Guiding Principles for the Effective Prudential Supervision of Cooperative Financial Institutions

September 16, 2011

This document has been developed by the International Credit Union Regulators' Network (ICURN)[1] as guidance for supervisory authorities involved in the prudential supervision of cooperative financial institutions such as credit unions, caisses populaires, savings and credit co-operatives, savings and credit associations, etc. They are not intended to be rules. Rather, they are intended to be guiding principles that will help establish an environment that will facilitate effective supervision.

It is acknowledged that the supervisors of cooperative financial institutions operate in a wide range of regimes ranging from OECD member countries to developing nations. Accordingly, the guidance may not always be applicable, relevant or even possible in all circumstances. That said, it is considered by ICURN that adoption of these guiding principles is desirable for all jurisdictions supervising cooperative financial institutions.

This guidance has been developed using the Core Principles for Effective Banking Supervision as released by the Basel Committee of Banking Supervision (September 1997, as revised in October 2006) as a guide. ICURN has been grateful for the ongoing support of the Basel Committee in its activities but wishes to emphasise that this document has not been developed or endorsed in any way by the Basel Committee for Banking Supervision. It has been developed independently by the ICURN Steering Committee as guidance for its members in assisting them to establish a regime that facilitates more effective supervision.

Supervisory authorities should focus on the goals of these guiding principles. ICURN acknowledges that its membership encompasses a wide range of structures ranging from delegated supervision to stand-alone regulators for a mutual industry to integrated regulators that have responsibility for prudential supervision as well as market conduct activities.

While a high degree of adoption of these guiding principles should facilitate more effective supervision, it will not prevent failures of individual institutions. Prudential supervision cannot, and should not provide an assurance than deposit-taking institutions will not fail.

[1] ICURN is an independent international network of credit union regulators that was formed in 2007 and which currently has members in 30 countries and jurisdictions. ICURN's mission is to promote a greater international coordination among the regulators of financial cooperatives through the sharing of information and positions of common interest, initiating research on financial cooperatives and their oversight, identifying of best practices and providing direct access to an exclusive forum for thought leaders worldwide on issues critical to sound credit union regulation. The Steering Committee, which leads ICURN, consists of senior representatives of the supervisory authorities for cooperative financial institutions in Australia, Brazil, Canada, India, Kenya, Poland, and USA. The World Council of Credit Unions serves as the ICURN secretariat.

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The Guiding Principles

The Guiding Principles incorporate 20 principles that are considered desirable in facilitating an effective system for the supervision of cooperative financial institutions. The principles are categorised into six groups:

Group 1 – Objective, independence, powers, transparency and cooperation
Group 2 – Licensing and ownership
Group 3 – Prudential regulation and requirements
Group 4 – Methods of ongoing supervision
Group 5 – Accounting and disclosure
Group 6 – Enforcement

Group 1 comprises GP 1, group 2 comprises GP 2–4, Group 3 comprises GP 4–15, Group 4 comprises GP 16–19, Group 5 comprises GP 20 and group 6 comprises GP 21.

Guiding Principle 1 – Objective, independence, power, transparency and cooperation
An effective system of supervision will have clear responsibilities and objectives defined for each authority involved in the supervision of the industry. It is essential for each authority to have operational independence, transparent processes, sound governance, and adequate resources and for it to be accountable in its discharge of its duties. An effective legal framework is also necessary including the powers for authorisation, supervision, powers to enforce compliance with relevant laws, safety and soundness and legal protection for supervisors. Where relevant, authorities must have the legal capacity to share information whilst protecting the confidentiality of such information.

Guiding Principle 2 – Permissible activities
The permissible activities of institutions that are licensed and subject to supervision must be clearly defined and the use of the terminology (i.e., credit union, caisses populaires, SACCO, etc.) used to describe the institutions undertaking these activities must be restricted and controlled by the supervisory authority. The supervisory authority must have the power to enforce against the use of the restricted terminology by unlicensed entities. Business powers and permissible activities may be proportional to the institution's size and ability to manage the risks inherent in such services and compatible with its business objectives.

Guiding Principle 3 – Licensing
The supervisory authority must have the power to establish and enforce the necessary criteria for licensing entrants. At a minimum, the licensing process should consider ownership (must be a cooperative structure), governance, fitness and propriety of board members and senior management, strategy, risk management and capital. This is not intended to be an exhaustive list and supervisory authorities should consider what additional criteria are needed to facilitate effective supervision in their regimes.

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Guiding Principle 4 - Ownership
The supervisory authority should ensure that the structure of any proposed institution complies with cooperative principles recognizing that some second-tier organizations have proportional voting for members. It is not appropriate for any individual or group of individuals to be in a position to exercise control from a minority position. Voting in credit union support organizations or associations may be proportional or representational.

Guiding Principle 5 - Capital Adequacy
The supervisory authority must establish and enforce the rules for an appropriate capital framework that all regulated institutions must comply with. The rules should balance cooperative principles and objectives with the need to protect depositors. Accordingly, supervisory authorities will need to carefully consider what meets the criteria for capital and to ensure that capital instruments are able to absorb losses in the event of failure.

When supervisors choose to align the capital requirements of credit unions to Basel standards, a simplified approach may be adopted for small or simple credit unions which are not allowed to hold complex financial instruments. For such institutions, compliance with the most advanced risk measurement techniques may be beyond their resources. Therefore, the regulator may require additional capital to support the limited information that may be available for supervisory authorities.

