Reform of the Credit Unions sourcebook

Response to PRA CP 22/15 and FCA CP 15/21

30 September 2015

Building Societies Association

Overview

The BSA is responding to this consultation on behalf of three major credit unions – No.1 CopperPot and Capital Credit Unions which are full members and Glasgow Credit Union which is an associate member. We concentrate in this response on those items within the joint CP that have greatest impact on these members.

We support a growing, diverse and sustainable credit union sector that brings additional competition to mainstream bank lenders as well as providing savings and credit to those otherwise reliant on payday lenders and loan sharks. Any measures that demonstrably promote this vision can be welcomed, but other measures, that could –perhaps inadvertently- hinder this vision, should be revised or reconsidered.

The replacement of the Version 2 status with a more flexible matrix of requirements for credit unions undertaking additional activities is in principle a reasonable development. But some of the requirements, especially the proposed 10% leverage ratio, we think are unjustified. Nor has the PRA done the necessary cost benefit analysis, as required by FSMA, given that there are significant costs. We comment on these matters below.

We also draw attention to one or two important risk issues – including one where credit unions have now been put at extra risk through regulatory activity.

Among the difficulties the sector faces is continued weakness among some smaller, near-insolvent credit unions, with a handful of credit unions still being declared in default each year and their members paid out from the FSCS. So we are puzzled by the emphasis in the joint CP on, in effect, a tougher regime for Version 2 CUs: it is far from clear how this deals with the problem we describe.

We encourage the PRA to continue a constructive dialogue with our members, and to assist in that, we include some specific counter-proposals for discussion.

The remainder of this response follows the order of the joint CP, using the same paragraph references.

Limit on shares and deposits

We fully support the protection of members' savings in a credit union. Members save with their credit union as an expression of solidarity, to enable loans to be made to other members, as well as with a view to their own future borrowing needs. Credit unions do not chase "hot money" through the savings best buy tables. So we do not think there is likely to be a major problem with savings balances exceeding the FSCS limit. But we question whether the PRA's proposed rule is fully justified. First, credit unions should be able to accept deposits that benefit from **temporary high balance protection** under FSCS rules[1] - as these deposits are not exposed to risk of loss. Second, we question whether those credit unions meeting the higher prudential requirements that replace Version 2 status should necessarily be prohibited from allowing aggregate savings to exceed the normal FSCS limit of £ 75,000. Clearly a policy to manage the concentration risk from large shareholdings would be sensible. But the PRA also proposes that these credit unions meet a leverage ratio of 10% - two and a half to three times higher than the ratio envisaged for banks under Basel III - so an absolute ceiling at the FSCS limit seems excessive.

Additional activities framework

In this response, we describe collectively the set of tougher prudential requirements applicable to credit unions undertaking additional activities (and tabulated in Matrix 2 published with the CP) as **"Matrix 2 requirements"** for brevity.

We are content with the principle that the Version 2 status be replaced with a more flexible regime, and that instead of basing Version 2 status on a point of time "snapshot" there should be continuing requirements and obligations. But we disagree both with the main proposal for a 10% leverage ratio, and with some of the range of limits that PRA, having derived them from PEARLS (where they are intended as management targets), has turned into hard prudential rules. At the same time, the PRA has missed the opportunity to read across from banking supervision where hard prudential minima are combined with **buffers** which banks generally maintain full, but can use, and deplete, under stress conditions, and then restore. We explain below where certain proposed requirements could be adapted into this model.

While we agree in part with the PRA's statement in paragraph 2.5 that *"the prescribed ratios are similar to those already in widespread use by UK credit unions"*, and that *"they are regarded as a valuable management tool"*, **this does not extend, without further justification, to turning them into hard prudential rules**. It has been suggested by PRA in discussions that it will not be monitoring quarterly compliance with each one of the limits in Matrix 2. But as they are hard prudential rules, this does not give the credit union any additional flexibility, for instance to dip below occasionally – the CU will have to have ensure it is **"at all times"** in compliance with each

[1] See PRA Rulebook : Depositor Protection, Chapter 10.
http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps615.pdf

rule and will also have to maintain some level of buffer above the new rule minimum to ensure it does not drift into inadvertent non-compliance. This aspect needs to be reconsidered by PRA.

