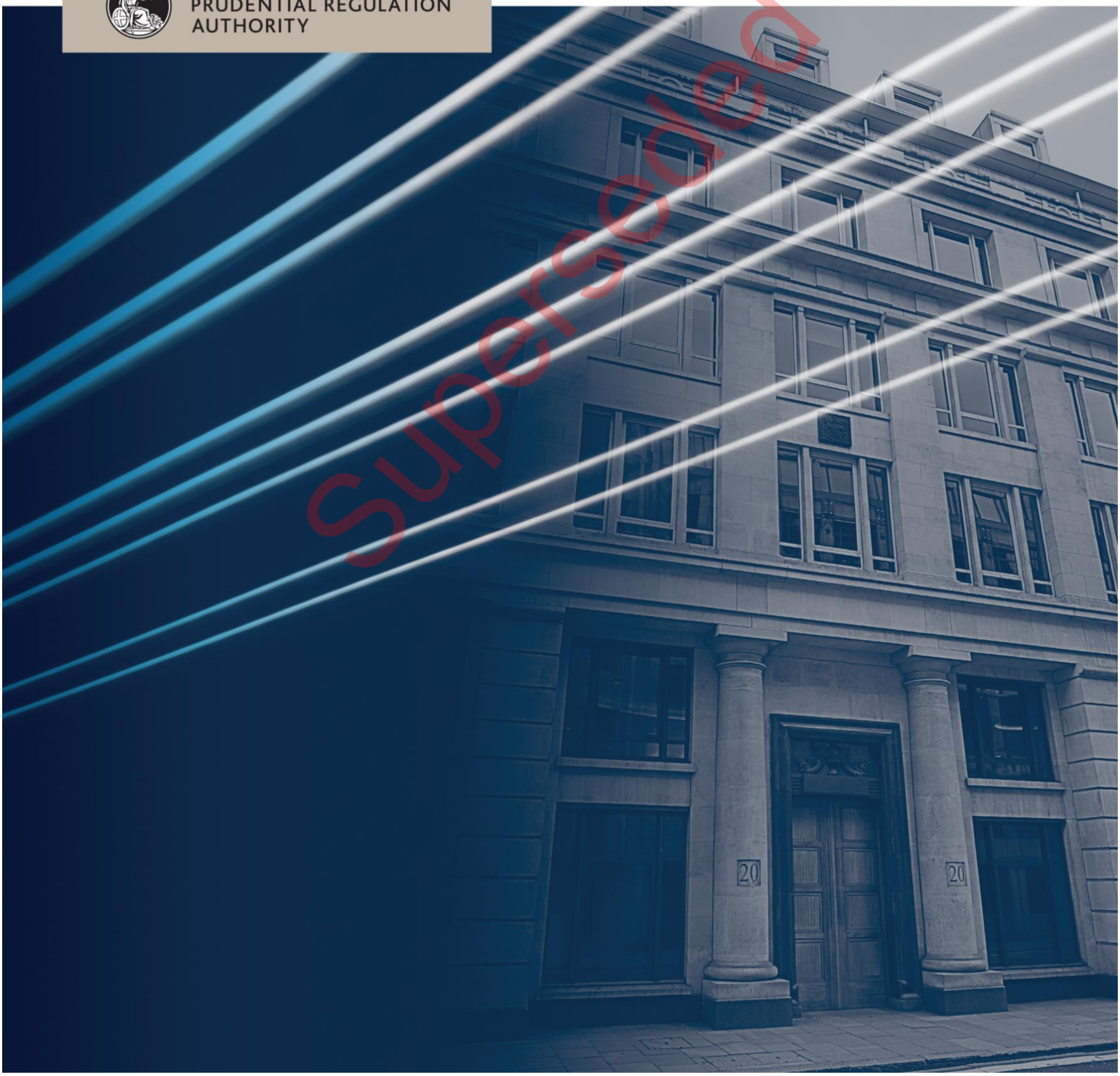
Supervisory Statement | SS2/16

The prudential regulation of credit unions

March 2020

(Updating February 2017)

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Introduction

1.1 This Supervisory Statement sets out the Prudential Regulation Authority's (PRA's) expectations of credit unions.[1] It applies to all UK credit unions as defined in the Credit Union Rulebook Part.

1.2 The statement seeks to advance the PRA's statutory objective of promoting the safety and soundness of the firms it regulates by setting out the PRA's expectations of how credit unions should comply with core elements of the regulatory framework contained in the Credit Union Rulebook Part.

2 Capital

2.1 A credit union will be expected to maintain the relevant minimum requirement specified by Credit Union 8.5 at all times.

2.2 A credit union will be expected to notify the PRA immediately should it become aware that it is likely to fall below its relevant minimum capital requirement. It will be expected to comply with the notification requirement in Credit Union 8.6 if its capital unexpectedly falls below the relevant minimum.

