fair4all finance

Good Practice Lending Guide

RM13 Credit Risk Governance

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1 Introduction

Governance is pivotal in a credit union due to its role in ensuring prudent operations, accountability, and member-centricity. Effective governance establishes a framework that guides decision-making, risk management, and ethical behaviour, safeguarding the interests of members and stakeholders. It provides the structure for strategic direction, setting clear goals aligned with the credit union's mission. Through transparent processes, governance enhances trust and confidence, essential in a member-driven institution.

Governance also ensures compliance with regulatory requirements, protecting both the credit union and its members. By defining roles, responsibilities, and reporting lines, it fosters effective leadership, enabling informed decisions and risk mitigation. Equally vital, governance shapes the credit union's culture, values, and ethical standards, influencing how staff interact with members and each other.

Ultimately, strong governance ensures the credit union's long-term sustainability, resilience against challenges, and the ability to deliver quality financial services to members while maintaining their trust and financial well-being.

Credit risk specific governance is crucial in a credit union as it safeguards financial stability and member trust. By establishing policies, controls, and decision-making frameworks, it ensures loans are extended prudently, minimising the risk of default. Effective credit risk governance ensures alignment with the credit union's risk appetite, regulatory requirements, and strategic objectives. It also maintains member confidence by preventing excessive risk-taking, sustaining healthy loan portfolios, and promoting responsible lending practices that benefit both the credit union and its members.

1.1 Scope of this document

The scope of this document, as part of the Good Practice Lending Guide, is the governance of credit risk as managed by credit unions, ie the risks to the business that directly result from lending to a customer/member. Consequently, it describes the key elements that should be covered within a firm's credit risk governance framework as a subset of an organisation's wider governance controls. The guide can be applied to all lenders. Non-PRA regulated firms will have less regulatory demands, but the concepts and best practices are still applicable (where applied proportionally).

This guide introduces the broader concepts of corporate governance and reflects on how these are appropriate to a credit union. This covers the framework, proportionality and what happens if things go wrong.

An overview of risk management governance follows and then a review of the regulatory requirements and expectations that the PRA and FCA place onto credit unions.

With this broader context, the specific requirements for a robust credit risk governance framework are explored. Some specific examples are provided as well as a case study into the impact governance failures have had on credit unions in the recent past.

2 Overview of corporate governance

Corporate governance in a credit union encompasses a range of practices and principles that guide the firm 's management, decision-making, and accountability mechanisms. It revolves around ensuring transparency, ethical conduct, and effective risk management, all while promoting the credit union's long-term success and the best interests of its members.

2.1 The role and responsibilities of the board

The board of directors stands at the heart of corporate governance in a credit union. It is responsible for setting the firm 's strategic direction, overseeing its operations, and ensuring adherence to regulatory requirements. The board's role extends beyond mere supervision – it also involves providing leadership, establishing the credit union's risk appetite, and setting the ethical tone that permeates the organisation.

A robust culture of risk management is imperative for a credit union's stability. This involves promoting a mindset that encourages proactive identification, assessment, and mitigation of risks across the firm. The board plays a crucial role in nurturing this culture by emphasising risk awareness, setting risk tolerance levels, and ensuring that risk management practices are integrated into the credit union's operations.

The board's responsibilities span a wide spectrum. It includes setting strategic goals, approving major decisions, appointing executive management, overseeing financial performance, and ensuring compliance with regulatory frameworks. Additionally, the board ensures alignment between the credit union's operations and its mission to serve members.

2.2 The board's relationship to its operational management

Boards delegate authority to executive management while maintaining oversight through regular reporting and updates. The credit union's management must provide the board with accurate and timely information to facilitate informed decision-making.

An important distinction lies between the board's strategic role and the management's operational responsibilities. The board sets the overarching strategy and risk parameters, but management is tasked with implementing day-to-day operations. Clear communication and collaboration between the two are essential for effective governance.

2.3 Common problems

Common challenges in governance and for credit union boards include:

- **Managing conflicts of interest:** Balancing personal interests of board members with the credit union's objectives requires transparent processes and policies
- **Recruiting suitable individuals:** Identifying diverse candidates with the right skills and commitment is crucial for well-rounded decision-making
- **Ensuring that appropriate MI is received by the Board:** Providing concise, relevant, and timely information enables informed decision-making without overwhelming the board
- **Defining an appropriate structure to support the board:** Clear committee roles, access to expertise, and administrative support facilitate effective oversight. Meeting all these objectives effectively is difficult while balancing proportionality for a credit union
- **Succession planning:** Planning for board member transitions ensures continuity and the transfer of knowledge

2.4 Consequences of poor governance

Poor corporate governance can lead to a range of negative outcomes. It may result in financial mismanagement, reputational damage, regulatory violations, and a loss of member trust. Ultimately, the credit union's stability, growth, and member satisfaction are compromised.

