



Credit Union Chair

By e-mail

7th October 2019

Re: Investment and Participation in Credit Union Owned Outsourced Service Providers

Dear Chair,

This letter considers and sets out the Central Bank of Ireland's (the Central Bank) regulatory expectations of credit unions when, they themselves or in partnership with a third party, invest in establishing a 'credit union owned outsourced services provider', (CUSP).

This letter also discusses the Central Bank's regulatory expectations where a credit union intends to outsource services to a CUSP. Appendix 1 of this letter sets out matters a credit union will need to address when establishing and participating in a CUSP. This letter is structured to:

- 1) Address the characteristics of CUSPs;
- 2) Set out the Central Bank's expectations for credit unions proposing to invest in CUSPs; and
- 3) Outline considerations for outsourcing to a CUSP.

Credit Union Owned Outsourced Service Providers

The establishment, governance and operation of CUSPs is an emerging trend in the Irish credit union sector. Properly established and operated, CUSPs have the potential to support credit unions business model sustainability through *inter alia*, realising scale and scope economies, deploying enabling technologies, accessing technical expertise and enhancing operational effectiveness and risk management capability.

CUSP characteristics typically include:

- They are established and owned by credit unions;



- They may include third party alliance partner(s) which may or may not have an equitable interest in the venture;
- Their purpose is to exclusively provide specific services to credit unions and/or credit union members;
- They often operate as commercial outsourced service providers, independent from their owners; and
- They may provide services to credit unions other than their owner credit unions.

CUSPs are typically established as independent, commercially operated service providers and governed and managed accordingly.

Investments by a credit union in a CUSP may be direct, in which case the credit union will be a shareholder/member of the CUSP. Investment may also be indirect, organised by a collective of investing credit unions through an incorporated legal entity owned by them and established solely to provide for aggregate shareholding in a CUSP.

CUSPs present a specific risk profile insofar as they are captive firms – they are owned by credit unions and cannot diversify their services as they exclusively service credit unions and members of credit unions.

A CUSP may only provide products and services related to, and in support of, the services provided by a credit union under the Credit Union Act 1997 (as amended) (the 1997 Act), the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (as amended) (the 2016 Regulations) or services that have been approved or are already prescribed by the Central Bank as additional services in accordance with Section 48 of the 1997 Act.

Investing in a CUSP

Protection of member funds is a core responsibility of credit union boards and management. Credit unions planning to incur expenses establishing or participating in a CUSP should satisfy themselves that the expenditure is in the long-term interest of members and within the credit union's overall risk appetite.

A credit union must be able to demonstrate to the Central Bank's satisfaction that the investment is directly linked to an authorised activity of the credit union and that it is necessary



in order to fulfil the credit union's current and future operating requirements¹, its strategic plan, long term goals, objectives and risk appetite. In determining whether to incur expenses establishing or participating in a CUSP, a credit union should have regard to Section 43(2) of the 1997 Act, which provides for the investment of funds that are surplus to a credit union's operating requirements, and with Regulation 25 of the 2016 Regulations that set out the permitted investment classes.

- Prior to investing in a CUSP, a credit union must make a notification to the Central Bank. The information required in submitting a notification is set out in Appendix 1 of this letter. Please note that this notification in relation to investing in a CUSP exists in addition to the general obligation pursuant to Section 76J(11) of the 1997 Act to notify the Central Bank where a credit union intends to outsource a material business activity to a service provider, of any material development affecting the service provider and their ability to fulfil their obligations.
- Recognising the significant investment commitment that might be required to establish or participate in a CUSP, the Central Bank emphasises that such investment decisions by credit union boards should be grounded in informed, rigorous due diligence of CUSP business models and material risks.
- Pursuant to Section 26 of the 1997 Act, as a credit union cannot carry on any business or activity, which is not appropriate, or incidental to its objects, a credit union cannot engage in activities through arrangements with a CUSP that it is not or would not be approved to engage in as a credit union.
- Concerning additional services a credit union may intend to seek approval to provide, a CUSP may develop services/products for a credit union provided that the credit union is satisfied that such additional services may properly be the subject of an application for approval by the Central Bank under Sections 48(4) & 49 of the 1997 Act, or which are already prescribed by the Central Bank pursuant to Section 48(2)(b) of the 1997 Act (per Regulation 48 & Schedule 2 of the 2016 Regulations). The credit union should consult with the Central Bank at a sufficiently early stage in the process.