We also consider that there are a few instances where large established credit unions that continuously meet the final version of the Matrix 2 requirements should be given additional flexibility in other directions. A good example is more frequent dividend payments. Rule 2.4 permits CUs to pay an interim as well as a final dividend. Our members, who would all fall under Matrix 2, want the flexibility to pay a **quarterly dividend**. Given the extensive additional prudential requirements proposed in Matrix 2, this is a reasonable and low-risk approach.

Lending

There are a couple of specific items which we think need clarification and if necessary amendment: the interaction of the proposed lending limit rules in section 3, Lending, may not work in a sensible way. Our members' understanding of the policy intention is broadly as set out in Matrix 1 and the CP narrative text: credit unions with a low leverage ratio are limited to £7,500 in excess of shareholding, while CUs with more than a 5% leverage ratio can lend up to £15,000, while those meeting the Matrix 2 requirements can lend up to 1.5% of total shareholding but with an absolute ceiling of £500,000 and a large exposure limit at 25% of capital. The problems relate to **mortgages**, and **subordinated loans** to other CUs.

Mortgages

Our members comprise three of the four major credit unions in Great Britain that have the mortgage lending permission, so the treatment of mortgages impacts them greatly.

First, the absolute ceiling at £500,000 is not appropriate in all parts of the country, given the big differences in house prices and borrowing needs. One of our CUs has individual members who are senior police officers all over the country, including in the high priced areas of London and the South East. The latest Land Registry data[2] confirm that the average property price in Greater London is now over £481,000. In London last year, Rightmove report[3] that even sale prices of flats averaged £460,000 while terraced houses and semi-detached houses averaged well over £500,000. Detached houses in the rest of Southeast England (excluding London) also averaged[4] well over £500,000. So a member who is a senior police officer with a basic salary of close to £ 200,000 might aspire to a detached house in a desirable location in the Southeast or outer London costing well over £500,000 – why should that member not be able to take a mortgage from her / his credit union and be forced to go elsewhere? That would serve only to reinforce the false idea that credit unions are designed only for low income people. We propose a higher limit of **£ 1 million** for mortgage loans only, for those CUs meeting the relevant Matrix 2 requirements.

Second, we disagree with Rule 4.1 (explained at paragraph 2.18) which we think is based on mistaken logic. Mortgage lending does carry particular ***but different*** risks for both the lender and the borrower. The regulation of mortgages under FCA rules addresses only the risks to the borrower, and these conduct rules – whether of FCA's own devising, or implementing the EU Mortgage Credit Directive – could in fact increase the risk to lenders. So the notion that restricting credit unions' mortgage lending to regulated mortgage contracts reduces their risk

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[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/447551/June_2015_HPI.pdf

[3] http://www.rightmove.co.uk/house-prices/London.html

[4] http://www.rightmove.co.uk/house-prices-in-South-East.html

to the credit union because the activity is subject to "appropriate [conduct] regulation" is not necessarily correct.

There is no good evidence-based reason why a large established credit union, that already meets the whole set of Matrix 2 requirements in order to do mortgage lending at all, should not **finance a long-term retirement property for a member, which will be let in the meantime, although this would clearly be a buy to let loan, not currently at least an RMC.** Such consumer buy to let lending, though due to be subject to some degree of oversight as a consequence of the implementation[5] of the EU Mortgage Credit Directive, will apparently not become a full regulated mortgage contract. **But it will be subject to regulation that the Government and the FCA consider "appropriate" – so credit unions should be able to undertake it.**

We also do not think it sensible to preclude the taking of property as (partial or full) security for a small business loan to a member, including a corporate member within the post-LRO common bond, that a credit union could otherwise make. Moreover, other changes flowing from the MCD will mean that *second* charge lending **will** become an RMC in 2016 – though not for credit unions (as they benefit from an MCD exemption). But we are not clear whether the PRA's rules for CUs have taken the MCD changes into account or not. The reference in paragraph 2.18 to the "current" PRA Glossary does not help. The actual text in section 1 of the draft Rule Book states that RMC has the meaning given in article 61(3) of the Regulated Activities Order, and as amended by the MCD Order (SI 2015 No. 910) this **will** include second charge lending generally. But new Article 61A (2) carves out credit union second charge lending from being an RMC. And if the security happens to be a first charge, we think it would not be an RMC either.

The complicated situation resulting from the MCD-driven changes on both buy to let and second charge lending mean that the PRA should pause and reconsider what it is trying to achieve through Rule 4.1. We think it may be simpler and more sensible just to drop it.

