World Council

May 2, 2014

Sent via email
Chairman Vitas Vasiliauskas
Bank of Lithuania
Totoriu str. 4, LT 01121
Vilnius, Lithuania
KUreguliavimas@lb.lt

Re: *Strengthening of the Credit Union Sector* – Discussion Paper

Dear Chairman Vasiliauskas:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Bank of Lithuania's discussion paper on *Strengthening of the Credit Union Sector*.[1] World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are nearly 56,000 cooperatively owned credit unions in 101 countries that serve 200 million natural person members and have more than €1.2 trillion in total assets.[2] In the European Union (EU), there are over 1,000 credit unions in 7 Member States that serve more than 7 million natural person members and have approximately €18.5 billion in total assets.[3]

We hope that you will find our comments useful as you consider how best to ensure a safe and sound Lithuanian credit union system.

Please also find attached with this comment letter a copy of World Council's August 2012 paper *Credit Union Shares as Regulatory Capital Under Basel III*[4] which sets forth World Council's current position on when credit union shares should be considered regulatory capital. We endorse the EU's approach to this issue in the context of cooperative banks' and mutuals' "Common Equity Tier 1" shares under Capital Requirements Regulation (CRR) Article 27 ("Capital instruments of mutuals, cooperative societies, savings institutions or similar institutions in Common Equity Tier 1 items") and Article 29 ("Capital instruments issued by mutuals, cooperative societies, savings institutions and similar institutions").[5]

We believe that the Basel III/CRR approach is appropriate for determining what types of credit union shares and other instruments, such as subordinated debt, should qualify as regulatory capital under national credit union rulebooks. Even though European credit unions are not subject to Basel III or the CRR/CRD IV package—nor should they be since credit unions having a high leverage ratio of at least 5% to be "adequately capitalized" combined with credit unions' limited investment powers make risk-based capital unnecessary—the CRR's approach to cooperative capital instruments is highly informative with respect to what types of

[1] Bank of Lithuania, *Strengthening of the Credit Union Sector* – Discussion Paper (Mar. 2014), *available at* https://www.lb.lt/strengthening_of_the_credit_union_sector_discussion_paper.
[2] World Council of Credit Unions, *Statistical Report 2012* (2013), *available at* http://www.woccu.org/documents/2012_Statistical_Report.
[3] European Network of Credit Unions, "Credit Unions in Europe"; http://www.creditunionnetwork.eu/cus_in_europe.
[4] World Council of Credit Unions, *Credit Union Shares as Regulatory Capital Under Basel III* (Aug. 2012), *available at* http://www.woccu.org/documents/WOCCU_Credit_Union_Shares_as_Capital.
[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, arts. 27-29, 2013 O.J. (L 176) 1, 37-40, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575.

credit union shares or bonds are sufficiently permanent and loss absorbing so that treating them as capital in the numerator of a leverage ratio is safe and sound.

Under the CRR's approach to cooperative capital shares, non-withdrawable cooperative shares that are accounted for as equity, have a high degree of permanence, and are able to absorb losses on a going-concern basis qualify as "Common Equity Tier 1" regulatory capital even if the shares can be redeemed for cash under limited circumstances. Other, less permanent cooperative shares and similar instruments can also qualify as "Additional Tier 1" or "Tier 2" regulatory capital, depending on their terms and conditions, under CRR Articles 51-71. We believe that treating credit union shares meeting the CRR's definitions of Common Equity Tier 1, Additional Tier 1, and Tier 2 capital as regulatory capital is safe and sound and helps protect the interests of the credit unions' savers as well as the national savings guarantee scheme.

Please find below World Council's detailed comments to in response to the discussion paper's questions.

Question 1: Why is it important for Lithuania to have credit institutions operating on cooperative grounds? What is their role within the Lithuanian financial system, what is exceptional about it?

