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Prudence and financial self-regulation in credit unions in Northern Ireland

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ABSTRACT

Credit unions in Northern Ireland are subject to a unique combination of statutory oversight and self-regulation. This paper investigates the association between prudence and the monitoring of financial ratios by credit union trade associations. We find that compliance with the mandated level of capital reserves is uniformly high, regardless of the existence or extent of self-regulation. However, after controlling for cross-sectional differences in profitability, age, size, growth and common bond type a positive association exists between self-regulation and financial ratios measuring prudence and loan book quality. These findings have policy implications for the regulation of credit unions in Northern Ireland and elsewhere regarding potential regulatory cost savings from reliance on self-regulation provided by trade associations.

1. Introduction

Credit Unions in Northern Ireland represent a successful non-profit form of financial institution that is self-supporting and grounded in the community. They have grown significantly over the past two decades with membership currently extending to 23.6% of the adult population in Northern Ireland (McKillop, Ward, & Wilson, 2010). In Northern Ireland, credit unions are regulated and supervised by the Registrar for Companies, Credit Unions and Industrial and Provident Societies (part of the Department of Enterprise, Trade and Investment in Northern Ireland) under the terms of the Credit Unions (NI) Order 1985 (and subsequent statutory amendments) (McKillop et al., 2010).[2] Statutory regulation is restrictive and to protect solvency, requires that credit unions maintain a minimum capital reserve level of 10% of total assets.

The use of financial ratios to promote prudence is encouraged by the Registrar and in addition some trade associations actively monitor financial ratios to improve loan book quality. Trade associations are umbrella bodies that provide a voice for the sector together with a variety of support services for their affiliated credit union members. Self-regulation in non-profit entities typically occurs with the creation of an industry-level body. The motivation for the creation of such a body may include resource maximisation, setting and ensuring compliance with standards and protecting institutional rules and norms (Bies, 2010). Further, the design of self-regulation is influenced by the perceived need to supplement or complement existing public regulation (Young, 2000). Most, though not all, of the credit unions in Northern Ireland are affiliated to a trade

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[2] The Northern Ireland regulatory regime investigated in this paper remained in force until March 2012 when responsibility transferred to the Financial Services Authority.

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association. Two trade associations in Northern Ireland provide deposit protection insurance and actively monitor their member's financial activities. The remainder of the credit union movement is subject only to statutory regulation.

A dearth of research into the effectiveness of self-regulation and the potential benefits from participating in self-regulatory organisations, such as trade associations, has been observed (Gugerty, Sidel, & Bies, 2010). The mix of public and self-regulation in Northern Ireland provides an opportunity to examine the association between the existence and extent of self-regulation and mandated capital requirements and best practice recommendations on financial prudence and loan book quality. Since 1990 the World Council of Credit Unions (WOCCU) has promoted the use of a set of financial ratios known as 'PEARLS' to facilitate supervisory control of credit unions.[3]

The study also has policy implications. HM Treasury (UK) undertook a review of the regulation of credit unions in Northern Ireland (HM Treasury, 2010). One tangible outcome of this review was the transfer of credit union financial regulation to the Financial Services Authority (FSA) in March 2012. This transfer occurred in Great Britain in 2002 and is believed to have been beneficial[4] though the regulatory burden on credit unions has increased (Baker, 2008; Ryder, 2009).

Using a sub-set of three PEARLS ratios that measure prudence and loan book quality for the period 1996–2008, we find that compliance with the mandated minimum level of capital reserves is high. In general, credit unions subject to self-regulation that actively monitors prudential reserve levels and loan book quality have better quality loan books. The policy implications of these findings are that self-regulation of financial ratios promotes loan book quality in the absence of specific legislation. Furthermore, reliance on the self-regulation provided by trade associations is a potential source of regulatory cost savings.

The paper is structured as follows. Section 2 describes, in an international context, the institutional and regulatory characteristics of the credit union movement in Northern Ireland and reviews the prior literature. The research design is presented in Section 3, the data analysis and findings are presented in Section 4 and Section 5 concludes.

2. Institutional background and prior literature

Credit unions are self-help, co-operative, non-profit financial institutions that, in Northern Ireland, provide simple savings and loans products to their members.[5] The credit union movement is a worldwide phenomenon with 52,945 credit unions in existence in 100 countries. The movement has attracted 188 million members and has amassed total assets of $1.46 trillion (WOCCU, 2010a,b). All credit unions are governed by a volunteer board of directors that are recruited from within their membership (Ward & McKillop, 2010). The membership is mostly restricted to persons who have a common interest, called a 'common bond' with each other. This common bond is typically either employment-related, geographical or through an association. In principle, the common bond reduces information asymmetry relating to credit-making decisions enabling credit unions to provide loans based on a person's reputation (Ward & McKillop, 2005a). In Northern Ireland credit unions are typically subject to two sources of regulation: public regulation and self-regulation.

2.1. Public regulation

The public regulation of credit unions worldwide is not homogenous. It is broadly similar to regulation applied to for-profit orientated financial institutions in some countries where the movement is mature (US, Canada, Australia). Where the sector is less developed it is restrictive (Great Britain, Northern Ireland, Poland) (Ferguson & McKillop, 1997, p. 231). For example, in the US credit unions are regulated by a government department, the National Credit Union Administration (NCUA) and in Great Britain, an independent external body, the Financial Services Authority (FSA) has regulated the credit union movement since 2002 (McKillop et al., 2010). Though credit union legislation is more restrictive in Great Britain relative to the US, similar monitoring activities are prevalent. In both countries credit unions have to file quarterly returns and automated financial analysis of these returns is used to highlight issues that require prompt attention.

In Northern Ireland, the Registrar reviews credit union annual returns and audited financial statements to determine if credit unions are complying with the relevant legislation and also to determine if they are 'financially sound'. The Registrar aims to inspect credit unions every 18 months, though this is not mandatory (Bingham, 2009). In terms of prudence, the registrar has to ensure that credit unions maintain a capital reserve balance of between 10% and 20% of their total assets. If this is not the case, as is normal in emerging credit unions, then the legislation requires that the credit union transfers at least 20% of their yearly surplus to capital reserves before a dividend distribution can be made.

The Registrar also recommends that credit unions include a specific loan loss provision to cover the potential loss from non-performing loans. The guidance suggests that a minimum provision for loan losses (calculated as 10% of net loans that are

[3] PEARLS consists of 44 financial ratios, with recommended target or minimum outcomes, which are aimed at providing information on six key financial areas: protection of members' funds (P), financial strength (E), asset quality (A), performance (return and cost levels) (R), liquidity (L) and signs of growth (S).

[4] The sector in Great Britain has experienced unprecedented growth. Over the period 2003 to 2008 membership increased by 41% and total assets increased by 46% (McKillop et al., 2010).

[5] In other some other countries, credit unions are much more sophisticated and can provide similar services to banking institutions, for example in the US, Canada and Australia several credit unions have converted to banks. See Heinrich and Kashian (2008) for a discussion of US demutualisation activity and Davis (2005, 2007) for a discussion of Australian demutualisation activity.