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Draft amendments to SS2/23 – Supervising credit unions

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4: Additional activities and membership size

4.1 A credit union that is undertaking 'additional activities'1 (see Table 1) or that has more than 15,000 members~~,~~ and is therefore subject to the requirement in Rule 10.3(3) of the Credit Unions Part of the PRA Rulebook, is expected to monitor its relevant business by using the ratios in paragraph 4.3 below, calibrated with values that are specifically aligned to its individual business model.

1 'Additional activity' means (1) an additional activity carried out or additional service provided by a credit union as described in Rule 3.3, Rule 3.5, Chapter 4, Rule 6.4, or Chapter 7 of the PRA Part of the PRA Rulebook, (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 in relation to a Great Britain credit union and pursuant to article 28F of the Credit Unions (Northern Ireland) Order 1985 in relation to a Northern Ireland Credit Union; (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 in relation to a Great Britain credit union and pursuant to article 28F of the Credit Unions (Northern Ireland) Order 1985 in relation to a Northern Ireland Credit Union; (4) providing credit cards; or (5) lending to corporate members; or (6) acting as the referring credit union or the receiving credit union in relation to the referral of a member pursuant to article 28E of the Credit Unions (Northern Ireland) Order 1985; or (7) engaging in a loan participation arrangement pursuant to article 28AA of the Credit Unions (Northern Ireland) Order 1985.

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.

4.3 By way of example only, the PRA considers that prudent practice suggests that the indicative ratio percentages for credit unions that undertake additional activities or have more than 15,000 members for all calculations save loans to assets are those outlined in Table 1.

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

Ratio	Additional investments	Additional lending and loan participation activities	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%

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Ratio	Additional investments	Additional lending and loan participation activities	Mortgages	Transactional accounts	Indicative ratio
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

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

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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 and any loan participation arrangements), 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, or referred members, including money held for deferred shares.
Net loans	The total amount outstanding at the relevant date on all loans to members, or referred members, (irrespective of when such loans were made) less provision for bad and doubtful debt. This includes where there is an exposure through a loan participation.
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, or referred members, where the loan is more than three months in arrears. This includes where there is an exposure through a loan participation arrangement.
Total loans	The total amount outstanding at the relevant date on all loans to members or referred members (irrespective of when such loans were made). This includes any loans written off during the period and where there is an exposure through a loan participation arrangement.
Net assets	Total assets less liabilities (excluding members' or referred members' shares and juvenile deposits).
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), pre-paid 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. (In general, shares are excluded as most credit unions pay a dividend on shares if they make a profit and any interest bearing shares or juvenile deposits should be excluded).
Loan income	The total amount of interest received on loans made to members or referred members during the 12-month period preceding the relevant date. This also includes interest received from a loan participation arrangement.

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19: Additional expectations for Northern Ireland Credit Unions

19.1 This chapter sets out the PRA's expectations of Northern Ireland Credit Unions (NICUs) as a result of changes made to the Credit Unions (Northern Ireland) Order 1985 ('The Order') to expand the scope of NICUs' activities.

Member Referral

19.2 Under article 28E of the Order, NICUs can refer members to other NICUs to access services or products. The effect of this is that when a member is referred to another NICU, the member concerned is to be treated as a member of the receiving NICU. This applies only for the purpose of providing the service concerned and for the period during which that service is provided.

19.3 In such cases the PRA expects that:

- A NICU that is receiving a referred member for a particular service should ensure they are complying with the relevant regulatory requirements and expectations with regards to that service, for example Chapter 17 for mortgage services.
- The receiving NICU does not rely on the due diligence carried out by the referring NICU. They must apply their own onboarding, affordability, AML, and credit decisioning standards.
- It is clear within the terms of any agreement for the provision of a product or service that the contract is between the member and the receiving NICU and that the referring NICU bears no liability for any arrears etc.
- For both the referring and receiving NICU, there should be minimum data-security standards for transferring member information with clear limits on what member data can be shared and for what purpose. NICUs will need to consider and ensure compliance with all requirements of applicable data protection law. There should be clear audit trails for all referral-related data, sufficient to enable the credit union to identify the origin, transfer, use, and reliance on member data throughout the referral lifecycle. At a minimum, firms should be able to evidence the parties involved in the referral, the data shared and its purpose, the member's consent, and key decisions taken on the basis of that data. Records should be accurate and securely maintained.
- There is clear monitoring of:

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- Volumes of referrals in and out.
- Types of products being accessed via referral.
- Delinquency rates for referred-member lending.
- Any operational incidents connected to referrals.

