World Council

June 11, 2013

Mr. Rafał Matusiak
President
National Association of Cooperative Savings and Credit Unions
Władysław IV 22
81-743 Sopot
Poland

Re: *Model Regulations for Credit Unions*

Dear President Matusiak,

I am writing in response to your questions regarding: (1) the character of World Council of Credit Unions's (World Council's) *Model Regulations for Credit Unions*[1] and how World Council developed these model rules; and (2) the specific background of Section II.2 of the *Model Regulations* on "Loan Classification System" and its forward-looking provision for loan loss (PLL) reserve methodology that is incorporated into the Polish KAPER system.

In brief: (1) World Council's *Model Regulations* resulted from extensive legal research regarding credit union laws globally and a public-private consultative process that was made possible through the funding of the U.S. Agency for International Development (USAID); and (2) the *Model Regulations'* forward-looking PLL reserve methodology is based on the World Council PEARLS Monitoring System and is the used in a number of jurisdictions worldwide including, within the European Union, the Member States of the United Kingdom and Poland (both of which have CRD Article II exemptions for credit unions). More detailed responses on these issues follow below.

1. Character and Background of World Council's *Model Regulations for Credit Unions*

World Council issued the *Model Regulations* in 2008 as the result of a research project funded by USAID's Cooperative Development Program entitled "Furthering Credit Union Development: A Business-Driven Systemic Approach to Improving Financial Performance and Increasing Outreach." The *Model Regulations* are intended to compliment World Council's *Model Law for Credit*

[1] World Council of Credit Unions, *Model Regulations for Credit Unions* (2008), *available at* http://www.woccu.org/functions/view_document.php?id=ModelCURegs

Unions[2] by setting forth a model rulebook to clarify and compliment the *Model Law*'s statutory requirements.

World Council developed the *Model Regulations* through a combination of the following: (a) researching existing credit union regulations and documented best practices in 18 jurisdictions including Great Britain, the United States of America, and Canadian provinces; (b) incorporating prudential requirements from World Council's "International Credit Union Principles for Safety and Soundness," which drew on World Council's PEARLS Monitoring System[3] and is reflected today in the International Credit Union Regulators' Network's *Guiding Principles for Effective Prudential Supervision of Cooperative Financial Institutions*;[4] and (c) via consultation with key stakeholders in the international credit union movement including the U.S. National Credit Union Administration's staff.[5]

In sum, the *Model Regulations* are a recommended rulebook based on global credit union laws and best practices as analyzed by World Council under the auspices of USAID and in consultation with public and private stakeholders. Regulators and other credit union stakeholders at the national level should weigh these *Model Regulations* against the level of development of the local credit union movement and tailor these rules to local conditions. This analysis should take into account factors such as the credit unions' asset sizes, the level of recovery on bad loans under the local debtor-creditor legal regime, the role and type of liquidity and capital support offered by the apex structures, local norms and regulations regarding accounting and taxation, and other material factors.

2. The *Model Regulations'* PLL Reserve Methodology

The provision for loan loss (PLL) methodology found in the *Model Regulations* Section II.2 is based on standards that originated in the World Council PEARLS Monitoring System and were, as noted above, incorporated into World Council's "International Credit Union Principles for Safety and Soundness" and then the *Model Regulations*. This forward-looking PLL methodology establishes provisions of 35% relative to face value for loans that are in arrears for 1-12 months—i.e. beginning well before a credit loss is incurred—and a 100% provision relative to face value for loans that have been in arrears for 12 months or more (regardless of whether recovery on the loan is possible). The *Model Regulations'* PLL methodology is used within the European Union in the

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2 *See, e.g.*, World Council of Credit Unions, *Model Law for Credit Unions* (2011), *available at* http://www.woccu.org/functions/view_document.php?id=2011ModelLawEnglish.
3 *See, e.g.,* David C. Richardson, World Council of Credit Unions, *PEARLS Monitoring System* (2002), *available at* http://www.woccu.org/functions/view_document.php?id=Monograph_4.
4 International Credit Union Regulators' Network, *Guiding Principles for Effective Prudential Supervision of Cooperative Financial Institutions* (2011), *available at* http://www.curegulators.org/functions/view_document.php?id=ICURN_Guiding_Principles_for_Supervision
5 *See Model Regulations for Credit Unions* at 2 (2008).

Member States of the United Kingdom and Poland pursuant to the CRD Article II credit union exemption that permits Member States to establish credit union-specific laws and regulations.

More specifically, World Council established the PLL reserve methodology found in PEARLS, as well as in the Bank of England's *CREDS Sourcebook*[6] credit union regulations and the Polish KAPER system, pursuant to a USAID-funded project called the "Cooperative Strengthening Program" that instituted a plan to recapitalize and reorient credit unions in Guatemala "through financial and technical assistance to achieve institutional reform" between 1987 and 1993.[7]

Adequate forward-looking PLL reserving was a necessary part of this Cooperative Strengthening Program and the PLL methodology in the *Model Regulations* has also performed well in many jurisdictions around the world. Specifically, the forward-looking PLL is the key element of the PEARLS system's "P – Protection" component and the PEARLS methodology explains the importance of its PLL approach as follows:[8]

> Adequate protection of assets is a basic tenet of the new credit union model. Protection is measured by 1) comparing the adequacy of the allowances for loan losses against the amount of delinquent loans and 2) comparing the allowances for investment losses with the total amount of non-regulated investments. Protection against loan losses is deemed adequate if a credit union has sufficient provisions to cover 100% of all loans delinquent for more than 12 months, and 35% of all loans delinquent for 1-12 months.
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> Inadequate loan loss protection produces two undesirable results: inflated asset values and fictitious earnings. Most credit unions are not anxious to recognize loan losses, and much less, to charge them off against earnings. That unwillingness leads to widespread abuse of the principles of safety and soundness. Reported net income is overstated, asset values are inflated, provisions for loan losses are inadequate, and member savings are not adequately protected.
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> …
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> The World Council of Credit Unions, Inc. promotes the principle that the allowance for loan losses is the first line of defense against non-performing loans. The PEARLS system evaluates the adequacy of protection afforded to the credit union by comparing the allowance for loan losses to loan delinquency.

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[6] Bank of England, Prudential Regulatory Authority, *Credit Unions New Sourcebook (CREDS)* § 7.5.2 (2013), *available at* http://fshandbook.info/FS/html/handbook/CREDS/1/1.
[7] David C. Richardson, Barry Lennon & Brian Branch, World Council of Credit Unions, *Credit Unions Retooled: A Road Map for Financial Stabilization* at 2 (1993), *available at* http://www.woccu.org/functions/view_document.php?id=Monograph_1
[8] *PEARLS Monitoring System* at 3-4 (2002).

Of course, these recommended levels of PLL and other PEARLS requirements can be tailored to the credit union movement's local circumstances, as has occurred with the Polish KAPER system. World Council was fully aware of and in agreement with the Polish KAPER system and its development based in principle on PEARLS and customized for the Polish credit union system and its relatively sophisticated level of development.

In the case of Poland, World Council believes that detailed technical norms and standards should be subject to a local agreement between the regulator and NACSCU taking into account international credit unions norms such as the *Model Regulations* and local conditions. We stand ready to support this dialogue to help ensure a strong and stable system of Polish credit unions for the benefit of 2.6 million of Polish families.

Please do not hesitate to contact me by email (medwards@woccu.org) or phone (+1-202-508-6755) should you require any additional assistance or have any more questions.

Sincerely,

Michael S. Edwards, *Juris Doctor*
VP and Chief Counsel
World Council of Credit Unions