



Consultation Paper | CP7/22

Credit Unions: Changes to the Regulatory Regime

September 2022





BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Responses are requested by Wednesday 21 December 2022.

The PRA prefers all responses to be sent by email to: CP7_22@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:

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Contents

1	Overview	2
2	Proposals	5
3	The PRA's statutory obligations	9
Appendices		15

1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed amendments to the regulatory regime that applies to credit unions.

1.2 The proposals would result in:

- amendments to the Credit Union Part of the PRA Rulebook (Appendix 1); a new Supervisory Statement (SS) 'Supervising credit unions' which the PRA proposes would supersede SS2/16 'The prudential regulation of credit unions' (Appendix 2), which will be deleted.

1.3 The CP is relevant to all UK credit unions.

1.4 The purpose of the proposals is to:

- provide more flexibility for credit unions when investing their surplus funds so long as they meet specified requirements and consider applicable guidance;
- set higher requirements and expectations of credit unions that pose greater risk to the PRA's safety and soundness objective (either due to their size, or activities undertaken); and
- clarify the PRA's existing expectations in key areas.

1.5 The PRA has considered the interaction between its primary and secondary objectives and the have regards principles, including in relation to proportionality, recognising the differences in the nature of and objectives of, businesses carried on by different persons, the principle of transparency, and the use of the PRA's resources in the most efficient and economical way.

1.6 The proposals in this CP broadly relate to amending and strengthening the regulatory regime in order to address risks posed by larger, more complex credit unions. The PRA considers that setting higher expectations of credit unions that pose greater risk (due to their size or activities undertaken) to the PRA's primary safety and soundness objective would help ensure higher standards among those credit unions, while at the same time retaining a simple PRA Rulebook in recognition of the diversity of the sector.

1.7 The PRA considers that its proposed changes may result in affected credit unions incurring incremental costs, but these costs are considered by the PRA to be proportionate, given the additional risks to safety and soundness posed by these credit unions. The PRA's proposal to extend the range of permitted investments provides benefits in terms of opportunities for diversification of investment portfolios and possibly increased returns. However, the PRA considers that credit unions should carefully consider the risk return trade-off, and ensure investment decisions reflect the risk appetite of the credit union. There may be an incremental cost to credit unions in developing expertise in investments and updating policies and procedures to reflect the new requirements and expectations. This cost could be avoided by credit unions not availing themselves of the opportunity to invest in the wider range of permitted investments. For the majority of credit unions, the proposed changes are limited to further details of the PRA's expectations on the existing regulatory framework, which should provide additional clarity of the PRA's expectations and reduce uncertainty. These credit unions are therefore not expected to incur material additional costs as a result of the proposals.

Background

1.8 The PRA considers that the existing Credit Unions Part of the PRA Rulebook is simple, reflective of the fact that when the regulatory framework was introduced, credit unions were viewed as simple savings and loans facilities run predominantly by volunteers. The PRA has considered whether a simply-calibrated regime continues to be appropriate for all credit unions given its consideration that a small, but growing, number of credit unions have moved away from the traditional model both in terms of size and complexity of products offered to members (eg mortgages, corporate loans).

1.9 The PRA recognises that a significant proportion of credit unions remain small, and operate relatively simple business models, and is mindful of the need to be risk-based, proportionate, and focussed on those credit unions posing potential risks to its key objective and not the sector as a whole. A sweeping review of the entire credit union regulatory regime was therefore not considered by the PRA to be necessary.

1.10 The PRA has also taken into consideration that HM Government's Financial Services and Markets Bill (the FS Bill) proposes to amend the Credit Unions Act 1979.¹ The FS Bill proposes to extend the range of products available for Great Britain credit unions to offer to their members, and proposes to add an additional legislative 'object'. This proposed additional legislative object will extend the range of permitted services Great Britain credit unions are allowed to offer to include hire purchase, conditional sale, and insurance mediation. The FS Bill also proposes to give HM Treasury (HMT) the power to add further services in future through secondary legislation, to reflect the changing financial services landscape. The changes that the PRA is consulting on take into account the proposed amendments to the Credit Union Act 1979, for example the change in the definition of 'additional activities' to include consumer credit (including hire purchase and conditional sale). The proposed amendments to the Credit Union Act 1979 also make clear that Great Britain credit unions may hold investments with other credit unions.

Summary of proposals

1.11 The proposed changes to the Credit Unions Part of the PRA Rulebook are:

- to include lending to corporate members and the provision of consumer credit within the definition of 'additional activities', with the effect of bringing credit unions undertaking these activities within the scope of existing additional systems and control requirements;
- to extend the range of products available to credit unions to invest in, to include a wider range of products, where a credit union meets certain requirements. This also includes clarification that credit unions may hold funds with other credit unions, as clarified by recent changes in legislation; and
- amendments to the PRA rules on lending limits, including confirmation that the current limits on credit union unsecured lending will also apply to the provision of hire purchase agreements and conditional sale agreements, which will be permitted products for Great Britain credit unions under the FS Bill's proposed amendments to the Credit Unions Act 1979.

1.12 The key proposed changes included in the proposed SS are:

¹ The proposed legislative changes will affect Great Britain credit unions only.

