Global Regulatory Update

(For Credit Unions and Financial Cooperatives)

World Council of Credit Unions
2020 Edition

Andrew T. Price, Esq.
Vice President of Advocacy
World Council of Credit Unions
European Network of Credit Unions
aprice@woccu.org

Panya Monford, Esq.
Advocacy Counsel
World Council of Credit Unions
European Network of Credit Unions
pmonford@woccu.org

World Council

Introduction

This is the 2020 Edition of the World Council of the Credit Unions Global Regulatory Update. This edition will cover the leading regulatory issues affecting credit unions in 2020. The priorities and conduct of both international standard setting bodies and national-level regulators over the last few years have foreshadowed that the upcoming year will spotlight regulatory efforts surrounding proportionality, increased scrutiny of AML/CFT issues, sustainable finance, privacy and open banking regulations, and others.

The Basel Committee on Banking Supervision has reached an important milestone with the completion of Basel III and the adoption of the Consolidated Basel Framework, and the finalization of the revisions to the market risk framework. The Committee is now turning its attention to focus on other issues, such as monitoring the efforts of the Network for Greening the Financial System, the reform interest rate benchmarks (i.e. LIBOR) and work on policy initiatives related to longer-term measures in response to expected credit loss accounting changes. More importantly for credit unions, the Committee in looking at the role of proportionality in the Basel Framework and considering whether other work is needed at the global level.

The Financial Stability Board's work program includes items such as FinTech, cross-border payment systems, interest rate benchmarks and global Stablecoins. Many of these proposals will likely be delivered to the G20 Saudi Arabian Presidency for consideration. Likewise, the Financial Action Task Force (FATF) is addressing issues such as Digital Identity, Beneficial Ownership for Legal Persons, Stablecoins, and more effective supervision at the national level.

World Council of Credit Unions' Advocacy Department continuously engages with these international standard setting bodies—incurring successes in reducing regulatory burdens for credit unions in many areas, such as prudential regulation, anti-money laundering, taxation and accounting standards. World Council's priority is to improve the regulatory operating environment for credit unions in a safe and sound manner. World Council of Credit Unions is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 85,000 credit unions in 118 countries with USD 2.2 trillion in total assets serving 274 million members.[1]

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[1] World Council of Credit Unions, *2018 Statistical Report* (2019), *available at* http://www.woccu.org/publications/statreport.

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Proportionality

Proportionality will continue to be a major theme for WOCCU with international standard setting bodies and national-level prudential regulators in 2020 and beyond. Many national-level prudential regulators often are either fearful or face pressure from other international bodies, such as the International Monetary Fund, to adopt the “gold-standard” of regulations designed for Global Systemically Important Banks and do not embrace the concept of tailoring rules, regulations and guidelines in a proportional manner appropriate for smaller, less complex financial institutions. Unfortunately, this conservative approach does not lend itself to endorsing a system that promotes institutional diversity and competition in the financial system. This often has the effect of unfairly penalizing institutions such as credit unions and other community-based financial institutions in their efforts to provide fundamental services to rural or underserved areas and communities. The unintended consequence of not providing proportionality and the effects that improperly tailored regulation has on financial exclusion is significant.

Credit unions operate on a not-for-profit, member-owned and controlled cooperative basis, therefore giving individuals of more modest means a greater opportunity at financial inclusivity than larger banks. Credit union members usually live and/or work in the local community where the credit union’s office or offices are located. Many credit unions are very small (often having less than USD 1 million in assets), are partly and at times entirely run by volunteers, and are typically governed by an unpaid board of directors. Some directors and executives are fairly (not lavishly) compensated. The directors and executives are the hallmarks of the cooperative structure that boosts the member benefits.

As financial institutions whose purpose is **not** the maximizing of its profit, credit unions are stable institutions that may experience less growth in profitable economic times but perform better in times of economic stress. This stability and the competitive pressures credit unions provide in a marketplace add to financial sector stability. Credit unions are often far less risky, are run quite conservatively and are often subject to stringent investment portfolio shaping rules which warrant a much lighter touch than regulations designed for large, systemically important and internationally active banks.

What is needed to help implement proportionality is further guidance from international standard setting bodies to national-level regulators directing them when less-complex regulatory approaches are warranted.

