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16 December 2019

Dear credit union team

Prudential Regulation Authority – CP 28 / 19 – Credit unions: review of the capital regime

ABCUL is delighted to have the opportunity to respond to the Prudential Regulation Authority's proposals for reform of the credit union capital requirements. ABCUL is the largest trade body for credit unions in England, Scotland and Wales with around 180 credit union members representing approaching two thirds of authorised credit unions in Great Britain.

Whilst ABCUL was very grateful for the way in which the PRA listened to our feedback in response to the consultation on the credit union rulebook in 2015 with the resulting rules published in 2016, we have had concerns ever since that process that the new upper capital requirement that it created of 8+2% of total assets is too high and does not appropriately reflect the risk that credit unions pose to the PRA's statutory objectives. Nor does it recognise the particular challenges that credit unions have in accumulating capital given their co-operative structure and social mission. Ever since the introduction of these rules, we have been keen to engage with the PRA to highlight some of the shortcomings of the resulting regime.

Challenges for credit union capital accumulation

In particular, we have been concerned at the challenge that meeting the minimum upper capital requirement for larger credit unions presents to credit unions with ambitions to grow past the size thresholds at 15,000 members or £10 million in assets. The PRA's original consultation seemed to assume the sector represented a steady state with a cohort of credit unions above the relevant size thresholds and the rest likely to remain below them. However, in practice credit unions are ambitious to grow and have a range of governmental and other supporters keen to facilitate a bigger role for our sector in society.

Credit unions' co-operative structure and social mission create dual pressures on our sector's ability to accumulate capital. Firstly, since credit unions are owned collectively by their member-customers, and each possesses an equal, single vote in determining rule changes and elections to boards, regardless of their financial investment in the credit union, we are not able to fund growth through raising capital by issuing equity shares in the way a private company could. This means that – aside from secondary capital which is typically invested on philanthropic or social investment (i.e. low financial return) grounds – credit unions are reliant almost entirely upon accumulated retained earnings to build their capital reserve fund.

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But since credit unions are equally focussed on providing affordable and responsible services in competition with high cost alternative creditors and to sections of the population who are poorly served by the mainstream, our profit margins are necessarily tight. This means that credit unions' growth potential is significantly circumscribed by their profitability. Only highly profitable credit unions can grow rapidly and this challenge is intensified in proportion to the minimum capital holdings required by the regulator. The levels of capital reserves required by the regulator, therefore, represent a direct constraint on growth.

Our analysis of the no change scenario

ABCUL has been under significant pressure from our members to raise the challenges that the capital regime creates for growing and ambitious credit unions. The members of ABCUL have passed motions at the Association's Annual General Meeting in both 2018 and 2019 calling on us to make reform of this requirement our top priority. This demonstrates the strength of feeling within the sector for change.

Responding to our members' expectations, we undertook some analysis which sought to establish the extent of the problems that credit unions would have in meeting the requirements as they grow through the size thresholds. The analysis was completed according to the following methodology:

For ABCUL member and former ABCUL member credit unions, as well as a select few for whom ABCUL has acquired publicly-available financial accounts, we have considered growth trends and size levels over the past five years and identified a sub-set of credit unions who have the potential to breach the size thresholds for the upper capital requirement or have already done so.

For this sub-set we have extrapolated their 5 year growth trajectory, profitability and capitalisation based on the following (fairly crude) assumptions:

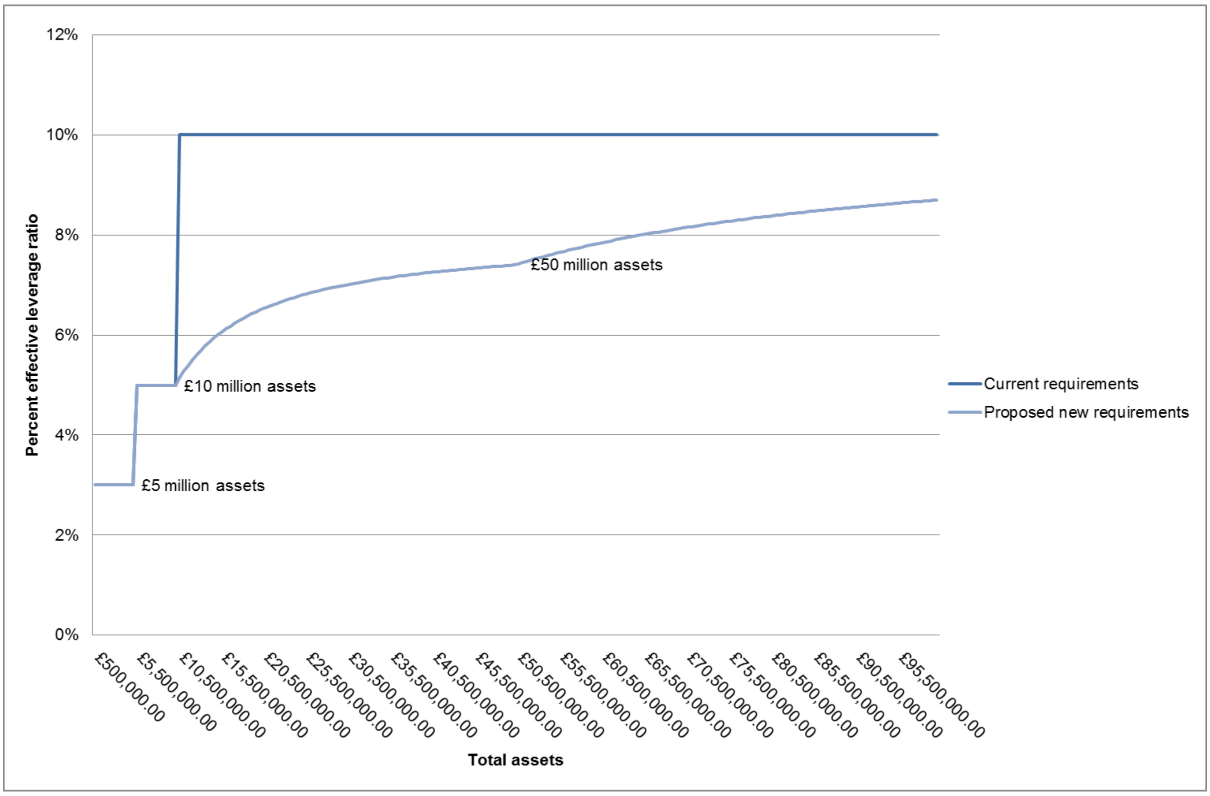
- Taken their mean growth rate for assets and members over the last 5 years (up to the most recent data we held at the time of our analysis (conducted in January 2019), i.e. 2017 year end) and applied this growth rate going forward for the next 5 years.
- Taken their mean (post-dividend) net income rate for the last 5 years and applied this to the asset position suggested by their forecast growth in assets.
- Assumed that all of their (post-dividend) net income is transferred to reserves each year.
- Assumed that any secondary capital that the credit unions hold is maintained at a steady state based on its position in the most recent year for which we have data.

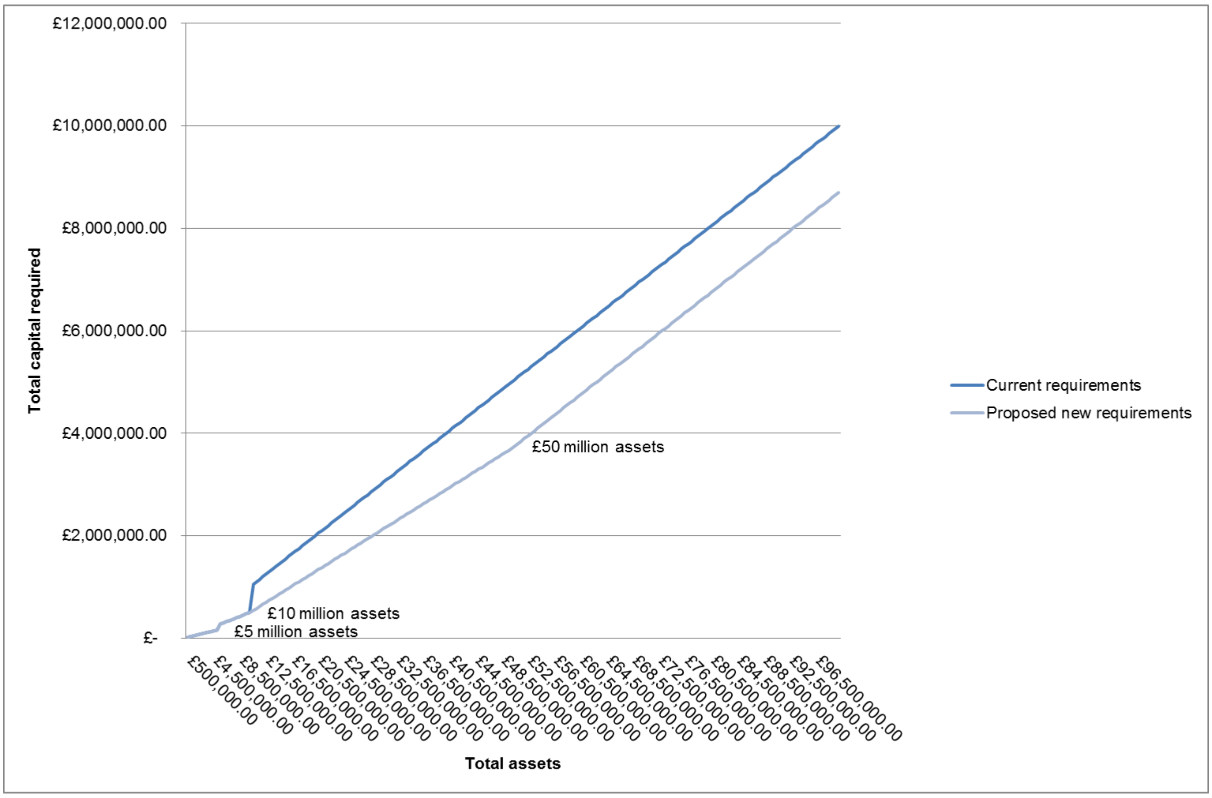
Under a no change scenario our analysis suggested at that time that 25 credit unions may face difficulty in achieving or maintaining compliance with the 10% capital requirement over the coming six years. 2 or 3 credit unions are only kept out of this number by their levels of secondary capital, much of which is represented by repayable subordinated debt.