Corporate governance in a credit union is a multifaceted framework that underscores the importance of responsible leadership, risk management, and accountability. The board's strategic guidance, ethical tone, and oversight functions are instrumental in fostering a risk-aware culture that safeguards the credit union's integrity and ensures its long-term prosperity.

3 Risk management governance

Risk management governance in a credit union involves structured processes to proactively handle risks. This includes:

- Identifying the nature and extent of the principle risks the credit union is willing to bear
- Assessing the likelihood and impact of risks materialising, along with related consequences
- Evaluating the credit union's ability to reduce risks and their impact
- Understanding exposure before and after mitigation efforts
- Operating relevant controls and assessing their effectiveness, costs, and benefits
- Considering how the credit union's values, culture, and incentives impact risk management

Credit unions must systematically identify and categorise their principal risks, including credit, interest rate, operational, compliance, and reputation risks. Risks are assessed for likelihood and impact to guide mitigation strategies.

Risk appetite defines the level of risk a credit union is comfortable with while pursuing goals. Internal controls, audits, and compliance procedures are put in place to control risks. Regular reporting ensures timely action, while cost-effectiveness of controls is evaluated.

The credit union's culture influences risk management. A risk-aware culture ensures staff understand their role, boosting risk management's effectiveness. Regular performance reviews maintain alignment between risk management and the evolving risk landscape.

4 Regulatory considerations

The Prudential Regulation Authority (PRA)[1] and the Financial Conduct Authority (FCA)[2] issue guidelines and standards that outline the expectations for governance practices. Additionally, the Financial Reporting Council (FRC)[3] provides codes and principles that influence governance practices and reporting transparency.

Regulatory requirements for governance in a credit union are designed to ensure effective oversight, risk management, and ethical behaviour. These requirements encompass various aspects of the credit union's governance structure and practices:

- **Role of the Board:** The board is responsible for developing the business strategy, providing effective governance and leadership, and promoting the long-term success of the firm. It sets the tone and culture from the top, ensuring that the appropriate values are embedded throughout the organisation
- **Board Composition:** The board should be composed of directors with a mix of skills, knowledge, and experience that aligns with the credit union's business model and inherent risks. This diverse composition facilitates well-informed decision-making and effective strategy setting
- **Balance and Independence**: An appropriate balance of executive and independent non-executive directors ensures sufficient independent challenge to management. Independence helps prevent conflicts of interest and strengthens governance oversight
- **Knowledge, Skills, and Experience**: The board collectively should possess adequate knowledge, skills, and experience to understand the credit union's business model and risks. This enables them to set the business strategy, make informed decisions, and oversee risk management effectively
- **Individual Fitness and Propriety:** Directors are required to act with honesty, integrity, due skill, care, and diligence. They should also be open and cooperative with regulators, ensuring they meet

[1] PRA – Supervising Credit Unions
[2] FCA – SYCS 4.1.1R
[3] FRC - UK Corporate Governance Code

the standards expected for their role

- **Culture and Leadership:** The board sets the appropriate tone and culture, which is then cascaded and embedded throughout the credit union. Effective leadership ensures resources are available to deliver the business strategy
- **Remuneration:** Remuneration policies and procedures should align with effective risk management. They should discourage excessive risk-taking and promote prudent business practices

The PRA also makes specific expectations for Credit Unions with Over £10m in assets, including:

- Clear separation of roles and responsibilities between the CEO, senior managers, and the board
- Board's understanding and ownership of strategy and risks
- Board possessing appropriate skills and experience relative to responsibilities and activities
- Maintenance of a board succession plan to manage unexpected loss of key individuals
- Ensuring compliance with the legal requirements for the Financial Services Compensation Scheme (FSCS), accurate single customer view, and provisioning policy
- Demonstration of control and responsibility for outsourcing arrangements
- Management against a board-approved 3-year business plan with plausible financial forecasts and risk mitigation strategies
- A process to inform the PRA of significant deviations from the business plan, articulating risks and benefits

Overall, these regulatory requirements ensure that credit unions operate with integrity, effective governance, and a focus on safeguarding the interests of stakeholders while managing risks prudently.

An example of the ongoing regulatory oversight the PRA provides credit unions is seen in the annual assessment letter[4] to credit union directors. This cover several areas the PRA expects a credit unions board to be focussed on, following periodic summary meetings. The expectations for governance include highlighting the difficulty in attracting and retaining suitably qualified and experience board members. Succession planning is a key governance requirement as it ensures that a board can meet its ongoing obligations to maintain appropriate board composition and staff key committees sufficiently. This letter highlights the PRAs focus in identifying an area of concern and reminding credit unions of their obligations.