While the Central Bank does not intend, at this time, to set binding limits specific to CUSP investments, it is expected that a credit union's overall limit should fall below 2% of total assets

¹ The term "operating requirements" broadly covers all activities, functions and requirements that are necessary and essential for the credit union to fulfil so that it may act within its objects, its licence and permissions from the Central Bank, provide services to its members in a timely and effective manner, and to comply with all applicable legal and regulatory requirements.



and individual limits should be less than 50% of this. For example, a credit union having €150m in total assets might set an overall limit of 2% – €3m; of which at most €1.5m may be invested in any one CUSP.

Outsourcing to a CUSP

A CUSP has the same outsource risk characteristics as any other third party service provider. The fact that CUSPs may be credit union owned (in whole or in part) does not in any way alleviate a credit union's board and management accountability and responsibility to ensure outsourcing risks are identified, assessed, monitored, reported on, managed and where appropriate, mitigated. The intensity of due diligence should demonstrate equal rigour as that applied to any other outsource service provider.

Consequently when outsourcing to a CUSP, credit unions must comply with their outsourcing, governance, risk management and business continuity obligations as set out in the 1997 Act, in particular Section 76J (Outsourcing).

- CUSPs can have differing business models and can be of varying complexity and potential which requires credit union scrutiny. When considering participation in CUSP arrangements, a credit union should ensure it has well-developed outsourcing objectives integrated within its business model strategy and risk appetite. The Central Bank expects credit unions to evidence that decisions to participate in CUSP arrangements are grounded in rigorous due diligence and risk analysis that considers the impact of outsourcing on the credit union's business model risk profile and the credit union's risk appetite. Due diligence needs to address the financial and legal obligations applying to credit union participation and should include exit arrangements, follow-on investment requirements and step-in risk.
- Credit unions become collaborative partners via CUSP arrangements and may cede a certain degree of operational independence particularly in areas of back and middle office operational standardisation. In such cases, a credit union's risk management function should consider CUSP operational capabilities and related business continuity and substitutability arrangements.
- Credit unions risk and compliance management systems and internal audit, should establish a clear line of risk oversight of outsourced activities, and provide for detailed management and board reporting. Service contracts must reflect Section 76J requirements including those providing effective access to the data of third party provider services by the Central Bank in accordance with Section 76J(5) of the 1997 Act.



- CUSP business models frequently includes chain-outsourcing². Rather than providing services themselves, it is likely that chain-outsourcing activity and associated risks will be a significant feature with CUSPs, particularly where technology-based services are concerned. Where a credit union outsources to a CUSP that has sub-contracting arrangements in place, the credit union must confirm that the CUSP oversees and manages the activities of the sub-contracted provider to ensure the fulfilment of all services in line with the original outsourcing contract and relevant service level agreement.
- A credit union must 'identify the operational risks it is exposed to, or is likely to be exposed to, and provide for the management and mitigation of those risks in the credit union's risk management system under Section 76(E) of the 1997 Act – Operational Risk. Prudent operational risk reserve planning should include assessment and allocation of appropriate operational risk reserves when outsourcing to a CUSP.

Conclusion

Where a credit union proposes to incur expenses through investing in the establishment of, or participation in, a CUSP, it should engage with the Central Bank at the earliest opportunity, addressing the issues outlined in Appendix 1 of this letter.

It is the responsibility of the boards and management considering the establishment of and participation in a CUSP to thoroughly investigate all legal and regulatory considerations (including licensing and authorisation requirements) that arise as a result of such proposals, in respect of themselves individually, collectively with other participating credit unions, and in respect of the CUSP entity.

While the focus of this correspondence is on CUSPs, many of the key issues raised apply equally to all outsourcing arrangements. Given the credit union business model is increasingly reliant on outsourcing partners, credit unions should have a particular focus on ensuring rigorous assessment, monitoring and oversight of all outsourced activities.