We believe that cooperative financial institutions play an important financial inclusion role in the EU because credit unions exist to serve their members/customers on a not-for-profit basis[6] and to promote thrift, rather than to maximize profits at the customers' expense as does a joint-stock commercial bank. Credit unions seek to increase underserved individuals' income and assets by giving them access to credit union financial services. The continued existence and operation of a successful and viable credit union movement is vital for the ordinary people of Lithuania and other EU Member States.

Although credit unions do need to earn net income in order to add to reserves and be sustainable, the fact that credit unions focus on service to members makes them more likely to serve people of modest means and other unbanked persons. This is especially true in low-income and rural areas that are often underserved by commercial banks because operating branch offices in these areas is less profitable, as the discussion paper notes. Roughly one-third of Lithuania's population lives outside of urban areas and many people in urban areas of Lithuania benefit from credit union membership as well. There are at least 135,000 credit union members in Lithuania (out of a 3 million person population) which is roughly 5.5% of the economically active population between ages 15 and 64.[7]

Credit unions also perform this important financial inclusion role throughout the EU, as the European Commission recognized in its 2007 *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - A European initiative for the development of micro-credit in support of growth and employment*.[8]

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[6] The *Oxford English Dictionary* defines "not-for-profit" as follows: "Designating an organization, corporation, etc., which does not operate for the purpose of making a profit. *Cf.* NON-PROFIT *adj.*, FOR-PROFIT *adj.*." This term originated in the cooperative movement and means that the primary purpose of a cooperative's existence is to serve its members, not to maximize profits at their expense as would a "for profit" enterprise, even though having a net operating surplus is of course necessary to ensure the cooperative's sustainability. "Not-for-profit" was used to describe a cooperative in its first recorded example, a 1913 article in the *Annals of the American Academy of Political & Social Science*, as follows: "The cost to the farmer may often be no more than where a coöperative, 'not-for-profit' association with less equipment undertakes to supply a service at actual cost." In the credit union movement, it is often said that credit unions are "not for profit, not for charity, but for service."

[7] *See* World Council of Credit Unions, *Statistical Report 2012* (2013), *available at* http://www.woccu.org/documents/2012_Statistical_Report.

[8] European Commission, *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - A European initiative for the development of micro-credit in support of growth and employment* at 4-26 (Nov. 13, 2013), *available at* http://eur-lex.europa.eu/search.html?type=expert&qid=1398968249491.

In the Republic of Ireland, for example, there are now only four retail banks operating with a branch network, and these four banks are actively reducing the number of branches they operate. The only other financial institutions offering personal savings and loans to consumers are the credit unions, and in many rural areas credit unions are the only remaining financial institutions with local branch offices. Credit unions similarly play a similar financial inclusion role in Poland, especially in low-income and rural areas. Roughly 97% of loans made by Polish credit unions meet the EU's definition of microloans (i.e. loans less than the equivalent of €25,000)[9] and 90% of Polish credit unions' loans are less than PLN 30,000 in value.

In Great Britain, the British government initiated the £38 million "Credit Union Expansion Project" in 2013 to modernize and grow the credit union industry in order to help more people on low incomes who are unbanked. This project is ongoing. According to British Welfare Reform Minister Lord David Freud: "Credit unions offer an alternative to vulnerable people who have few safe options to get cash when they need it most. They are the antidote to predatory loan sharks or high-interest lenders."[10]

Question 2: Do you support the proposal that credit unions should immediately strengthen their capital by accumulating the major part of institutional capital from earnings retained from operations?

World Council supports inclusion of shares within credit unions' regulatory capital so long as those shares meet standards for "Common Equity Tier 1" similar to those established by the CRR for other types of cooperative or mutual financial institutions in CRR Article 27 and Article 29, or qualify as Additional Tier 1 or Tier 2 capital under CRR Articles 51-71. The Additional Tier 1 and Tier 2 categories can include withdrawable instruments under some circumstances.