Subordinated loans

Turning to subordinated loans, there seems to be some discrepancy between paragraph 2.15 and the Rules in section 3. Our understanding of Rules 3.4 and 3.5 is that a credit union that satisfies Matrix 2 requirements may make a subordinated loan of 1.5% of total shareholding, with an absolute limit of £ 500,000, to another credit union, whether a member of the first credit union or not. Paragraph 2.15 however states that (all) loans to other credit unions are capped at £15,000. It is not clear whether this is further qualified by paragraph 2.16 or not. Clearly, limiting subordinated loans to a ceiling of £15,000 means they can add little practical value in helping to sort out capital shortfalls at weaker CUs.

Return on lending

Matrix 2 requirements include a new rule requiring the CU to achieve a return on its loan book above 6% pa. While it is obvious that credit unions must –as our members already do – achieve an adequate return on lending in order to be sustainable, and in principle it is reasonable for PRA to press for this through CREDS, we think a simple price floor is the wrong approach, and could even fall foul of PRA's own competition objective in section 2H of FSMA[6] : "**the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities"**.

[5] https://www.fca.org.uk/news/ps15-11-buy-to-let-mortgages-implementing-mortgage-credit-directive-order-2015-feedback-on-cp15-3-final-rules

[6] Introduced by section 130 of the Financial Services (Banking Reform) Act 2013

Moreover, an average price floor at 6%pa is likely to be harmful in the current interest rate environment, where the Bank of England itself commented[7] on 15 July 2015 that interest rates on personal loans had fallen to the lowest levels since records began. Our members also offer mortgage loans – and these need to be competitive with the market, just as much as personal loans. As the Guardian reported[8] on 8 August, a creditworthy borrower can borrow £7,500 to £15,000 unsecured at 3.6% from up to five mainstream lenders, while the Bank's own data show rates on two to five year fixed rate mortgages between 2% and 3%.

For any credit union with an occupational common bond, where typically the members are in employment on modest but reasonable incomes, and therefore credit worthy, this rule makes the CU uncompetitive across the board. Police officers, for example, will have no difficulty accessing the kind of deals reported by the Guardian. So their credit union will be unable either to lend to them at 6%, nor to find high-return borrowers to lend to at 12% in order to offset a tranche of competitive lending at 3-4%. Even for credit unions with a geographical common bond, where there will be some demand for higher-rate credit, the reason why the 6% floor will be counterproductive is that it imposes adverse selection on the credit union – as it steers the credit union to servicing primarily the higher-risk segment. For every loan that a credit union makes to a reasonably creditworthy member at say 4%, it must make an equivalent loan to a riskier member at 8%, just to preserve the minimum yield of 6% averaged across the book.

This rule leads to perhaps unintended consequences and therefore should be reconsidered.

Provisions and write-offs

We disagree with some of the specific rules now proposed, and we think the general direction of travel appears to be inconsistent with international accounting standards as applied to credit unions under FRS 102.

We agree that impairment of loans should be addressed by rigorous provisioning : it is in nobody's interests – least of all the CU's members – to pretend that impaired loans are sound. But it is a mistake is to require bad debts to be ***written off*** where more than twelve months in arrears.

For mortgage lending, this is not feasible at all (although repeated at Rule 4.3(1) in the section on Mortgages). The correct course of action for a mortgage loan will be to pursue repayment (in accordance with FCA conduct rules) and provide for any anticipated security shortfall – but it is unlikely that a property would have been taken into possession and sold within twelve months of arrears commencing.

Even for conventional credit union unsecured personal loans, twelve month write off is unnecessary and counterproductive. We think PRA has muddled the concepts of **writing off** and **making full provision**. We agree that in general unsecured personal loans that are in arrears for twelve months or more should be fully provided – though we are not persuaded that this needs to be a rule. But there should be no rule requiring a CU to **write off** such a loan (and thereby release the borrower from liability) – it is for the CU's management to decide, case by case, which loans should still be pursued for recovery and which written off as irrecoverable.

We think it is also a mistake to move away from requiring a **general provision** on conventional unsecured loans. Loan losses are a cost of doing unsecured lending, which should be factored in to product planning and pricing, and making an upfront general provision helps build resilience – indeed, this is a simpler, lower cost, but better targeted measure than some of the PRA's other proposals.

