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Czech Republic: Technical Note on Selected Issues on the Credit Union Sector

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

CZECH REPUBLIC

SELECTED ISSUES ON THE CREDIT UNION SECTOR

TECHNICAL NOTE

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GLOSSARY

CUA	Act on Credit Union
CRD	Capital Requirements Directives
CAR	Capital adequacy ratio
CCA	Consumer Credit Act
CCD	EU Directive on Consumer Credit
CNB	Czech National Bank
CU	Credit union
DIF	Deposit insurance fund
EU	European Union
NPL	Nonperforming loan
WOCCU	World Council of Credit Unions

EXECUTIVE SUMMARY

The business models of credit unions (CUs) in the Czech Republic are fundamentally different from the traditional CUs that are typically non-for-profit cooperatives operated for the benefit of a defined set of members. Most of the Czech CUs are profit-driven business enterprises that are in direct competition with banks. However, they suffer from the inefficiencies arising from their small scale of operations and comparative disadvantages relative to a bank branding. Their limited resources also have implications on the robustness of their governance framework and risk management practices—factors that would raise their risk profiles and hence a higher probability of failure, relative to the larger banks.

Notwithstanding the small size of the CU sector, it has the potential of having disproportionate impact on the deposit insurance fund (DIF) as well as reputational consequences to the financial system and standing of the Czech National Bank (CNB). The CU sector in the Czech Republic has been growing rapidly in recent years. The growth was boosted by the higher deposits rates offered by the CU and that CU deposits enjoy the same protection as bank deposits. There are concerns that a significant event in the CU sector may deplete the DIF's resources. A problematic CU sector also poses reputational risks to the overall financial system in the Czech Republic and to the standing of the CNB as a supervisor.

There is a need to restructure the CU sector, aimed at striking a delicate balance between minimizing financial and supervisory risks arising from the sector while recognizing the social role of prudently managed CUs. It is internationally recognized that CUs perform meaningful social roles for their members, as demonstrated by their high penetration rates in a number of countries. A few Czech CUs focus on fee-based activities and offer value-add services to their members. The key recommendations for the restructuring are:

- The CNB is advised to establish criteria and specify scale threshold for existing CUs focusing on deposit-taking and lending activities to apply for a banking license. The remaining CUs to be given a reasonable transition period either to alter their organizational structure to comply with the enhanced regulatory requirements for CUs (Recommendation 5) or plan for an orderly exit.

- It is important to carefully plan for the migration of CUs to banks and the resolution of CUs that do not qualify to be licensed as banks or remain as CUs. The plan includes transitional arrangements for the restructuring of CUs to meet the proposed enhancements to the CU regime or to wind-up their operations in an orderly manner.

- The licensing process should assess not only the current financial conditions of the applicants but also their fitness and propriety to manage a bank.

- The CNB is advised to enhance the licensing and regulatory for CUs to ensure the long-term sustainability of CUs, in line with international best practices.

- Going forward, the CNB is advised to enhance its supervisory resources to conduct risk-based supervision that addresses the risk profiles of smaller banks and CUs more adequately.

I. General Characteristics of Credit Unions

1. **This section outlines the general characteristics of CUs in selected countries who are members of the World Council of Credit Unions (WOCCU) as a backdrop for the analysis of the CU sector in the Czech Republic in the subsequent sections.** The key features of the CU sectors in the Czech Republic, Ireland, the United Kingdom, and the United States are summarized in the Appendix.

2. **CUs are non-for-profit cooperatives that offer savings, credit, and other financial services to their members.** It is estimated that there are 52,945 CUs in 100 countries serving more than 188 million people, with aggregate assets totaling US$1,461 billion as at end-2010.[1] Membership in a CU is typically based on community, organizational, religious, or employment affiliations. CUs typically collect deposits from their members to fund loans granted to other members and to provide other financial activities.

3. **Given the CUs' non-profit orientation, CUs members typically enjoy higher returns on savings, lower rates on loans, and fewer fees.** CUs in some countries also play a social role in promoting access to affordable financial services by individuals who face geographical, cultural, or financial challenges.

4. **The penetration rates[2] of CUs are mainly influenced by cultural factors, stage of economic development, and as regulatory regimes.** Globally, the US has the largest CU sector while Ireland has the highest number of CUs within the EU.[3] Ireland has the highest penetration rate of 71 percent while the US recorded 44 percent. Both countries also have relatively large CUs in terms of average asset size: US$37 million and US$124 million, respectively. In the UK, the CUs are much smaller, with average asset size of US$2.5 million, and a much lower penetration rate of 2.2 percent. Romania's CU sector is relatively young, with 17 CUs with an average size of US$2.5 million.

5. **CUs generally have limited scope of operations compared to banks.** CUs are typically not permitted to engage in noncore activities beyond deposit taking and lending. Some countries may even impose restrictions on core activities; for example, CUs in the UK are subject to restrictions on its lending activities in terms of amounts and period of credit. In the US, many CUs offer a broader range of services such as credit and debit cards, retirement accounts, and are permitted to expand their lending programs to include real estate, member business loans, and even nonmember business loans. Nonetheless, CUs in the US may only grant business loans up to an aggregate limit of 12.5 percent of total assets.

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[1] Source: WOCCU 2010 Statistical Report.

[2] Total number of reported CU members/economically active population.

[3] Source: WOCCU 2010 Statistical Report.

6. **CUs are required to adopt prudent investment policies and controls.** They are expected to establish strict limits on investment in nonearning assets, such as buildings and equipment, shares or debt obligations of other cooperatives, and long-term securities or obligations. Investments in nonfinancial businesses or assets are typically prohibited.

7. **The governance structure of CUs reflects the not-for-profit and member-driven nature of their cooperative structures.** CUs do not have external shareholders and the principal-agent issues are less important than those arising from corporate structures. CU members elect a volunteer board of directors from their membership. Typically, the directors do not receive remunerations for their services. Each member has one vote for board elections, regardless of their financial stakes in the CU concerned. The concept of independent directors also does not apply although rotation of directors is encouraged so as to promote fresh and objective perspective in board deliberations. The composition of the board tends to reflect the demographic makeup and the financial needs of the members. In particular, a CU's policies must balance the interests of both savers and borrowers.