[4] Letters to credit unions: PRA annual assessment of the credit union sector – 2023

5 Proportionality

Proportionality in governance, within a credit union context, refers to tailoring the extent of governance practices to the size, complexity, and risk profile of the firm. This principle recognises that one-size-fits-all approaches may not be suitable and emphasises that governance measures should be commensurate with the credit union's characteristics. The following topics highlight the key aspects of proportionality in credit union governance:

5.1 Sizing the appropriate level of governance

Proportionality involves determining the right balance of governance practices based on the credit union's size, scope, and nature of operations. This means that smaller credit unions may have streamlined governance structures while larger firms might have more comprehensive frameworks.

Proportionality acknowledges the need to weigh the costs and benefits of governance measures. For smaller credit unions, excessive governance requirements might be resource-intensive and divert attention from core functions. Therefore, governance practices should be practical and yield commensurate benefits.

The level of governance should also align with the risk exposure associated with the credit union's activities. Higher-risk activities demand more robust governance measures to mitigate potential negative outcomes, while lower-risk functions may require lighter oversight.

5.2 Examples of proportionality application:

- **Board Composition**: Smaller credit unions might have a less extensive board with multi-functional roles, whereas larger firms might have dedicated committees
- **Risk Management**: High-risk credit unions might require specialised risk committees and more detailed risk assessments, while low-risk ones could have simplified risk management processes
- **Reporting**: Smaller credit unions might produce less frequent and more concise reporting to their board and other key stakeholders, compared to larger credit unions with extensive reporting obligations

In essence, proportionality in credit union governance acknowledges that governance practices should match the credit union's unique characteristics. It promotes flexibility in structuring governance frameworks, ensuring that they are effective and relevant without being overly burdensome. By aligning governance with size, complexity, risk exposure, and cost-effectiveness, credit unions can strike the right balance between prudent oversight and operational efficiency.

6 Credit risk specific governance

6.1 Board role and ownership

Credit risk is the potential loss that a credit union faces when borrowers or members fail to meet their loan or credit obligations. Given that credit unions primarily engage in lending and credit activities, effective credit risk management is paramount to ensure the firm 's financial stability and sustainability. The board's responsibilities in this area should include:

- **Setting Risk Appetite and Policies:** The board is responsible for defining the credit union's risk appetite and establishing policies that outline acceptable levels of credit risk exposure. This involves determining the types of loans the credit union is willing to offer, the credit criteria for borrowers, and the limits on loan concentrations
- **Approving Credit Policies:** The board approves and oversees the credit union's lending policies and procedures. These policies provide guidance to management on evaluating loan applications, assessing borrower creditworthiness, and determining appropriate terms and conditions for loans
- **Risk Assessment and Monitoring:** The board ensures that the credit union's risk assessment methods are effective and appropriate. This includes evaluating the credit union's risk tolerance, conducting regular reviews of the loan portfolio, and monitoring the quality of loans to identify early signs of deterioration
- **Portfolio Diversification:** The board guides the credit union in achieving an appropriately well-diversified loan portfolio. While the scope for diversification is often limited for a credit union given the specialised market often in a specific geographical area, by spreading loans across different product and borrower types, the credit union can mitigate the impact of economic downturns on its credit risk exposure
- **Loan Approval and Review:** The board may establish committees or delegate authority to review and approve loans beyond certain thresholds. These committees assess loan applications that fall outside standard criteria, ensuring that higher-risk loans are subject to additional scrutiny and approval

- **Risk Mitigation Strategies:** The board works with management to implement risk mitigation strategies. This could involve setting aside appropriate loan loss provisions, ensuring compliance with regulatory requirements, and instituting measures to address potential credit risk scenarios
- **Oversight of Management:** The board oversees the credit union's senior management in their execution of credit risk management strategies. This includes reviewing management reports on credit quality, arrears/delinquencies, and loan performance
- **Aligning with Strategy:** The board ensures that credit risk management aligns with the credit union's overall strategic goals. Decisions related to lending and credit activities should be in line with the credit union's mission and objectives
- **Communication with Stakeholders:** The board communicates the credit union's credit risk profile to stakeholders, including members, regulators, and external auditors. Transparency in credit risk management builds trust and credibility
- **Continual Improvement:** The board promotes a culture of continuous improvement in credit risk management. Regular reviews and evaluations help identify areas for enhancement in credit policies, processes, and risk assessment methodologies

Overall, the board's role in managing credit risk is to provide strategic guidance, oversight, and decision-making that align with both risk appetite and long-term goals. By setting policies, overseeing risk assessment, and ensuring prudent lending practices, the board contributes significantly to maintaining the firm's financial health and safeguarding the interests of its members.