[7] Bank of England Credit Conditions Survey Q2 2015 pages 6 and 7. http://www.bankofengland.co.uk/publications/Documents/creditconditionsreview/2015/ccr15q2.pdf
[8] http://www.theguardian.com/money/2015/aug/08/borrowing-personal-loans-cost-cards-interest

Accounting practice has also moved away from an **"incurred loss"** to an **"expected loss"** model for loan loss provisioning, as agreed by the International Accounting Standards Board in 2014. As stated by the ICAEW at the time :

The new model focuses more on the level of credit losses expected in the future and allows for earlier recognition of losses than was previously possible under the IASB's standards.

So it seems odd for PRA in effect to be encouraging a move back towards an incurred loss model, with consequently less built in resilience to loan losses.

Borrowing

We reject PRA's plan to abolish the higher borrowing powers currently available to Version 2 CUs – we do not consider the fact that currently Version 2 CUs may not be using the higher range of borrowing to be sufficient justification for removing it entirely. There is a very simple reason why many Version 2 CUs, including our members, have no current need for higher borrowing – with general interest rates at record lows for the last six years, the cost of unsecured borrowing for prime borrowers is also very low by historic standards, credit union borrowing rates are not necessarily competitive, and lending volumes have been lower – but the steady inflow of members' regular savings has continued. Many credit unions are therefore very liquid at present. As general interest rates rise, this situation is likely to unwind. Borrowing rates from commercial competitors will rise somewhat, and credit unions may well see loan demand increase, with potential also for an element of seasonality (higher loan demand around Xmas / New Year and summer holidays), and stronger growth in bigger ticket loans, such as car loans, as consumer confidence continues to improve in tandem with economic growth. **We would not oppose a modest lowering of the borrowing limit – say to 30% for CUs meeting Matrix 2 requirements**.

Investment

We are content with the proposals relating to investment, but need an important piece of clarification. We support the change in Rule 6.4 (5) but we need to probe further exactly what is meant by a "product". The background to our concern is that, concurrently with this CP, but as a consequence of the implementation of the EU's amended Deposit Guarantee Schemes Directive, credit unions lose the protection they previously enjoyed under the FSCS. Not only that, as holders of unsecured deposits with banks, their claims are liable to be written down or converted to equity in the bail-in needed to recapitalise that bank. So, at a stroke, the credit quality of all credit unions' deposits with banks has been undermined.

Both among smart real-money investors, and in day to day interbank dealing, there is a pronounced shift from unsecured toward secured depositing. Instead of placing a book deposit, or buying an unsecured CD, such investors are either turning to (secured) reverse repo – that is, purchase and resale transactions whose economic substance is that of borrowing secured on collateral in the form of liquid securities – gilts, etc – or purchasing covered bonds – collateralised securities issued by banks with high credit quality and liquidity (and indeed recognised in authentic international standards (Basel III and CRD 4) as an important component of deposit-takers' liquidity).

So, PRA needs to ensure that at least one of items (1) , (2) and (5) of Rule 6.4 will allow a large CU meeting Matrix 2 requirements to buy and hold covered bonds instead of making unsecured deposits. We do not think the natural meaning of "product" necessarily encompasses covered bonds, though they may possibly qualify under either (1) or (2). PRA needs urgently to clarify how Matrix 2 CUs can hold covered bonds, amending Rule 6.4 if necessary. It would also be sensible for PRA to clarify, with proper reasoning, whether CUs can undertake reverse repo.

Capital

While we fully support the adequate capitalisation, and thereby the resilience, of credit unions, our members fundamentally disagree with the PRA's proposal to move to a **10% leverage ratio**, for large credit unions, which would be the most onerous capital requirement for credit unions in any advanced jurisdiction. We note that the CP does not use the term "leverage ratio" (though it is now the accepted term in use by the Basel committee, the Bank of England itself, the FPC and the PRA to refer to a simple non-risk weighted capital to assets ratio) but we use it throughout in this response to underline the divergence of the PRA's proposals for credit unions from other areas of Bank / PRA policy, and indeed from other comparable credit union jurisdictions. Moreover the statement in the CP that "the increase in the ratio from 8% risk-adjusted brings it into line with internationally- accepted standards" is demonstrably incorrect on at least two levels. The absence of cost-benefit analysis on such a major change is also unfortunate. (Nor, as we pointed out above, does this change do anything to address the problem of numerous small, near-insolvent credit unions in the UK.)

