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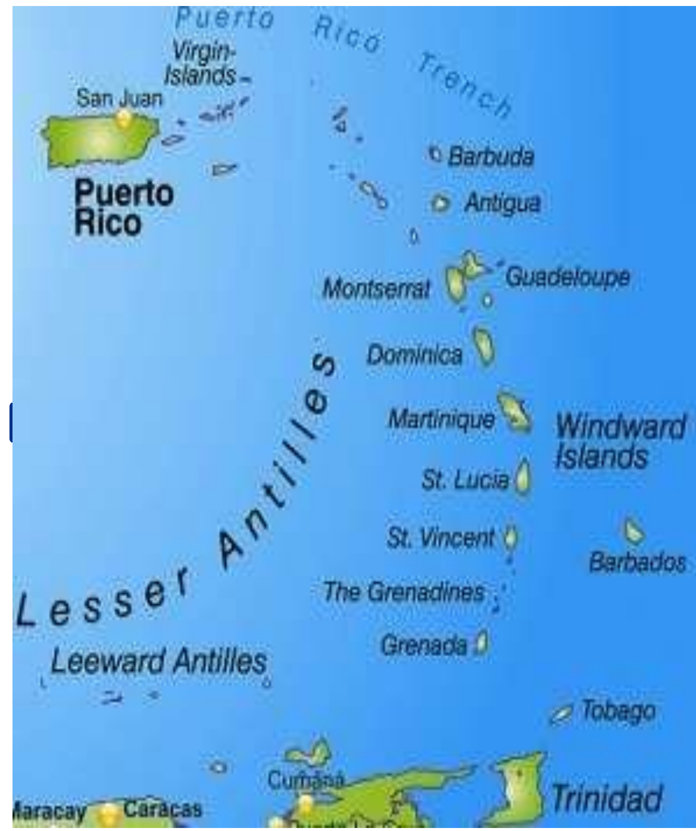
14th OECS Credit Union Summit

De-risking Practices
Implications for Credit Uni
and Solution



September 15, 2016

Introduction

PESTLE Analysis

Before we commence our discussion on de-risking and its impact on credit unions, it is very important that I begin by a brief scan of the OECS Credit Union sector in the sub-region by performing a PESTEL analysis; this will set the context for the presentation and provide useful insights on the existing operating environment for credit unions in the Organisation of Eastern Caribbean States (OECS).

Political

The credit union sector in the OECS is supported by a stable political environment. The OECS countries have democratically elected governments, who are elected every five (5) years. The credit union sector has benefited from good political support, respect, and recognition from governments in the sub-region over the years.

Introduction

Economical

Most of the OECS economies experience significant decline over the last decade due mainly to loss of income resulting from reduced banana export, reduction in income from tourism caused by the 2001 (9/11) terrorist act on the USA and further by challenges resulting from the global financial crisis in 2008 and the global recession. Most of the islands recorded negative economic growth after 2008. During the last three (3) years, economic growth has been very slow, with most countries recording less than 3% growth. Some countries also incurred significant national debt during the period of recession in an effort to meet shortfall in government revenue collections and finance capital projects. There are also some challenges with high levels of unemployment and misalignment of the educational system and the technical skills required to drive productivity and economic growth to the next level.

Introduction

Social

The standard of living in the OECS has been adversely affected by the slow economic growth in recent years. However, the region has made significant strides in poverty reduction and improving the standard of living of middle and lower income earners. The credit union has been a driving force in improving the standard of living of persons in the OECS. While the global economic are currently growing at 3% annually average economic growth in the OECS was 1.6% in 2013 and 2.7% in 2014 and 2015. Growth in the global economy is projected at 3.5% and the OECS average growth is projected at 3% annually in the medium term.

Technology

The sub-region has seen significant improvements in the access and use of modern technology. There is an excellent telecommunication systems and widespread use of cell phones, computers and the internet. The telephone system is comparable to that of the USA, Canada and other more developed countries. Modern banking facilities are widely used in the OECS, including ATM online banking, debit and credit cards. Mobile phones are used to settle bills and transfer of funds in some countries.

Legal

There are enabling legal framework for the sector with the harmonized Co-operative Act passed in the OECS states in 2011 and 2012. The legislation and final legal framework for regulation is still work-in-progress and should be treated as top priority in the short to medium term.

