Credit Unions: changes to the regulatory regime

BSA response to CP7/22

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Building Societies Association

Introduction

The National Credit Union Forum (NCUF) represents seven of the largest credit unions in the UK. Collectively they hold combined total assets of £600m as at the end of September 2022. They help over 260,000 members by providing access to £300m of lending and enabling them to build their financial resilience through £510m of savings products. Overall, NCUF credit unions account for around a quarter of the mainland UK credit union sector (excluding Northern Ireland).

Summary

The BSA and its NCUF credit union members broadly support the proposals in CP7/22 and welcome the additional transparency on the PRA's approach to supervising the sector. In many areas, the draft supervisory statement clarifies existing practice as well as proposing some new additions and some necessary enhancements. We agree with the PRA's stance of enhancing the existing framework rather than a sweeping review of the entire regime which we agree is not currently necessary.

We note the comments on proportionality and targeting the enhancements to address risks posed by larger and more complex credit unions, while retaining the overall simplicity of the regime. This approach aligns to the PRA's other work to develop a new 'Strong and Simple' framework for non-systemic banks and building societies.[1]

While we agree it is appropriate to strengthen requirements for those credit unions that undertake a wider range of activities, we would note that even the largest credit unions retain a relatively simple business model and ask that the PRA resist the temptation to apply requirements that were designed for larger more complex financial institutions to credit unions. We recognise that many of the themes included in the CP correspond to more detailed requirements that exist for larger firms, such as on liquidity, operational resilience and exit planning. We believe that the CP currently strikes a good balance of covering these important aspects while keeping the requirements proportionate. However, proportionality needs to be achieved not just through the rules themselves, but also through a pragmatic implementation of the rules. As such, the PRA needs to avoid 'mission creep' or any misguided conception that 'best practice' is to shift towards an ever more detailed and complex implementation when this may not be the most effective way to further improve the resilience of the sector.

Another area where we would ask for a degree of caution is in applying aspects of the building societies sourcebook (SS20/15) to credit unions. While there is lots of useful background content in the sourcebook, care is needed on considering the appropriateness of applying requirements, and in particular any limits, that were designed for building societies to the credit union business model. For example, the topic of interest rate risk and how it can impact credit unions is quite different to building societies and is discussed in more detail below.

[1] The PRA has launched a project to simplify the regime that applies to small banks and building societies following the UK's exit from the EU. Credit unions already have a simple regime that needs to be made stronger in places but should not become overly complex by the enhancements.

Proposed changes to the Credit Unions Part of the PRA Rulebook

We support the proposed changes to the credit unions part of the PRA Rulebook. Some of these relate to changes introduced by the Financial Services and Markets Bill (FSMB) which is currently going through Parliament. As such, we support the updates to refer to hire purchase and conditional sale agreements and for these to be treated as additional activities. Related to this, we agree that larger credit unions or those that undertake additional activities should meet the systems and controls expectations in PRA Rule 10.3, but we question why the threshold here is in terms of the number of members when this could sensibly be aligned to the other thresholds based on asset size.

We support the changes to extend the range of permitted investments in order to both modernise and future-proof the framework. We believe it is good to allow credit unions access to a broader range of instruments to invest in, such that they can benefit from this flexibility and achieve a degree of diversification. However, most credit unions will continue to want to invest their liquidity in the safest possible liquid assets. As such, we believe that credit unions should have access to a Bank of England Reserve Account given the relative safety of holding liquid funds with the Bank of England compared to investing in other instruments. Credit unions provide diversity to UK financial services and allowing credit unions access to Bank of England facilities is important for competition. We understand that this is a decision for the Bank of England rather than the PRA and we are engaged with the Sterling Markets Division of the Bank of England on this topic.

In terms of the revisions to the Credit Unions part of the PRA Rulebook, we understand that the PRA's intent is to make changes to implement the new instruments in the FSMB, and that existing limits for existing instruments are retained. This point could be made clearer in the final policy statement to improve the overall coherence of the various limits to make them more user friendly and hence easier to understand. Clarification of the policy intent behind the limits would also be welcome and aligned to the recent PRA discussion paper on future policy DP4/22. We would also like to query the proposed 5% counterparty limit on corporate bonds in 6.4A vs the 75% single counterparty limit in the draft supervisory statement as discussed below.

Proposed new Credit Unions Supervisory Statement

We welcome the updated supervisory statement as this makes transparent the PRA's approach and sets expectations for how firms should demonstrate their compliance.

Liquidity and investments

We agree with the PRA's view that 'credit unions are typically liquid, and that credit union failures tend not to be liquidity-related.' We therefore concur that liquidity risk management should be appropriately tailored to the business model and proportionate. Furthermore, retail funding in the form of credit union shares is quite different from that of other financial institutions. Credit unions do not target rate-sensitive 'hot money' and many members save small amounts regularly and often with a view to getting a loan, rather than making

substantial lump sum deposits that then get moved around. Retail funding can therefore be considered to be reasonably ‘sticky’.