We first analyse the PRA proposal into its two elements. The current requirement for Version 2 CUs is that risk adjusted capital / total assets >= 8%. It is important to realise that this is not a risk-weighted ratio in the generally understood sense (the asset categories are not weighted to reflect relative risk). The only adjustment is to add back into capital any excess provisions above the formula level, so slightly increasing the denominator. The current requirement is therefore really a modified leverage ratio. The PRA's proposals have two elements – to remove the excess provision from the capital denominator; and to raise the minimum ratio from 8% to 10%. In one sense, this is a return to the past – a reversion to the primitive 10% reserve ratio applicable under the Credit Unions Act for CUs that wanted a Section 11C certificate. PRA's predecessor the FSA made a considered move[9] (based on proper cost-benefit analysis) away from this approach in 2001.

The removal of the so-called risk-adjustment could be justified as part of a package introducing other aspects of risk-sensitivity, in which case there would be more alignment with emerging international best practice in credit union regulation – as we explain below. But as proposed the PRA's new 10% leverage ratio is surprisingly onerous. One of our members - well capitalised under both current and proposed rules -has modelled its impact – and the effect is to halve its cushion of surplus capital from 94% of the current minimum to 47% of the new minimum. Clearly this will have an impact both on the potential rate of loan growth (and therefore on lending capacity and competition), and also potentially on pricing. The (opportunity) costs from the halving of a major credit union's surplus capital cannot be regarded as of minimal significance. We address this further in the section on cost-benefit analysis below.

International comparisons

Turning to the question of "internationally-accepted standards" we have researched the published capital requirements of the leading credit union regulators overseas, and the conclusions are greatly at variance with PRA's assertions and proposals. Our research covers the following comparable jurisdictions: **United States** (Federal – NCUA), **Australian** (APRA), **Canadian provinces** – Ontario and British Columbia, and **Ireland**. Only in Ireland is a 10%

[9] FSA CP 77 (2000) : http://www.fsa.gov.uk/library/policy/cp/2000/77.shtml paragraphs 7.39 to 7.43 and 11.22 to 11.42

leverage ratio in place, moreover this was introduced[10] - as a panic measure - in 2009, at the height of the financial crisis when that country and its whole financial system were virtually bankrupt, and its credit unions in particular at grave risk, so we do not consider it an appropriate precedent for the UK in 2015. But even in Ireland, the regulator proposed[11] an alternative risk based calculation from 2010 onwards though this has not yet been taken forward : in 2013 the Irish regulator stated[12] that ***"Consideration will be given to a risk weighted asset approach for category 2 credit unions following restructuring of the credit union sector."***

We have also examined the publications of the International Credit Unions Regulators Network (ICURN) - in particular ICURN's **Guiding Principles for the Effective Prudential Supervision of Cooperative Financial Institutions[13]** where again no mention is made of this alleged "internationally accepted standard" – which in itself is not surprising as the advanced regulators in fact do the opposite. ICURN's Guiding Principle 5 just says:

CAPITAL ADEQUACY

The supervisory authority must establish and enforce the rules for an appropriate capital framework with which all regulated institutions must comply. The rules should balance cooperative principles and objectives with the need to protect depositors. Accordingly, supervisory authorities will need to carefully consider what meets the criteria for capital and to ensure that capital instruments are able to absorb losses in the event of failure.

When supervisors choose to align the capital requirements of credit unions to Basel standards, a simplified approach may be adopted for small or simple credit unions that are not allowed to hold complex financial instruments. For such institutions, compliance with the most advanced risk measurement techniques may be beyond their resources. Therefore, the regulator may require additional capital to support the limited information that may be available for supervisory authorities.

The facts as to other major jurisdictions are briefly as follows. The **US Federal** jurisdiction, the **NCUA**, is in the process of moving the largest, established credit unions ***onto*** (not away from) proper risk weighted capital requirements. The NCUA's revised proposals[14] [15]would apply risk-based capital requirements to CUs above US$ 100 million assets, and these would be set at 10% (corresponding to well- capitalised) and 8% (corresponding to adequately –capitalised, but with an earnings retention requirement). Risk weightings would be comparable to Basel standardised RWs. The current non risk weighted ratio is 7% capital to assets, and this would remain as the sole requirement for smaller credit unions, and as a parallel requirement for larger credit unions[16].