8. **Unlike banks, CUs do not raise capital from financial markets and are funded internally by members.** The institutional capital of a CU comprises mainly reserves and accumulated retained earnings. However, CUs may use secondary capital instruments such as subordinated debt that does not dilute the cooperative structure to augment their capital base.

9. **Generally, a proportionate approach is adopted for the regulation and supervision of CUs as credit institutions.** CUs are subject to similar prudential requirements as banks but tailored to reflect the scale and nature of their operations. The key differences in the regulatory requirements recognize the fact that CUs are owned by its members, not profit driven, and limited to the provision of financial services to their members only.

II. Overview of the CU Sector in the Czech Republic

A. Characteristics of CUs in the Czech Republic

10. **CUs in the Czech Republic are profit-driven cooperatives enterprises with minimal social role.** With an average size of US$93 million, the CUs in the Czech Republic are much larger than those in the UK (US$2.5 million) and Ireland (US$37 million), although both these countries have much higher penetration rates and per capita income. The number of CU members in the Czech Republic has declined from a high of 47,952 as at end-2009 to 34,003 as at end-Jun 2011, resulting in a low penetration rate of less than 0.3 percent, which is closer to that registered by Romania (0.4 percent) with a much smaller CU sector.

11. **Any person who intends to place deposits with a CU may apply for membership, which effectively means that the CU is open to members of the public and not limited to**

specified affiliation. Members of a CU could be legal entities including related companies.[4] Notably, there were two CUs that accept only deposits from related entities. One CU had been operating based on its own funds and only accepted members when queried by the CNB.

12. **The business models of the majority of the CUs attract members by offering higher deposits rates compared to banks.** The average interest rate on client deposits was 3.3 percent, three times higher than rates offered by banks of 1.1 percent (Table 1). The higher deposit rates are one of the key factors driving the rapid growth of the CU sector in the Czech Republic in recent years. However, the mission also met two CUs that adopt niche business strategies that focus on fee-based revenue without deposit taking or lending activities.

Table 1. Czech Republic: Selected Indicators of CUs Compared to Banks

(In percent; 2010)

	CUs	Banks
Average interest rate on client loans (1)	7.2	5.2
Average interest rate on client deposits (2)	3.3	1.1
Interest margin (1)–(2)	3.9	4.1
Client deposits/loans	138.5	118.7
Client NPL ratio	10.3	6.4
Coverage of NPLs with provisions	9.3	49.0
Tier 1 capital adequacy ratio	12.6	14.1
RoE	2.1	21.8
RoA	0.2	1.3
Share of sector in client loans	0.6	99.4
Share of sector in client deposits	0.7	99.3

Source: CNB

[4] Prior to 2004, CU membership was limited to natural persons. However, with the increase in minimum capital that came into effect in 2004, this membership restriction on CUs was lifted to allow CUs to seek capital injection from legal entities.

13. **Another key factor fuelling the growth of the CU sector is that deposits placed with CUs are insured with the DIF.** The level of deposit insurance cover is 100 percent of insured deposits up to a maximum of €100,000 per depositor per CU. The Czech Republic adopted the European Union (EU) measure to raise the maximum level of DIF coverage from €50,000, as a response to the financial crisis in 2009. With the higher DIF coverage, households may be motivated to diversify their deposits across banks and CUs to seek maximum protection, without adequate consideration for the safety and soundness of the institutions involved. The DIF is a "pay-box only;" i.e., it can only be used to compensate insured depositors in a failed CU. The DIF is ex ante funded by a fee of 0.04 percent on insured CU deposits. In the event of a shortfall in funding, the DIF may raise funds by issuing securities in the market. If funding could not be raised at reasonable terms, the government may have to step in to provide support.

14. **There are concerns that a significant event in the CU sector may deplete the DIF's resources and cause reputational damage to the wider financial system in the Czech Republic.** As at end-2010, about 97 percent (CZK 19.7 billion) of CU deposit was insured with the DIF, while DIF assets totaled only CZK 18 billion. In May 2011, the DIF paid compensation in respect of deposit liabilities of a CU totaling CZK 70 million.

15. **On the other hand, CUs charge higher loan rates compared to banks, which strongly suggest that they focus on riskier clients.** The average interest rate on client loans charged by CU was 7.2 percent, higher than the average loan rate of 5.2 percent imposed by banks. This is not consistent with the typical business model of the CU, which aims at providing credit at affordable cost. Despite the riskier portfolio, the average interest margin earned by CUs in 2010 was 3.9 percent, lower than the 4.1 percent recorded by banks. Banks were also able to lend out more of their clients deposits, with a lower client deposit/loan ratio.

16. **CUs are taxed the same way as other corporate entities including banks.** The only difference is that the provisions on loans granted by CUs are tax deductible, on a portfolio basis, up to 1.5 percent of the value of the portfolio (2 percent of total assets for banks). A portfolio includes loans granted to individuals in EU member states up to CZK 1.5 million per individual but excludes loans to related parties and purchased loans. The tax deduction applies to CUs with nominal capital of at least CZK 20 million, which should be met by all CUs, as the minimum required capital is CZK 35 million.

17. **CUs may participate in CERTIS, the interbank payment system operated by the CNB.**[5] CERTIS conducts all types of interbank payments in Czech currency. If a CU participates in the payment system, the CNB shall maintain an interbank payment account in Czech currency on the basis of a contract with the CU. The interbank payment account may not be subject to

[5] CERTIS is a gross settlement system (i.e., without netting arrangements in place). In the event of default by a sending member institution, only the direct beneficiaries are affected with no impact on other participants in the system.

execution of judgment or preliminary measure by the court. The volume of transactions originated by CUs within CERTIS is negligible compared to banks. Nevertheless, before allowing a CU to become a participant in CERTIS, the CNB evaluates the financial condition and operational capacity of the CU concerned.

18. **CUs did not have an access to the CNB's liquidity window and were not involved in the central credit register.** However, as from 2012, CUs will be eligible for the CNB's open market operations and be able to access the liquidity window. The central credit register was only open to banks for the exchange of information on credit exposure of existing and potential clients and to perform market analysis using the aggregated data.

19. **One Czech CU operates a foreign branch in Slovakia, which was established in January 2010.** The business activities of the branch have been rather limited so far: the branch represents only 2 percent of its total deposits and its share in total loan portfolio is around 4 percent. The clients of the branch are protected under the DIF. There are no foreign branches of CUs headquartered in other countries operating in the Czech Republic.