- to set additional expectations for credit unions with more than £10 million in assets with respect to liquidity risk management and contingency funding, with a further expectation for credit unions with more than £50 million in assets and/or credit unions that wish to undertake more sophisticated investment business as per the above, to undertake basic liquidity stress testing;
- to provide more clarity on PRA expectations regarding the amount and quality of capital held by a credit union;
- to set out additional detail on PRA expectations of credit unions that offer mortgages, including consideration of relevant sections of SS20/15 'Supervising building societies' treasury and lending activities'² as evidence of good practice;
- to set an expectation that the largest credit unions (with more than £100 million in assets) consider the steps and resources needed to wind down their business in an orderly manner and are able to evidence that they have evaluated the risks and how best to mitigate them;
- to set expectations for credit unions that provide credit cards;
- to set expectations for credit unions that provide loans to corporate members. This includes minimum expectations for credit unions undertaking secured lending to corporate members;
- to set expectations around risk management, including operational risk management for credit unions with more than £10 million in assets, with good practice guidance for all credit unions;
- to clarify existing expectations for all credit unions on governance, business plans, and forecasts; and
- to set expectations regarding a credit union's internal audit function, including indicators that it may not be fulfilling its role.

Implementation

1.13 The FS Bill was introduced into Parliament on Wednesday 20 July 2022. The proposals set out in this CP are based on the version of the FS Bill that was introduced into Parliament. The PRA will provide an update if there are any material changes to the FS Bill that affect the proposals in this CP.

1.14 The proposed changes would take effect upon publication of the final policy.

Responses and next steps

1.15 This consultation closes on Wednesday 21 December 2022. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP7_22@bankofengland.co.uk. Please indicate in your response if you believe any of the proposals in this consultation paper are likely to impact persons who share protected characteristics under the Equality Act 2010, and if so, please explain which groups and what the impact on such groups might be.

² April 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/supervising-building-societies-treasury-and-lending-activities-ss>.

2 Proposals

Proposed changes to the Credit Unions Part of the PRA Rulebook

Extending the definition of additional activities

2.1 The PRA proposes to extend the definition of ‘additional activities’ in the glossary of the Credit Unions Part of the PRA Rulebook, to include lending to corporate members and the provision of consumer credit (ie hire purchase agreements, conditional sale agreements and the provision of credit cards).

2.2 Credit unions that have more than 15,000 members or undertake ‘additional activities’ (eg mortgages, loans of larger amounts over a longer term, make investments with a longer maturity, or provide transactional accounts) are subject to an additional layer of requirements. Credit unions opting to undertake one or more of these additional activities must meet additional systems and controls requirements (Rule 10.3 in the Credit Unions Part of the PRA Rulebook) and are expected to meet additional expectations set out in the proposed SS (eg monitoring its relevant business using specified ratios).

2.3 Given the additional risks involved in the provision of loans to corporate members and consumer credit, their inclusion within the definition ensures credit unions undertaking these activities would be subject to existing additional systems and controls (Credit Unions 10.3) requirements (which includes financial risk management requirements).

2.4 The PRA considers that the proposal is consistent with the regulatory principle that a burden which is imposed should be proportionate to the expected benefits, and the principle that the differences in the nature and objectives of different business models should be recognised.

Extending the range of credit union permitted investments

2.5 The PRA proposes to extend the range of permitted investments to include a wider range of products, where a credit union is meeting certain requirements.

2.6 Chapter 6 of the Credit Unions Part of the PRA Rulebook provides credit unions with a limited range of options when investing their surplus funds.³ Capital protection is at the heart of this principle. The PRA considers that some credit unions struggle to find a sufficient number of high-rated counterparties willing to accept credit union funds, and feel pressured to spread concentration risk and may feel obliged to place funds with lower-rated institutions.

2.7 The PRA considers any changes to the credit union investment framework should reflect the fact that it is the savings of members (which can be withdrawn on demand) that will be invested. The PRA therefore considers it appropriate to focus on the low end of the risk spectrum, concentrating on fixed income investments, and investments with particular characteristics that will ensure appropriate levels of investment and liquidity management risk.

2.8 The PRA proposes to expand the range of products available to credit unions to invest in, which will include a wider range of products including: corporate bonds, undertaking for collective investment in transferable securities (UCITS), qualifying money market funds and supranational

³ Credit Unions 6.3 sets out the permitted investments: (1) a deposit placed with a UK authorised credit institution (repayable within twelve months); (2) a loan, other than a subordinated loan qualifying as capital, to a UK authorised credit institution, with a maturity of up to 12 months; (3) a sterling-denominated security issued by the UK government with a maturity of up to 12 months; (4) a fixed-interest sterling-denominated security guaranteed by the UK government, with a maturity of up to 12 months, provided that such guarantee is unconditional in respect of the payment of both principal and interest on the security; or (5) as above with a maturity of up to five years if the credit union meets certain conditions (as provided in Credit Unions 10.3).

bonds. The PRA proposes to implement this by extending the allowable investments under Rule 6.4 of the Credit Unions Part of the PRA Rulebook. A credit union may only hold Credit Unions 6.4 investments if it complies with Credit Unions 10.3 requirements.