As noted above, our attached August 2012 paper *Credit Union Shares as Regulatory Capital Under Basel III*[11] sets forth the details of our position on this issue. The statements concerning World Council's views on shares on pages 5-6 of the Discussion Paper are therefore not accurate; we view retained earnings as a very important and the most desirable form of credit unions capital, but membership and other capital shares also play a very important role in credit unions' institutional capital—if they have appropriate terms and conditions—and provide additional protection for the interests of savers and the national savings guarantee scheme.

As outlined in our 2012 paper, in order for credit union shares to qualify as Basel III "Common Equity Tier 1" regulatory capital, the shares should be perpetual, non-withdrawable, accounted for as equity, available to absorb losses that exceed retained earnings on a going-concern basis (such as by writing down the value of all shares in that class *pari passu* in order to absorb the loss), and be redeemable only under limited circumstances (such as out of the proceeds of newly issued shares), as set forth in the CRR. Article 29 of the CRR says that the terms of redemption for cooperative Common Equity Tier 1 shares should be as follows:

> The following conditions shall be met as regards redemption of the capital instruments:
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> > (a) except where prohibited under applicable national law, the institution shall be able to refuse the redemption of the instruments;

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[9] *Id.* at 2.

[10] Department for Work and Pensions, Press Release: "Credit union £38 million expansion deal signed" (Apr. 16, 2013); https://www.gov.uk/government/news/credit-union-38-million-expansion-deal-signed.

[11] World Council of Credit Unions, *Credit Union Shares as Regulatory Capital Under Basel III* (Aug. 2012), *available at* http://www.woccu.org/documents/WOCCU_Credit_Union_Shares_as_Capital.

(b) where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption;

(c) refusal to redeem the instruments, or the limitation of the redemption of the instruments where applicable, may not constitute an event of default of the institution.

Shares that do not meet the requirements of "Common Equity Tier 1" capital, however, can and should qualify as either "Additional Tier 1" or "Tier 2" capital if they have the appropriate terms and conditions. This can include withdrawable shares, for example, if their terms and conditions are equivalent to the requirements of CRR Articles 51-61 in the case of Additional Tier 1 shares, or CRR Articles 62-71 in the case of Tier 2 shares.

Regarding the concept of shares that are "withdrawable" versus shares which are "non-withdrawable" but "redeemable," the prohibition on withdrawablility in the Common Equity Tier 1 share context is primarily because a "withdrawable" obligation is by definition a form of debt/liability, and not "equity." Common Equity Tier 1 instruments must be accounted for as equity, and therefore cannot be withdrawable even if the conditions under which it can be withdrawn are very limited, such as if the member leaves the credit union.

In contrast, an obligation which is not withdrawable but can be "redeemed" for cash under limited circumstances is typically equity under the IFRIC Interpretation No. 2 international accounting standard and therefore eligible to qualify as Common Equity Tier 1 if the CRR's other requirements for cooperative shares are met. Most significantly, a share "redemption" can be for less than the par value at which the credit union issued the share without a default event occurring, such as if the shares in that class have been written down to absorb a loss.

Specifically, IFRIC Interpretation No. 2, items 5-9, concluded that redeemable cooperative shares can qualify as equity as follows:[12]

> 5. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulation and the entity's governing charter in effect at the date of the classification, but not expected future amendments to those laws, regulations or charter.
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> 6. Members' shares that would be classified as equity if the members did not have a right of redemption are equity if either of the conditions described in paragraphs 7 or 8 are present. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.
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> 7. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.
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> 8. Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.

[12] International Financial Reporting Interpretations Committee, *Members' Shares in Co-operative Entities and Similar Instruments*, IFRIC Interpretation 2, at 2-3 (Nov. 2004).

9. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.

We believe that there are at least two possible approaches to this redemption issue for credit union and other cooperative "Common Equity Tier 1" shares: The "Get-in-the-Queue Model" and the "Quebec Model":

- **Get-in-the-Queue Model:** In the Get-in-the-Queue model, a Common Equity Tier 1 share can be redeemable if: (a) the credit union has the right to refuse the redemption; and (b) the redemption can only be made out of the proceeds of newly issued shares, so that the institution's capital level does not decrease as a result of the redemption.