Financial performance of CUs

20. **While the CU sector in the Czech Republic is very small in terms of asset base (0.6 percent of banking assets), it has been growing rapidly.** As of June 30, 2011, total assets held by CUs amounted to CZK 24.5 billion, compared to the total assets in the banking sector of CZK 4,267 billion. The growth in asset base is driven by significant expansion in the client deposits of CUs. (Please refer to Table 2 on the growth rates since 2008.)

21. **Notably, the volume of client deposits of CUs more than doubled since end-2008**, **resulting in corresponding expansion in client loans (Table 2).** As at end-June 2011, client loans totaled CZK14.0 billion or 65 percent of total receivables (CZK 21.6 billion); the balance of the receivables is mainly held as deposits with credit institutions (CZK 5.2 billion). The loan-to-deposit ratio was 71.5 percent as at end-2010, a decline from the record 82 percent in August 2008. Industry feedback suggested that CUs had been aggressive in pursuing growth in loan portfolios, including refinancing doubtful commercial bank borrowers. Quick assets[6] as a percent of total assets declined sharply from 32 percent as at end-2008 to 16 percent as at end-June 2011, reflecting a significant decline in the liquidity profile of CUs.

[6] Quick assets comprise cash, receivables from central banks, receivables from credit institutions payable on demand, and bonds issued by central banks and general government (including securities used as collateral for repos).

Table 2. Czech Republic: CU Sector—Analysis of Key Balance Sheet Items
(In millions of CZK)

	31.12.08	31.12.09	31.12.10	30.6.11	*% of Total*
Total assets, of which:	12,057	17,649	19,890	24,481	
Growth rates of assets		***46.4%***	***12.7%***	***23.1%***	
Breakdown of assets					
Cash balances	341	430	643	1,028	***4.2%***
Credit institutions	4,472	7,073	5,189	5,223	***21.3%***
Client loans	6,673	8,778	12,569	14,005	***57.2%***
% inc/(dec)		***31.5%***	***43.2%***	***11.4%***	
Tangible assets	430	585	810	808	***3.3%***
Other assets	114	221	144	295	***1.2%***
Total liabilities, of which:	11,797	17,378	19,826	24,296	***99.2%***
Client deposits	10,291	15,672	17,668	19,911	***81.3%***
% inc/(dec)		***52.3%***	***12.7%***	***12.7%***	
Provisions	0	1	2	422	***1.7%***
Share capital	1,156	1,387	1,895	2,349	***9.6%***
Total equity	261	271	64	186	***0.8%***
Reserves	99	127	80	91	***0.4%***
Retained earnings	110	145	23	-23	***-0.1%***
Net income from current year	51	0	-39	118	***0.5%***
Number of CU members	35,942	47,952	34,003	39,386	

Source: CNB

22. **Market concentration in the CU sector is high and increasing, due to the consolidation in terms of number of CUs.** The 5 largest CUs represented around 87.7 percent of assets of the CU sector as at end-March 2011. The number of CUs has been declining and as at end-2009, there were 33 CUs in the process of liquidation, of which 8 completed the process in 2010. Another three CUs commenced liquidation in 2010. The high number of CUs exiting the market was largely attributable to marginal players who no longer met the more stringent regulatory requirements administered by the CNB. Prior to 2006, CUs were supervised by the Office of Supervision of Credit Unions and a large number of CUs had ineffective risk management and governance. The increase in the minimum regulatory capital from CZK 0.5 million to CZK 35 million in 2004 also led to the voluntary liquidations of some CUs. However, total assets of the CU sector had expanded strongly since 2008, despite the consolidation. As a result, assets of the 14 remaining CUs rose by 12.7 percent in 2010 year-on-year and another 23.1 percent in the first 6 months of 2011.

23. **CUs reported relatively low levels of provision for nonperforming loans (NPLs) compared to banks in 2008–09, which contributed to their reported profits (Table 3).** In

2010, about 79 percent of the operating income was derived from net interest income with another 10.8 percent from fees. The average NPL ratio for the CU sector was 10.3 percent, almost doubled that of the banking sector (6.4 percent) for 2010. The actual NPL ratio might be higher than reported because some CUs had sold their NPL to third parties or related parties. The CNB has started to monitor the CU's practices in effecting the sale of loans. Despite the higher NPL ratio, CUs made much lower provisions for loan losses as indicated by the average NPL coverage ratio of only 9.3 percent compared to the 49 percent recorded by banks (see Table 1).

Table 3. Czech Republic: Analysis of CU Sector Profit and Loss
(In millions of CZK)

	31.12.2008	31.12.2009	31.12.2010
Operating income and expenses	438	458	513
Net interest income	390	393	406
Net fee and commission income	51	62	55
Other operating income (net)	(7)	(18)	29
Administration costs	(353)	(375)	(393)
Depreciation	(16)	(20)	(22)
Provisions	(1)	(0)	(1)
Impairment of assets	(14)	(56)	(125)
Total profit or loss before taxation	54	7	(29)

Source: CNB

24. **Arising from inspections conducted by the CNB, some CUs were required to increase their NPL provisions in 2010.** Consequently, impairment of assets more than doubled in 2010, resulting in an overall operating loss of CZK 29 million. The percentage of loans receivables with default (classified as substandard, doubtful, or loss) to total receivables has been increasing steadily from 1.9 percent (CZK 209 million) as at end-2008 to 8.7 percent (CZK 1.9 billion) as at end-June 2011, with another CZK 1.4 billion on the "watch" list. The CNB's inspection findings indicated weak compliance culture in a number of CUs as evidenced in their failure to properly classify loans and make adequate provisions for NPLs.

25. **The CNB found the CU sector to be generally resilient to liquidity shocks.** In 2010, the 3-month cumulative net receivables exceeded the net payables by almost 25 percent on average under the assumption of a 20 percent outflow of deposits. The ratio of quick assets to total assets fluctuated within a band of 15.8 percent to 21 percent in 2010. However, these favorable liquidity indicators may also suggest that the CU sector failed to maximize its funding to increase interest income by providing loans with longer maturities.