2.9 The PRA recognises that this would move the emphasis away from capital protection, which would be a step change, and in order to minimise any corresponding risks it proposes to put in place the following safeguards:

- Corporate bonds must be traded on a UK regulated-exchange and must be investment grade or higher rated by at least two recognised agencies.
- UCITS and money market funds must be regulated in the UK and have a minimum asset size of at least £100m total assets, and be composed of instruments permitted under credit union rules with a credit rating of investment grade or higher, by at least two recognised credit rating agencies that are registered in the UK.
- Supranational bonds must be investment grade or higher, rated by at least two recognised agencies.
- A 5% counterparty limit is proposed for credit union's capital invested directly in corporate bonds or supranational bonds, with a single counterparty, and no more than 30% of total capital resources to be invested cumulatively in the new investment classes (corporate bonds, UCITs, money market funds and supranational bonds).
- Rules 6.5 and 6.6 in the Credit Unions Part of the PRA Rulebook requires that credit unions investing surplus funds must consider and document their decision and account for counterparty, concentration, and liquidity risk. Given its consideration that the liquidity transformation risk of credit union holdings of longer duration and potentially more complex instruments, the PRA proposes to link the expanded range of investments to additional liquidity guidance, including the expectation that credit unions holding such investments undertake basic liquidity stress testing (see paragraph 2.16).

2.10 The PRA also proposes to clarify in the SS that credit unions with over £10 million in assets should be expected to meet investment counterparty and concentration limits in relation to the existing investment products. This includes an expectation that an amount equivalent to no more than 75% of a credit union's total capital should be held with a single counterparty.

2.11 The FS Bill proposed amendments to the Credit Unions Act 1979 including confirmation that Great Britain credit unions may hold funds with other credit unions (which the PRA considers to be current practice among Great Britain credit unions). In line with this, the PRA proposes to clarify in Credit Unions 6.3 that funds placed with other credit unions are permitted investments.

Amendments to Chapter 3 of the Credit Unions Part

2.12 The PRA proposes amendments to confirm that the current limits on credit union unsecured lending will also apply to the provision of hire purchase agreements and conditional sale agreements, which will be permitted products for Great Britain credit unions under the FS Bill's proposed amendments changes to the Credit Unions Act 1979.

2.13 The PRA also proposes amending Rules 3.4 and 3.5 of the Credit Unions Part of the PRA Rulebook to clarify that the lending limits specified apply to the aggregate total of outstanding loans of a member (or another credit union) to a credit union, rather than a single loan. The PRA considers this to be the existing intention of the rules and already interpreted in this way by credit unions and therefore does not expect there to be an associated cost to credit unions of these rule amendments.

Proposed Credit Union Supervisory Statement and superseding of Supervisory Statement 2/16

2.14 The PRA proposes to introduce a new credit union SS ‘Supervising Credit Unions’ as set out in Appendix 2. The PRA proposes that the expectations set out in its existing SS2/16 will be superseded by the new SS, and SS2/16 will be deleted.

Liquidity

2.15 Credit unions are required to maintain a board-approved liquidity management policy under Credit Unions 10.5. The PRA proposes to clarify basic liquidity management expectations for all credit unions in the SS. Credit unions with more than £10 million in assets (currently circa 103 credit unions) would be expected by the PRA to maintain a board-approved liquidity management policy that sets out (among other expectations) their strategy for liquidity risk management, and how they would address liquidity shortfalls in an emergency. The proposed draft SS in Appendix 2 sets out further details on what areas the PRA would expect such documentation to include.

2.16 Further, the PRA proposes to set an expectation that credit unions with total assets of more than £50 million (currently circa 18 credit unions) and/or credit unions that wish to undertake more sophisticated investment business, as outlined in paragraphs 2.8 and 2.9, undertake basic liquidity stress testing. Ideally this would be calibrated based on historic data, where such data is available to credit unions at a sectoral level. The PRA has set out in paragraphs 3.4 and 3.5 of the SS how a credit union might meet the stress testing expectations.

2.17 Current credit union liquidity rules (Rule 9.1 and 9.2 in the Credit Unions Part of the PRA Rulebook) require credit unions to hold a minimum of 10% of their callable deposits in funds/instruments they can access within eight days. Unlike other liquidity regimes, the regime does not assess stressed outflows. SS2/16 makes no material reference to what the PRA considers to be good liquidity practice.

2.18 The PRA considers that credit unions are typically liquid, and that credit union failures tend not to be liquidity-related. The PRA considers it important that it balances its risk appetite with its need to be proportionate with any further regulatory measures. The PRA is therefore proposing to introduce additional expectations of the larger credit unions, where a liquidity disruption would have a greater impact, and where the credit unions are more capable of implementing more complex requirements.

2.19 The PRA considers that the proposal is consistent with the regulatory principle that a burden which is imposed should be proportionate to the expected benefits, the principle that the PRA’s resources should be used in the most economic and efficient way, and the principle that the differences in the nature and objectives of different business models should be recognised.

