

Credit Union Team
Prudential Regulation Authority
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CP7/22 Credit Unions: Changes to the Regulatory Regime

Dear Credit Union Team,

We welcome the opportunity to respond to this consultation. The Association of British Credit Unions is the primary trade association representing credit unions in England, Scotland and Wales, with around two thirds of credit unions in mainland Great Britain affiliated to the Association.

Following continued consultation of our membership, ABCUL has considered the PRA's proposals to change the credit union regulatory regime with regard to the needs of our diverse range of member credit unions.

Overall, we believe the PRA's proposals support British credit unions to be professional, well-governed and financially sound. The new supervisory statement provides a clear, robust, and tailored approach to credit union supervision. We fully support the PRA's intentions with its proposals to tailor the level of expectation of credit unions to the scale and complexity of its business model. We consider that the PRA's proposals on the whole balance its primary objective of ensuring the prudential safety and soundness of firms with its secondary objective to promote competition. However, our response will highlight where we consider that the proposals may have unintended consequences or apply disproportionately to a sub-set of credit unions.

We would like to thank the PRA for its continued support and regard to ensuring the strong and competitive performance of the credit union sector. We appreciate the review of the credit union regulatory regime and the clarity on the PRA's expectations at this time, as the credit union sector plans to grow and expand into a wider range of services in 2023.

Our consultation response will first address the proposed amendments to the PRA rulebook and will then consider the draft supervisory statement in order of the document's subsections.

Proposed Changes to the PRA Rulebook

Extension of Additional Activities Definition

We assess that the PRA's proposal to include corporate member lending within the definition of additional activities is fair and proportionate to the risks associated with this activity. Whilst credit unions can already offer corporate member lending, we understand that the PRA is responding to emerging risks as more credit unions look to lend to corporate members.

We understand the heightened risk associated with corporate member loans and agree that credit unions that undertake this lending should have sufficient regard to this risk, and the wider financial health of their businesses. The additional activity requirements are not viewed as onerous, therefore we do not consider that the additional activities requirements will act as a barrier to credit union corporate member lending activity.

We assess that it is fair to define the provision of credit cards, as a small portion of credit unions look to start offering this product in the foreseeable future. It is recognised that credit cards pose greater risk financial risk than traditional credit union loan products and applying additional activity requirements to these products is seen as a sensible proposal.

As there are heightened conduct regulations associated with hire purchase and conditional sale agreements, we agree that it is appropriate for the prudential requirements to ensure these products are offered soundly and professionally by credit unions taking advantage of legislative reform. We would also note the additional activity requirements are proportionate for medium to large credit unions, which are more likely to have the capacity to meet FCA regulations for these products in the first place. Therefore, we believe it is reasonable to include hire purchase and conditional sale agreements as additional activities.

New Permitted Investment products

We support the PRA in looking to widen the range of investment products available to credit unions. We hold no objections or concerns related to the proposed rules for the new permitted investment products. The proposed restrictions on the quality and limit of these investments are reasonable given the more complex nature of these investments.

Lending Limits

We believe that the proposed term limits for hire purchase and conditional sale agreements are appropriate.

We agree that it is fair to apply the current limits on outstanding loan balances across all loans held by a member. However, we would see there being clarification needed as to how the amendments to rule 3.4 and 3.5 would apply to credit unions that would breach the new limit on all loans held by that member but are within the previous limit on the balance for individual loans. Though the PRA assesses that credit unions generally interpret the pre-existing loan value limits to mean the sum of all outstanding loan balances held by a member, there are likely to be exceptions where the credit union has reasonably interpreted the limit on the outstanding balance to apply to each individual loan.

Proposed Supervisory Statement

Overall, we assess that the proposed supervisory statement provides clear and easy to understand guidance on the PRA's expectations of credit unions in a broad range of areas. We agree with the PRA's tiered approach to setting expectations that reflect the credit union's size and complexity. However, we would wish to make comments on areas of the draft supervisory statement that may result in unintended consequences in practice or are disproportionate in some cases.

We think that further guidance on how the content of the supervisory statement applies to credit unions would be beneficial to include within the final draft, to clarify the meaning of expectation as opposed to a rule. It could also be clarified if credit unions may not need to meet all these expectations in certain circumstances, to ensure that the expectations are applied appropriately to the diverse range of credit union business models.

In addition, we would ask that the PRA review the £10m assets threshold put in place for many of the new expectations in the supervisory statement and consider increasing this threshold to £15m. We believe the threshold should be increased to £15m in assets in line with the PRA's current definition of large credit unions for its supervisory approach to the sector. Maintaining this threshold would not only ensure consistency in the supervision and regulatory requirements imposed on medium-sized credit unions, but also proportionality. Credit unions under the £15m assets threshold can still be recommended to consider the expectations placed on larger credit unions as best practice.