Co-operatives in the region currently operates under laws and regulations that have been modernized to ensure that the legal framework of the sectors; facilitate growth, development and expansion of the sector.

Co-operatives continues to improve their systems, processes and governance structures.

Environment

The sector continues to promote practices, policies and activities that supports the effort to preserve the environment.

De-risking Practices, Implications and Solutions

De-risking is a fairly recent issue that has been affecting the financial services sector globally and regionally. The term of de-risking emerged from the aftermath of the credit crisis issues that surfaced during the global financial crisis and recession that negatively impacted on many large banks and financial institutions that were deemed to be too large to fail. The pressures that resulted from regulators, politicians and the press in response to the global financial crisis forced financial institutions to revisit their risks and formulate force exit strategy on certain customers and business components that posed a level of risk to their business which could not be managed..

What is de-risking and why do we need to respond to this phenomena?

There are several definitions for de-risking.

These definitions can be summarized by stating that de-risking is a strategy adopted by Banks and other financial institutions to terminate or restrict business relationship with customers that are perceived to pose regulatory risk to the institution such as:

- Money Laundering
- **Illicit Business Activates**
- Fraudulent Business Transaction
- **Involvement in overly Complex Asset backed Securities**
- On-line Lenders
- **Money Transfer Business**
- Virtual Currency Exchange Transactions
- **Correspondent Banking in High Risk Jurisdictions**

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De-risking Practices – Implications and Solutions

De-risking also involve exiting certain relationship, products, markets and jurisdiction to reduce exposure to ethical, reputational and financial risk. In so doing, vulnerable users are cut off from much needed credit.

Alternative to de-risking

- **Regulators expect financial institutions to take a risk base approach instead in assessing their customer relationship and wholesale exiting of customers.**

- Banks should ensure that they have adequate personnel and systems in place to deal with risky clients.

- **Using a risk base approach the bank decide how much risk they are willing to accept versus how much money they are spending to control the risk.**

De-risking Practices – Implications and Solutions

Why should credit unions in the OECS be concerned about de-risking and what is at stake?

Analysis of growth of the OECS Credit Union movement between 205 and 2015:

	2005	2010	2015
Number of Credit Unions	69	57	49
Number of Members	223 K	278 K	336 K
Total Assets	US$390 M	US$700 M	US$961 M
Loans Receivable	US$241 M	US$445 M	US$695 M
Deposits	US$333 M	US$593 M	US$789 M

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Issues Surrounding De-risking in the OECS

1. Regional offshore Banks correspondent relationship have been terminated between 2012 and 2015.

2. **Other commercial Banks have been put under severe pressure to keep their correspondent banking relationship.**

3. After the Panama paper dilemma international commercial banks in the region have been faced with more regulatory requirements e.g. They are no longer willing to permit opening of bank account for IBC.

4. **Commercial banks no longer allow businesses to operate savings accounts. They are required to maintain current accounts.**

5. Credit unions policies and procedures in respect of know your customer and source of funds collected over the counter – under increased scrutiny.

6. **FATCA – (US) Foreign Accounts Tax Compliance Act**

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Issues Surrounding De-risking in the OECS

7. **Reduction in interest rates on loans continue to erode revenue base and result in reduced profitability.**
8. Increase in loan losses and impairment write off due to increase delinquency.
9. **Increase pressure to generate income from fees and commission to replace lost income and meet the cost of operation and provide reasonable returns to shareholders.**
10. Threats of fines by regulators in UK "Financial Conduct Authority" (FCA) imposed fines of £474 million in 2013 and £1 billion in 2014.
11. **Fines by US regulators, "Securities and Exchange Commission" imposed in 2014 was US$4.16 billion.**
12. Increase user fees makes it prohibited for small customers to use the service of large commercial Banks.

Implications for Credit Unions

Global effect

De-risking has several implications for credit union operating globally and in the Caribbean.

The world council of credit unions is cognizant of the implication of de-risking on the global credit union sector. As a result, it has been involved on several discussions with the Financial Action Task Force (FATF) about Anti-money Laundering Countering Financing of Terrorism (AML/CFT) and customers de-risking.

