Credit unions : Review of the capital regime

BSA response to PRA CP 28/19

January 2020

Introduction

The BSA (principally on behalf of its six[1] large credit union members) broadly welcomes and supports the review of the credit union capital regime proposed by the PRA in CP 28/19. We particularly welcome the immediate effect on our members of the graduated approach; the delinking of capital requirements from both membership numbers and "additional activities"; and the tougher approach to weaker small credit unions with capital below 5%. We have a few other detailed comments, and we also commend the PRA for having undertaken proper cost benefit analysis in CP 28/19.

Detailed comments

Graduated approach

The proposed move from the "slab" to the graduated approach for the relationship between increasing asset size and capital requirements is particularly helpful in facilitating prudent growth by credit unions. The capital requirement ladder is unusually steep – rising from a capital / assets ratio (CAR) of 3% for the smallest CUs, through 5% for the next band, to 10% (or 8% + 2%) for the larger CUs. As the excellent charts in the CBA section illustrate, each step change constitutes a major (and unnecessary) barrier to growth – most of all at the transition where a CU crosses £ 10 million total assets for the first time (this is very well captured in Chart 2). The result that a credit union's total capital requirement appears to double as granting one new loan takes a CU across the £10 million threshold was clearly a massive barrier. So a move to a graduated approach is strongly supported.

Delinking from membership numbers and additional activities

Similarly we support this delinking. It is asset size, rather than mere number of members, that is prudentially significant. A numerically large membership at a credit union with modest total assets could well mean either that the typical member has very small loans or savings balances, or that there is a high proportion of inactive members – but neither of these justifies tipping a CU into the highest capital ratio category.

Nor is there sufficient correlation between each "additional activity", and higher risk, to justify the current blanket approach whereby any amount of additional activity catapults a CU into having to meet the highest capital ratio across its entire book. For instance, an "additional activity" might mean no more than setting the CU's upper personal loan limit at £20,000 rather than £15,000 – a necessary move, over time, as the real value of any monetary limit is eroded by inflation.

More importantly, however, the PRA has stated a welcome realisation – that where there are risks associated with such additional activities, these should be managed through systems and

[1] No.1 CopperPot ; Glasgow ; Scotwest ; Capital ; London Mutual ; Leeds City

controls, rather than solely by a much higher capital requirement. Our credit union members agree.

Tougher approach to small weak CUs with capital < 5%

The FSCS statistics for credit union failure confirm that the "problem" is not – typically – large, adequately capitalised CUs, but small, unsustainable, poorly-managed CUs with weak capital. These are currently required only to observe a 3% capital ratio. Several such CUs failed recently and their savers had to be paid out from the FSCS, with the cost falling on building societies, sound credit unions, and banks, who all pay the levies for the FSCS deposit-taking sub scheme. We support a tougher approach to this category – if as a result these CUs raise their capital ratio to the target of 5%, the improved resilience will reduce their propensity to fail, and the consequent burden on the FSCS, and will at the same time improve the public perceptions of credit unions generally, which suffers unfairly as a result of the frequent failures of weak CUs.

For these CUs, we think a further measure, patterned on existing expectations for banks and building societies, could be appropriate. While the turnaround of a weak credit union so that it achieves full ongoing sustainability would be the ideal, sadly experience confirms that in many cases the outcome will be a rescue merger or a windup with FSCS payout. It would therefore make sense for weak credit unions to be obligated to plan proactively for either rescue merger (if there are any suitable rescue partners with compatible common bonds); or an orderly, managed wind-down. Even the latter is greatly to be preferred to the situation often encountered in the past when the FSCS declares a CU in default – that, while the FSCS may be able to compensate depositors, the wind up of the remainder of the credit union is *disorderly*. Sensible advance planning could mitigate this, and enhance any recoveries from the winding up, to the benefit of the FSCS and its contributories.

Removal of buffer – effect on larger CUs.

PRA also proposes changes to the buffer of 2% introduced in 2016 when the original proposals were modified. The effect is that for CUs between £10 million and £50 million total assets, the hard minimum requirement stays at 8% CAR, but there will be no PRA buffer on top – though any CU will naturally set its own buffer above the hard minimum. For CUs above £50 million however, the effect is less benign : the hard minimum actually increases from 8% to 10% CAR (though only on the graduated basis). This might over time have consequences for the internal rate of return needed to maintain capital levels, and may raise the question whether for some kinds of credit union lending the interest rate ceiling should perhaps be revisited (given the inter-relationship between capital ratio, asset growth and profitability).

Conclusion

The proposals in CP 28/19 will bring great benefits, especially to those credit unions otherwise facing cliff edges in the present capital regime, and are therefore broadly welcomed and supported. Rapid post-consultation implementation would also be very much welcomed.

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BSA EU Transparency Register No: 924933110421-64