Our support for the proposed rules in comparison

If we now compare the proposed new capital regime to this same data using the same assumptions, 16 of these 25 credit unions are either brought into compliance for the full 5 year forward forecast or at least for the majority of it. For this reason, we strongly endorse the proposals and support the PRA's package which will make a significant contribution to supporting credit unions' capital compliance while not meaningfully reducing their safety or soundness.

The benefits of the regime are visible in the following charts which first, show the proportional capital requirement under the existing rules and under the proposed rules as a capital-asset ratio, and second, shows the absolute capital value required to be held under the same two conditions.





What the charts show is that the proposals as put forward accord directly with the "simpler, not weaker" mantra as set out by Sam Woods in the Mansion House speech "credit union meets robot" on 24 October. The first chart shows the abrupt step up in capital that the current 10% requirement represents for credit unions. At the point of crossing the £10 million asset figure, a credit union is suddenly expected to double their capital from 5% to 10% or £500,000 to £1 million.

Now, in reality, credit unions with ambitions to grow would identify this requirement well before reaching the relevant threshold and seek to accumulate capital at the higher 10% rate long before reaching the threshold in order to be ready in time. In practice, this has meant that many credit unions in the 5% camp have actively sought to manage their balance sheet growth down in order to stay the right side of the threshold while they seek the £1 million required. In some extreme circumstances this has seen credit unions hand back their deposits to members with high balances because this would only add to their capital requirement as long as they – like many credit unions – struggle to lend their deposit funding to the fullest extent.

But as the first chart in particular demonstrates, by introducing the graduated approach as advocated by ABCUL, the PRA is recognising that accumulating capital at a rate of 10% is particularly challenging for credit unions at the smaller end of the scale. So by reducing the requirement between £10 million and £50 million to 8% and additionally, only requiring the higher rates of accumulation in relation to assets above the £10 million and £50 million thresholds, credit unions who are still establishing themselves and building scale economies, are given flexibility to achieve this basic scale before the requirement upon them escalates.

And since sub-£10 million credit unions are so small relative to the wider banking sector, they represent almost no risk at all to the PRA's statutory objectives of financial safety and soundness. The high appetite for accepting (managed) failure that the PRA applies in relation to category 5 credit unions today under its stated supervisory approach is testament to this low-risk profile. Therefore, providing these credit unions with the space to grow before their capital requirement ratchets up is entirely appropriate and in no way weakens the overall PRA framework. It is instead a fair acknowledgement of the challenges credit unions face and a practical support for the sector's growth by removing unwarranted barriers.

As both charts show, under the proposed new rules, as credit unions grow beyond the £50 million threshold and the 10% capital requirement applies, the capital required of credit unions will tend towards 10% in proportion to the £1.3 million reduction in capital expected of a credit union as it reaches the thresholds as compared with today's rules. As a credit union grows and £1.3 million represents an ever smaller proportion of the credit union's balance sheet, so the effective capital requirement increases.

The proposals are therefore appropriate and fit with the objectives as summarised in the "simpler, not weaker" mantra. They are closely based on proposals we put to the PRA in an options paper in February 2019 and we strongly support them.

Our support for simplifying the thresholds

Other aspects of the proposals which will add to the regime's simplicity are the removal of the membership size thresholds for capital requirements at 5,000 members and 15,000 members and the removal of capital requirements linked to performing “additional activities”. We have long-argued for the removal of the membership thresholds because it penalises credit unions with relatively few assets per head of membership which tend to be those credit unions most closely focussed on the social mission of financial inclusion and therefore least able to accumulate capital quickly. Membership levels can be challenging to manage and credit unions can be victims of their own success in engaging their communities where numbers tip them into a higher capital requirement.

We accept that credit unions performing “additional activities” or with high membership levels relative to their asset base do carry certain additional risks but we support the PRA’s rationale in managing these risks through the governance requirements at 10.3 and expanded upon through the Supervisory Statement.