2.3 [deleted]

2.4 [deleted]

2.5 [deleted]

2.6 Where a credit union's capital ratio is below 5%, the PRA expects a credit union to engage more fully with the PRA. In particular, the PRA will expect a credit union to engage with the PRA on its ongoing sustainability and its capacity to budget and business plan. As part of that discussion and only in certain circumstances, the PRA will expect credit unions to engage with the PRA on whether they have a viable future and if not, what plans they have to close the credit union in an orderly fashion, which could be by way of insolvent wind-up, solvent wind-down or the transfer of its engagements to another credit union.

3 Liquidity

3.1 The PRA expects all credit unions to maintain the minimum prescribed ratio of liquidity at all times and to comply strictly with the notification requirement in the Credit Union Rulebook Part 9.5.

4 Additional activities and membership size

4.1 A credit union that is undertaking 'additional activities' (see Table 1) or that has more than 15,000 members and is therefore subject to the requirement in the Credit Union Rulebook Part 10.3(3) is expected to monitor its relevant business by using the ratios in paragraph 4.4 below, calibrated with values that are specifically aligned to its individual business model. The PRA expects the values selected by the credit union to provide an accurate and reliable business tool by which its Board may routinely and accurately monitor the credit union's performance against its strategic plan

[1] On Monday 16 March 2020, this SS was updated – see annex for full details.

and its regulatory obligations. The PRA also expects the credit union to be able to provide details of its chosen ratios and evidence of the rationale underlying them on request.

4.2 The PRA expects such a credit union to review performance against its target ratios at least monthly and to satisfy itself that performance is consistent with maintaining a business that is viable over a 12 month period and sustainable over a 36 month period.

4.2A Where a credit union is experiencing significant growth of members, the PRA will expect the credit union to consider the risks associated with increased membership and where appropriate take steps to address those risks. This should include consideration of operational risks (for example, whether systems are capable of managing additional capacity, whether the credit union has sufficient staff to cope with the increasing demand) and whether any changes need to be made to update their processes and procedures.

4.3 Where a credit union that is undertaking additional activities or that has more than 15,000 members concludes either that its business is no longer viable in the shorter term or sustainable in the longer term, the PRA expects to be notified immediately. The PRA will then expect the credit union to discuss with it what options it may have open to it, such as merger or transfer of engagements, and whether arrangements should be made for an orderly withdrawal from its additional activities.

4.4 By way of example only, the PRA considers that prudent practice suggests that the indicative ratio percentages for all calculations save loans to assets are those outlined in Table 1.

Table 1: Indicative ratios for credit unions that undertake additional activities or have more than 15,000 members

Ratio	Additional investments	Additional lending	Mortgages	Transactional accounts	Indicative ratio
Credit union's borrowings as percentage of total asset	Y	Y	Y	Y	≤5%
Total shares as percentage of total assets	Y	Y	Y	Y	≥70% and ≤90%
Total bad debt written off as percentage of total loans		Y	Y	Y	≤10%
Net assets as percentage of sum of total shares and juvenile deposits		Y	Y	Y	≥105%
Bad debt (more than three months in arrears) as percentage of total loans	Y	Y	Y	Y	≤20%
Non-earning assets as percentage of total assets	Y	Y	Y	Y	≤10%
Net zero cost funds as percentage of non-earning assets	Y	Y	Y	Y	≥200%
Loan income over 12 months as percentage of total loans		Y	Y	Y	≥6%
Net loans as percentage of total assets			Y	Y	Deliberately left blank

4.5 Table 2 sets out the PRA's definitions of the terms set out in Table 1 for the purposes of the ratio calculations.

Table 2: Definitions for ratio calculations

Term	Definition
Total assets	The total assets of a credit union that appear on its balance sheet.
Borrowings	The total closing balances of all loans received by a credit union (excluding any subordinated loans), authorised overdrafts and committed lines of credit.
Total shares	The total amount of money held by a credit union, at the relevant date, relating to shares paid in by members, including money held for deferred shares.
Net loans	The total amount outstanding at the relevant date on all loans to members (irrespective of when such loans were made) less provision for bad and doubtful debt.
Net liquid assets	Assets which can be realised for cash at short notice, and within at most eight days, less any liabilities payable within 30 days.
Bad debt	Total amount of loans to members where the loan is more than three months in arrears.
Total loans	The total amount outstanding at the relevant date on all loans to members (irrespective of when such loans were made). This includes any loans written off during the period.
Net assets	Total assets less liabilities (excluding members' shares).
Juvenile deposits	The total amount due to juvenile depositors.
Non-earning assets	The total amount of cash, current account balances (excluding any balances earning interest), prepaid expenses and fixed assets.
Net zero cost funds	The total sum of a credit union's capital and liabilities excluding any liabilities that are subject to interest payable by or charges to the credit union. In practical terms, this is likely to only constitute a credit union's reserves.
Loan income	The total amount of interest received on loans made to members during the 12 month period preceding the relevant date.