26. **While the average Tier 1 capital adequacy ratio (CAR) of CUs was relatively favorable at 12.6 percent as at end-2010, the distribution is uneven.**[7] Three CUs accounting for more than 50 percent of the sector's assets had CAR of less than 10 percent. Capital requirements increased by 80.7 percent with the largest proportion (96.3 percent) allocated to credit risk. Operational risks accounted for 3.7 percent of regulatory capital and the capital requirements for market risks were very low. Leverage in the CU sector[8] was conservative at 10.7, mainly because CUs engage in minimal derivatives activities.

III. Regulation and Supervision of Credit Unions in the Czech Republic

27. **CUs in the Czech Republic are regulated as credit institutions[9] pursuant to the EU Capital Requirements Directives (CRD).** Unlike CUs in Ireland and the UK, Czech CUs are not exempted under the CRD and are also subject to the EU Directive on Consumer Credit (CCD). The Czech Republic has established a dedicated legislation governing CU, that is, the Act on Credit Union (CUA). The CUA provides the legal framework governing licensing, governance, and prudential requirements, as well as professional market conduct.

A. Licensing Regime

28. **The licensing criteria reflect the cooperative nature of CUs.** The applicant must have at least 30 members and minimum paid-up capital of CZK 35 million (compared to CZK 500 million for banks). The professional qualification, credibility, and experience of the proposed directors, control committee, credit committee, and senior executives, as well as persons having qualifying interests in the CU, are assessed as part of the licensing application. Other licensing requirements cover the adequacy of technical and organizational set-up, feasibility of business plan, and the transparency of group structure.

29. **CUs are only allowed to offer their services to members (and to certain other entities such as state without precondition of their membership) and the scope of their activities is defined in the CUA.** However, as noted earlier, CUs may accept any natural or legal person as its members. The prescribed scope of services of a CUs include (a) receipt of deposits; (b) provision of loans; (c) financial leasing; (d) payment system, clearing, and issuance and

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[7] All CUs reported CARs exceeding the regulatory threshold of 8 percent as at end-2010 2010, but one CU had a significantly lower CAR of 5.16 percent. The average CAR for the CU sector fell to 11.6 percent as at end-June 2011.

[8] The sum of balance sheet and off-balance sheet assets expressed as a multiple of regulatory capital.

[9] Credit institutions are defined as "an undertaking whose business is to receive depositor other repayable funds from the public and to grant credits for its own account."

administration of payment instruments for members; (e) guarantees; (f) opening of letters of credit; (g) provision of collection; (h) purchase and sale of foreign currencies; and (i) rental of security boxes. CUs are not permitted to provide investment services, financial/money brokerage or serve as a depositary institution.

Governance, risk management, and internal controls

30. **General governance of a CU rests with the elected board of directors.** The CUA expects the board to decide on strategies and policies on (a) interest on deposits and loans; (b) provision/receipt of loans/deposits to/from another CU union or bank upon a proposal of the Credit Committee; (c) trading in foreign currencies, exchange rate, and interest rate instruments to manage financial risks, (d) trading in registered securities; and (d) determining charges for activities and services provided to members. Board members and executives shall perform their activities with due professional care and to ensure prudent and stable operations of a CU. For accountability, the board must prepare an annual report on a CU's activities to be approved by a members' meeting. Approved annual reports are submitted to the CNB.

31. **The CNB must be promptly notified of adverse developments affecting a CU's operations and of any board member or executive not meeting the fit and proper criteria.** Board members who have breached their duties are liable jointly and severally for causing damage to the CU or creditors of the CU.[10] The CNB may require a CU to terminate the appointment of a board member or executive if they fail to meet the fit and proper criteria. However, the CNB has not exercised its powers against any director or executive although it has withdrawn the licenses of CUs found to be in breach of the CUA or not financially sound due to governance lapses.

32. **The CUA requires CUs to establish credit committees as part of their governance structure.** A credit committee shall have at least three members who are neither a member of the board of directors, a member of the control committee, nor a person in charge of internal audit. The role of the credit committee is to exercise oversight of credit risks and to decide on (a) the provision of loans to members pursuant to articles of association; (b) the guarantee for loans or bank guarantees on behalf of members; (c) the security of loans.

33. **The CUA excludes certain interested parties from being covered by the DIF.** All non anonymous retail deposits and deposit of legal entities held in Czech koruny and foreign currencies are insured. Deposits of banks, foreign bank branches, and financial institutions as well as "subordinated deposits" are not covered. Other persons not entitled to be compensated with respect to deposits from the DIF due to their special relation with a CU are (a) members of a CU's elected body and executives; (b) entities controlling a CU, persons with qualifying interest

[10] Section 6a of the CUA.

in such entities and management of such entities, and persons close[11] to a CU's members of elected bodies, executives, and entities controlling a CU; (c) entities with qualified interest in a CU and entities controlled by such entities; (d) members of the Bank Board of the CNB; and (e) entities controlled by a CU.

34. **CUs are expected to implement internal controls and risk management systems that are adequate for nature, scale, and complexity of their operations.** These include clear and transparent organization structure, measures to address potential conflict of interests or incompatible functions, and remuneration policies that contributes to effective risk management. Proper arrangements for internal audits and compliance functions are part of a CU's internal control systems.

35. **The CNB may require a CU to commission external audits of their risk management and controls every three years.** The external auditors of a CU must not have any relationship with any member, director, or executive of the CU and their family members. The CNB has the right to reject the appointment of an external auditor and has done so in practice, when it found that certain auditors had failed to discharge their obligations effectively. The CNB has in fact required all CUs to commission such external audit and receive the audit reports through the CUs.

Prudential requirements

36. **CUs must maintain the minimum capital requirement at all times, calculated either on the basic[12] or special approach.** Use of the special approach is subject to prior consent of the CNB, who may impose conditions. The CNB sets the methodology for calculating capital adequacy, rules for determining capital, terms and conditions for using basic and special approaches, and rules for risk transfers.

37. **CUs must also maintain a risk fund and a reserve fund.** A risk fund is established, at inception, by transferring at least 10 percent of annual profits after taxes until the fund reaches 20 percent of the aggregate loans and guarantees provided by the CU. A CU must also transfer at least 10 percent from its profit after taxes on a yearly basis to a reserve fund until it reaches 20 percent of the registered capital.