What is Proportionality?

In simple terms, proportionality is the simplification of rules for smaller, less complex and less risky financial institutions; or in other terms, the tailoring of rules to reflect the size, risk profile and complexity of the financial institution. In addition to tailoring rules, supervision in the form of fewer exams, lessened reporting and reporting frequency is also an example of proportionality. The concept of proportionality, however, is easier to explain than the actual application of it. **International-**level regulations are generally designed for Global Systemically Important Banks (G-SIBs). **National-**level regulators, however, typically have the flexibility to apply international-level regulations for non-internationally active banks such as credit unions. However, regulators are hesitant to deviate from the global standard and need direction on how to ensure that their proportionally tailored regulator framework will meet the standards of global regulation. This "tailored" approach to regulation should therefore reflect the different nature of credit unions' business models, systemic importance, cross-border activity and, more generally, the risks to which they are exposed.

Examples where proportionality has been implemented include the United States' exception by the NCUA from its Basel III Risk-Based Capital Rule exempting credit unions with less than USD 100 million; the CFPB's exemption for credit unions under USD 10 billion in assets from direct examinations by the CFPB and exemption from debit card interchange price controls; in the EU exemptions from the Basel III Capital Requirements Directive (CRD IV) from application of the EU's Basel III rules.

Key Events in Proportionality

1. Joint BCBS-BCG Statement on Proportionality: Statement issued by the Basel Committee and the Basel Consultative Group supporting the use of proportionality in implementing the Basel Framework.
2. Core Principles For Effective Banking Supervision: Embed the role of proportionality including that "supervisory practices should be commensurate with the risk profile and systemic importance of the banks being supervised."
3. WOCCU Letter to the Basel Committee on Proportionality in Regulation at the Global Level: Letter urging additional guidance on proportionality, including a set of high-level principles or weighing factors on when less complex regulatory approaches are warranted.
4. Basel Committee Survey on Proportionality in Bank Regulation and Supervision: Survey that covers examples of proportionality measures where a jurisdiction did not adopt or implement the full Basel Framework.

What this means for Credit Unions

If national-level regulators understand the importance of proportionality, they should embrace establishing regulations that are safe and sound, but less-expensive and time-consuming for less-complex and less-risky institutions such as credit unions.

The Bottom Line

Prudential regulators and international standard-setting bodies need to avoid "One-Size-Fits-All" regulations that cause smaller, less-complex institutions to comply with rules designed for Global Systemically Important Financial Institutions.

AML/CFT

Anti-money laundering and counter-financing of terrorism (AML/CFT) had a big year thanks to the increased use of digitalization, such as cryptocurrencies and cyber warfare, as well as issues with identification of beneficial owners, digital identity and De-Risking (Correspondent Banking). With cross-border transactions continuing to increase, standard setting bodies such as the Financial Action Task Force (FATF) have focused on Know-Your-Member (Customer) and anti-money laundering requirements, and cross-border interaction between prudential regulators. The European Council adopted conclusions in response to their 2019-2024 strategic agenda with the goal of strengthening terrorism and cross-border crime prevention. Furthermore, the Basel Committee published the "Introduction of Guidelines on Interaction and Cooperation Between Prudential and AML/CFT Supervision," which aims to outline methods to implement mechanisms that will facilitate cooperation between prudential and AML/CFT supervisors. Additionally, the evaluation of compliance vs. effectiveness of AML/CFT policies within the financial sector has become an important issue when considering AML/CFT systems in different countries. A country's technical compliance with FATF regulations does not always predict their effectiveness in actually combating anti-money laundering or terrorist financing. Closing this deficit will likely be an important agenda item for regulators and supervisory bodies in 2020.

AML/CFT requirements are often a large source of regulatory burden and are often disproportionately borne by smaller institutions, such as credit unions, that do not have the economies of scale and resources as their larger bank counterparts. Further, the enforcement and regulatory infrastructure continues to increase the sophistication and complexity of requirements in an effort to combat the movement of illicit funds through the system. This approach often does not strike the necessary balance and proportionality in requirements that should be implemented for credit unions. The focus often becomes an exercise in adherence to policies and procedures, and documentation of compliance instead of focusing efforts on actual risks or risk reductions.

