

Credit Union law and regulation:

forthcoming changes and the way forward

November 2009

Agenda



- **Summary of changes to credit union law**
- **Changes to prudential regulation and CRED**
- **Getting there: what this will mean for you**



Roadmap: where are we now?

- **Changes to credit union law**

- July 2009: draft legislative reform order (LRO) published
- 2 December 2009: LRO laid before Parliament
- 1 July 2010: likely effective date

- **Regulatory changes**

- 11 November: CRED review CP published
- 10 February 2010: deadline for responses
- 1 July 2010: rule changes to take effect, subject to consultation and to transitionals, at same time as LRO
- Yet to come: a credit unions regulatory guide (CURG) – more on this later



Summary of legislative reforms

In summary, LRO will:

- **enable credit unions to combine common bonds (subject to number of persons eligible in locality bonds)**
- **remove restrictions on**
 - non-qualifying members
 - annual dividends (8 % cap goes, except on winding up)
 - charging for ancillary services

Summary of legislative reforms

And it will allow credit unions :

- **to admit corporate members, provided they do not:**
 - make up more than 10% of membership
 - hold more than 25% of shares (apart from deferred shares)
 - borrow more than 10% of amount on loan to all members
- **to issue deferred shares which :**
 - count towards capital (when members pay in money for deferred shares, credit union has to transfer that sum to reserves)
 - are similar to deferred shares under Building Societies Act 1986
 - are different from other credit union shares in being transferable, but not withdrawable, and carrying no right to borrow
 - are generally repayable only on winding-up or dissolution of credit union, after all creditors have been repaid

Summary of legislative reforms



- **to issue interest-bearing shares so long as they have:**
 - registered an amendment of rules to provide for it
 - submitted accounts with:
 - reserves of at least £50,000 or 5% of total assets, whichever is greater
 - report from auditor that systems are adequate to manage interest-payment

LRO is intended to clarify the position on “attachment” of shares

- must be a term in loan to member saying whether member’s shares are ‘attached’ (non-withdrawable)
- FSA checking with HMT whether term may be varied by mutual agreement to permit withdrawal

Review of the Credit Unions Sourcebook (CRED)



Two main drivers for the review

- legislative reforms
- our experience of regulating credit unions since 2002

Experience since 2002

- overall growth, but also credit union failures
- some rapid collapses of high-profile credit unions
- more failures following stagnation

Raising prudential standards



Strong case for raising prudential standards, with following intended outcomes

- credit unions financially sounder and better managed, with fewer failures and defaults
- members' savings protected by credit unions themselves, not just by FSCS cover
- consolidation (by merger, for example) within sector more feasible where credit unions no longer viable
- changes complement LRO, aiding sustainable development of sector and its contribution to countering financial exclusion

Raising prudential standards

CRED CP sets out proposed changes in three areas:

- raising prudential standards
- technical changes arising from LRO
- restructuring CRED

Priority areas for attention

- Capital
- Liquidity
- Governance
- Reporting
- Provisioning

Capital

Increased initial capital requirements for all new credit unions (that is, start-up funding necessary to get established)

Proposed changes.....

- version 1 credit unions - £10,000 (up from £1,000)
- version 2 credit unions - £50,000 (up from £5,000)

...so that new credit unions are

- better-prepared for costs arising in first year
- and make better start towards maintaining ongoing capital requirement

Capital

Minimum capital-to-assets ratio for smaller V1 credit unions

Proposed change....

- to introduce a 3% minimum capital-to-assets ratio, to replace the current bare solvency requirement, in order to
- increase resilience of individual credit unions

No change to:

- existing requirement for version 1 credit unions to transfer 20% of their profits to reserves each year, until reserves reach 10% of total assets
- ongoing ratio for large version 1 credit unions (depending on size - 5%, or 8% risk-adjusted)
- capital ratio for version 2 credit unions (8% risk-adjusted)

Liquidity

Liquidity ratios

Proposed changes....

- increase liquidity ratio to 10% of 'total relevant liabilities' (mainly freely withdrawable or "unattached" shares)....
-and apply this to all credit unions....
- but remove the existing additional requirement that version 1 credit unions must not let ratio fall below 10% on two consecutive quarters

Rationale.....

- higher liquidity means greater resilience
- shares becoming less "sticky" – increased competition

Transitional provisions



We propose transitionals for capital and liquidity....

New minimum ratios to take full effect on 30 September 2012:

- minimum capital-to-assets ratio for version 1 credit unions - 3%
- minimum liquidity ratio for all credit unions - 10%

Interim stage from 30 September 2011:

- minimum capital-to-assets ratio for version 1 credit unions - 1.5%
 - minimum liquidity ratio for all credit unions - 7.5%
- (but version 1 credit unions will also remain subject to existing requirement that ratio should not be below 10% for two consecutive quarter-ends)

Governance



Main conclusions

- many credit union problems can be put down to poor governance
- doing LRO-activities will make increased demands
- considered amending rules on senior management, systems and controls, but decided they are strong enough
- will focus instead on securing timely compliance with existing requirements

Overall message: no proposed rule changes, but increased vigilance

Supervisory returns



Submission period for annual return (CY) and accounts

- Current position - seven months after financial year-end
- Proposal – this should be reduced to four months after financial year-end, for year-ends falling after effective date of CRED changes

More timely financial information means credit unions and FSA can react more quickly to emerging problems

Provisioning



Provisioning for bad and doubtful debts

No change proposed to:

- overarching *rule* that credit union should make adequate provision
- *rule* requiring specific provision when loan is:
 - 3 months in arrears - 35% of member's net liability
 - 12 months in arrears - 100% of member's net liability

But new *guidance* that credit unions should consider additional specific provisions:

- 6 months in arrears - 60% of member's net liability
- 9 months in arrears - 80% of member's net liability

Reason for new guidance:

- transition between current provisioning points is too abrupt
- can result in unanticipated losses at year-end



Changes arising from LRO

These are largely technical

- designed to make sure rules on shares and deposits, liquidity, lending, large exposures and provisioning fit with what is in LRO (e.g. to distinguish the treatment of deferred shares from ordinary shares)

NB Draft rules may need to be amended if HMT say that LRO permits variation (by mutual consent) of term in loan “attaching” shares.