Capital

2.20 The PRA proposes to set a number of additional expectations with respect to the amount and quality of capital held by a credit union:

- It expects credit unions to consider whether additional capital should be held over and above the credit union’s minimum requirement, in order to meet Rule 8.1 of the Credit Union Part of the PRA Rulebook. Credit Unions 8.1 requires credit unions to have adequate capital, taking into account the nature, scale, and complexity of its business. Examples of where the PRA might expect credit unions to hold additional capital in order to meet Credit Unions 8.1 include where a credit union is growing rapidly, providing more complex products, or funded by lower quality capital (such as subordinated debt or interest-bearing deferred shares). A credit union wishing

to provide credit cards should also hold additional capital to cover potential claims arising from Section 75 of the Consumer Credit Act 1974.

- It proposes to set an expectation that, in circumstances where there are specific risks present (eg high risk business models, governance concerns etc) and a credit union has not taken up the PRA's invitation to apply for a 'voluntary requirement' (VREQ), as provided by section 55M of Financial Services and Markets Act 2000 (FSMA), credit unions should expect that supervisors will consider whether it is appropriate to impose an additional capital add-on (ie via the PRA's own initiative powers, as provided by section 55M FSMA 2000 'own initiative requirements' or 'OIREQ').⁴ As with firms subject to Capital Requirements Regulations (CRR), the PRA has the capacity to set capital or require a certain quality of capital to be held by way of an OIREQ (assuming a credit union does not agree to do so voluntarily) in order to, for example, absorb unexpected reductions. This tool would be applied at the discretion of the supervisor and should not be expected as a matter of course if a credit union undertakes a certain activity.
- It proposes to clarify that, with the exception of credit unions that have been established for less than five years, it would not expect more than 50% of a credit union's capital base to be composed of subordinated debt or interest-bearing deferred shares. Where the capital base of a credit union (that has been established for more than five years) exceeds this level, the PRA would expect to be notified of this, and of the credit union's plan to reduce their reliance on these sources of capital.

Mortgages

2.21 The PRA proposes to set an expectation that credit unions that offer mortgages should, as evidence of good practice, consider relevant sections of SS20/15 'Supervising building societies' treasury and lending activities'.⁵ The proposed draft SS in Appendix 2 sets out more detail on the sections credit unions are expected to consider, and the PRA's expectation that they are able to evidence that they have given consideration to the relevant risks, and put mitigating controls in place, where appropriate.

2.22 There is no PRA-specific regulatory regime for credit unions offering mortgages⁶ at present. The PRA's supervision relies instead on principle-based supervision, and reference to best practice. If the PRA receives greater numbers of applications from credit unions seeking mortgage permissions (only five currently offer mortgages), the PRA will review the appropriateness of the regulatory framework (rules and SS), as it relates to mortgage lending.

Exit strategy planning

2.23 The PRA proposes to include an expectation in the SS that the largest credit unions (ie those with more than £100 million in assets) consider the steps and resources needed to (i) wind down; and (ii) achieve a transfer of engagements in an orderly manner, with minimal negative effects on members. Credit unions would be expected to evidence that they have evaluated the risks and impact of a wind down/transfer and considered how best to mitigate them.

⁴ The use of the PRA's own-initiative powers in s.55M FSMA is subject to the satisfaction of the statutory criteria in s. 55M(2), which states:

"The PRA may exercise its power under subsection (3) in relation to a PRA-authorized person with a Part 4A permission ("P") if it appears to the PRA that—

(a) P is failing, or is likely to fail, to satisfy the threshold conditions for which the PRA is responsible,

(b) P has failed, during a period of at least 12 months, to carry on a regulated activity to which the Part 4A permission relates, or

(c) it is desirable to exercise the power in order to advance any of the PRA's objective."

⁵ April 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/supervising-building-societies-treasury-and-lending-activities-ss>.

⁶ Conduct requirements do apply via the Financial Conduct Authority's (FCA) MCOB sourcebook.

2.24 Credit unions are not currently subject to recovery and resolution planning requirements (the sole requirement is to have an accurate Single Customer View). The PRA has considered whether this should continue to be the case for the larger and more complex credit unions (given banks and building societies of similar size are subject to such requirements). The PRA considers the proposed expectations set out above are proportionate, and that the cost to credit unions of hard requirements could outweigh the benefits.

Other areas

2.25 Additional expectations are also proposed in a number of further areas (see draft SS) including:

- expectations for credit unions that provide credit cards, eg the maintenance of a board-approved credit card policy that sets out how they would monitor and mitigate the risks arising from the activity;
- expectations around providing loans to corporate members, in terms of managing risks arising from the activity. This would include minimum expectations for credit unions undertaking secured lending to corporates;
- expectations around operational risk management for all credit unions, with additional expectations for credit unions with over £10 million in assets and over £50 million in assets;
- (for all credit unions) clarification of the PRA's expectations on business plans and forecasts;
- (for all credit unions) clarification of the PRA's expectations with respect to governance (eg board skills, succession planning);
- (for all credit unions) clarification of the PRA's expectations regarding a credit union's internal audit function, including indicators of good practice; and
- expectations of a credit union's risk management framework for credit unions with over £10 million in assets, eg to maintain a risk appetite statement with further expectations for credit unions with over £50 million in assets or those undertaking more complex activities.

3 The PRA's statutory obligations

3.1 In carrying out its policy-making functions, the PRA is required to comply with several legal obligations. The PRA has a statutory duty to consult when changing rules (FSMA s138J). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so.