2020 AML/CFT Outlook

De-Risking (Correspondent Banking): The G20 in Osaka statement indicated that they continue to monitor and address the causes and consequences of the withdrawal of correspondent banking relationships (De0Risking). They note that mobilizing sustainable finance and strengthening financial inclusion are important for global growth. In many instances, De-risking has the effect of eliminating access to financial services—often to rural or underserved areas, or in small countries with limited financial markets. Often the cause of the decision not to serve a market is tied to both profit and AML/CFT regulatory burdens. De-risking threatens progress on financial inclusion, can often increase remittance prices and fees, and affects the ability to provide humanitarian assistance to refugees from political conflicts or natural disasters. Additionally, eliminating groups from the established financial system can often frustrate AML/CFT objectives and reduce the ability to fight financial crime. FATF recognizes that financial exclusion is a key risk to financial integrity. Expect efforts to continue to reduce De-Risking. WOCCU often hears from members throughout the world that credit unions have difficulty gaining access to a correspondent bank and either have no access or are forced into a second- or third-tier bank, which is either expensive or too complicated to provide effective services.

Digital Identity: Digital transactions are increasing at an incredible rate with the forecast to reach 726 billion transactions annually. By 2020 an estimated 60% of world GDP will be digitalized. Integrating digital finance and digital identity for effective authentication of customer identity, both for authorizing account access and supporting AML/CFT efforts, is an enormous challenge. Ensuring that systems provide the appropriate level of reliability and independence in light of the money laundering, terrorist financing, fraud and other illicit activities, is the focus of regulatory oversight. Expect guidance from FATF on assessing whether Digital ID systems are reliable and independent in line with a risk-based approach to customer due diligence. For credit unions, the opportunity that technology can assist in this area and ease regulatory burden is promising. However, the costs and potential regulatory requirements can likewise displace credit unions from the market.

Beneficial Ownership of Legal Entities: The use of legal entities (corporations, trusts, partnerships, foundations, etc.), while providing essential and legitimate economic roles, are also a misused vehicle for illicit purposes, such as money laundering, bribery, fraud and other activities. Legal entities can often to be used to hide the identity of the true owner or the person or persons controlling either assets or money. Providing timely and accurate legal and beneficial ownership information can not only assist law enforcement and other authorities, but also assist financial institutions such as credit unions with their AML/CFT responsibilities.

The FATF recommendations and guidelines on beneficial ownership have placed tremendous pressure on national-level regulators to make information public to support compliance efforts and meet their Member/Customer Due Diligence requirements. Further, the pressure that regulators are under to meet FATF recommendations often filter down to a morass of compliance burdens for credit unions. Until such time as national-level regulators implement reliable and trustworthy public information systems that can be used to meet these requirements, credit unions and other financial institutions will be expected to implement internal processes and procedures, and navigate time-consuming efforts to identify beneficial owners.

Cryptocurrency: Regulators are still struggling to provide a regulatory framework for cryptocurrencies. There has historically been a concern with their use to launder money and engage in other illegal activity. Theft and fraud continue to be an ongoing issue for users of cryptocurrencies. Where credit unions typically see losses in connection with cryptocurrencies are when members use credit cards or lines of credit to purchase cryptocurrencies. Some exchanges or services even allow purchases directly from a bank account. With the volatility in price and the increase in fraud and theft, the losses can fall back on the credit union. The ability to hide ownership of the cryptocurrencies also makes their use difficult to meet AML/CFT expectations. Expect to see further development and guidance evolving in numerous areas

Key Documents

1. FATF Guidance on Correspondent Banking Services: Contains guidance on the roles of institutions in correspondent banking relationships.
2. FATF Draft Guidance on Digital Identity: Contains guidance on digital finance and digital ID, with guidance for government and regulated entities on how to apply a risk-based approach to using digital ID systems.
3. FATF Best Practices on Beneficial Ownership for Legal Persons: Identifies key features of an effective system for identifying beneficial ownership for legal persons.
4. FATF Guidance for a Risk-Based Approach, Virtual Assets and Virtual Asset Service Providers: Outlines need for countries and virtual asset service providers to understand money laundering and terrorist-financing risks, and guidance on appropriate mitigating measures to address them.