The credit union regulators of the **Canadian provinces** issued an important statement on capital adequacy principles[17] in December 2012. The first principle is stated as follows:

Taking into account the unique structure of credit unions, capital adequacy standards should be modelled on the Basel framework for quality and quantity of capital, and the OSFI's published guideline applicable to federal deposit-taking institutions for risk weighting……..

[10] Regulatory Reserve ratio for Credit Unions (2009) https://www.centralbank.ie/regulation/industry-sectors/credit-unions/Documents/Regulatory%20Reserve%20Ratio%20-%20August%202009.pdf
[11] ibid- Section 3 : Proposed Risk based Approach
[12] Central Bank of Ireland, CP 76 (Dec 2013) : paragraph 5.9.1
[13] http://curegulators.org/curegulators_resources
[14] http://www.ncua.gov/about/Documents/Agenda%20Items/AG20150115Item4b.pdf
[15] http://www.ncua.gov/Legal/Documents/RBC/RBC-2015-Proposed-Rule-FAQs.pdf
[16] http://www.ncua.gov/Legal/Documents/RBC/RBC-Proposal-Comparison.pdf
[17] http://cupsa-aspc.ca/pdf/publications/CapitalAdequacyPrinciples.pdf

Capital requirements in **Ontario**[18] are : for Class 1 CUs, 5% leverage ratio, for Class 2 CUs, both a 4% leverage ratio, and an 8% risk weighted ratio.

Capital requirements in **British Columbia**[19] are : 6% risk weighted (absolute minimum, but restrictions apply), 8% risk weighted (adequate), 10% risk weighted (target).

In **Australia**, APRA will be applying Basel III to credit unions on the same basis as other deposit takers[20]. Australian CUs will therefore have to calculate their capital adequacy on a risk weighted basis, presumably using the revised standardised approach, and maintain a risk weighted ratio of 8% minimum[21], with a capital conservation buffer of 2.5% on top. In due course, if Basel finalises a leverage ratio, that will apply as well – probably at a level of 3-4%.

From the above research, it is clear that – far from moving into line with international standards, PRA proposes to diverge from them. PRA may have been led astray by the so-called "Model Regulation" of the World Council of Credit Unions, which advocates a 10% leverage ratio. This was designed for the development of credit unions in Central and South America, and has no relevance to advanced jurisdictions.

Problems with a leverage ratio as primary capital constraint

There are two basic issues – whether, for larger and more established credit unions, a risk weighted capital ratio should at least supplement a leverage ratio, and at what level either of these ratios should be set. On the first issue, it is clear that the US Federal, Canadian provincial and Australian jurisdictions all favour risk based ratios at least for larger CUs. As to level, all these jurisdictions are tending to approximate to the Basel level of 8% RWA, with - in effect - a buffer of 2% on top. So – paradoxically – the current capital requirement for Version 2s is closer to actual international standards than the PRA's proposals.

There are two principal reasons why a high leverage ratio, acting as the sole or principal capital constraint, is the wrong answer for Matrix 2 credit unions. First, some of the largest credit unions, such as our members, are also increasingly active as mortgage lenders. The risks from mortgage lending are quite different in degree to those arising from traditional CU unsecured personal lending, and these relativities are reflected in CUs' relative pricing for mortgages as opposed to personal loans. Were it to be the case that all credit unions' business remained personal unsecured loans only, risk weighting would make little difference -but this is no longer the case for the largest CUs

The second reason not to move to a leverage ratio is that it effectively overstates the risk from credit unions' liquid asset holdings. At a time when – as explained above – credit unions have particularly high liquidity, it makes no sense to assume – as a leverage ratio calculation must – that those liquid assets are as risky as their unsecured loan book.

In discussion, PRA has advanced the argument that some credit union boards are incapable of understanding even a simple risk weighting calculation. We doubt this exaggerated rhetoric, and even if there were substance to it, the correct response would be to educate boards, not regress to a primitive leverage ratio.