3.2 The PRA fulfils its statutory obligations and public law duties by providing the following in relation to the proposed policy:

- **a cost benefit analysis;**
- **compatibility with the PRA's objectives:** an explanation of the PRA's reasons for considering that making the proposed rules is compatible with the PRA's duty to act in a way that advances

its general objective,⁷ insurance objective ⁸ (if applicable), and secondary competition objective;⁹

- **FSMA regulatory principles:** an explanation of the ways in which having regard to the regulatory principles has affected the proposed rules;¹⁰
- **impact on mutuals:** a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons;¹¹
- **HMT recommendation letter:** the Prudential Regulation Committee (PRC) should have regard to aspects of the Government’s economic policy as recommended by HMT; ¹² and
- **equality and diversity:** the PRA is also required by the Equality Act 2010¹³ to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services, and functions.

3.3 Appendix 4 lists the statutory obligations applicable to the PRA’s policy development process. The analysis in this chapter explains how the proposals have had regard to the most relevant matters listed in paragraph 3.2, including an explanation of the ways in which having regard to these matters has affected the proposals.

Proposed changes to the Credit Union Part of the PRA Rulebook, proposed Credit Union Supervisory Statement and deletion of SS2/16

3.4 The PRA’s proposals would result in:

- amendments to the Credit Union Part of the PRA Rulebook (Appendix 1);
- new SS ‘Supervising credit unions’ which the PRA proposes would supersede SS2/16 ‘The prudential regulation of credit unions’ (Appendix 2), which would be deleted.

3.5 The PRA considers that its proposals would advance its primary objective to promote the safety and soundness of PRA-authorized firms, facilitate effective competition, and improve transparency.

PRA objectives

3.6 The PRA considers that its proposals would support its primary statutory objective to promote the safety and soundness of PRA-authorized firms by ensuring credit unions that pose greater risk to the PRA’s objective (ie due to their size or complexity of activities) are subject to higher standards. The PRA considers its proposals set out in the draft supervisory statement advance the PRA’s primary objective by clarifying its expectations of credit unions.

3.7 The PRA has assessed whether the proposals in this CP facilitate effective competition. Higher requirements and expectations could be seen as presenting a barrier to expansion for credit unions, which the PRA needs to balance against prudence in the face of service expansion and asset growth. The PRA considers that the proposals in this CP are proportionate, that they support good practice,

⁷ Section 2B of FSMA.

⁸ Section 2C of FSMA.

⁹ Section 2H(1) of FSMA.

¹⁰ Sections 2H(2) and 3B of FSMA.

¹¹ Section 138K of FSMA.

¹² Section 30B of the Bank of England Act 1998.

¹³ Section 149.

and that they do not represent a barrier to the growth of responsible and well-run credit unions, rather they support the maturity of the sector.

3.8 Second, the PRA considers that the expansion of activities for credit unions could, eventually, see them compete more directly with (smaller) building societies and banks, but with a different regulatory regime. However, the PRA considers that most credit unions occupy a niche position in the market for basic loans (mostly small, unsecured, personal loans) and savings accounts, and do not necessarily compete directly with banks or building societies. Furthermore, the PRA considers that many credit unions, especially those with community-based common bonds, target customers that are generally unprofitable for banks and building societies to pursue, many of whom are not eligible for credit elsewhere. The PRA further considers that legislative restrictions that credit unions are subject to also mean that any impact on competition, even from larger credit unions providing more complex products, is unlikely to be significant.¹⁴

Have regards

FSMA regulatory principles

3.9 In developing these proposals, the PRA has had regard to the regulatory principles. The following four of the principles are of particular relevance:

- **The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of that burden:** The PRA has followed this principle when developing the proposals outlined in this CP, eg by targeting changes at those credit unions posing the greatest risks to the PRA's objectives (ie due to their size and complexity of activities). For the majority of credit unions with less than £10 million assets the regime is largely unchanged with the exception of additional clarity on the PRA's expectations of the existing regulations.
- **The need for the PRA to use its resources in the most efficient and economic way:** The PRA considers that targeting changes at those credit unions posing the greatest risks to the PRA's objectives, as outlined above, should enable the PRA to use its resources in a more efficient and targeted way.
- **The desirability of recognising differences in the nature and objectives of businesses carried on by different persons (including mutuals):** The PRA considers its proposals take account of the considerable difference in size, business model and operational capability across credit unions, eg by keeping the regime simple, but providing additional guidance and further expectations for those that carry out additional activities, the regime caters to the different range of credit union business models.
- **The principle that the PRA should exercise its functions transparently:** The PRA's proposals include setting out in the SS further detail of the PRA's expectations of credit unions across several key areas.

3.10 The PRA has considered the remaining FSMA regulatory principles (see references in Appendix 4), and considers that they are not relevant to this proposal.

Impact on mutuals

3.11 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms, and if so, details the

¹⁴ For example: an interest rate cap (the maximum a credit union can charge on a loan) is 42.6% APR in Great Britain (3% a month) and 1% a month in Northern Ireland (1% a month); and a 10% membership limit on corporate members.

difference. The proposals would only affect credit unions, which are all mutual institutions, and consequently there is no comparison to be made in compliance with this requirement.

HM Treasury recommendation letter

3.12 HMT has made recommendations to the Prudential Regulation Committee (PRC) about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.