De-risking has resulted in credit unions being under greater pressure from regulators especially those that are related to entities providing money transfer services. It has also resulted in the loss of correspondent banking relationships and greater scrutiny by examiners. Credit unions have also encountered difficulties when opening new bank accounts in North America and other jurisdictions.

Implications for Regional Movement

Credit unions will incur increase operational costs as they accept customers who have been forced to exit the banking system. This increase cost will result from the following:

- **Increase compliance cost as persons who are perceived to be high risk transfer this risk from banks and other financial institution to credit unions.**

- Increase interest expense as the level of members deposits increase from new members.

- **Increase payroll costs as additional staff will be required to serve the rapidly growing membership base.**

- Increase liquidity and limited investment opportunities.

- **Increase exposure to money laundering due to credit unions' inability to monitor the rapidly increasing membership base and adequate capabilities to detect persons with intent to commit financial crimes.**

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Implications for Regional Movement

- As large Banks and other institutions exit business these customers are turning to small banks and credit unions for services. This results in increase risk and compliance cost to these institutions.
- **Customers that are bad actors will migrate to intuitions that are not well equipped to detect them.**
- Increase IT costs resulting from the need to keep records for a larger membership.
- **Reduce interest spread and reduced profitability.**
- The risk that commercial Banks may refuse to accept cash from credit unions if the banks are threatened closure of their correspondent banking relationship.
- **Increase exposure to loan loss delinquency.**
- Increase credit risk management challenges.

The Solution – Strategic Response

1. ***Credit Unions can pursue several course of action in response to the challenges resulting from de-risking. These include:***

   A strategic response that must be driven globally by WACCO and regionally by the Caribbean Confederation of Credit Union and its affiliates. This is necessary because in the global market the international Banks and the regulators are key stakeholders and sets the tone for the global financial market. Credit unions rely on commercial Banks for cheque clearance and other banking services. One of the most significant issues at the stake in the fall out from de-risking is the fear by bankers of loss of correspondent banking relationship. Without the service of correspondent banking relationship money cannot be transferred from one jurisdiction to the another. It means that there can not be exchange of goods and services, no wire transfer, letters of guarantee, letters of credit, bank draft, etc. These are critical services that must be accessed by individual and business in order to facilitate trade in a global market setting.

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The Solution – Strategic Response

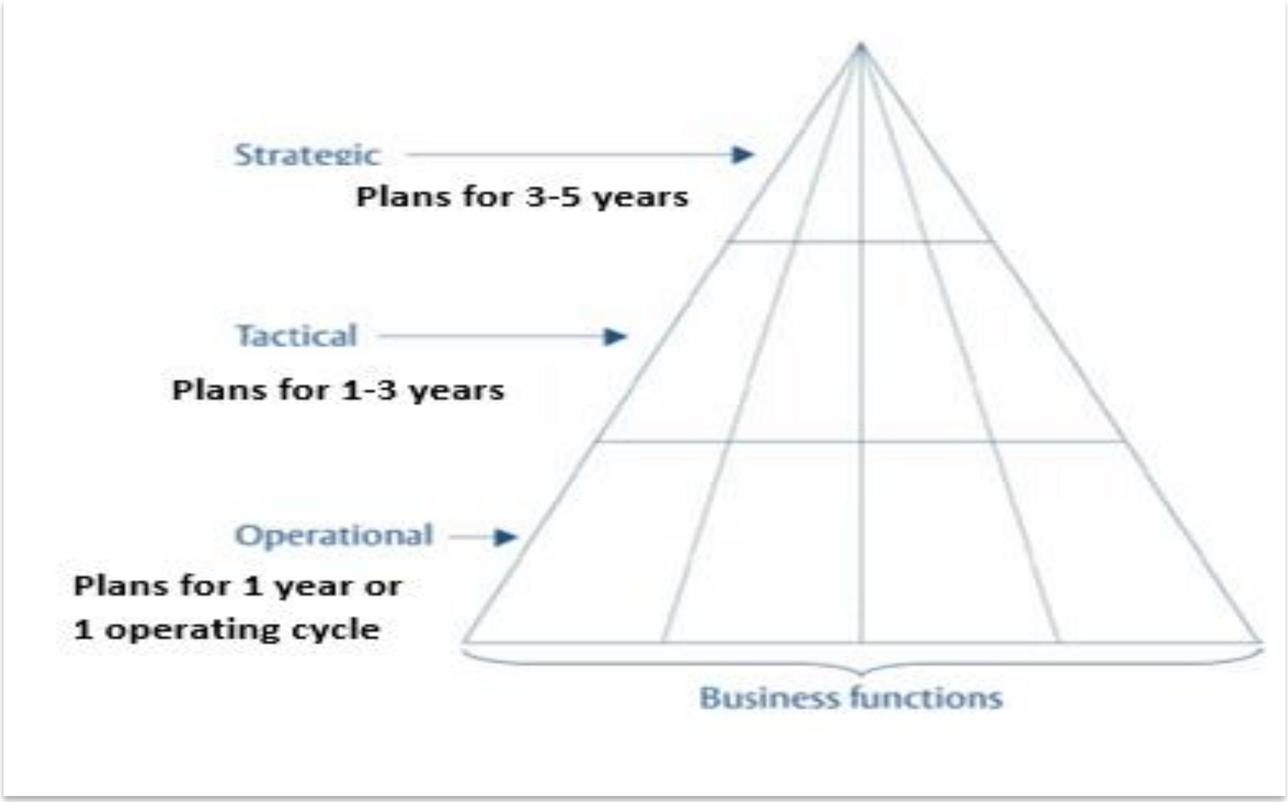
1.1 The regional strategic response should enable the following actions:

1. Analyse the implication of de-risking on regional credit union sector.
2. **Scope and articulate certain strategic questions. Why? What? How?**
3. Examine:
   - External drivers
   - Internal factors
   - Strategic boundary

4. **Obtain information on the issue and gain valuable insights.**
5. Perform a strategic analysis.
6. **Examine the competitive landscape.**
7. Examine the strategic options.
8. **Formulate an appropriate strategy.**

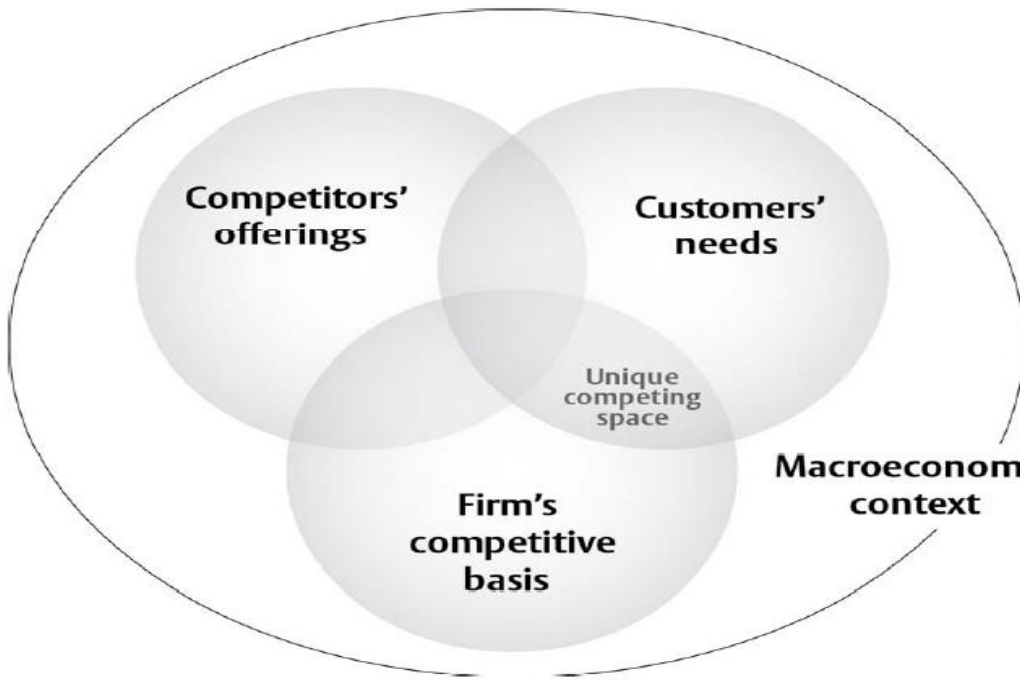
The Solution – Strategic Response

1.2 The strategic response should address de-risking at the three (3) levels indicated in the drawing below.



The Solution – Strategic Response

1.3 Unique Competing Space



Unique Competing Space

1.4 The movement existing competing space can be analysed briefly

1. Credit Unions size as a percentage of Regional GDP

	2005	2010
Assets	9.1%	13.1%
Loans	6.4%	9.4%
Deposits	7.6%	10.8%

2. Share of the Credit Unions deposit taking institutions

	2005	2010
Assets	5.8%	7.1%
Loans	8.6%	9.7%
Deposits	8.8%	11.5%

Value Proposition

1.3 What is the Regional Credit Union's value proposition

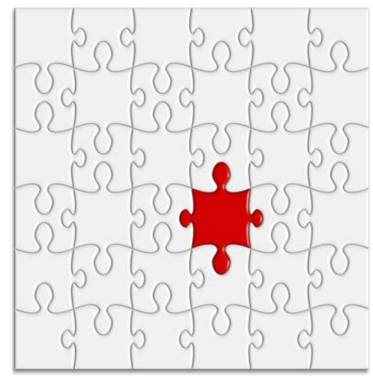
1. ***What are your product offerings?***
2. *Are these products clearly distinguished?*
3. ***What separates you from the competitors?***
4. *How do you price your products?*
5. ***How are you perceived in the market place?***
6. *Where is your brand position in the market?*

The Solution – Analysing Financial Statements

2. Analysing financial statements

This is to analyse your credit union's balance sheet or statement of financial position and the statement of profit and loss or comprehensive income:

- This analysis will provide answers for certain questions and based on the current position the credit union can determine its response for example:



  - ➢ What is the current liquidity status?
  - ➢ What is the current cost of capital?
  - ➢ What is the current interest spread?
  - ➢ Is the credit union practicing risk base lending?
  - ➢ What is the current delinquency rate?
  - ➢ How reliable is the credit union clients/members acceptance procedures?
  - ➢ How effective is the compliance department?
  - ➢ What is the current loan to deposit return?
  - ➢ What is the current investment levels and are the rate of returns comparable with similar entities?
  - ➢ Are there proper risk management policies?
  - ➢ Are there proper policies, procedures and practices for the recruitment, development and retention of staff?