A better approach for Matrix 2 might be to keep a leverage ratio, set at a far more modest level, as a back stop, with a higher risk adjusted ratio as the primary requirement. This would be fully in line with internationally accepted standards, where the Basel Committee is introducing a

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[18] http://www.ontario.ca/laws/regulation/090237#BK18

[19] Capital Requirements Regulation, BC Reg 315/90, sections 9 and 10 : https://www.canlii.org/en/bc/laws/regu/bc-reg-315-90/latest/bc-reg-315-90.html

[20] http://www.apra.gov.au/ADI/Pages/Default.aspx

[21] Prudential Standard APS 110, paragraphs 22-29, Attachment A : http://www.apra.gov.au/adi/Documents/150507-APS-110-Capital-Adequacy.pdf

leverage ratio (expected to be in the range 3% to 4%) to act as a back stop to the more complex risk weighted requirements that apply.

Finally, PRA has missed the opportunity to reflect another aspect of internationally accepted standards, by not introducing some form of **capital buffer**. Australia applies the Basel III capital conservation buffer. The Canadian provincial credit union regulators already understood this in 2012 : CUPSA's capital adequacy principles also say :

Quantity of capital should include appropriate capital conservation and countercyclical buffers reflecting international best practice.

US Federal capital adequacy standards have an effective buffer through the distinction between what is an ***adequately capitalised*** , and a ***well capitalised*** credit union. Under the NCUA's latest proposals, as explained above, a CU with an 8% risk weighted capital ratio would meet the minimum standard, but would be subject to earnings retention requirements to build capital. At 10% risk weighted capital ratio, the CU would be regarded as well capitalised, and the earnings retention obligation would fall away. This is equivalent to a basic requirement of 8% with a 2% buffer.

Counter-proposal on capital

Taking all the above considerations into account, we propose – for discussion - the following alternative as part of the Matrix 2 requirements. A credit union with assets above £ 10 million and/or more than 10,000 members and/or undertaking additional activities could be required :

to maintain a minimum risk weighted capital ratio of 8%, using simple risk weights for mortgages and liquid assets (based on standardised Basel);

to build, and maintain, but with permission to use under stress, an additional buffer of 2% (risk weighted) ;

and to maintain (as a back stop) a non risk weighted leverage ratio of 4%.

the denominator in both cases would be capital without the present provisions adjustment.

The PRA's proposed rule (at 8.7 /8.8) on 20% earnings retention would then apply to any credit union whose risk adjusted capital fell below 10%.

In terms of international consistency, this counter-proposal would be very close to (i) the rules applicable to larger credit unions in Ontario ; (ii) the US Federal NCUA rules for larger credit unions ; and (iii) application of Basel III to Australian CUs.

Liquidity

As mentioned above, many credit unions currently hold high or very high liquidity, as demand for loans is subdued. So higher liquidity requirements may not create any problems today, but that does not mean they are either necessary or justified. Nor do we accept the removal of seasonal flexibility. PRA provides no evidence that its assertion that seasonal fluctuations are now less significant represents a "new normal" rather than a temporary change.

The PRA's proposals substantially increase the liquidity requirements for Matrix 2 credit unions (without any specific justification) while at the same time removing the sensible seasonal buffer provision in CREDS. Moreover, by changing the denominator of the liquidity ratio from net (unattached) shares to total shares, the effect of the requirement is raised even higher – again without justification: the point about attachment of shares is that attached shares cannot be withdrawn while the loan is outstanding, so they do not create liquidity risk in the same way that unattached shares might.

Counter-proposal on liquidity

A more sensible approach would be to retain the seasonal buffer, but raise the minimum requirement. **Our counter-proposal - for discussion - is as follows: Matrix 2 credit unions must maintain liquidity of at least 10% of unattached shares at all times. They should also maintain a 5% buffer above that, for use during seasonal or other outflows. But their liquidity should not fall below 15% (in total) on two successive quarter ends.**

Waivers, modifications and updating of monetary limits

All the rules in Matrix 2 should be capable of being waived or modified through the process provided in FSMA. The draft Rulebook does not indicate whether this is to be the case. There will always be situations in which a particular rule can be shown either not to be meeting its purpose, or to be unduly burdensome, and therefore deserving of waiver or modification.

The PRA should also be ready to review and raise monetary limits at suitable intervals. Although this may not be needed in the short term, as the real value of these limits will persist in the current low inflation environment, this will not always be the case. The PRA should state that the real value of all monetary limits in the Rule Book will be periodically reviewed and revalorised.