3.13 **Competition:** The PRA has had regard to this principle in its assessment of whether the proposals facilitate effective competition (see paragraph 3.7).

3.14 **Better outcomes for consumers:** The PRA has had regard to this principle by ensuring credit unions that pose greater risk to the PRA's safety and soundness objective are subject to higher prudential standards, thus helping to secure an appropriate degree of protection for credit union members.

3.15 **PRA transparency:** The PRA has had regard to this principle by providing more detail on its expectations of credit unions.

3.16 The PRA has considered the remaining aspects of government economic policy as laid out in the HMT recommendation letter (see references in Appendix 4), and considers that they are not relevant to the proposals.

Equality and diversity

3.17 The PRA considers that the proposals do not give rise to equality and diversity implications.

Cost benefit analysis

3.18 This section sets out the expected costs and benefits of the proposals in this CP. The proposals fall broadly into three areas:

- higher requirements and expectations of larger credit unions, and credit unions doing more complex activities;
- an extension of permitted investments for credit unions; and
- additional expectations, published in the proposed new SS, to provide more detail on PRA expectations for all credit unions in key areas.

3.19 The proposals in this CP set out options that credit unions would be allowed to undertake as their businesses expand. As such, there is little experience from firms on which we can base a quantitative analysis, and the PRA does not consider it reasonably practicable to provide a quantitative estimate of the costs and benefits. The PRA has therefore provided a qualitative analysis for these proposals.

3.20 Overall, the PRA considers that the expected costs of these proposals imposed on credit unions are proportionate, or indeed outweigh, the benefits that will result. The cost-benefit analysis proceeds by setting out the firms and markets affected by the proposals, the baseline for the analysis, and the analysis of costs and benefits.

Affected firms and markets

3.21 The proposals in this CP apply to credit unions in general, and large credit unions or those undertaking more complex activities in particular. There are around 400 credit unions that will be affected by these proposals on an ongoing basis. The PRA considers credit unions fulfil a niche role in the market for basic loans and savings accounts, in some cases providing credit and other basic financial services to customers that are generally unprofitable for banks or building societies to pursue, or who may be ineligible for credit elsewhere.

3.22 The vast majority of credit unions are small, servicing customers within this niche role, and will continue to do so into the future. The PRA's regulatory regime to date reflects the historic nature of credit unions, which is proportionate for the size and activities traditionally undertaken in this sector. However, the PRA considers that the continuing expansion of a small number of larger credit unions means the existing regime is, in some respects, no longer reflective of the business being undertaken, and potentially limiting to the ongoing growth of some.

Baseline for the analysis

3.23 The baseline for the analysis sets out expectations for conditions in the credit union sector if the PRA chose to take no action. In the absence of the proposals in this CP, the PRA considers large credit unions would face barriers to their expansion, given existing limits on their permitted investments and activities. Moreover, the PRA considers a risk to the safety and soundness of larger credit unions (and potentially across the broader credit union population) could also materialise, where the PRA's prudential standards are outpaced by the expansion into more complex financial activities of credit unions. Lastly, the PRA considers that credit unions in general would continue to be less certain of its supervisory approach, which could increase costs, either as credit unions seek clarification, or do not meet expectations in error, and face costs of undertaking remedial actions.

Benefits and costs

3.24 In general, the PRA considers the benefits of the proposals arise from avoiding the limits to credit union operations of the existing regime, as well as ensuring that any expansion into new activities by credit unions is accompanied by appropriate consideration of the prudential risks. The costs to credit unions would arise from meeting the necessary criteria to ensure appropriate risk management of any new activities or investments that they undertake. The benefits and costs for each of the three broad areas noted in paragraph 3.18 are discussed below.

Higher requirements and expectations for more complex activities

3.25 As noted above, the PRA considers that the expansion of large credit unions into more complex activities threatens the PRA's primary safety and soundness objective, as the current regime is calibrated for smaller, less complex businesses. The benefits of setting higher expectations for credit unions undertaking more complex activities would be to:

- help ensure appropriate prudential standards are met, supporting the PRA's primary safety and soundness objective;
- provide scope for credit unions to expand while maintaining prudential standards, supporting the PRA's secondary competition objective; and
- support proportionality by retaining a simple rulebook in recognition of the diverse nature and complexity of different credit unions of the sector.

3.26 In particular, the PRA considers that as larger credit unions expand, they represent a greater risk to safety and soundness as the potential loss from failure, as well as the disruption to deposit

holders and borrowers, increases. Higher expectations for liquidity management will help ensure the risk of a 'run' on a credit union is appropriately managed. Similarly, the PRA considers that the introduction of basic wind-down planning would help ensure minimum disruption to consumers (and the activities in local economies) that large credit unions support. Lastly, setting PRA expectations for mortgages broadly aligned with those of building societies would help ensure that the risk appetite of credit unions is aligned with their capacity to manage those risks, and in line with existing PRA expectations for building societies.

3.27 The PRA considers that higher requirements are likely to see larger credit unions incur costs to meet the additional systems and controls requirements (Rule 10.3 in the Credit Unions Part of the PRA Rulebook) and additional supervisory expectations. However, the PRA considers that these costs are proportionate to the additional risks involved, and would only be incurred where credit unions choose to expand their business by undertaking these more complex activities.