Credit unions are directed to the Credit Union Handbook ³as an additional source of reference on outsourcing, as is the Central Bank's '*Report on Thematic Outsourcing Inspections in Credit*

² Chain outsourcing occurs when outsourced service providers (OSPs) engaged by the regulated firm have themselves outsourced certain related activities to other OSPs. This introduces further challenges to a regulated firm's span of control and requires robust controls and monitoring

³ [Credit Union Handbook](#)



*Unions (April 2017)*⁴. Credit unions should also consider the Central Bank's paper entitled – '*Outsourcing – Findings and Issues for Discussion – (November 2018)*'⁵ which sets minimum supervisory expectations concerning the management of outsourcing risks and sets out key issues that regulated firms should consider in order to mitigate these risks effectively. Other useful reference documents include the Central Bank's '*Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks (September 2016)*'⁶ and the European Banking Authority (EBA) '*Guidelines on Outsourcing (February 2019)*'⁷.

Credit unions should also refer to the Central Bank's publication entitled '*Business Model Strategy: Guidance for Credit Unions*' (February 2019) for a consideration of business model risk considerations and expectations regarding partners, outsourcing and shared services. It is important that there is clarity as to how the outsourcing relationship relates to the credit union's strategic plan, long-term goals, objectives, and resource allocation requirements.

Credit unions who wish to explore the issues raised in this letter should contact the team in our Business Model and Engagement Unit at rcu@centralbank.ie.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Patrick Casey', written over a horizontal line.

Patrick Casey

Registrar of Credit Unions

cc Chief Executive Officer

⁴ [Report on Thematic Outsourcing Inspections in Credit Unions \(April 2017\)](#)

⁵ [Outsourcing – Findings and Issues for Discussion](#)

⁶ [Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks \(Sept 2016\)](#)

⁷ [European Banking Authority \(EBA\) 'Guidelines on Outsourcing \(February 2019\)'](#)



Appendix 1

Establishing a CUSP

A credit union may be able to invest in a CUSP where it is relevant to the credit union's operational requirements and consistent with Section 6 and Section 26⁸ of the CUA 1997. When a credit union intends to incur expenditure establishing a CUSP, it should engage with the Central Bank at an early stage.

The Central Bank expects a credit union's board and management to demonstrate and illustrate a developed understanding of CUSP arrangements and risks and an ability to oversee the credit union's management of the arrangements and associated risks.

In this respect, a board is expected to ensure it is fully informed of the nature and risk characteristics of any proposed CUSP arrangement and be able to demonstrate how it has factored CUSP due diligence and risk assessment into its decision-making and risk oversight processes.

Regulatory Expectations of Credit Unions Investing in, Establishing and/or Participating in a CUSP

- A. A credit union may be able to incur permissible expenses to fund CUSP arrangements, provided that the credit union is able to demonstrate to the Central Bank's satisfaction that:
- I. the expenditure incurred in investing in the CUSP is directly linked to an authorised activity of the credit union and it is necessary in order to fulfil the credit union's current and future operating requirements.
 - II. the CUSP arrangement is compatible with its objects and purposes (per Section 6(1)(a) and Section 26 of the 1997 Act); and
 - III. the funding of the CUSP arrangement at no time involves undue risk to members' funds.

The credit union should obtain its own independent legal advice in this respect.

⁸ Section 26 of the 1997 Act states that '*a credit union shall not carry on any business or activity which is not appropriate or incidental to the objects for which, in accordance with section 6, it is formed*'.



- B. When considering investing in a CUSP a credit union should ensure as part of its legal due diligence that it is satisfied the CUSP arrangement has the following characteristics:
- a. A CUSP should be a body corporate established as a separate legal entity from the founding credit union(s) and, as relevant, non-credit union entities, in order to solely and exclusively provide services to credit unions and the members of credit unions;
 - b. A CUSP should only provide products and services related to, and in support of, the services provided by a credit union under the 1997 Act, the 2016 Regulations or that have been approved by the Central Bank or which are already prescribed by the Central Bank as additional services;
 - c. The credit union's exposure as an investor in a CUSP should be limited to the amount it has invested/guaranteed in a CUSP and its additional commitments knowable and limited in advance of investment pursuant to contractual agreement;
 - d. A CUSP should be operationally separate from the credit union(s) which founded it, invest in it once formed, or which obtain services from it;
 - e. A CUSP board should contain at least one independent director;
 - f. A credit union's role in the establishment of and ongoing interaction with a CUSP, and the formation and operation of a CUSP itself must otherwise be in compliance with all applicable legal requirements and, without limitation, those under competition law.

