ABCUL
Association of British Credit Unions Limited

Depositor protection responses
Joanna Bibby-Scullion and Rosie Kameen
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

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Dear Joanna and Rosie,

Implementation of the Mortgage Credit Directive and the new regime for second charge mortgages

We appreciate the opportunity to respond to this consultation. The Association of British Credit Unions Limited (ABCUL) is the main trade association for credit unions in England, Scotland and Wales. Out of the 338 credit unions which choose to be a member of a trade association, 69% choose to be a member of ABCUL.

Credit unions are not-for-profit, financial co-operatives owned and controlled by their members. They provide safe savings and affordable loans. Some credit unions offer more sophisticated products such as current accounts, ISAs and mortgages.

At 31 December 2013, credit unions in Great Britain were providing financial services to 1,122,461 people, including 126,217 junior savers. The sector held more than £1.1 billion in assets with more than £676 million out on loan to members and £949 million in deposits.[1]

Credit unions work to provide inclusive financial services has been valued by successive Governments. Credit unions' participation in the Growth Fund from 2006 – 2011 saw over 400,000 affordable loans made with funding from the Financial Inclusion Fund. Loans made under the fund saved recipients between £119 million and £135 million in interest payments that otherwise would have been made to high-cost lenders. The DWP has contracted ABCUL to lead a consortium of credit unions under the Credit Union Expansion Project, which will invest up to £38 million in the sector and aims to make significant steps towards sustainability.

Response to the consultation

Implementing the recast Deposit Guarantee Scheme Directive

We have a number of concerns relating to the proposals contained in this consultation. Credit unions are atypical financial institutions and this fact is recognised in many different ways by the

[1] Figures from unaudited quarterly returns provided to the Prudential Regulation Authority

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regulatory authorities, including the Prudential Regulation Authority. The European Union, likewise, has recognised this in providing in the Deposit Guarantee Scheme Directive for credit unions to be treated differently under the scheme than other firms. This flows from the scope of the Directive which mirrors that of the Capital Requirements Directive and Capital Requirements Regulation which allow for credit unions to be exempted on the basis that they are a national concern which, though sharing characteristics with credit institutions, warrant special treatment due to the various restrictions that are placed upon them (the common bond and interest rate cap, in particular, but also limits borne of the co-operative ownership structure) and the social good that they seek to engender in society. ABCUL is a member of the European Network of Credit Unions and lobbied specifically on this point during the passage of the Directive receiving positive assurances throughout that the scope would mirror that of the CRD. We firmly believe the final text reflects this position. As such we believe that there is a clear discretion available to the PRA in making special arrangements for credit union in relation to this Directive and the package of reforms here proposed.

Proposal to remove credit unions' deposit protection

Of particular concern in this respect is the proposal to remove credit unions' own protection as depositors in credit institutions. To date, credit unions have enjoyed the same level of protection under the scheme as have individual customers. We believe strongly that this is warranted on the basis of the fact that while credit unions are more financially-knowledgeable and aware than perhaps are individuals, they are not so sophisticated as other commercial providers in the market who are more sufficiently capable of managing their investment risk and taking appropriate action where the level of apparent risk exceeds an acceptable level. It is a deep irony that the Directive's effect of extending FSCS protection to all non-financial firms does not recognise that a credit union and a large plc-firm with huge financial management and control resources are incomparable in their resource and capacity to manage investment risk yet credit unions are denied protection while large non-financial firms are not.

Furthermore, credit unions face significant barriers in the mobility of their deposited funds:

- Under credit union regulations in the CREDS Sourcebook, credit unions are limited to bank deposits and sterling-denominated government securities in their investments.
- As a result of numerous factors, such as extraordinary monetary support and increasing regulation in relation to both conduct and prudential matters supplemented by commercial risk-aversion, credit unions are finding increasing difficulty in securing deposit accounts with banks and building societies. This severely restricts their investment options and precipitates concentration risk.

As a result of these factors, credit unions are more vulnerable than most financial firms to exposure to a failing credit institution. The difficulty of identifying a viable investment and then securing the facility with the counterparty can be time consuming and ultimately outwith the credit union's control. Firms operating without such restrictions are much better-able to respond to changing market conditions and the threat of counterparty failure.

Finally, it must be noted that there are a number of credit unions at the smaller end of the sector for whom the loss of £85,000 as a result of bank failure would mean the closure of that credit union due to insolvency. This would push the credit unions' members on to the resources of the Financial Services Compensation Scheme in addition to those of the failed bank. This cannot be

sensible as it could significantly increase the compensation costs but, perhaps more importantly, the complexity of dealing with a failure situation for the FSCS. What's more, where credit unions are able to liquidate their holdings in a failing bank at times of financial stress, the lack of protection would cause them to do so more readily and therefore potentially exacerbate a failure of confidence in the counterparty institution and, in particular, any liquidity gap.