Guiding Principle 6 - Risk management
The supervisory authority must ensure that regulated institutions have in place appropriate and adequate risk management processes and systems. The risk management system must be able to identify, evaluate, monitor, manage and control the risks to which the regulated institution may be exposed. Policies and limits for risk undertakings must be clearly established and periodically reviewed. The risk management system should be commensurate with the size and complexity of the institution and its activities.

Guiding Principle 7 - Credit risk
Credit risk is generally the most significant risk for cooperative financial institutions. Accordingly, supervisory authorities should ensure that regulated institutions have appropriate policies in terms of their risk specific undertakings and adequate systems to manage such risks. It is essential that regulated institutions are able to manage their credit portfolios effectively in terms of monitoring the performance of the portfolio and the collection of distressed facilities. The supervisory authority should also focus on ensuring that regulated institutions focus on forms of lending which they are capable of undertaking whilst avoiding areas which require expertise they do not possess.

Guiding Principle 8 - Problem assets, provisions and reserves
The supervisory authority must be satisfied that regulated institutions have adequate policies and processes for managing problem assets and provisioning appropriately for such assets. It is essential for supervisory authorities to satisfy themselves that regulated institutions are adequately provisioned for troubled/problem loans and other impaired assets. Provisions should also be

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considered for untroubled loans to reflect historical loss experience and changes in economic conditions that may affect the quality of the loan portfolio as a whole. Some provision may be required for contingent liabilities, depending on the probability of a corresponding cash outflow.

Guiding Principle 9 – Large exposures

The supervisory authority should satisfy itself that regulated institutions have appropriate and adequate policies and processes around large exposures (concentration risk). The supervisory authority should set rules around the definition and limit of large exposures to which regulated institutions can be exposed and should have the power to intervene should these be breached.

Guiding Principle 10 – Conflict of interests and related party exposures

The supervisory authority should have the power to establish rules to control conflicts of interests and related party exposures. It should have in place powers that permit it to intervene where such rules are breached. Related party transactions should be required to be undertaken at arm's length and there should be rules that require disclosure and reporting of such transactions.

Guiding Principle 11 – Interest rate risk and market risk

The supervisory authority should require regulated institutions to have in place policies and processes to manage interest rate risk to which regulated institutions may be exposed. In particular, supervisory authorities should be attuned to the interest rate risk of fixed rate lending portfolios.

Guiding Principle 12 – Liquidity and funding risk

The supervisory authority should require regulated institutions to develop reasonable and prudent liquidity management strategies and contingency plans (i.e., via central bank borrowing, standby facilities, and/or liquid reserves in an regulated central financial facility, etc.) which cover the funding of the institution and the ongoing monitoring of the liquidity/funding position of the regulated institution. Supervisory authorities should have the ability to intervene when it believes that a regulated institution has an excessively risky funding base or liquidity position. Liquidity risk should be addressed both on a per-institution and on a network-wide basis. Soundly managed network-wide liquidity and stability facilities are highly desirable.

Guiding Principle 13 – Internal controls

The supervisory authority should satisfy itself that regulated institutions have in place an appropriate level of internal controls that are commensurate with the size and complexity of the institution and its activities. This should include arrangements around delegations of responsibilities, authorisations, segregation of duties, reconciliations and accounting.

Guiding Principle 14 – Abuse of financial services

The supervisory authority should satisfy itself that regulated institutions have in place policies and procedures that will prevent them from being used

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unintentionally for criminal activities, including money laundering. This should include having in place "know your customer" rules. Where the supervisory authority does not have responsibility for regulating such activities, it should ensure it has in place a process of regular liaison or a memorandum of understanding for working with the responsible authority.

Guiding Principle 15 – Operational risk
Supervisors must be satisfied that credit unions have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should commensurate with the size and complexity of the institution and its activities.

Guiding Principle 16 – Internal audit
The supervisory authority should consider the need for an appropriately qualified, independent and adequately resourced internal audit function. The internal audit function should focus on ensuring that the internal control function operates effectively. Where there is an internal audit function, it should report to an appropriate level within the regulated institution and must have direct access to the board where it considers this necessary. The scope of internal auditing within an organization may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations.

Guiding Principle 17 – Supervisory access
The supervisory authority should have complete and unfettered access to all aspects of regulated institutions and their subsidiaries that it considers necessary and must have the ability to enforce access where this is not provided.

Guiding Principle 18 – Supervisory approach, techniques and resources
The supervisory authority should develop and maintain a thorough understanding of the operations of individual regulated institutions and should deploy an effective and ongoing combination of offsite and onsite supervisory techniques. The supervisory authority should have appropriately qualified and independent staff and be adequately resourced to implement its supervisory approach.

Guiding Principle 19 – Supervisory reporting
The supervisory authority should have the ability to collect, review and analyse financial and/or statistical reports from regulated institutions in whatever form it requires. It should also have the ability to have such reports or forms independently verified where it considers this necessary.

Guiding Principle 20 – Accounting & disclosure
The supervisory authority should satisfy itself that regulated institutions maintain adequate records that have been prepared in accordance with the relevant accounting laws in its jurisdiction.

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Guiding Principle 21 – Corrective and remedial powers of the supervisory authority

The supervisory authority should have at its disposal an adequate range of enforcement tools to facilitate timely corrective action. This should include the ability to issue appropriate legal orders, to revoke licenses, or to recommend revocation. This also includes the ability to impose restrictions on the activities and operations that institutions conduct.

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