The Solution – Analysing Financial Statements

2. Analysing financial statements (Cont'd)

- This analysis will provide answers for certain questions and based on the current position the credit union can determine its response for example:
  - What impact will de-risking have on the credit union financial position and operating results?

The answers to these and other questions will help management formulate an appropriate response and solution.

The Solution – Analysing Financial Statements

3. *Performance Indicators*

In analyzing the financial statements different categories of ratios should be examine. For e.g. ratios that deals with the following:

- Profitability ratio
- Liquidity ratio
- Gearing ratio
- Employee ratio
- Pearls ratio and analysis
- Non-financial indicators to assess performance and potential distress

The Solution – Risk Management

Adoption of an enterprise risk management system.

This will enable the credit union to identify significant risks that affects credit unions including:

- **Strategic Risk:** Strategy Development and Implementation, Competition, Performance and Viability and Demographics of Members
- **Operational Risk:** Information Technology Risk, Fraud, Member Satisfaction and Personnel
- **Financial Risk:** Market/Investment Risk, Structural Risk (Asset/Liability Mismatch Risk), Liquidity Investment Management and Capital Management
- **Credit risk:** Default Risk and Concentration Risk
- **Compliance risk:** Regulatory and Other Legislative Requirements

These risk should be analysed, categorised and the level of tolerance defined based on the credit unions' risk appetite.

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The Solution - Other Initiatives

Redefine the role and function of the supervisory committee. This should be renamed the audit committee and its should be given the autonomy to function as such...

Establish a regional examination body well staff and equipped to perform the assigned tasks.

Go to the next level in consolidation of credit unions across jurisdiction.

Pool excess cash resources and provide syndicate loans.

Adopt common financial reporting standards.

Share and adopt best practices.

Establish a risk management department of the OECS to co-ordinate the risk management role with compliance officers in individual credit unions.

Greater emphasis on human resource management and learning and development (L&D).

Greater emphasis on customer profiling.

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QUESTIONS