would be an unwarranted regulatory burden.

We urge the EBA to clarify that using these CRD IV-based ratios are not required with respect to DGS levies on institutions that are exempt from the CRD IV under Article 2(5), and that supervisors should not include ratios based on CRD IV measures when calculating DGS assessments for credit unions and other institutions that are exempt from the CRD IV under Article 2(5).

Question 6: Do you agree with the option to use either capital coverage ratio or Common Equity Tier 1 ratio as a measure of capital? Would you favour one of these indicators rather than the other, and why?

Credit unions rely on retained earnings—a form of Common Equity Tier 1 capital—as their primary source of regulatory capital.[7] We believe that a leverage ratio of Tier 1 Capital to total assets is likely to provide the best indicator of the institution's likely risk to the DGS fund because a leverage ratio is less susceptible to regulatory capital arbitrage than risk-weighted assets.

A leverage ratio of Common Equity Tier 1 to total assets in the case of credit unions, however, would be generally similar to the credit unions' ratio of total Tier 1 capital to total assets.

We do not support using Risk-Weighted Assets in these equations because credit unions are exempt from the CRD IV risk-based capital requirements under Article 2(5) and therefore would not have to calculate Risk-Weighted Assets except for purposes of the DGS levies. We believe that credit unions calculating Risk-Weighted Assets solely for purposes of DGS levy classifications would be an unwarranted regulatory burden.

Question 7: Are there any particular types of institutions for which the core risk indicators specified in these Guidelines are not available due to the legal characteristics or supervisory regime of these institutions? Please describe the reasons why these core indicators are not available.

We support the proposed guidelines' provision for national competent authorities to exclude and adjust the core risk indicators for certain sectors based on the legal characteristics and reporting requirements of those sectors. In addition to being exempt from the CRD IV, credit unions in the EU are subject to a range of bespoke,

[7] *See id.* ("The following are included in the meaning of 'capital' for the purposes of this chapter: (a) audited reserves; (b) interim net profits; (c) deferred shares; (d) subordinated debt meeting the requirements set out at (4); (e) initial capital; and (f) revaluation reserves, arising from the differences between book values and the current market values of property fixed assets . . . .").

nationally-determined regulatory requirements and, as noted above, CRD IV-derived indicators and categories in capital adequacy and liquidity are not appropriate or relevant for credit unions. The potential for competent authorities to make special considerations for low risk sectors is welcome, however, we believe this national discretion should go beyond the track record of similar institutions and also take into account legal restrictions on the institution that limit these institutions to lower-risk lines of business, such as retail-banking services in localised areas, and also take into account public policy objectives like financial inclusion.

Credit union rulebooks typically limit credit unions to engaging primarily in low-risk retail deposit and lending activities in a localised area. Although difficult to quantify, these restrictions reduce a credit unions risks in myriad respects compared to the business activities European commercial banks are permitted to engage in.

We also believe that competent authorities should be able to take into account credit unions' financial inclusion mission and the desirability of diversity in the financial sector, and be able to assign institutions that promote these public policy goals a lower risk rating in order to further the public good. National authorities are the best positioned to understand which local financial institutions have a social mission that promotes financial inclusion and other societal benefits. National authorities are also the policymakers who are best positioned to consider these financial institutions' contributions to civil society as a form of value in the context of DGS levies.

The ENCU appreciates the opportunity to comment on the EBA's draft guidelines on methods for calculating contributions to Deposit Guarantee Schemes. Please do not hesitate to contact me or Jeanette van Eijk at +32 2 626 9500 should you have any questions regarding our comments.

Sincerely,

Michael S. Edwards
Vice President and General Counsel
European Network of Credit Unions
World Council of Credit Unions