- **Quebec Model:** The Quebec model is a variation on the Get-in-the Queue model that the Financial Markets Authority of Quebec has implemented for credit unions in Quebec, Canada. It is the same as the Get-in-the-Queue model except that the credit union may maintain a liquidity pool funded by the proceeds of newly issued shares that have not yet been counted towards the credit union's capital ratio. As outstanding shares are redeemed, they are immediately replaced by the "new" shares from this liquidity pool. If the pool is exhausted, this model then becomes the Get-in-the-Queue model.

As noted above, however, shares with less stringent redemption standards can qualify as Additional Tier 1 or Tier 2 capital. Having additional capital in the Additional Tier 1 or Tier 2 buckets protects the institution's savers as well as the savings guarantee scheme, and therefore public policy should support including these items in the numerator of a credit union's capital.

If the member can only redeem the shares if he or she quits the credit union and only then if the credit union remains well capitalized after the redemption, there is a strong argument that these shares meet the definition of Additional Tier 1 and should be included in numerator of the credit union's leverage ratio. Similarly, Tier 2 items should be includable in the leverage ratio numerator up to at least 50% of total capital.

<u>Question 3: Do you support the concept of deposits with variable interest rates?</u>

Traditionally, the dividends (i.e. interest) paid on credit union shares is variable, however, credit unions need to be able to pay pre-determined interest rates on deposits in order to be able to attract sufficient funding. Great Britain amended its credit union law in 2011 to allow payment of pre-determined rates of interest on deposits[13] because reliance on shares with variable dividend rates did not attract sufficient funding for the credit unions' loan books and had contributed to the credit unions not being able to accumulate high levels of retained earnings in many cases.

Rather than establish variable rates on deposits, we would recommend retaining fixed-interest rates on deposits while exploring the possibility of new classes of shares or bonds issued by the credit unions that would have a variable dividend based on the credit union's financial performance.

[13] The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 § 19 (Nov. 8, 2011) ("Interest-bearing shares"), *available at* http://www.legislation.gov.uk/uksi/2011/2687/made.

Question 4: Do you see any other alternatives on how credit unions could accumulate sufficient institutional capital buffers for the coverage of potential losses?

As suggested above, adding additional shares and or new classes of shares and other instruments that qualify as Common Equity Tier 1, Additional Tier 1, or Tier 2 capital would provide additional institutional capital buffers to cover potential losses and protect the national savings guarantee scheme as well as the interests of uninsured depositors and shareholders.

Members holding these forms of capital shares, as well as any non-member subordinated debt holders, would also be more likely to help impose financial discipline on the credit union's management because of their personal risk of loss in these investments. Of course, the member-shareholder or subordinated debt investor would need to receive a clear disclosure of this risk when they make this investment. (Disclosures of this type are most effective when the disclosure is printed on a single piece of colored paper, such as purple paper, and uses clear language.)

Another approach to increasing credit union capital levels would be placing undercapitalized credit unions on a "Capital Accumulation Plan" (CAP), which is also called a "Net Worth Restoration Plan" (NWRP), as part of a "Prompt Corrective Action" regime.[14] The Bank could establish this regime as either a generally applicable regulation, or on a case-by-case basis with individual credit unions based on the credit union agreeing to a supervisory contract like a "Letter of Understanding and Agreement" (LUA).[15]

In the CAP/NWRP approach, a credit union that needs to increase its capital ratio typically must increase the value of its capital on a quarterly basis by an amount equivalent to at least 1/10th of a percent (0.1%) of its total assets. Usually this is achieved by a quarterly transfer of that amount (or more by choice) from undivided earnings to its regular reserve account until it meets its capital target.[16] Adding shares meeting the applicable definition of regulatory capital would be another way to increase the credit union's capital ratio. The credit union is typically restricted from increasing its asset size until it is at least "adequately capitalized," and is usually subject to other restrictions based on its level of undercapitalization such as restricting dividend payments on shares.[17]