The Central Bank expects a credit union to document the due diligence it has undertaken to satisfy itself as to the matters above before it embarks on the establishment of, or participation in, a CUSP.

Notwithstanding the credit union's due diligence and associated legal advice, the Central Bank (in its capacity as the authority responsible for administering the system of regulation and supervision of credit unions) reserves the right to form its own views and to take such supervisory measures as it sees fit in relation to individual proposals including, without limitation, the imposition of regulatory directions pursuant to Section 87 of the 1997 Act.

Notification of Intention to Establish a CUSP

In order to support supervisory understanding of the credit union's participation in a proposed CUSP arrangement, the following information should be submitted in electronic PDF format:



- Confirmation that the credit union has undertaken due diligence to assure itself it has satisfied the points listed at A and B above. The credit union should provide a copy of legal advice obtained in relation to the points detailed at (A);
- Copy of the CUSP membership agreement and constitution;
- Copy of any intended licencing/contractual agreements governing the use by a credit union of CUSP products and services;
- Description of intended governance/management & staffing arrangements;
- Description how the credit union intends assuring compliance with Section 76J the 1997 Act;
- The CUSP business case which should detail:
 - a. Operational model showing
 - i. Services that will be outsourced by a credit union to the CUSP;
 - ii. Activities the CUSP will perform for a credit union;
 - iii. Activities CUSP will outsource to third party OSPs;
 - b. Contracting parties (who will be contracting with whom);
 - c. Required funding from credit unions;
 - d. The revenue model indicating how services will be charged for and by whom;
 - e. Projected financials (CUSP Balance Sheet and P&L) including revenue and operating cost assumptions;
 - f. Business continuity risk assessment and plan; and
 - g. Risk assessment and proposed risk treatment covering the following risk areas;
 - i. Financial risk;
 - ii. Operational risk;
 - iii. Business model risk;
 - iv. Governance & Management risk;
 - v. Business continuity risk;
 - vi. Chain-outsourcing risk;
 - vii. Substitutability risk;
 - viii. Concentration risk;
 - ix. Compliance risk;
 - x. Reputational risk.



Following receipt of the information (and any further information requested) the Central Bank will review the CUSP proposal and seek to revert as expeditiously as possible while meeting its obligations to operate a rigorous and effective gatekeeper function.

Member Transparency

Accounting for an investment in a CUSP will, as applicable, be subject to Part VII of the 1997 Act, Regulation 47 of the 2016 Regulations, and to a credit union's accounting advice. In the interests of member transparency, the Central Bank expects that a credit union's investments in CUSPs is noted in the credit union's annual report as follows:

Credit Union Owned Service Providers (CUSP)

The credit union has invested in the following CUSPs.

<i>CUSP Name</i>	<i>Outsourced services</i>	<i>Funding/Investment</i>
<i>XXX Dac</i>	<i>Payment services</i>	<i>€xxx,xxx</i>
<i>XXX CLG</i>	<i>Risk management services</i>	<i>€xxx,xxx</i>
<i>XXX Dac</i>	<i>Lending services</i>	<i>€xxx,xxx</i>
<i>Total</i>		<i>€x,xxx,xxx</i>

Notification obligations following establishment of a CUSP

Without prejudice to the requirements of Section 76J(11)(a), where a credit union is a member of a CUSP, it is expected to inform the Central Bank of any material change to inter alia the objects of the CUSP, its governance arrangements, its business activities, its financial performance and its funding arrangements.

Where a credit union as an investing credit union, ceases to obtain services from a CUSP, it must inform the Central Bank and set out how it intends ensuring compliance with Section 43(2) (Investments) of the 1997 Act.