Extension of permitted investments

3.28 The PRA considers that the growth of large credit unions, and of the sector itself more generally, expands the aggregate amount of surplus funds that credit unions need to invest. Providing additional classes of permitted investments for credit unions would provide opportunities for diversification of investment portfolios, which may facilitate the spreading of risk of investment portfolios over a wider range of products and with a broader range of counterparties. As the total of surplus funds expands, current limits to permitted investments can restrict the scope for appropriate returns on these funds, as well as the capacity for credit unions to expand. The benefit of providing for additional classes of permitted investments would be to avoid any barrier to expansion that current limits to permitted investment might create, while ensuring the safety and soundness of credit unions. The expansion of permitted investment would provide opportunities for diversification of investment portfolios, and create opportunities for increasing returns on these investments.

3.29 The PRA considers the introduction of new investment classes is not expected to result in a material increase in costs to credit unions undertaking such investments; credit unions should ensure that any costs incurred are proportionate to the return provided on such investments. The PRA considers that investing in products that are not capital-protected presents additional risk in the event of a default, although any costs arising from this should be minimised by the required investment grade rating and the counterparty and concentration limits. There may be some costs incurred for credit unions to develop their expertise in order to fully understand the risks posed in respect of these investment classes, ensuring that any investment decisions reflect the fact that it is members' savings (which typically can be withdrawn on demand) that will be invested. Some credit unions may choose to use investment advisors to facilitate investment in new investment classes, and will therefore incur costs in terms of fees and commissions payable. Systems, controls, policies and procedures would also need to be updated to reflect the new requirements and expectations set. Credit unions would be required to manage their liquidity and would be expected to meet liquidity expectations, including around stress testing. The PRA further considers that it is up to each credit union whether they wish to invest in the new investment classes; a credit union can avoid any such costs by choosing not to undertake such investments.

Provision of additional expectations

3.30 The PRA is proposing to provide additional clarity on the PRA's expectations of credit unions. The benefit arises from reducing uncertainty and helping credit unions 'get the basics right', particularly for smaller credit unions where there is less experience and expertise in dealing with supervision. The PRA does not expect material costs to arise as a result of the proposed clarification of the PRA's expectations.

Appendices

1	Draft Credit Union Rulebook Instrument	16
2	Draft Supervisory Statement xx/22 ‘Supervising credit unions’	21
3	[Superseded] Supervisory Statement 2/16 ‘The prudential regulation of credit unions’	22
4	PRA statutory obligations	22

1 Draft Credit Union Rulebook Instrument

PRA RULEBOOK: NON-CRR FIRMS: CREDIT UNIONS INSTRUMENT 2022

Powers exercised

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
 - (1) section 137G (The PRA’s general rules) and;
 - (2) section 137T (General supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: Non-CRR Firms: Credit Unions Instrument 2022

- D. The PRA makes the rules in the Annex to this instrument.

Commencement

- E. This instrument comes into force on [DATE].

Citation

- F. This instrument may be cited as the PRA Rulebook: Non-CRR Firms: Credit Unions Instrument 2022.

By order of the Prudential Regulation Committee

[DATE]

Annex

Amendments to the Credit Unions Part

In this Annex new text is underlined and deleted text is struck through.

1 APPLICATION AND DEFINITIONS

...

1.2 In this Part, the following definitions shall apply:

additional activity

means:

- (1) an additional activity carried out or additional service provided by a *credit union* as described in 3.3, 3.5, Chapter 4, 6.4 or Chapter 7;
- (2) entering into a *conditional sale agreement*, as the seller, with a *member of the credit union* pursuant to section 11E of the Credit Unions Act 1979;
- (3) entering into a *hire purchase agreement*, as the person from whom goods are bailed or (in Scotland) hired, with a *member of the credit union* pursuant to section 11E of the Credit Unions Act 1979;
- (4) providing credit cards; or
- (5) lending to *corporate members*.

...

conditional sale agreement

has the meaning given in section 31(1) of the Credit Unions Act 1979.

corporate bond

means a bond issued by a company and traded on a *regulated market* in the UK.

corporate members

has the meaning given:

- (1) in relation to a *Great Britain credit union*, in section 5A of the Credit Unions Act 1979; or
- (2) in relation to a *Northern Ireland credit union*, in article 14A of the Credit Unions (Northern Ireland) Order 1985.

credit rating

has the meaning given in Article 3(1)(a) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

credit rating agency

has the meaning given in Article 3(1)(b) Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

...

hire purchase agreement

has the meaning given in section 31(1) of the Credit Unions Act 1979.

...

qualifying money market fund

has the meaning given in the Glossary to the FCA Handbook.

...

supranational bond

means a bond issued by any of the following supranational institutions:

- (1) African Development Bank;
- (2) Asian Development Bank;
- (3) Bank for International Settlements;
- (4) Caribbean Development Bank;
- (5) Council of Europe Development Bank;
- (6) Development Bank of Latin America;
- (7) European Company for the Financing of Railroad Rolling Stock;
- (8) European Bank for Reconstruction and Development;
- (9) European Central Bank;
- (10) European Investment Bank;
- (11) European Investment Fund;
- (12) European Union;
- (13) Inter-American Development Bank;
- (14) International Bank for Reconstruction and Development;
- (15) International Finance Corporation;
- (16) International Finance Facility for Immunisation;
- (17) International Monetary Fund;
- (18) Islamic Development Bank; or
- (19) Nordic Investment Bank.