- Where referral fees are charged, the PRA expects NICUs to establish practices to ensure that referral arrangements do not create inappropriate incentives or conflicts of interest. This could include ensuring that arrangements are approved and periodically reviewed by the Board, that fees are not linked to loan performance or other outcomes that could encourage excessive risk taking. NICUs are also expected to identify and manage any conflicts of interest arising from referral income and to monitor concentrations resulting from referral arrangements.

19.4 For the avoidance of doubt, the PRA considers that an arrangement by which one credit union refers a member to another credit union would generally fall outside outsourcing as defined under PRA rules[19] This is on the basis that the referral would only take the form of an introduction, there will be a contractual relationship between the referred member and receiving NICU, and the receiving NICU is not performing the service on behalf of the referring NICU (which will have no involvement in the service provided).

[19] See footnote 18 for requirements and expectations that apply to credit unions in relation to outsourcing.

19.5 NICUs wishing to refer members in this way should be aware that they are subject to the additional activities requirement under Rule 10.3.

Loan Participation

19.6 Under article 28AA of the Order, a NICU may participate in a loan participation agreement. This is a lending arrangement in which one lender (the originator) makes and services a loan to the borrower, while one or more other lenders (participants) buy an economic share of that loan. Where a NICU wishes to participate in such arrangements, the PRA expects:

- That each NICU carries out its own due diligence and credit analysis. The participating credit union may need to receive personal data from the originating credit union for this purpose.
- The borrower deals only with the originating credit union, of which the borrower is a member, or referred member. The originating credit union remains the sole lender of record and holder of any security. Participants have an interest in the loan's cashflows and losses in accordance with the terms of a separate participation agreement, but have no direct contractual relationship with the borrower. The originating credit union, where the borrower

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is a member, or referred member, is responsible for communicating with the member, making, monitoring, administering and enforcing the loan.

- That, for funded loan participations, NICUs clearly set out in the loan participation agreement:
  - An express statement that the participant lenders acquire a beneficial/economic interest only: the originator remain sole lender of record.
  - That payments to the participant lenders are conditional on borrower payments (there is no guarantee by the originating NICU);
  - clear pro-rata sharing of principal, interest, fees, arrears and recoveries.
  - Explicit confirmation of how any attached shares and any other security held by the member at the originating credit union are to be treated, including whether participant credit unions are considered to have a proportionate interest in those shares to the extent that the shares are used as collateral or set off, and treatment of recoveries.
  - The governance around any decisions regarding the administration and enforcement of the loan (including which decisions require consent of all participating NICUs).
  - A statement addressing how participant interests are treated if the originator enters stress or insolvency including (where relevant and subject to applicable insolvency law), any reliance on the originating credit union for cashflows and recoveries, any contractual or structural mitigants (for example, arrangements relating to servicing) and operational continuity.
  - Whether there is the possibility for a participating NICU to 'buy-out' another NICU's interest in the loan (assuming this would not breach the regulatory loan limits).
- That the NICU has a Board approved participation policy. This should cover the above considerations, including due diligence and the contents of the loan participation agreement, as well as eligibility criteria, acceptable structures, limits and Board reporting. It should also cover concentration limits by borrower and participation counterparty and, where the borrower is a corporate member borrower, by sector; governance around decisions on loan enforcement; and stress analysis covering borrower default scenarios, originator liquidity stress and delayed enforcement scenarios.
- That NICUs make adequate provisions for any bad debts arising from such loans in line with the NICU provisioning rules (Rule 3.11 of the Credit Unions Part).