The Bottom Line

International standards continue to have a tremendous role in shaping national-level AML/CFT requirements. Regulators need to ensure that new requirements are proportionately tailored, risk-based, and do not disproportionately burden smaller institutions such as credit unions that do not have the economies of scale and resources as their larger bank counterparts.

Privacy and Open Banking

Innovation and advancement in technology has catalyzed cybersecurity and solutions to ensure privacy protections, such as data breaches, identity theft and cyberattacks. Privacy laws have historically existed under their own legal bubble, but with increased cyberwarfare--privacy and cybersecurity have become intertwined and, predictably, will become involved in a marriage of regulatory reforms and guidelines. What this means for credit unions is that they are left to navigate a complicated, intertwined and, often, inconsistent set of regulations. What we are seeing from a global perspective is a shift from privacy being a traditional regulatory requirement to regulations that give the consumer significant rights. This leaves the financial institution in a position of having to tailor their operations in a manner to accommodate those rights—often in ways that cannot be anticipated, or that create a significant expense or investment to meet the standards.

The European Union General Data Protection Regulation (GDPR) adopted in April 2016 and effective in May 2018 led the way for this shift. This has been followed by the California Consumer Privacy Act (CCPA), which—in many respects—mirrors the GDPR. Many other U.S. States also have proposals in their respective legislatures. Canada updated its Personal Information Protection and Electronic Documents Act (PIPEDA) in 2018 to bring its privacy framework in line with the rest of the world. Singapore adopted the Personal Data Protection Act (PDPA) and Australia adopted its Customer Data Right (CDR), moving towards an open banking framework for its citizens. All of these frameworks are so intertwined with developments in FinTech, cryptocurrencies and payments systems that the complexity of compliance will likely become enormous.

Privacy will continue to be of immense concern for policymakers, and World Council will continue to urge regulators to consider credit unions and financial cooperatives when shaping and implementing regulations. Burdensome regulation will disproportionately encumber smaller financial institutions and could become a barrier to providing financial services. The amount of resources and capital necessary to keep up with regulation can be difficult, if not impossible to manage. World Council will continue to evaluate formidable solutions, and advocate for proportionate application of privacy and cybersecurity laws.

Key Documents

1. WOCCU EU Data Protection Reform/EU-US Privacy Shield Compliance Guide: Contains guidance for compliance with the EU GDPR (Login required).
2. International Organization for Standardization (ISO): ISO standard for privacy information management (ISO/IEC 27701.

The Bottom Line

> While privacy frameworks should provide proper protection for consumer/member personal data, they should not be overly complex, costly or burdensome to prevent smaller financial institutions such as credit unions from participating in the market.

Sustainable Finance

Sustainable finance is an emerging area of regulation in the financial sector, and generally refers to any form of financial service that integrates environmental, social and governance criteria into business and investment decisions. Many policies or regulations adopted are designed to address the United Nations' Sustainable Development goals and are designed to combat climate change. In the financial sector, these global concerns and events will undoubtedly play a role in the emerging policies surrounding sustainable finance.

The EU is considering an action plan for early 2020. The Basel Committee on Banking Supervision (Basel Committee) is closely monitoring the work of the Network for Greening the Financial System and the role that climate-related events play when it comes to financial risk. What this means for credit unions is that we are likely to see evolving policy changes that affect:

- a framework for green mortgages.
- legislation on reporting.
- labels for retail products and related investment products.;
- prudential standards that may affect underwriting and other operational matters; and
- incorporation of climate-related items into stress testing for investments and others.

The outlook for sustainable finance will likely involve mandates requiring regulators to consider sustainability and climate change as a part of all relevant regulations in the future. Voicing the needs of our member credit unions will be vital as these changes occur to make sure the credit union cooperative model is fully considered when making these policy changes.

Key Documents

1. United Nations Sustainable Development Goals: Contains the United Nations' blueprint to achieve a better and more sustainable future for all.
2. Network for Greening the Financial System: Website for the organization originally started by eight central banks to help strengthen the global response to meet the goals of the Paris agreement.

The Bottom Line

Regulators need to consider the unique needs of the credit union cooperative model when implementing policies to address societal and environmental concerns. More importantly, changes should not be imposed that undermine the safe and sound operation of financial institutions.