In addition to increasing earnings retention, the undercapitalized credit union is also required to file a CAP/NWRP with its regulator setting a quarterly timetable of steps the credit union will take to increase its capital ratio so that it becomes at least "adequately capitalized" by the end of the term of the CAP/NWRP, and remains so for at least four (4) consecutive calendar quarters thereafter.[18]

The CAP/NWRP must be approved by the regulator, and must include: (a) the projected amount of earnings to be transferred to the regular reserve account in each quarter of the term of the CAP/NWRP; as

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[14] *See, e.g.*, Title 12 of the Code of Federal Regulations (12 C.F.R.) §§ 702.201-702.206 (setting forth the rules for NWRPs and related "Prompt Corrective Action" supervisory actions of the US National Credit Union Administration (NCUA)), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.3.2&rgn=div6

[15] *See* National Credit Union Administration, "Letters of Understanding And Agreement"; http://www.ncua.gov/Legal/Pages/LUA.aspx.

[16] *See* 12 C.F.R. § 702.201 ("Prompt corrective action for 'adequately capitalized' credit unions."), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.3.2.1.1&rgn=div8.

[17] *See* 12 C.F.R. §§ 702.202-702.204 (setting forth NCUA's mandatory and discretionary supervisory actions for credit unions that are "undercapitalized," "significantly undercapitalized," and "critically undercapitalized"), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.3.2&rgn=div6

[18] *See* 12 C.F.R. § 702.206 ("Net worth restoration plans."), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.3.2.1.6&rgn=div8.

well as (b) the types and levels of business activities in which the credit union will engage in during the CAP/NWRP (which are typically more limited than the full range of business activities allowed in the credit union's rulebook); (c) the steps the credit union will take to correct any unsafe or unsound practices or conditions identified by the regulator; and (d) any other requirements that the regulator believes are necessary to maintain the credit union's safety and soundness such as improving the quality of the credit union's management.[19]

Questions 5 & 6:

Do you support the proposal to introduce a regulatory ratio of deposits with variable interest rates to other liabilities, so as to increase the flexibility of interest expenses incurred by credit unions and to create incentives for credit union members to participate in the credit union's management process?

Are there any other efficient alternatives that you would offer to minimise the burden of fixed deposit interest rates on the credit unions' profitability and to incentivise the involvement of members in a credit union's management process?

As noted above in response to Question 4, we believe that—if this approach is adopted—classes of shares with variable dividend rates would be more likely to achieve incentives for credit union members to participate in the credit union's management process than would variable interest rate deposits. Variable-rate deposits could result in the credit unions facing difficult liquidity management issues since they would be unable to offer market rates on deposits.

Calling these variable-rate instruments shares or bonds, however, would fit better with the credit union model and not present the same problems with liquidity management since the shares or bonds would be more permanent than an ordinary term deposit. Also, shares and bonds would not likely be compared by members with deposit products offered by banks if the terms "share" and "bond" are used.

Question 7: Do you support the proposal for credit unions to integrate into cooperative banks?

We do not support the proposal to convert Lithuanian credit unions into cooperative banks because the same "highly federated cooperative" model is frequently used by credit unions with great success. For example, the Desjardins Group[20] in Quebec, Canada, and the SICREDI[21] credit union federation in Brazil are very successful examples of credit unions operating in the highly federated model that is also used by some cooperative banks like Rabobank.

In addition, credit unions integrating into cooperative banks would make the system subject to the full CRD IV package—since as banks they would no longer qualify for the Article 2(5) CRD IV exemption that applies to Lithuanian credit unions[22]—and CRD IV compliance would likely increase substantially the credit

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[19] *See id.*
[20] http://www.desjardins.com/ca/
[21] http://www.sicredi.com.br/
[22] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance, art. 2(5)(14), 2013 O.J. (L176) 338, 350 ("in Lithuania, the 'kredito unijos' other than the 'Centrinė kredito unija'"), *available at* http://eur-lex.europa.eu/legal-content/EN/ALL/;jsessionid=2XdLTj6ThSPGnzYB3CvFGVQ2R1T5J2HS5G9Z8GNP8vSQMgSGT7tQ!-269749841?uri=CELEX:32013L0036.

unions' regulatory burdens and compliance costs. These new compliance costs would likely decrease the credit unions' net income and frustrate the efforts to increase their retained earnings.