We would, however, like to call for a review by PRA of the relevance and usefulness of the ratio set which it requires credit unions to monitor in relation to performing additional activities. While we fully accept the benefits of this kind of requirement and largely agree with the ratios that the Supervisory Statement stipulates credit unions must monitor, certain of the ratios seem to us, and our members, to be of very limited practical usefulness and might be better replaced with others from the financial ratios defined by the World Council of Credit Union’s PEARLS system.

For example, the requirement to monitor net zero cost funds over non-earning assets, the ratio measuring non-earning assets as a proportion of total assets and the expectation that loan income over 12 months should be 6% or more all seem to ABCUL and its membership as of limited practical utility.

The new engagement requirement

Whilst overall we are very happy to endorse the proposals as they are set out here, we do have certain concerns at some of the questions raised by the package. We would like to seek some clarity as regards the proposed new engagement requirement for credit unions below 5% capital-assets. As noted above, the PRA currently adopts a high tolerance for failure within the credit union sector since in general its fortunes do not have a significant influence over the safety and stability of the financial services industry or the wider economy due to our limited scale. Where a category 5 credit union meets its regulatory minimum requirements and has a functional single customer view system, the PRA is unlikely to take any proactive action.

In light of this supervisory approach, the new engagement requirement for 3% seems incongruous and we would like to seek reassurances from the PRA that this does not mark a departure from the established approach for the smallest credit unions. We accept, of course, that the new expectations of firms in this group – i.e. that they share details of the budgeting and business planning – are not onerous in theory but we would not support the PRA dedicating much more of its limited credit union supervision resource overseeing such matters for credit unions whose risk profile, due to their limited scale, is minimal. The PRA should also be proportionate in its expectations of the detail and sophistication of the documents provided by credit unions in this category – since they are likely to be smaller, with more limited resources, the documentation supporting their plans is likely to reflective of their capacity. Provided the plans are credible and backed up with justifiable reasoning, they should be acceptable to the PRA in our view.

In addition, we would also like to make clear in connection with the engagement requirement that ABCUL has already begun a programme of outreach to credit unions within our membership who sit in this cohort in order to offer support and assistance in responding to the new requirements. We are committed to doing our part – in keeping with the themes of the ABCUL Town Hall Consultation – to support the sustainability of credit unions and to support the sector to make the most of its plentiful potential. As such we hope that the new requirement will be applied sensibly, proportionately and in coordination with efforts such as our own which hope to make the most constructive possible use of the new requirements.

The case for risk-based capital in the longer term

Finally, we would like to make clear that while we support the package and wish to see it passed into full rules as soon as practicable, we do also retain a commitment to exploring risk-based capital rules into the future. The proposals put to PRA in February 2019 by ABCUL set out two options for taking some level of account within the regulatory capital framework for the risk base underlying a credit union balance sheet. Under the capital requirements to which banks and building societies are subject, recognition is given to the risk profile of the assets which make up a firm's balance sheet. This is underpinned with a backstop leverage ratio which provides a floor for the capital requirements calculated according to risk. As a result, the pure leverage ratio maintained by most major banks is around 3%.

Credit unions are in no position today to adopt full banking regulation as flows out of the Basel Accords and the Capital Requirements Directives of the EU. We strongly support the freedom that UK regulators have to define and police credit union regulation which is allowed for by exemptions from EU regulation. But we do not accept that the only way that risk considerations could be introduced for credit unions is through applying full banking regulation.

Credit unions' balance sheets have a number of low risk attributes – firstly, many credit unions utilise "attached shares" which is a mechanism for securing loans to members against their cash deposit holdings in the credit union so that they can mitigate the risk of default up to the level of savings held. These loan assets are therefore free of credit risk. Secondly, many credit unions are significantly under lent with funds sitting in corporate bank accounts earning very little in interest. Because of restrictions in the investments that credit unions can make with surplus deposit funding, the vast majority of this money is sitting in major British banks which are highly secure. Therefore, these bank account assets represent very little risk too.

Of course, we recognise that were a risk-based capital regime to be brought in for British credit unions, it is likely not to be appropriate for all credit unions and would require levels of assurance and reporting which might negate the benefits in terms of reduced absolute capital levels. In addition, we recognise that some credit union assets might be considered high risk and therefore attract risk weighting in excess of 100% while some secondary capital instruments relied upon by credit unions are likely to be considered less robust than cash reserves thereby reducing their capital value.

However, we still believe that there is a prima facie case for a review of whether a risk-based regime could add flexibility and responsiveness by allowing credit unions to tailor an approach to risk-reward in their balance sheets which is more appropriate to specific firm needs when compared to the regime which today treats all credit unions as a homogenous block distinguishable only on the basis of their size.

Yours sincerely,

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