38. **The prudential requirements applicable to CUs are intended to ensure the safety and soundness of their operations.** These include prudential rules relating to exposures rules on off-balance sheet assets and liabilities, minimum liquid assets, large exposures, investment, deposits, guarantees and liabilities, and rules for acquiring, financing, and assessing assets. In

[11] Family members and certain other persons as defined by the Civil Code.

[12] This approach uses standard formulas.

addition, CUs shall not (a) issue subordinated bonds or acquire receivables subject to subordination; (b) enter into contracts with conditions that are disadvantageous and such contracts are deemed invalid; and (c) acquire a direct or indirect interest in a legal entity or otherwise gain influence on management of a legal entity (except for securing a CU's receivables). A pledge of a CU's enterprise or any part thereof shall be inadmissible.

39. **CUs are required to establish limits for credit, market, concentration, and liquidity risks, which are approved by the board of directors, or a designated board committee.** All exposures in excess of the established limits must be reported to the board. In addition, CUs must report all large exposures, both to a single counterparty and to groups of connected counterparties, to the CNB on a monthly basis. Any violation of regulatory concentration limits must be reported to the CNB without undue delay.

40. **However, there are no restrictions on the lending activities of CUs**, **as in the case of the UK, Ireland, and Romania.** The regulatory regimes in these countries impose restrictions on both the size and duration of loans granted by CUs, which also clearly distinguish between secured and unsecured loans. Please refer to the Appendix.

41. **The basis for NPL provision for CUs is the same as banks.** CUs are required to classify borrowers according to two categories: not in default (standard and watch) and in default (substandard, doubtful, and loss). Substandard, doubtful, and loss classifications are assigned to borrowers (on a portfolio basis) when full payment is uncertain, highly improbable, or impossible, respectively, or nonpayment is 90 to 180, under 360, or over 360 days past due, respectively. If no repayment is expected or if payment is 360 days past due (regardless of collateral value), the loan is considered loss. Repayment from collateral is not considered in assigning a classification; it is considered when determining the amount of provision. Impairment of a homogenous portfolio is determined through objective criteria such as changes in unemployment, property prices, and payment behavior. Monthly reports are provided to the CNB with information on classified loans, past due loans, large classified credits, newly past due large loans, and a reconciliation of provisions and reserves.

42. **CUs may use one of three methods to determine loss amounts: coefficient method, discounted future cash flows, or statistical models method as set out by the CNB.** CUs typically use the coefficient method that applies fixed percentages against loan classifications (1 percent watch, 20 percent substandard, 50 percent doubtful, and 100 percent loss) taking into account the prospects of recoveries and collateral values. CNB rules provide qualitative guidelines for revaluations. The CU must assess values of collaterals regularly (quarterly) for the purpose of maintaining/adjusting loan provisions. Where valuations are outdated or collateral is illiquid, higher provisions are expected. Loans are upgraded and NPL provision adjusted when they are no longer impaired and there is a record of performance (usually six months). Refinancing of NPLs does not result in an upgrade in classification.

43. **The CNB has found under-provision for NPLs in many CUs and some CUs did not adequately identify exposures to connected counterparties in their credit risk management.** As noted in Section B, the level of NPL provision by CUs is low, even though CUs are taking higher credit risks compared to banks. CUs with low NPL coverage ratio tend to assume high recovery of defaulted loans through pledged assets, mainly in the form of properties. In this regard, a recession or a sharp decline in property prices would have significant impact on a CU's profitability and capital adequacy. Some CUs did not impose appropriate limits on connected counterparties and/or fail to properly identify connected parties. In this regard, industry feedback suggested that the definition of connected parties is subject to differing interpretations and hence difficult to enforce.

44. **Permitted investment activities under the CUA are conservative.** A CU may place (a) deposits in other CUs or banks; b) trade in foreign currencies, exchange rate, and interest instruments to manage its financial risks; and (c) trade in registered securities. Investments in other assets may be acquired only in relation to securing its receivables, for a maximum period of six months; for example, CUs may not acquire interests in other legal entities, although they are allowed to do so only in the process of collateral realization. Given the conservative investment requirements, the CNB does not require CUs to report their concentration risks arising from foreign currency assets and liabilities.

Market conduct rules

45. **CUs are required to make adequate disclosures to potential members and members on provisions of the articles of association including all facts related to membership; terms and conditions for deposits, loans, and other services; rights and duties of members; and terms and conditions of deposit insurance.** Changes in any facts or terms shall also be notified to members in a timely manner. The CNB prescribes the content and frequency of disclosures on CUs' compliance with prudential requirements and risk management.

46. **Members who have deposited have made further member's investment are entitled to have one vote for each whole multiple of a basic member's investment.**[13] This practice is not in line with the traditional CU model where each member is entitled to one vote regardless of his or her financial stake in a CU. However, a consent of members regardless of votes ensuing from further members' investments is required for decisions relating to expulsion of a member, amendment of the articles of association, election or removal of a member to/from control committees, major disposition of assets, change in the legal form, and merger or dissolution of a

[13] Section 4 and 4b of CUA. According to industry feedback, this provision was introduced in 2004 to mitigate the impact of the significant increase in capital requirement on CUs. The amount of further member's investment deposited into the registered capital of a CU shall always be a whole-number fivefold multiple of a basic member's investment.

CU. At least two-thirds of the votes of members are required in approving a merger or division of a CU, subject to the prior approval of the CNB.

47. **A member's share in the profit of a CU is determined by the ratio of the member's deposit against total deposits of all members.** The distribution of profits is decided at a members' meeting and the provisions of the commercial code relating to the division and use of profit of a cooperative do not apply. Similarly, a members' meeting decides on how the operating loss of a CU is to be funded.

48. **The CUA establishes measures to minimize conflict of interests arising from involvement of members in governing and managing a CU.** Loans granted to elected board members, members employed by the CU, and their family members must be made on an arms length basis, subject to the prior consent of either the board of directors or the control committee. Such loans must be disclosed in the CU's annual reports. A member of the credit committee and a member authorized to approve loans shall not act as guarantors on loans they have decided. A member must abstain from decisions on transactions in which he/she has an interest.

49. **There is no explicit limit on related party exposures and CUs are not required to report on related party exposures separately.** The CUA defines related parties as members of the credit union, or of its elected bodies, managerial persons, and persons close to them under the Civil Code. The CNB would only be informed of related party exposures if such transactions exceed the large exposures limits, that is, more than 10 percent of own funds.