- not meant to change policy intent of rules, but may affect how they are applied

We also propose to:

- amend supervisory returns
- vary credit union permissions

Changes arising from LRO

Supervisory returns and guidance

No change to returns now, but.....

- **Credit unions doing new LRO-activities will need to fill out a supplementary sheet analysing data from main body of returns on:**
 - corporate members
 - deferred shares
 - interest-bearing shares

So no change:

- for credit unions not doing those activities
- to your underlying computer systems

Interim solution pending consideration of our own systems and information needs; revision of returns will be subject to further consultation in due course

Changes arising from LRO

Variation of permissions

- **Currently, credit unions' deposit-taking permissions limited to 'retail (investment) customers' - does not cover all corporate bodies**
- **LRO gives FSA power to change limitation, so credit unions do not have to apply individually for a variation of permission**
- **But credit unions can opt out by giving notice to FSA**
- **FSA proposes to exercise power once LRO comes into force**
- **Details in LRO and consultation paper**



Restructuring CRED

We plan to replace CRED with two documents....

.....a new, revised Credit Unions Sourcebook, to be called “CREDS”, which will

- contain all prudential changes we have covered today
- reduce duplication between CRED and the main FSA Handbook by cutting out detailed guidance to main Handbook, and replacing it with general pointers
- be re-ordered and re-numbered to rationalise piecemeal additions and deletions over time – such as additional Chapter 7A and missing Chapters 12 and 16
- more details in consultation paper

And....

Restructuring CRED



...a new regulatory guide for credit unions (or “CURG”)

The purpose is to:

- move all guidance on legislation out of CRED into one place
- re-write it to take account of LRO-changes
- reduce confusion between requirements deriving from legislation and FSA rules
- use less legalistic language
- make it easier to keep up to date

We will consult on CURG in due course, and aim to bring it into effect at the same time as the LRO

Next steps

Responses to CRED CP by 10 February 2010

Rules made once responses have been analysed and any changes made

Draft of CURG to be circulated for comment

**All to come into effect on the commencement date of the LRO
(1 July 2010)**

Let's now turn to some of the practical implications for you.....

Getting there



**Preparing to meet the amended rules in
CRED (or CREDS);**

**Adapting to the new possibilities of the
LRO.**



Getting there - Raising prudential standards **FSA**[®]

Credit unions need to make early plans for meeting the new capital ratio, for example, by:

- **reducing expenditure**
- **increasing income**
- **moderating dividends**
- **moderating asset growth**
- **obtaining subordinated debt**
- **issuing deferred shares**

If that is not possible, it means considering:

- **merger**
- **or, in the last resort, closure.**

**IPSA and the CUA govern what a CU is
and what a CU is statutorily able or unable
to do;**

**The LRO changes IPSA and the CUA;
BUT**

Getting there



**IPSA and the CUA do not govern
precisely what your CU can do;**

Your own credit union's rules do that.

Changing your rules

Subject to your current rules (and law)

Therefore –

- **A properly-constituted and advertised General Meeting;**
- **The required 2/3 majority on proposals;**
- **Proposals to include properly-worded, comprehensive, new or amended rules;**
- **Submission of amendments (partial or complete) to FSA for “registration”.**

Changing your rules



A credit union cannot act on new/amended rules until they have confirmation from the FSA that those rules have been Registered.

The challenge

c. 500 CUs

Almost all will want to change something –
and most will have to;

We all need Model rules, or Model rulebooks

The challenge



We will work with the Trade Bodies to agree Model Rules

We will work to change application forms, etc., to be ready for submissions of amended or new rulebooks,

BUT

The challenge



None of us is ready yet so –

Please do not submit any requests to change rules to meet the new regime until we say we are ready.

When we do invite submissions.....



If the submitted rules are in agreed Model terms,

If they are accompanied by the required confirmations and declarations, *and*

Provided they are compliant with the statute,

We will register them.

However.....



Some of the new opportunities pose greater threats than others;

We will need to know when your credit union starts to do some of what its new rules allow it to do, specifically...

PRIN 2.1.1R



“A *firm* must deal with its regulators in an open and co-operative way, and must disclose to the *FSA* appropriately anything relating to the *firm* of which the *FSA* would reasonably expect notice.”

Issuing Interest-bearing shares; - notification,
plus evidence of reserves, auditor's
statement, balance sheet

Issuing Deferred Shares – notification

Welcoming corporate members – notification

and, in each case, a copy of a Business Plan

Summary

- **We all need time**
- **We all need to work together**
- **We will register acceptable rulebooks**
- **We will oversee the more risky activities**
- **We will let you know when we can accept applications**

Thanks for your attention and

Good Luck!