The illustrative example in 3.4 of the draft supervisory statement is helpful to guide firms on the PRA’s expectations for a basic liquidity stress test (which can otherwise be interpreted quite broadly to mean a range of different things). As per our comments above on proportionality, we encourage PRA supervisors to guard against making this calculation any more complicated, or evolving to become more similar to the Liquidity Coverage Ratio (LCR) which is often not the most useful metric in any case for monitoring and managing day to day liquidity. We, therefore, believe it is correct for credit unions themselves to consider what assumptions are appropriate and that the PRA should not inappropriately compare those assumptions to LCR inputs used by larger firms (given the points above on the overall liquidity of the sector and the stickiness of share deposits).

We encourage the PRA to give guidance on the 60 day notice provision for the withdrawal of shares. While this is not used in practice, it is legally enforceable and could be used, including during a severe stress. It would therefore make sense for credit unions to be able to include it as a management action in liquidity stress testing and/or as a plausible action in its contingency funding plan where these are produced.

We support the guidance in section 7 of the draft supervisory statement which sets out the PRA’s expectations for newly permitted liquidity investments and management of counterparty concentration risk. That said, we believe there is a potential conflict between the 5% capital limit for corporate bonds (which must be investment grade) versus the 75% for banks (which in many cases are lower rated). More broadly, we believe that diversification limits would be better served applying to ‘surplus funds’ rather than ‘capital/reserves’.

Capital

We agree that for certain credit unions, it can be appropriate for them to hold additional capital add-ons to capture additional risks, and this PRA power already exists. We also agree that the PRA should pay close attention to the quality as well as the quantity of capital and we strongly support the PRA having the ability to deal with individual credit unions by applying capital add-ons to firms that are outliers. We support the PRA being transparent on what they deem as riskier behaviour. The draft supervisory statement refers to credit unions that are growing rapidly or funded by lower quality capital such as subordinated debt or interest bearing deferred shares. We, therefore, agree that no more than 50% of capital should be made up of such instruments. This affects the broader resilience and reputation of the sector.

At the same time as supporting the proposed approach for outlier firms, we would caution against the PRA using capital add-ons in all cases as a blanket tool as it is not necessarily clear which risks are already covered by the minimum requirements in the 5% or 10% min ratio. Furthermore, this capital is not risk weighted and hence there can be competitive issues with other firms if the PRA puts layers upon layers of capital add-ons inappropriately.

We would also like to raise an inconsistency in the current rules. In 2020, the capital rules were updated to a tiered approach as set out in 8.5 and 8.5a, where depending on the credit union’s size they are required to hold minimum capital requirements of either 3%, 5%, 8% or 10%. However, rules 8.8 and 8.9 still refer to how a credit union must meet a ratio of 10% and take actions accordingly. We propose that the PRA reviews these rules with a view to aligning them to the tiered regime.

Mortgages, interest rate risk and the building society sourcebook

We agree that those credit unions that conduct mortgage lending should do so in a prudent way. We acknowledge that the building society sourcebook (SS20/15) includes some useful information that could be relevant for any lender undertaking mortgage lending. We believe this is as true for challenger banks as it is for credit unions that undertake mortgage lending. However, we do not believe that the three building society sourcebook lending approaches, and in particular, the indicative limits (in appendix 2) are suitable for credit unions. The structure and calibration of these limits would not reflect the true risks in an otherwise well-managed credit union mortgage portfolio. For example, MIG insurance is not economical unless a lender is operating above a certain scale and hence we do not support making this a requirement for credit unions.

The current limits for mortgage lending in appendix 2 of SS20/15 are all expressed as % total loan book. This may be appropriate for building societies where the majority of assets are mortgages. However, this is less logical for a credit union where mortgages may not be as large a proportion of the loan portfolio. NCUF and the BSA are strongly against the application of the limits in SS20/15, even as guidance, to credit unions and we request that the PRA considers this very carefully if proceeding down this route, which may not be the intent in any case.

The current limits on fixed rate lending for building societies are designed to limit interest rate risk in the banking book (IRRBB) rather than credit risk. The aim is to avoid finding that too much of a building society's balance sheet is 'locked in' to a particular, often low, net interest margin. This could, in theory, leave a society with reduced flexibility to manage its margin using the rest of its non-fixed rate assets if interest rates change adversely.

However, as mentioned above, credit union interest rate risk is not really comparable to IRRBB that exists for a mortgage bank. The majority of credit union member share accounts do not incorporate a contractual commitment to pay interest, so do not have contractual re-pricing risk. These share accounts are remunerated by a discretionary dividend, declared at the end of the year rather than committed to in advance. Therefore, when deciding the level of the dividend to be paid, the credit union will be in full knowledge of the impact of the dividend at the time it is determined. This is a very different situation to classic IRRBB where any fixed rate liability costs are 'locked in' up front.

It is also relevant to remember that credit unions' unsecured personal loans are often fixed rate but at a higher APR to reflect the higher credit risk on the product. As such, shifts in interest rates, while important to consider, do not generate the same degree of interest rate risk as might be the case for a building society's balance sheet which will be more dominated by low or very low margin mortgages.