50. **CU are subject to the Consumer Credit Act (CCA), which became effective in May 2010**. The CCA is a transposition of the EU Directive of on Consumer Credit (CCD) and provides for (a) provision of with pre-contractual information to clients; (b) regulation of information in contracts and advertisements; and (c) the right to withdraw from an agreement and early redemption by clients.

Dissolution, winding-up and resolution

51. **Insolvency of a CU is governed by the Act on Insolvency.** The liquidation of a CU is provided under the CUA and the Commercial Code. The standard liquidation procedures for commercial entities apply to issues not covered by the special provisions under the CUA. The CNB may apply to the court for a CU to be wound up if (a) the number of members has fallen below 30; (b) the capital has dropped below CZK 35 million; (c) breach of requirements to appoint a board of directors or convene a members' meeting or the CU has been dormant for over 1 year; and (d) whether the establishment, merger, or division of the CU has breached the CUA. A CU shall also be dissolved if its license is withdrawn.

52. **The CNB shall withdraw the license of a CU when it identifies serious shortcomings in its business activities and these serious shortcomings persist.** The CUA defines "a

shortcoming in business activities as (a) a breach of licensing conditions; (b) a breach of the CUA and related regulations and decisions issued by the CNB; (c) activities that are prejudicial to the interests of the CU's depositors/members or that endangers its safety and stability; (d) the CU is managed by persons who do not have sufficient professional qualifications or who are not credible; (e) inadequate provisions and reserves; (f) if an elected body of a CU has not performed its duties for over 60 days; (g) refusal to submit information required during an inspection or allow CNB entry into its premises; (h) a breach of prudential rules; (i) failure to approve financial statement within 6 months from the end of last financial year; and(j) failure to comply with reporting requirements. A CU may appeal against the CNB's decision within 15 days. An appeal filed against some decisions shall not have a deferring effect (i.e., a restriction or prohibition/exclusion of some licensed CU's activities and an order of an extraordinary audit at the expense of a CU).

53. **The CUA has been amended to permit the conversion of CUs to banks, if the CNB decides to issue a banking license to the CU.** Generally a change of a CU's legal form is not permissible. However, a CU may merge with another CU and may be divided into more CUs, both subject to the prior consent of the CNB. Industry feedback indicated that the potential for conversion to banks and the possibility of share transfers amongst members have attracted investors' interests to inject new capital into CUs.

54. **The CNB shall apply to the court for the appointment and removal of a liquidator of a CU.**[14] The liquidator's remuneration and its term of service are determined by the CNB. The liquidator's expenses and remuneration shall be paid by the CU. Where the assets of the CU are insufficient to pay liquidation expenses, the CNB shall pay first and then claim from the CU. A liquidator shall, without any undue delay, provide the CNB with financial statements and documents prepared in the course of winding-up as well as other required information requested by CNB.

55. **The CNB applies the same resolution powers and tools for banks on the CUs, except for conservatorship and bridge-bank.** These included remedial and crisis management measures, insolvency rules, and use of state budgetary resources. The CNB will be soon enabled to provide liquidity against collateral to a CU. However, conservatorship can be imposed only on banks, not on CUs. The concept of bridge-bank does not apply as CU may merge with another CU only or split-up only among other CUs.

[14] A liquidator of a CU shall be appointed and removed from office by a court upon a proposal of the CNB only.

Supervisory approach for CUs

56. **CUs in the Czech Republic have been supervised by the CNB since 2006.** The CNB's supervisory scope includes licensing, ongoing supervision, enforcement and imposition of remedial measures, and penalties. The acquisition of qualifying holdings and the appointment of board members as well as senior management of CUs are also subject to the approval of the CNB. Ongoing supervision of CUs involves both off-site surveillance and on-site inspections. The CNB supervises CUs on both a solo and consolidated basis.

57. **Under the current risk-based supervision approach, the CNB's allocation of supervisory resources to the CU sector is determined by the size of the sector and efficiency considerations.** Given the small scale of the CU sector, the supervisory resources allocated to the CU sector is correspondingly small. Taking account of the availability of supervisory resources, it was considered that resources might be more efficiently deployed in the dominant banking sector. There are two CNB officers dedicated to off-site surveillance of CUs. On-site inspections, which may involve 5 to 10 inspectors depending on the scope of inspections and the scale of the CU concerned, are conducted by inspectors drawn from the inspection unit.

58. **CUs are required to file regulatory returns quarterly and annually.** The CNB may require certain CUs to provide more frequent submissions, if necessary. Reports on organizational structure are also provided to CNB. CUs are liable to sanctions (including penalty of up to CZK 1 million) for inaccurate or misleading information provided in the returns. The CNB has imposed fines on some CUs for failure to meet their reporting obligations.

59. **The CNB analyzes the financial condition of and risks taken by individual CUs quarterly.** This serves as a basis for decisions on the intensity and manner of their supervision. The observance of prudential limits and rules (e.g., for credit exposure) and early warning indicators are monitored on a monthly basis. These reports are requested from CUs particularly in periods when no on-site examination covering the given area is conducted.

60. **The basis for NPL provisions by CUs and ineffective controls over exposures to connected parties have been key findings of CNB's on-site inspections.** The CNB conducts both full-scale and thematic inspections on CUs. The number of CU inspected ranges from two to five per year. Two CUs were inspected in 2010. The CNB has found more serious and more frequent shortcomings in the internal control systems in the CU sector, relative to the banks. Other deficiencies included organizational structures that lack clear clarity on the responsibilities and powers of employees and outsourcees, inadequate measures to minimize conflicts of interest, insufficient staffing, and inadequate internal controls.

61. **The CUA empowers the CNB to take a wide range of preventive, corrective, and enforcement powers over CUs.** These powers ranges from requiring CUs to rectify shortcomings noted restrictions in activities, imposition of financial penalties, restructuring, and revocation of license. Over the last three years, the CNB had taken enforcement actions and

imposed fines on CUs for breaches of regulatory requirements. The CNB revoked the license of Úvěrní družstvo PDW, Praha, in March 2010 and that of Vojenská družstevní záložna in December 2010 due to persisting serious shortcomings in their activities.