Cost benefit analysis

The PRA is required to do Cost Benefit analysis by section 155 (2) (a) and (10) of FSMA. The only permitted exception is where the increase in costs is either zero or of minimal significance. PRA asserts that costs of only minimal significance are expected because "most credit unions already operate in line with the requirements proposed". But this is false reasoning, and PRA has fallen into the basic error of assuming that because some, or most, credit union may happen to be in compliance with the new rule today, there are no costs, including opportunity costs involved.

We illustrated above the actual estimated impact on one of our members – halving the surplus capital from 94 % on top of minimum requirements to 47%. The following stylised example illustrates more clearly why this kind of capturing of existing capital surplus matters – affecting growth and pricing.

Version 2 Credit Union A currently has a 16% risk-adjusted ratio, showing a 100% surplus over its minimum requirement of 8%. A's prudent board sets its own internal capital floor, well above that minimum, at 12% - i.e. with a buffer of 4% (or 50% of the minimum). That means A's growth is planned with the constraint of keeping above 12%. Unexpected losses or other unforeseen circumstances, might lead to A dipping into its buffer, which would then be rebuilt. But at present A has spare capital of 4% to expand its lending immediately as opportunities arise.

The removal of the excess provision adjustment reduces A's ratio to 14.5%, while the minimum requirement is increased to 10%. A's total capital surplus reduces from 100% to 45%. A's Board, being prudent, continues to maintain a 4% internal capital buffer over the regulatory minimum – this now corresponds to 40% of the new minimum. But an internal capital floor of 14% is very close to the actual capital of 14.5% - only ½% spare. The effect of the PRA's proposals on a prudent CU that keeps a healthy internal capital buffer is to slash its spare capital, and therefore its lending capacity by nearly 90%.

In the steady state, maintaining a higher capital requirement also affects the relationship between the CU's maximum rate of growth, and its level of retained surplus (and therefore loan pricing). At any given level of capital, *ceteris paribus*, the maximum rate of asset growth possible while maintaining that capital ratio is proportional to the rate of profit retention: the faster a CU grows, the more profit it must retain. In the same way, for the same rate of asset growth, the higher the (static) required capital ratio, the higher the minimum profitability that must be achieved – alternatively, the higher the static capital requirement, the lower the maximum rate of asset growth that a given level of profitability can sustain. So, of necessity, a higher capital requirement will either depress asset growth potential, or tend to push up loan rates, or reduce dividends, or some combination of these.

This analysis does not conclude that capital requirements should not be raised at all – rather, it challenges the PRA's simplistic view that to do so involves no significant costs. In our view, the PRA's proposals should have been supported by a proper, substantive cost-benefit analysis.

Other issues

We highlighted above, in the section on investments, that as a result of the recent changes to the FSCS compensations arrangements as a consequence of the amended EU Deposit Guarantee Schemes Directive, credit unions have lost the FSCS protection that their deposits with banks and building societies previously enjoyed, and- moreover- by virtue of the implementation of the EU Bank Recovery and Resolution Directive, credit union deposits could *in extremis* be written-down during the bail-in and resolution of a failing bank. Credit unions consequently need some practical low-risk or risk-free alternatives for holding their liquid assets. We referred above to the need to clarify a credit union's ability to buy and hold covered bonds. The other missing item, at least for credit unions meeting Matrix 2 requirements, is access to reserve accounts at the Bank of England. Since late2009access to these sterling monetary facilities has been open to all banks and building societies, even the smallest. For operational reasons, they would not be suitable for smaller credit unions, but we think there is now a strong case for Matrix 2 credit unions to be able to hold reserve accounts at the Bank. We have already made this point in response to the Treasury's recent consultation on the Bank of England Bill.

FCA proposals

The FCA's proposals cause little concern to our members – in many respects they are a necessary consequence of the separation of the present sourcebook between the two regulators. We have no particular comments to make.

Conclusion

The replacement of Version 2 status with a potentially more flexible matrix of prudential requirements for large established credit unions intending to undertake additional activities is in itself reasonable. But our members take issue with specific proposals – the 10% leverage ratio, the changes on liquidity, the rule on return on lending, and certain others detailed above, and some further clarifications are also needed. In view of the greater risk that credit unions now face from the loss of FSCS cover for their liquidity held at banks, we urge the authorities to agree that Matrix 2 credit unions at least should have access to reserve accounts at the Bank of England.

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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 £330 billion, and account for approximately 20% of both the UK mortgage and savings markets