Capital

We believe it is reasonable for the PRA to expect that credit unions should act to review and potentially improve their capital composition where it is reliant on mostly alternative forms of capital out with the historical norms of accumulated reserves/retained earnings. We agree that in the long term a credit union should be able to hold a reasonable proportion of its capital requirement in retained earnings and not rely too heavily on external investment, as part of maintaining a sustainable business model. Though a credit union may reasonably be supported from these forms of capital in the short term to recover from financial shocks or where a strategic imperative exists around long-term business planning and product/service innovation, these credit unions that are reliant on these forms of capital may be vulnerable to financial risks in the long-term.

However, the new expectations on capital composition as proposed may prevent investment in well-capitalised credit unions, which in turn could prevent potential growth for these credit unions and the sector more widely. We would suggest that an amendment be made so that the expected limit on alternative forms of capital only applies to 50% of the credit union's capital requirement, as opposed to 50% of its total capital. This change would enable credit unions to receive the investment they may need to accelerate growth whilst ensuring they have a strong capital base

It would be reasonable for the PRA to remain explicit in its expectations that credit unions should consider how they will not be reliant on these external sources of capital investment for the long-term. We believe the PRA is fair in its stated approach of working with the relevant credit

unions to reduce their reliance on these alternative forms of capital where overall sustainability is questioned/at risk. It's important to recognise the sectors definite desire to see product and service innovation and to operate more competitively within the wider financial services market across the country.

Furthermore, we hold concern around the draft supervisory statement's approach to imposing capital add-ons to credit unions in certain circumstances.

Our first concern is around the uncertainty this presents to credit unions. Whilst the PRA may only look to impose capital add-ons in a small number of cases, the message conveyed in the supervisory statement is unclear on the extent and frequency that this measure will be applied. This presents challenges for business planning for credit unions.

Our second concern is one of proportionality. Though capital add-ons feature commonly in the supervision of other types of firms, many of these firms have a lower base capital requirement that may be supplemented with capital add-ons. Credit unions, on the other hand, have a simple and tiered capital regime that is tailored to the scale and scope of the sector. As part of this approach, larger credit unions are required to hold a much higher amount of capital as a standard, in proportion to the greater risks they pose.

Further clarification on the circumstances where the PRA will look to impose a capital add-on and an indication of the scale/value of a potential add-on would provide more certainty and assurance to credit unions.

Liquidity

The proposed expectations of what a liquidity management policy should include are detailed but provide a useful standard of best practice for maintaining liquidity management policy. However, the proposed expectations demand a much greater focus and resource to be spent on liquidity management for credit unions with over £10m in assets. We would suggest that the PRA consider if this threshold can be increased to over £15m assets to ensure consistency with the current threshold of supervision for large credit unions, and to keep expectations proportionate to medium-sized credit unions.

In addition, we would assess that the proposed expectations for liquidity stress testing may be disproportionate for some of the proposed

categories of credit union it would apply to. Liquidity stress testing will likely require notable resources to conduct for a credit union and present a significant increase in risk compared to previous requirements. Whilst this expectation may be reasonable for the largest credit unions, we believe it is disproportionate to hire purchase and conditional sale agreements, as well as corporate member loans. The work involved with liquidity stress testing, on top of other compliance requirements, may serve as a barrier to credit unions offering these products to their members.

Additional Activities and Membership Size

We agree with the inclusion of a new expectation that credit unions with a rapidly growing membership size should consider and address risks associated with their membership growth.

Lending

We agree with the new and clarified expectations for lending to corporate members. The proposed expectations for managing risk of corporate member lending are proportionate to the level of risk involved with business lending and provide useful clarification to credit unions looking to start providing these loans.

We also agree with the PRA's supervisory approach to mortgages taken in the new supervisory statement. The wording of this subsection of the supervisory statement and references to best practice provide enough flexibility for credit unions to only consider the content of SS20/15 that is relevant to their business. The new expectations are not overly prescriptive, whilst setting clearer expectations and standards in this area that will help continue the professional and prudentially sound provision of credit union mortgage products.

We would also support the new clarified expectations for risk management related to credit cards, as more credit unions look to offer this product. However, we would find it unreasonable and unnecessary to expect a credit union board to hold direct experience of providing credit cards. Whilst it is reasonable for a credit union to have the right knowledge operationally to provide credit cards, we do not see the need for there to be specific experience of credit card provision on the board when its involvement is limited to risk management and oversight of this product.

Investments

We disagree with the proposal to introduce limits on investments held with a single counterparty in the new supervisory statement.

We would strongly object to the 20% limit for the share of investments to be held with a single counterparty. Credit unions may only hold investments with a small handful of highly rated counterparties as a valid risk-mitigation strategy. The credit unions may opt to concentrate their investments on a small number of highly rated counterparties if have limited knowledge and expertise of investments, or just a low-risk appetite. Though diversification of investments may make sense in many cases, the forced diversification to hold investments with at least five counterparties may lead to credit unions having to opt for investment options that exceed their risk appetite. They may also be forced to make investment decisions that they do not have the expertise to fully consider. Forcing a credit union to diversify their investments in such cases would be counterintuitive to the aim of lessening risk.

We would also object to the investment limit of 75% capital being held with a single counterparty. A credit union may reasonably vary the size of its investments according to the quality and risk of the counterparty it is held with. A credit union may come to the valid conclusion that an investment with greater value than its capital held with a highly rated counterparty is a safe investment.