19.7 NICUs wishing to participate in loan participation arrangements should be aware that they are subject to the additional activities requirement under Rule 10.3.

19.8 The PRA recognises that, given the contractual relationship between the originator NICU and the participating NICU, loan participation arrangements may give rise to a direct credit risk exposure for the participant credit union in relation to the originating credit union.

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However, where a participation is structured such that the participant credit union's returns or commitments are dependent on payments by the underlying borrower, the PRA would generally expect the participant to treat its exposure, for the purposes of the lending limits framework, as an exposure to the underlying borrower rather than to the originating credit union.

19.9 Accordingly, the limits on individual loans (Rule 3.5) and large exposures (Rules 3.6 and 3.7), and on the capital to assets ratio (Rules 3.8 and 3.9) apply to the participant credit union in respect of its interest in the underlying loan. Credit unions should, however, recognise and manage any residual credit risk to the originating credit union arising from the structure of the arrangement.

19.10 For the originating credit union, the PRA expects exposures in relation to loans subject to loan participation arrangements to reflect the extent of effective credit risk transfer to participants. Where a legally robust arrangement transfers risk on a pro rata basis, limits on individual loans, large exposures and the capital to assets ratio (Rules 3.8 and 3.9) should apply only to the retained exposure. Credit unions should ensure that any risk transfer is clearly evidenced, enforceable in stress, and appropriately reflected in risk management, provisioning and stress testing.

Unfunded loan participation

19.11 Where a NICU participates in an unfunded loan participation arrangement – that is, where the NICU does not advance funds but assumes a proportion of the credit risk underwritten by the originating credit union – the PRA expects (in addition to the above, where relevant) the following:

- Each NICU must undertake its own independent credit assessment of the borrower and the originating credit union's underwriting standards before accepting risk exposure.
- The NICU should ensure that the contractual documentation governing the loan participation arrangement clearly sets out:
  - (Where applicable) an express statement that the participant lenders acquire an economic or beneficial interest only: the originator remain sole lender of record.
  - The allocation of credit risk and loss-sharing mechanisms; (including clear treatment of principal, interest, fees, arrears and recoveries).
  - Rights of participating credit unions over any security.
  - Rights of participating credit unions over any attached shares at the originating credit union.
  - Any triggers for payment or indemnity.

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- The governance around any decisions regarding the administration and enforcement of the loan.
- A statement addressing how participant interests are treated if the originator enters stress or insolvency.
- Whether there is the possibility for a participating NICU to 'buy-out' another NICU's interest in the loan (assuming this would not breach regulatory loan limits).

- The NICU should have appropriate risk-management and monitoring arrangements to track the performance of the underlying loan and any changes in the borrower's creditworthiness.
- The originating credit union must provide sufficient information flow to enable ongoing oversight, while ensuring compliance with data-protection requirements.
- The NICU should generally treat the credit protection provided under the arrangement as equivalent to a loan to the member or referred member borrower for the purposes of the PRA's lending, large exposure, provisioning and capital requirements. However, the PRA recognises that there may be differences in the specific terms and mechanics that govern the loan participation agreement. For example:
  - The trigger for payment by the participating NICU. The agreement may define different triggers for when the participating NICU becomes obliged to compensate the originating NICU, which could occur either before or after the borrower has been in arrears for three months.
  - Whether payment is automatic or discretionary.
  - Whether losses are shared pro rata or only after specified thresholds are breached.
  - Whether there are caps on losses.
  - Whether the protection covers only principal or also interest and costs.

19.12 As a result, the PRA expects firms to discuss the treatment with their supervisory contact where they consider that the specific features of an arrangement raise uncertainty as to the appropriate application of the PRA requirements.

19.13 For the avoidance of doubt, the PRA does not expect the PRA rules on investments (chapter of the Credit Unions Part) to apply to unfunded loan participation arrangements.

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