As a result of all these factors we urge the PRA to reconsider its proposal to withdraw protection from credit unions' deposits. Indeed, we call on PRA to go further and to consider the case for credit union deposit protection to be extended beyond £85,000 in order to ensure that failure of a bank need never cause the failure of a credit union and in clear recognition of the fact that credit unions face constraints and restrictions which other firms do not face.

Scheme funding and risk-based levies

We note the PRA's intention to await the outcome of the ongoing EBA consultation on risk-based levies before making its own proposals on how to implement this policy. We have some concerns relating to the possible risk-based levy framework and will respond to both EBA and PRA consultations on this in due course. However, our overriding position is that any risk-based levy would be counter-productive if its effect were to undermine the financial position of levy payers and therefore we hope that a risk calculation can be constructed which takes proper account of this detrimental potential outcome.

In relation to the policy position regarding legacy levies, we reserve judgement until the risk-based levy calculation has been finalised. However, we once again make the point that a levy system which undermines a firm's financial viability would be counter-productive and if this were then applied to the significant legacy balance to pay from the failures of 2008 its negative effect would be magnified significantly.

Temporary high balances

We have no strong view in relation to these measures. In many cases credit union depositors would not be affected greatly due to the limitations on total deposits in credit unions flowing from the size of credit unions' balance sheets and the maximum individual shareholding rules in CREDS.

We would like to query whether THBs are to be included in the levy calculations by FSCS. We cannot see where this is specified in the consultation document and supporting appendices but this may be resulting from the status of the risk-based levy issue above. It would appear, given the ex-post calculation of THB coverage proposed, that there would be no practical means of establishing THBs for use as a data upon which levies are calculated, however, clarification of this point would be appreciated.

Disclosure requirements

We appreciate that the recasting of FSCS requires a new emphasis for the standardised disclosure material. However, credit unions are likely to incur disproportionate expenses in re-printing promotional material in order to comply with the new disclosure statement. We would therefore request the formal use of discretion and flexibility in the application of the new disclosure

requirement and, in particular, a transitional period under which credit unions are able to update material in line with their usual stationary purchase cycle.

Merger provisions

Once more, we have no substantive comments to make on this measure and accept it is a positive step for consumer protection. However, once again we would question how these extra protected deposits will be accounted for when calculating levy payments.

Repayment periods

We support the notion that compensation ought to be paid within 7 days in the vast majority of cases. We have concerns, however, at the administrative burden which is required in order to make this a reality. In particular requirements around the Single Customer View system, as below, will be a significant challenge for many credit unions.

<u>Single customer view changes</u>

In general, we have concerns as regards the administrative burden of the new proposed reporting and other requirements under changes to the single customer view. Credit unions, as small financial co-operatives seeking to serve some of the most vulnerable consumers in the country are likely to face disproportionate burdens in relation to the administrative requirements of the reformed SCV and we urge PRA to recognise this in relation to its statutory obligation to ensure that reforms do not unduly burden mutual societies or hamper competition.

Opt-out limit

We have some concerns in relation to the proposed removal of the opt-out for deposit-takers with fewer than 5,000 accounts. While we appreciate the motivation behind this change relates to concerns on the part of PRA and FSCS of failures in credit unions without a functioning SCV systems, we are concerned that a minority of some of the smallest credit unions will not be in a position to comply with the electronic requirement since they operate with manual, paper-based systems. We therefore urge PRA to consider whether the opt-out might be maintained on a reduced basis for firms with fewer than 1,000 accounts or where the firm in question is able to demonstrate that electronic verification presents them with particular difficulties due to their manual operating model.

We would also strongly urge PRA to consider a 12 month transitional period to allow credit unions who are not currently subject to electronic verification time to make the necessary adjustments and changes to their software systems. It is unreasonable and unrealistic to expect credit unions in this category to be able to comply from day one and a transitional period in which credit unions are given time to get up to speed would be entirely in keeping with past policy on such matters.

Changes in reporting

We welcome the proposal here to integrate the implementation and SCV reports. This should have the effect of reducing some of the burden of the SCV verification and reporting requirements. However, the new reporting requirements in relation to controls and protections and exclusion files

are likely to present a disproportionate burden upon credit unions as small deposit-takers operating with tight margins. Any steps that can be taken to mitigate the impact of these requirements on small deposit-takers would be very welcome.