The overall mix of assets on a credit union's balance sheet are unlikely to be dominated by fixed rate, low margin mortgages to the same extent as might be the case for a building society. Each credit union will have a different balance sheet structure depending on their particular business model and niche.

Finally, it is worth considering whether a credit union can enter into an interest rate swap. It is currently unclear whether a credit union has the legal ability under the Credit Unions Act. Moreover, it may be challenging to find market counterparties that are willing to engage with credit unions to offer interest rate swaps for relatively small portfolios if they have not done

so previously. This is important to understand, particularly depending on how rigidly any use of the building society sourcebook may be used for credit unions given that it is generally expected that building societies will make use of interest rate swaps, except for those societies on the administered approach to treasury risk management.

With all of the above in mind, we would also caution against any general move towards requiring the use of FSA017 which is designed for building societies and may not be very meaningful for a credit union.

Exit strategy

We can support the overall objective of exit strategy planning, whether through solvent wind down or a transfer of engagements. However, we also note that this is a new addition being contemplated that is not in the current requirements and could be a significant project for those firms captured. We also note and agree with the PRA's conclusion that it is not appropriate to require any credit unions to comply with recovery and resolution planning rules (with the exception of the Single Customer View).

We believe that some of the potential barriers to a smooth wind-down could be legal or regulatory in their nature and common across different credit unions. For example, we are not clear whether a credit union will be able to sell its loan portfolio to another entity. While transfer of engagement is a well-trodden route for smaller credit unions that are no longer viable on their own, it would be more challenging for a larger credit union to find a compatible partner. Nor is it clear how, if at all, a credit union could transfer its business to some other entity (i.e. not another credit union). We propose that a collaborative approach should be taken on some of these issues that relate to regulatory constraints and will be common across credit unions. We intend to work on this together within NCUF and discuss our findings with the PRA in due course.

Credit cards

We agree that where credit unions offer credit cards to their members they should do so in a prudent way. The draft supervisory statement highlights the risk of claims arising under section 75 of the Consumer Credit Act 1974 or losses from fraud. While we agree in principle that firms should consider the potential capital impact of such risks crystallising, we are not aware of any historical information to quantify this risk, and how far it can be relied upon if not from the credit union sector. We would therefore welcome more guidance from the PRA on how this can be achieved.

Operational resilience

Operational resilience is an important topic across the financial services sector, and credit unions are no exception. However, we again note the difference in the business models of credit unions when compared to each other within the sector as well as when compared to larger financial institutions.

As such, we welcome that the proposals in CP7/22 appear proportionate. They stop short of mirroring the complexities of the requirements for larger firms (such as requiring clauses in contracts that a supplier would be unlikely to agree to for smaller firms with less bargaining power). We agree with this approach, which generally appears proportionate. However, there

is a reference in paragraph 10.6 of the draft supervisory statement to credit unions needing to have an exit plan from a material outsourcing arrangement. Again we would encourage the PRA to be clearer on how simple such an exit plan could be in practice to avoid 'mission creep' or over-engineering of expectations for how this requirement is met.

Risk management

We recognise and agree with the importance of sound risk management as set out in the supervisory statement, including firms having the ability to identify, manage, monitor and report on risks. However, techniques such as stress testing and scenario analysis, including combinations of scenarios, could be interpreted in many different ways and there is a risk of over-engineering.

The draft supervisory statement says that credit unions with > £10m assets should have risk appetite statements that "include clear, objective and quantitative measures which the whole board has approved." We agree that certain risks, particularly financial risks should include quantitative metrics, but we do not believe it is appropriate for all risk types, and this will vary depending on the specific risks of the credit union. We would, therefore, suggest that this statement should say "..and, where appropriate, include quantitative measures." Furthermore we believe that effective risk management works best when the risk appetites are embedded and useful to the credit union first and foremost rather than viewed as something that needs to be done for the regulator.

Corporate lending

We support the proposals for lending to corporates. Again, the term 'scenario analysis' could imply a more complex analysis than perhaps the PRA has intended here, which could be as simple as considering the impact of a number of corporate loans defaulting simultaneously. We therefore think this is an area of the supervisory statement where an example could be useful.

Governance, business planning, internal audit

We agree with the PRA's view of the importance of sound governance and how this is fundamental to the safety and soundness of credit unions. We agree with the examples of good practice. The PRA could add more detail on what is considered sufficient for the way internal audit provides challenge to the Board (second bullet under paragraph 9.4 in the draft supervisory statement).

Other issues

The PRA could enhance the usability of the supervisory statement by including a table setting out which requirements apply to credit unions of different sizes eg >£100m, £50m, £10m. A related point is that one of the thresholds for firms being subject to additional requirements is 15,000 members. We propose that the PRA reviews the 15,000 member threshold and provides supporting data if it needs to be retained.

The PRA has noted the likely increase in costs for credit unions to comply with the additional requirements (paragraph 3.27). Can the PRA share more of its analysis of the likely costs and hence support the statement that those costs are proportionate?

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £477 billion, and account for 23% of the UK mortgage market and 18% of the UK savings market.