Credit unions also can thrive using a model that is similar to the "highly federated" model but not as tightly integrated. For example, the British "Credit Union Expansion Project" involves creating a shared back office system for British credit unions through a service company established by the Association of British Credit Unions Ltd. (ABCUL) called Cornerstone Mutual Services.[23] This service company arrangement allows the credit unions to offer more complex financial services products to members—such as current accounts—by pooling the credit unions' resources to achieve favorable economies of scale. Credit unions in the U.S. state of Maine that are member of a central credit union called Tricorp Federal Credit Union[24] employ a similar, collaborative shared services model.

One advantage that the British and Maine collaborative model is that the credit unions remain independent entities and this system does not create a "single point of failure" like the highly federated model. In the highly federated model, the central credit union becomes the "single point of failure" because, if the central fails, it will cause a domino effect where its losses cascade down to retail-level credit unions. In this scenario the credit union system typically collapses in general because the retail-level credit unions are not organized to operate without the central, even if some do have sufficient capital to absorb the losses. For this reason the centrals of most highly-federated systems are run very conservatively and attempt to have minimal exposure to potential investment losses by focusing their business activities on payments, settlement, and liquidity.

Question 8: Do you support the proposed cross-guarantee principle within a cooperative bank, which ensures unlimited mutual financial obligations of its members' (credit unions) debts?

Adopting cross-guarantees for a system of financial institutions that are already in operation, as is the case with Lithuanian credit unions, creates a major risk of contagion whereby the losses of the weaker institutions in the system can spread to stronger institutions through the cross-guarantee mechanism.

It would be a mistake to establish such a system of cross-guarantees without first resolving institutions with weak balance sheets or low levels of institutions capital in order to limit significantly the contagion risk.

Question 9 &10:

What alternatives could you suggest for ensuring the effective management, stronger mutual assistance and more effective risk sharing of credit unions that do not integrate into cooperative banks?

By what means could the corporate governance and internal control function of credit unions be strengthened?

Credit Union Corporate Governance

The most important and effective mechanisms for improving the corporate governance and internal controls of credit unions are: (1) ensuring that credit union board members and managers are well trained and understand how to operate a credit union safely and soundly; and (2) ensuring, through external examination, that the credit union has in place effective operational policies and follows these procedures. Additional

[23] *E.g.,* ABCUL, "Credit union shared business model project gathers pace" (Jul. 30, 2012); http://www.abcul.org/media-and-research/news/view/263.
[24] http://www.tricorp.org/

training for credit union directors and managers as well as establishment of model policies, as well as standards for measuring compliance with those procedures using on-site examinations, would be the most effective approach.

The "one-member-one-vote" structure is a feature of all primary cooperatives (i.e. those serving natural person members) under the International Cooperative Alliance's *7 Cooperative Principles* adopted in 1995,[25] and is not responsible for the credit unions' governance problems. Rather, the members should have the role of voting for the board of directors of the credit union, and the board should have management control like in other types of financial institutions.

The influence of one-member-one-vote is therefore generally limited to selecting the board of directors—all candidates for which should be fit and proper persons who are knowledgeable in financial matters—as well as important decisions concerning the credit union's form of organization (such as whether the credit union should convert to a bank charter).

As suggested above, the credit unions' boards should be composed of fit and proper people who are knowledgeable enough about financial matters be able to safely and soundly operate a credit union, and should receive additional training as necessary. In the United States of America, for example, the fit and proper standards for credit union directors, their level of required knowledge, and, if necessary, remedial training they must undergo are set forth in a National Credit Union Administration regulation and other guidance from the agency.[26] This regulation also establishes the directors' fiduciary duty to run the credit union in a prudent and safe manner as a well-defined and enforceable legal standard.[27]

External monitoring and grading of the ability of the credit union's management by the Bank would also be a way to ensure that weaknesses in the credit union's management abilities are identified at an early stage, before problems appear.