IV. Key Recommendations to Restructure the CU Sector in the Czech Republic

62. **There is a need to restructure the current CU sector to address the risk it imposes to DIF resources and potentially to taxpayers' money and the reputational risks on the financial sector and the CNB.** It is no longer tenable for many of the profit-driven CUs in the Czech Republic to continue in their current mode. In contrast with the traditional CUs, most of the Czech CUs operates in direct competition with banks but suffer from the inefficiencies arising from their small scale of operations and comparative disadvantages relative to a bank branding. These factors are inherent constraints to growth, unless imprudent compromises were made by CUs to pursue market share. The consequences of unhealthy competition have been demonstrated by the deteriorating quality of the loan portfolios of CUs, which were masked by the low NPL provisions in some CUs. A problematic CU sector also poses reputational risks to the overall financial system in the Czech Republic and to the standing of the CNB as a supervisor.

63. **It is imperative that the restructuring strikes a delicate balance between minimizing financial and supervisory risks arising from the sector while recognizing the social roles of CUs that are prudently managed.** The business models of the CUs in the Czech Republic should be distinguished from the commonly acceptable role of CUs; that is, fulfilling a social role for its members, not driven by profits and observance of the cooperative spirit. In effect, the Czech CUs are small-scale banks that are unable to compete effectively with banks on a level playing field. Consequently, these CUs have disproportionate impact on the DIF and pose high risks to the supervisory objectives of the CNB. The potential reputational damage to the financial sector of the Czech Republic is also not to be underestimated. On the other hand, it is internationally recognized that traditional CUs do perform meaningful social roles, as demonstrated by their high penetration rates in a number of countries.

A. Recommendation 1

64. **The CNB and the Ministry of Finance are advised to establish criteria and specify scale threshold for existing CUs focusing on deposit-taking and lending activities to apply for a banking license.** The core business activities of these larger CUs are the same as banks as they are not subject to any restriction on their membership. The CNB should, therefore, be empowered to regulate and supervise these CU as banks, albeit calibrated in line with its risk-based regulatory framework and supervisory approach. The CUA has already been amended to facilitate such a conversion.

65. **The remaining CUs should be given a reasonable transition period either to alter their organizational structure to comply with the enhanced regulatory requirements for CUs (Recommendation 4) or plan for an orderly exit.**

66. **The CNB is advised to proactively manage the perception of some CUs that their application for banking licenses is encouraged.** This recommendation is in line with the emerging trend of CUs applying for conversion into banks. One conversion was completed in May 2010,[15] while another two CUs have indicated intention of applying for conversion. A bank status would allow the CUs to undertake a more comprehensive range of business activities without the constraints placed on CUs. Other motivating factors include achieving better economies of scale and a bank branding lowers deposit funding costs, which may help to increase market share. Industry feedback suggested that there are increased investors interests in injecting additional capital into CUs in anticipation of possible conversion. There are merits in sending a clear signal that only those serious players with long-term commitments and adequate capacity will be allowed to be upgraded to banks.

B. Recommendation 2

67. **It is important to carefully plan for the migration of CUs to banks and the resolution of CUs that do not qualify to be licensed as banks or remain as CUs**. Key parameters of the plan include:

- a diagnostic review, preferably supplemented by on-site inspections, of existing CUs to determine how many CUs qualify to be licensed as banks or new CUs. The relevant entities have to properly address any serious shortcomings noted before submitting an application. This helps to ensure that only viable entities are allowed to continue operations either as banks or CUs;
- ascertain the financial positions of those CUs that would have to be liquidated (including the adequacy of their NPL provisions) and assess any potential impact on the DIF; and
- transitional arrangements for the restructuring of CUs to meet the proposed enhancements to the CU regime or to wind up their operations in an orderly manner.

C. Recommendation 3

68. **The licensing process should assess not only the feasibility of meeting prudential requirements applicable to banks but also the fitness and propriety of the applicants to manage banks.** While the minimum capital requirement for those CUs applying to be converted to banks will be raised sharply from CZK 35 billion to CZK 500 billion, this is just the first and

[15] Fiobanka a.s. was formed through the conversion of an existing investment firm (Fio burzovní a.s.) and subsequent merged with its related CU (Fio CU).

may be the easiest hurdle. More importantly, the applicant should demonstrate that it is able to meet all other regulatory requirements, financial and nonfinancial, applicable to banks both at the licensing stage and on an ongoing basis. Critical considerations include more robust corporate governance and risk management, effective infrastructural support such as upgrading information system, and adequate expertise in managing a full range of banking business. The CNB conducted due diligence in the conversion of the first CU, which took about two years to complete. The mission is confident that the CNB has the capacity to ensure proper screening of all applicants.

D. Recommendation 4

69. **The CNB is advised to enhance the licensing and regulatory for CUs to ensure the long-term sustainability of CUs, in line with international best practices promulgated by the WOCCU.** In particular, the CUA should be amended to incorporate prudential requirements on: (a) restrictions on membership based on clearly articulated membership criteria; (b) observance of non-for-profit objective; and (c) limits on size and duration of loans, security of collaterals and basis for loan classifications, and NPL provisions. As the restrictions and limitation cannot be imposed as a part of the licensing procedure, it would require amendments to the CUA.

E. Recommendation 5

70. **Going forward, the CNB is advised to enhance its supervisory resources to conduct risk-based supervision that addresses the risk profiles of CUs more adequately.** The CNB's current risk-based supervision approach allocation of supervisory resources to the CU sector is low due to the size of the sector and it was considered that its limited resources might be more efficiently deployed in the dominant banking sector. Many supervisors have found that smaller entities tend to higher probability of failure (relative to large entities) due to various reasons, including the limited financial resources to attract and retain high caliber staff, institute effective risk management ensure adequate checks and balances, and implement adequate controls, or deal with systemic events. International best practices for risk-based supervision typically consider two dimensions of risks to the supervisory objectives—the impact of failure (with the size of the financial entities as a proxy) and the probability of failure. The latter factor is driven by qualitative supervisory assessment on the governance and risk management of financial entities.