...

3 LENDING

...

3.2 Subject to 3.3, a *credit union* must not make:

- (1) an *unsecured loan*, a *conditional sale agreement* or a *hire purchase agreement* that is repayable within more than five years from the date of its provision; or
- (2) a *secured loan*, that is not a *conditional sale agreement* or a *hire purchase agreement*, that is repayable within more than ten years from the date of its provision.

3.3 If a *credit union* complies with 10.3, it may make:

- (1) an unsecured loan, a conditional sale agreement or a hire purchase agreement that is repayable within ten years from the date of its provision; or
- (2) a secured loan, that is not a conditional sale agreement or a hire purchase agreement, that is repayable within 25 years from the date of its provision.

3.4 Subject to 3.5, 3.6 and 3.7 the outstanding balance of ~~a loans~~ by a credit union:

...

3.5 Subject to 3.6 and 3.7, the outstanding balance of ~~a loans~~ by a credit union that satisfies ~~satisfies~~ satisfy the requirements in 10.3:

...

6 INVESTMENT

...

6.2 ~~Surplus funds~~ must be invested in ~~capital-protected products~~ accordance with this Chapter or held as cash in the custody of ~~officers~~ of a *credit union*.

6.3 A *credit union* must not hold *investments*, save that it may hold an *investment* that is:

- (1) a *deposit* placed with a *credit institution* or with a *credit union* which is authorised in the UK to *accept deposits* on terms that the *deposit* shall be repayable within at most twelve months from the date on which that *investment* is made;

...

6.4 If a *credit union* complies with 10.3, it may hold an *investment* that is:

...

(6) a corporate bond which:

- (a) has a maturity that is up to five years from the date on which that *investment* is made;
and
- (b) has been assigned a credit rating of investment grade or higher by at least two credit rating agencies which are registered with the *FCA*;

(7) a supranational bond which:

- (a) has a maturity that is up to five years from the date on which that *investment* is made;
and
- (b) has been assigned a credit rating of investment grade or higher by at least two credit rating agencies which are registered with the *FCA*;

(8) in a UCITS which:

- (a) is authorised by the FCA;
- (b) has assets under management of at least £100 million;
- (c) itself holds only investments that would be permitted to be held by that credit union pursuant to 6.4; and

- (d) itself holds only *investments* which have been assigned a *credit rating* of investment grade or higher by at least two *credit rating agencies* which are registered with the *FCA*; or
- (9) in a *qualifying money market fund* which:
 - (a) is authorised by the *FCA*;
 - (b) has assets under management of at least £100 million;
 - (c) itself holds only *investments* that would be permitted to be held by a *credit union* pursuant to 6.4; and
 - (d) itself holds only *investments* which have been assigned a *credit rating* of investment grade or higher by at least two *credit rating agencies* which are registered with the *FCA*.

6.4A A *credit union* shall not:

- (1) directly invest more than 5% of its capital in *corporate bonds* or *supranational bonds* issued by a particular *counterparty*; and
- (2) invest more than 30% in total of its *capital* in investments permitted by 6.4(6)-(9).

...

2 Draft supervisory statement ‘Supervising credit unions’

3 [Superseded] Supervisory Statement 2/16 'The prudential regulation of credit unions'

~~[Superseded] Supervisory Statement 2/16 'The Prudential regulation of credit unions'~~



4 PRA statutory obligations

The statutory obligations applicable to the PRA's policy development process are set out below. This CP explains the policy assessment of relevant considerations.

- Purpose of the policy proposals (FSMA s138J(2)(b)).
- Cost benefit analysis (FSMA s138J(2)(a) and (7)(a)); and an estimate of those costs and benefits (if reasonable) (FSMA s138J(8)).
- Analysis of whether the impact on mutuals is significantly different to the impact on other authorised firms (FSMA s138J(2)(c) and 138K).
- Compatibility with the PRA's primary objectives (FSMA s138J(2)(d)(i), 2B and 2C).
- Compatibility with the PRA's secondary competition objective (FSMA s138J(2)(d)(ii) and 2H(1)).
- Compatibility with the regulatory principles (FSMA s138J(2)(d)(ii), 2H(2) and 3B).
- Have regard to the HMT recommendation letter (BoE Act s30B).
- Have due regard to the public sector equality duty (Equality Act s149).
- Have regard, subject to any other requirement affecting the exercise of the regulatory function, to the principles of good regulation and when determining general policy or principles to the Regulators Code (Legislative and Regulatory Reform Act 2006 s21 & 22)
- Have regard, so far as consistent with the proper exercise of those functions, to the purpose of conserving biodiversity. Conserving biodiversity includes, in relation to a living organism or type of habitat, restoring or enhancing a population or habitat (Natural Environment and Rural Communities Act 2006, s40).
- Consultation of the FCA (FSMA s138J(1)(a)).
- *Where the consultation proposals a PRA rule change or amendment to onshored BTS that affects the processing of personal data - consultation with the Information Commissioner's Office (article 36(4) General Data Protection Regulation).*