BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

The Board of Directors

Chris Donald
Credit Unions Team
chris.donald@bankofengland.co.uk

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Dear Directors

PRA annual assessment of the Category 4 credit union sector

As a category 4 credit union, we carry out an annual risk assessment of your credit union to assess the prudential risks attached to the firm's business and operations, and the effectiveness of the credit union's framework of risk management and control. Category 4 credit unions include all credit unions with assets above £40 million, although there is supervisory discretion to include credit unions outside this range. This letter provides feedback on some of the key themes that have emerged over the past year from our annual risk assessments of Category 4 credit unions.

Supervisory modules

In line with the PRA's approach, Category 4 credit unions are now subject to a more in depth focus in certain risk areas as part of the PRA's annual risk assessment, on a rotating basis. In a three year period, a Category 4 credit union can expect to be subject to a governance review (also known as a 'Board Effectiveness Review', or BER), a credit risk review, and, going forward, an operational risk and resilience review.

Based on the findings from governance reviews and credit risk reviews carried out for credit unions within this peer group over the past year, we have identified the below good and poor practice.

<u>Governance</u>

Good practice

- The board has an appropriate range of skills and experience relevant to the activities carried on by the credit union.
- The credit union carries out an analysis of skills gaps and prioritises identified gaps when recruiting replacements and buys in external expertise as necessary.
- The board demonstrates a clear understanding and ownership of strategy, focusing on this as a key agenda item at board meetings.
- The credit union has a risk appetite statement which the board has signed up to and reviews on a regular basis (at least annually). The risk appetite statement includes quantifiable risk measures for all key areas of risk, and triggers in place to ensure that a credit union can take action before its risk appetite is breached.
- The board is provided with management information which clearly indicates the credit union's financial position and whether key financial measures are being met with reference to the board's risk appetite.
- The internal audit function carries out checks to assess the soundness of the credit union's governance checks (eg observations of board meetings to determine whether there is comprehensive strategy-setting process, which considers all matters of material relevance and documents the reasons for its decisions, checks of the board minutes to ensure actions are carried out etc).

- There is a clear separation between the role and responsibilities of the General Manager/CEO/SMT (largely operational, keeping the board informed and bringing recommendations to the board) and that of the board (largely strategic, approving key policies, making key decisions and overseeing performance, appraising the CEO).
- The CEO/General Manager has formal objectives which they are assessed against via a formal appraisal process, led by the Chair.
- A formal assessment of the board, both individually and collectively is carried out annually, led by the Chair.
- A formal assessment of the Chair is carried out annually by the Vice-Chair.
- Directors rotate key positions (Chair, Vice-chair, Treasurer) as part of the credit union's succession planning.

Poor practice

- Directors demonstrate a poor understanding of risks facing the credit union (failure to look at or understand management information, lack of understanding of risks attached to investing in certain financial products etc).
- The board gets bogged down in operational detail instead of focussing on strategy.
- Management information produced for the board is inadequate (eg excessive in detail without providing an overview of key areas or reference to the board's risk appetite).
- The board fails to respond to the recommendations of the internal audit function.
- Certain board members dominate discussions.
- There is no formal training plan is in place for directors (both new and existing directors).

<u>Credit Risk</u>

Good practice

- The credit union's credit risk appetite is articulated in a formal risk appetite statement that has been agreed by the board and is reviewed on a regular basis (at least annually). The statement includes reporting triggers at which the board would consider taking action to ensure the risk appetite is not breached and a description of mitigating actions the credit union might take if the triggers are breached. (eg XYZ credit union has a risk appetite of no more than 5% of loans in arrears, with a reporting trigger at 4% or +1% movement in a monthly period. If the reporting triggers are breached the credit union has identified possible mitigating actions it could take as including stricter underwriting standards, increased resources dedicated to credit control etc. *Please note the numbers included here are for purely illustrative purposes.*)
- Policies are up to date, consistent and aligned with the credit union's stated risk appetite and reflective of current practices.
- The credit union's lending strategy and procedures around this have been clearly disseminated throughout the organisation ensuring that all staff have a clear and consistent view of the credit union's approach to lending.
- The credit union operates a model for checking adherence to loans policies incorporating a number of individuals (eg the loans manager checks a sample of loan files every month, the compliance officer or supervisory committee every quarter and internal audit every year as part of the internal audit workplan).
- The credit union has a robust credit control procedure where established controls are in place – for example chaser phone calls, arrears letters – and are applied consistently.

Poor practice

- Policies are out-of-date (eg references to the old PRA 'CREDS' sourcebook and to old committee structures making it unclear which committees responsibilities lie with), inconsistent with other policies/ procedures (eg maximum loan term and amount differs across policies) and not reflective of current practices and procedures.

- More than one credit committee with different approaches and tolerances resulting in inconsistent outcomes on loan decisions.
- Policies are too high level (eg refer to assessing whether the policy is ‘affordable’ without setting out what constitutes a loan to be affordable).
- There is not a clear approval process for larger loans/ credit policy exceptions.
- Lack of board oversight and a clear monitoring and reporting process on credit risk.

Operational risk and resilience

As part of our new regulatory approach, one of the new areas of focus going forward is operational risk. Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems, or from an external event. Examples of the types of events this covers include internal/external fraud, employment practices, damage to physical assets, business disruptions and systems failures and execution, delivery and process management failures. We expect credit unions falling in your peer group to give consideration to:

- what governance and oversight arrangements for operational resilience are in place;
- what the credit union’s risk thresholds for operational resilience are and how are these documented and monitored;
- how the board is satisfied that risk governance provides sufficient assurance to the board on operational resilience effectiveness;
- how external dependencies and risks are identified and managed;
- how the credit union manages its control environment for technology; and
- whether the credit union has documented the core systems which are critical to the operation of your business and the function they carry out.

As part of our work in this area the PRA sent a questionnaire to a number of banks and building societies in 2016 to help understand firms’ current policies and capabilities in a key aspect of this area, cyber security. We have now rolled out the questionnaire to Category 4 credit unions who may expect to receive feedback on the results in Q3 2017 (if they have not already).

Next steps

As directors of a credit union, you have personal and joint obligations to serve your members and to meet regulatory and legal requirements. In doing so, we expect you to bear in mind the points set out above and act appropriately. This letter has been shared with all UK trade bodies and you may wish to discuss with them the points we have made.

If you have any questions about the contents of this letter, please contact your named supervisor.

Yours faithfully

Chris Donald
Credit Unions Team