APPENDIX 1. OVERVIEW OF CU SECTORS IN SELECTED COUNTRIES*

	Czech Republic	Romania	Ireland	UK	US
Population[16]	10.5 mn	21.4mn	4.5 mn	62.2 mn	310.2 mn
GDP[17]	US$192.0bn	US$161.6bn	US$222.2bn	US$2,250.2bn	US$14,526.5bn
Banking sector[18] assets	US$224.4bn (CZK 4,267bn)	US$109.64bn EUR 81.8bn	US$1594.84bn EUR 1179.4bn	US$13775.34bn EUR 10187.4bn	US$11,593bn[19]
Number of CUs[20]	14	17	498	480	7,491
No of members[5]	34,003	64,248	3 mn	0.9 mn	91.8 mn
Penetration rate[5&21]		0.4%	70.7%	2.2%	43.9%
Total assets of CU sector[5]	US$1.3bn[22] (CZK 19.9bn)	US$42mn	US$18.3 bn	US$1.2 bn	US$926.5 bn
Average Size	US$92.9mn	US$2.5mn	US$36.7mn	US$2.5mn	US$123.7mn
Total savings in CU sector[5]	US$ 1.1bn (CZK 21.6bn)	US$34 mn	US$15.9bn	US$1.0bn	US$797.3bn
Total Loans in CU sector[5]	US$0.9bn (CZK 17.8bn)	US$30 mn	US$8.1 bn	US$0.8 bn	US$572.4bn
NPL ratio	10.3%	n/a	About 15%?	n/a	1.74[24]
Coverage of NPL with provisions	9.3%	High delinquencies was reported[23]		n/a	1.13%[25]

[16] Source: Swiss Re Sigma, World Insurance in 2010
[17] Source: WEO, September 2011 (data for 2010)
[18] Source: EIB. Foreign exchange conversion rate on November 22, 2011.
[19] Source: Federal Reserve, February 2011, includes Banks with assets >300Mln only.
[20] Source: WOCCU 2010 Statistical Report.
[21] Total number of reported CU members/economically active population. Source: WOCCU.
[22] Foreign exchange conversion rate on November 15, 2011.

	Czech Republic	Romania	Ireland	UK	US
Regulatory requirements on NPL Provisions	coefficient[26], discounted future cash flows, or statistical models			> 35% of net loans in arrears between 3 to 12 months >100% of net loans in arrears for > 12 months > 2% general provision against net loans in arrears < 3 months[27]	
Ave deposit rate – CU (2010)	3.3%	n/a	n/a	n/a	0.18% to 2.09% (different maturities)
Ave deposit rate – Banks (2010)	1.1%	6% (RON)[28] 3% (EUR)[13]	2.17%[29]	2.46%[30]	0.14% to 1.78 (different maturities)
Ave loan interest rate – CU (2010)	7.2%	n/a	n/a	n/a	3.35% to 11.64% (various maturities/ types)
Ave loan interest rate –Banks (2010)	5.2%	12% (RON)[13] 6.5% (EUR)[13]	5.93%[14]	5.84%[15]	3.51% to 13.17% (various maturities/ types)
Minimum capital - CU	CZK 35 mn	n/a	Regulatory Reserve	< $8m assets- positive net worth.	6% capital asset ratio[19]

[23] Romanian Federation of Credit Unions (FEDCAR) & World Council of Credit Unions (WOCCU) http://www.woccu.org/involved/partnerships/activities?id=114

[24] Table 8, 2010 Year-end Statistics for Federally Insured Credit Unions.

[25] Net charge-off to average loans

[26] Applies fixed percentages against loan classifications (1% watch, 20% substandard, 50% doubtful and 100% loss)

[27] Source: FSA Website, http://www.fsa.gov.uk/smallfirms/resources/faqs/credit_unions/cu_provision.shtml

[28] Source: National Bank of Romania Statistics.

[29] Source: Central Bank of Ireland, Consumer Loans .

[30] Source: Bank of England Statistics, Monthly interest rate of UK monetary financial institutions (excl. Central Bank) sterling instant access deposits from households (in percent) not seasonally adjusted.

	Czech Republic	Romania	Ireland	UK	US
- Banks	CZK 500mn	4.5-7%[31]	Ratio[32] of > 10% w.e.f 30 Sep 2009. 10.5% (CT1)[33]	> $8m assets - 8% risk weighted capital asset ratio[34] 4.5-7%[35]	8% T1+T2 (Core T1 4%)[36]
Deposit insurance coverage	Up to €100,000 per depositor per CU			**£85,000** per person per CU w.e.f 31 Dec 2010	Up to US$250,000 per depositor as from 17 Sep 2010
Supervisor of CUs	Czech National Bank	National Bank of Romania	The Registrar of Credit Unions	Financial Services Authority (FSA)	National Credit Union Administration (NCUA)
Regulatory restrictions on loans granted by CUs	None	Restriction applies to credit activities - limited to small loans for < 5 years[8]	A loan to a member shall not: - > 5 years if total outstanding i.r.o loans > 5 years is > 20% of total outstanding; - > 10 years if total outstanding i.r.o loans > 10 years is > 10%	Version One[37] - 5 years (unsecured) to 10 years (secured). - max £7,500 to £15,000 in excess of a member's shares Version Two - 10 years (unsecured) to 25 years (secured).	Cannot use > 12.5% of assets for business loans[38]

[31] Basel III standards for Core Tier 1 Capital

[32] Total regulatory reserve CU expressed as a percentage of total assets. Total Regulatory Reserve = statutory reserve and non-distributable additional regulatory reserve account.

[33] Central Bank of Ireland, April 2011, http://www.centralbank.ie/press-area/ speeches/Pages/AddressbyJonathanMcMahon,DirectorofCreditInstitutions,CentralBankofIreland,totheFinancialServicesInnovationCentre,Universit.aspx

[34] Source: WOCCU, Basel Capital Requirements for Credit Unions

[35] Basel III standards for Core Tier 1 Capital

[36] Federal Reserve Board, Risk-Based Capital Guidelines

[37] The UK regime differentiates between version 1 and version 2 CUs. Version 2 CUs are larger, with more than £1 million in assets and more than 3,000 members and they are allowed to lend larger amounts for longer periods and/or offer wider ancillary services.

[38] As of 2007

	Czech Republic	Romania	Ireland	UK	US
			of total outstanding - resulting in outstanding liability > the greater of: *a*) £30,000, and *b*) 1.5% of the total assets of the CU.	- max £15,000 in excess of a member's shares or 1.5% of total shareholdings, whichever higher. <u>Large exposures</u> Individual: not > 25% of capital Aggregate: not > 500% of capital	

***** Data as at end-Dec 2010 unless specified otherwise.