5 Maximum deposit levels

5.1 When a credit union gives notice in accordance with the Credit Union Rulebook Part 2.3 it will be expected to inform the PRA of its current loans to assets, capital, and liquidity ratios. It will also be expected to provide the PRA with details of the proposed use of the funds to be deposited and to confirm that its Single Customer View is complete and up-to-date. Should a credit union not satisfy the PRA that its acceptance of such a deposit would be prudent the

PRA may be expected to impose a requirement to prevent it from so doing.

6 Fixed-rate shares and deposits

6.1 The PRA expects that any credit union that intends to issue fixed-rate shares or deposits complies strictly with the statutory mandatory requirements that must be satisfied before beginning such activity.[2]

2 These requirements are accessible via this link: https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector/credit-unions.

6.2 Credit unions that wish to offer shares in an ISA tax-free wrapper will be expected to refer to the relevant regulations issued by HM Revenue and Customs. Credit unions should be aware that approval from HMRC does not provide any degree of exemption from compliance with the statutory requirements referred to above in paragraph '6.1'.

7 Lending

7.1 The PRA expects all credit unions to pay close attention to the quality of their underwriting of loans, whether unsecured or otherwise. Credit unions will be expected to apply a consistent lending policy in making all credit decisions and to retain records of such decisions for at least the life of the loan in question.

7.2 Where a credit union proposes to undertake fixed rate lending (including mortgage lending) the PRA expects the credit union to be able to demonstrate, on request, that it has a thorough understanding of any risks that this activity may create, particularly interest rate risk. In some circumstances the PRA may require any fixed-rate lending for periods of more than two years to be reported using form FSA017.[3] Where a credit union's fixed-rate lending exposes it to specific material prudential risk it will be expected to make sufficient additional capital provision to mitigate such risk.

8 Investment

8.1 The PRA expects that the assessment required by the Credit Union Rulebook Part 6.5 will be proportionate to the complexity, or otherwise, of the proposed investment.

8.2 The PRA expects the assessment to include consideration of any source and time-band concentrations implicit in the proposed investments.

8.3 The PRA expects all investments made in accordance with the Credit Union Rulebook Part 6.3(1) and 6.4(1) to comply with the 12 month restriction in order to ensure that the investment is entitled to be regarded as a deposit for the purpose of these Rules.

9 Governance and organisation

9.1 Good governance is fundamental to the safety and soundness of all financial institutions. Accordingly, all directors will be expected to fully understand their individual and corporate responsibilities and, in the context of the size and complexity of each individual business, to have the technical competence necessary for them to set, and to oversee, the strategy of their credit union. All directors will be expected to understand the risks implicit in their credit union's business model and to exercise appropriate oversight of the management of those risks.

9.2 All directors, without exception, will be expected to ensure that their credit union fully complies with the requirements of the Financial Services Compensation Scheme (FSCS) and that their credit union's provisioning policy and practices are prudent and effective.

3 FSA017 'Interest rate gap report': https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector/banks-building-societies-and-investment-firms.

9.3 In particular, but not exclusively, the PRA expects that:

(i) directors of all credit unions, irrespective of size and complexity will ensure that the credit union complies with the Fundamental Rules by maintaining its Single Customer View file accurately and in a form agreed by the FSCS at all times;

(ii) all directors have a thorough understanding of the obligations set out in the Credit Union

(iii) Rulebook Part 10, 11, 13 and 14, and Part 12 (Whistleblowing) where it applies;

(iv) directors understand that all outsourcing arrangements are commercial, business decisions, and that sole responsibility for ensuring operational continuity and data security, amongst other things, rests with the individual credit union;

(v) where a credit union outsources any of its essential functions, the continuity and quality of the outsourced functions or services must be maintained in the event of termination of the outsourcing either by transferring the outsourced functions or services to another third party or by performing them itself;

(vi) where the credit union outsources its internal audit function it does not employ its external auditor for that purpose unless in exceptional circumstances and, if so, only for the minimum practicable period; and

(vii) all directors satisfy themselves that their credit union regularly and accurately complies with the provisioning requirements in the Credit Union Rulebook Part 3.11 and 3.12.

Annex: SS2/16 updates

This annex details changes made to SS2/16 following its initial publication in February 2016 following Policy Statement (PS) 4/16 'Reform of the legacy Credit Unions sourcebook'.[4]

March 2020

13 March

This Supervisory Statement was updated following publication of Policy Statement 6/20 'Credit unions: Review of the capital regime',[5] to update capital requirements (deleted paragraphs 2.3-2.5, added new paragraph 2.6, amended paragraph 4.1, added new paragraph 4.2A, amended paragraphs 4.3 and 4.4, and amended Tables 1 & 2).

This SS was also updated to simplify the formatting and language where helpful to aid readability, and to update links in footnotes.

February 2017

23 February

This SS was updated following publication of PS4/17 'Responses to CP36/16 and correction to PS2/16 PIN rules',[6] to provide a table of definitions of terms used for the purpose of ratio calculations (see new paragraph 4.5A and Table 2).

4 February 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/reform-of-the-legacy-credit-unions-sourcebook.

5 March 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime.

6 February 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/responses-to-cp-36-16-and-correction-to-ps-2-16-pin-rules.