We believe the requirements to maintain an investment policy for credit union undertaking additional investments are proportionate.

Governance and Organisation

We agree with the approach to setting governance expectations for credit unions over a certain asset size as best practice, with the flexibility for these credit unions to not fulfil all of these best practices if they are not appropriate. We would, however, argue that these expectations are applied to credit unions above £15m, to ensure consistency with the PRA's current supervisory approach, as we have discussed earlier in our response.

We would suggest amendments to the best practices set out for formal assessment of board members. First, there are concerns around the practicality of a formal assessment of all board members to be conducted annually, as this may be a time-consuming undertaking for the chair that is acting in capacity as a volunteer. The second

amendment would be that the annual formal assessment of the chair has the flexibility to be conducted by a panel, rather than this expectation being placed on the vice-chair alone.

Regarding the new expectations on business planning, the expectations for what a business plan should include are sensible and provide useful clarification for credit unions in this area.

However, we are concerned that the set expectation for all credit unions to share risks and benefits, stress tests and financial projections for any significant business model changes with the PRA may be a disproportionate measure for smaller credit unions. It may be appropriate for the PRA to amend this expectation so that it only applies to credit unions over a certain assets size. We would also raise that further clarification on what would qualify as a significant change to the business model would be beneficial.

Risk Management

We support the PRA's approach to risk management in the supervisory statement. It is vital credit unions are encouraged to have sufficient risk management processes in place that are appropriate to the scale and risk of their businesses. We agree that it is proportionate for the largest or more complex credit unions to be expected to undertake scenario analysis and testing, to ensure they have paid due regard to potential financial shocks that they may be exposed to.

However, we would like to raise two concerns with the proposed expectations for the credit union's internal audit function. Our first concern is that the expectation that the internal audit function is sufficiently independent from the board will be impractical in many cases for credit unions. Whilst this expectation is more feasible where an internal audit function is outsourced, it will be largely impractical for most of the credit unions that do not outsource this function.

Our second concern is that the new internal audit function requirements are prescriptive and are likely disproportionate to small credit unions. We would suggest that a note to allow for proportionate application of the new requirements is included in section 9.4 of the supervisory statement.

Operational Risk and Resilience

We strongly agree with the PRA's outlook that proactive management of operational risk prevents reputational damage to the sector through mitigating disruption to credit unions' services and members.

We assess that the newly stated expectations for operational risk management are reasonable for the majority of credit unions. The list of operational risks that credit unions should consider provides clear and useful expansion on pre-existing rules 17.1 and 17.2 in the PRA's rulebook. However, these expectations may not necessarily scale down proportionately to the smallest credit unions. As a result, we would recommend that this section includes a caveat that expectations for risk management should be applied proportionately to the scale and nature of the credit union.

The more prescriptive expectations for credit unions over £10m and £50m in assets respectively are proportionate to both their capacity and responsibility to prevent disruption to their members.

Exit Strategy Planning

We believe that extensive exit strategy planning is an unnecessary requirement for even the largest credit unions, provided they are prudentially sound. Continuous exit strategy planning would be resource intensive requirement, which is likely unnecessary where the credit union is well-capitalised, has a strong business model and has conducted full stress-testing and scenario analysis. It would be more proportionate for exit strategy planning as a reactionary supervisory measure, which is not employed if the neither the PRA nor credit union holds any concerns for the short to medium term financial health of the business.

We would also add that it is unlikely that a transfer of engagements would be viable in the context of the largest credit unions, with only a small number of credit unions currently existing at this scale. If the PRA is looking to takes steps to ensure orderly resolution for the largest credit unions if required, it should consider options for transferring business as allowed for banks and building societies, such as the selling of loan books.

Additional Comments

In addition to our response to the PRA proposals, we would like to raise two further key changes to the regulation of the credit union sector that we wish for HM Treasury and the PRA to consider in the near-term.

The first change is reform of the current statutory limit on a credit union's common bond, where there is a geographic aspect. The current limit of 3 million persons eligible under the common bond is highly restrictive for credit unions looking to conduct strategic mergers or simply to expand into a new common bond area. This greatly limits the opportunities for credit union growth and business development. We would therefore like to initiate a discussion on either raising the current limit from 3 million persons, or a fundamental reform on how British credit unions common bonds are capped.

The second Change in PRA rules to allow for equity-style investments that would enable growth of Credit Union Service Organisations (CUSOs) in the British credit union sector. CUSOs have played a significant role in the development of credit union movements internationally, notably in the United States, where the majority of the adult population is a member of a credit union. However, the current legislation and regulation of the British credit union sector do not have the same provisions to enable the facilitation and development of CUSOs as in the USA. A key change we believe would support this development in the British sector would be for the regulation of credit unions to be amended to permit equity-style investment in CUSOs.

We would strongly encourage HMT to engage with ABCUL and the credit union sector around the potential to carry forward these changes in the near future.

Please get in touch should you wish to further discuss our consultation response.

Yours sincerely,

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