In-flight transactions

We appreciate the clarification of in-flight transactions. This should assist credit unions in completing the SCV file more quickly and straightforwardly. For a small credit union applying these requirements however, we would like to flag the possibility that some of the PRA's assumptions as to the destination of un-applied account balances may not be accurate. In many credit unions, payments into accounts are made via a two-stage process whereby the payment is made into a credit union's corporate account and later attributed to the correct members' account in the credit union's accounting software system. As such, it is conceivable that in the case of a small credit union which failed before the second of these two stages had been completed for some pending transactions, the assumption that payments would be automatically returned to their originator if not attributed to the correct account may not necessarily hold (though in the majority of cases this process would be completed daily). Therefore while we support the clarification of the cut-off point for in-flight transactions, we would simply point out that in a small, failing credit union this may not necessarily deliver the clarity which the PRA seeks.

As we made clear in our response to the consultation process which introduced the SCV system a number of years ago, in the case of failing credit unions there is often a long process of decline and deterioration which precedes the ultimate referral to FSCS and this can result in a breakdown of record-keeping and the management of payments in and out. While this is not to be excused and ABCUL does not advocate for it as a responsible way of doing business, the reality is that this needs to be reflected in the working assumptions of PRA and FSCS.

Speed of producing file

We have serious concerns about the proposed reduction of the deadline for producing SCV files form 72 hours to 24. Many credit unions will find significant difficulty with complying with this proposal, particularly smaller credit unions who may not operate or open at all during some days of the week or may be entirely led by volunteers and therefore not able to call on contracted resource to deliver the file where required. In the case of larger better-resourced credit unions, 24 hours would still represent a significant challenge to deliver the SCV report given the much-more limited resources they have available relative to large deposit-taking institutions.

We would urge the PRA to re-consider its proposal and allow at least 48 hours for all SCV files with the possibility of extending this in the case of a credit union which has particular operational challenges to overcome in terms of resourcing the delivery of its SCV file. We believe 48 hours would strike a much-more appropriate balance between the resource constraints of firms and the demands of the SCV report and the needs of FSCS in ensuring that compensation is delivered within the 7 day target.

Standardised file format

We appreciate the notion of standardising the file format for SCV reports to FSCS. In the long-term this will help credit unions to comply by providing clarity as to the precise informational requirements of FSCS from an SCV submission. However, we are concerned that appropriate

transitional arrangements be provided to allow credit unions to adjust their software packages appropriately in order to ensure that they can comply. This is not a small undertaking and is disproportionately difficult to comply with for a small provider such as a credit union for whom such a change can represent a significant cost. A period of 12 months to adjust software would be appropriate.

Exclusions definition

We have no objection to these additions to the exclusion file except to say that credit unions can only act on information that they can be reasonably expected to have and in relation to the absolute entitlement to funds in its accounts, there are circumstances where a credit union may not be able to reasonably know of such questions of entitlement and therefore cannot be expected to exclude such funds.

Exclusions file format

Once more, we accept and appreciate the case for this standardisation but would like to see appropriate transitional arrangements put in place to give our members the time required to implement file adjustments. A period of 12 months would be welcome in this regard.

Keys and codes and flags

We do not object to these requirements but, once again, urge consideration be given to allowing appropriate transitional arrangements enabling credit unions to have the time they need to implement.

New fields

This is unlikely to affect credit unions.

Joint accounts

We have no comment on this proposal which seems appropriate.

Verification

We have no objection to the proposal to require a full SCV file as part of the verification process. We are of the view that this is likely to be as straightforward, if not more so, than the process for providing a representative file.

We strongly support the risk-adjusted basis for verification in relation to credit unions which are brought into electronic verification under the proposed removal of the opt-out. We would suggest, however, as above that all of these requirements are introduced after a transitional period of 12 months to allow credit unions time to make the required adjustments to their systems and, in the case of a credit union new to electronic reporting, to put a compatible system in place for the first time. It is unreasonable to expect firms to be able to comply with this requirement from day one.

<u>Continuity of access</u>

While we appreciate that it is not in the PRA's gift, we would like to use this opportunity to highlight the fact that we strongly believe the continuity of access arrangements proposed for other deposit-takers should be made available to credit unions. It would be significantly more preferable for all concerned were the FSCS able to resolve into a continuing credit union, the accounts of a failed credit union rather than moving automatically to compensation in all cases. This would reduce the burden of costs on FSCS levy-payers, ensure continued access to credit union services for members of the failed institution and underpin an enhanced reputation on the part of the credit union sector generally which sees a number of failures each year but which are all generally very small institutions which are not a fair reflection of the increased sophistication and professionalism of most credit unions today.

Yours sincerely,

Matt Bland
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