When a weakness is identified as part of an examination, the regulator could require the credit union's management to take remedial measures to fix these weaknesses using supervisory contracts, such as a "Letter of Understanding and Agreement" between the regulator and the credit union. In this approach the credit union agrees pursuant to the supervisory contract to take measures to fix the weaknesses, and the regulator can hold it accountable if it does not fix the problems as agreed.

Common Bonds

Much is made in this proposal of the supposed benefits of a narrow common bond, and implies that geographic common bonds are responsible for credit unions' problems in Lithuania. We do not agree that narrow common bonds provide additional corporate governance discipline, and limiting credit unions common bonds in Lithuania is unlikely to produce the positive results that the Discussion Paper forecasts. Credit unions in countries like Canada and Australia operate very well with very permissive common bonds,

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[25] *See* International Cooperative Alliance, *Cooperative Identities, Values & Principles*; http://ica.coop/en/whats-co-op/co-operative-identity-values-principles ("In primary co-operatives members have equal voting rights (one member, one vote) and co-operatives at other levels are also organised in a democratic manner.").

[26] 12 C.F.R. § 701.4 ("General authorities and duties of Federal credit union directors"), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.2.0.1.4&rgn=div8 ; National Credit Union Administration, "Duties of Federal Credit Union Boards of Directors," Letter to Federal Credit Unions 2011-02 (Feb. 2011), *available at* http://www.ncua.gov/Resources/Pages/LFCU2011-02.aspx.

[27] 12 C.F.R. § 701.4 ("General authorities and duties of Federal credit union directors"), *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=6691ee85b9fb4a55591fa3d83dea1e12&node=12:7.0.2.3.2.0.1.4&rgn=div8.

and the common bond's original purpose as a form of credit enhancement no longer works as intended in the EU because of consumer protection legislation.

In the old days, credit unions in many countries would post a list of the members who were delinquent on their loans in the credit union's branch office, and the other members would bother those members until the delinquent members became current on their loans. The narrow common bond worked in this old time scenario because, if all of the other members knew the member who did not pay (such as because they worked at the same factory or lived in the same small village), the delinquent member would be bothered frequently about his or her delinquency and would have a substantial incentive to repay his or her credit union loans even if he or she did not pay back other lenders (in order to be left alone).

This practice is now illegal in the EU and many other jurisdictions because consumer financial protection laws prevent credit unions from disclosing the names of delinquent borrowers publicly in this fashion. The narrow or limited common bond is therefore obsolete in the sense that it can no longer perform its intended purpose.

In the modern era, the most vocal proponents of the narrow common bonds are commercial banks and their associations, especially the American Bankers Association in the United States of America. These commercial banks argue in favor of the narrow common bond for credit unions in order to limit credit unions' ability to compete with them.

In contrast, the common bonds in the second and third largest credit union systems in the world, Canada and Australia, are typically permissive. Most Canadian credit unions have a common bond of "all persons who live or work in the chartering province," and many of these provinces are larger than Lithuania. Similarly, Australian credit unions for the most part are no longer limited by common bond restrictions.

Narrow common bonds also create risk for the credit union, since a narrow common bond will hinder the credit union's efforts to attract new members as older members grow old and retire. Younger members are the ones that usually want to borrow (since older members are usually net savers) so we typically recommend more expansive common bonds, especially geographic ones, so that the credit unions can continue to attract new, younger members and remain sustainable institutions that have adequate loan demand.

Thank you for the opportunity to comment on the Bank of Lithuania's discussion paper on *Strengthening of the Credit Union Sector*. If you have questions about our comments, please do not hesitate to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and Chief Counsel
World Council of Credit Unions