6.2 Setting explicit roles for senior management

The boards strategic requirements for credit risk are implemented at an operational level by a senior manager and their team. The role of a Manager of Credit Risk in a credit union is pivotal in ensuring the firm 's financial stability and sustainability by managing and mitigating credit risk associated with lending activities. This role involves a range of responsibilities aimed at evaluating borrower creditworthiness, implementing risk management strategies, and ensuring compliance with established policies and regulations. Here are the specific responsibilities typically associated with this role:

- **Credit Policy Development and Implementation:** The Manager of Credit Risk is responsible for developing and maintaining the credit union's credit risk policies and guidelines. This involves defining the parameters for lending, establishing acceptable risk thresholds, and ensuring alignment with regulatory requirements
- **Risk Assessment and Analysis:** This role involves conducting thorough risk assessments of borrowers applying for loans. Managers of Credit Risk analyse financial statements, credit histories, and other relevant information to determine the creditworthiness of potential borrowers

- **Credit Scoring and Underwriting:** Managers of Credit Risk oversee the development and application of credit scoring models that assist in assessing borrower risk. They work closely with underwriting teams to evaluate loan applications, ensuring that loans are underwritten in line with established criteria and risk appetite
- **Portfolio Monitoring:** Continuous monitoring of the credit union's loan portfolio is essential to identify early signs of credit deterioration. The Manager of Credit Risk tracks loan performance, delinquency rates, and other key indicators to proactively address potential issues
- **Risk Mitigation Strategies**: This role involves collaborating with operational teams to develop risk mitigation strategies. Managers of Credit Risk help identify strategies to manage and reduce credit risk exposure, such as adjusting lending criteria, diversifying portfolios, and implementing credit enhancement mechanisms
- **Compliance and Regulatory Adherence:** Ensuring compliance with regulatory requirements is paramount. Managers of Credit Risk work closely with the compliance team to ensure that all lending practices adhere to applicable laws and regulations
- **Data Analysis and Reporting:** Data-driven decision-making is essential in credit risk management. Managers of Credit Risk analyse data to assess portfolio trends, identify emerging risks, and generate reports for senior management and the board of directors
- **Staff Training and Development:** This role involves training and mentoring credit analysts and underwriters to ensure that they possess the necessary skills to assess credit risk accurately and consistently
- **Policy and Process Improvement:** Managers of Credit Risk continually evaluate the effectiveness of credit risk policies and processes. They identify areas for improvement, propose changes, and implement enhancements to strengthen risk management practices
- **Collaboration with Stakeholders**: Effective communication with internal stakeholders, including executive management, underwriting teams, compliance officers, and auditors, is crucial. Managers of Credit Risk provide insights and recommendations to support informed decision-making
- **Reporting to Senior Management and the Board:** The Manager of Credit Risk regularly reports on credit risk exposures, portfolio performance, and risk mitigation strategies to senior management and the board of directors. Clear communication ensures alignment with the credit union's strategic goals

Overall, the Manager of Credit Risk holds a critical role in safeguarding the credit union's financial health by overseeing credit risk assessment, mitigation strategies, compliance, and portfolio monitoring. This role ensures that the credit union's lending practices are sound, compliant, and aligned with its risk appetite and strategic objectives.

6.3 Three lines of defence

The "Three Lines of Defence" is a risk management framework that delineates the roles and responsibilities of different parts of an organisation in managing and mitigating risks. This framework ensures that risk management is robust, comprehensive, and well-coordinated. In the context of a credit union managing credit risk, the Three Lines of Defence framework involves three distinct layers of risk management:

6.3.1 First line of defence: operational units

The first line of defence consists of the operational units responsible for the day-to-day activities that generate credit risk. In a credit union, these units include loan origination, underwriting, and credit monitoring departments. Their responsibilities within the Three Lines of Defence framework include:

- **Risk Identification**: Identifying and assessing credit risks associated with lending activities. This includes evaluating borrower creditworthiness, determining appropriate loan terms, and establishing credit limits
- **Risk Control and Mitigation**: Implementing controls and measures to mitigate credit risk at the operational level. This might involve adhering to credit policies and guidelines, conducting thorough credit assessments, and monitoring borrower behaviour
- **Monitoring and Reporting**: Monitoring the performance of loans and credits in the portfolio to identify early signs of deterioration. Operational units provide regular reports on credit quality, delinquencies, and other relevant metrics to the second line of defence

6.3.2 Second line of defence: risk management and compliance

The second line of defence is responsible for overseeing and coordinating risk management activities across the organisation. This includes establishing policies, providing guidance, and ensuring compliance with regulations. In the context of credit risk management:

- **Policy Development**: Developing and maintaining credit risk policies that guide the credit union's lending activities. These policies outline acceptable levels of credit risk exposure, risk assessment criteria and risk mitigation strategies
- **Risk Oversight**: Monitoring the credit union's overall credit risk profile and ensuring that operational units adhere to established policies. This involves reviewing reports, conducting risk assessments, and escalating issues when necessary
- **Guidance and Training**: Providing guidance and training to operational units to ensure consistent and effective credit risk management practices. This helps operational staff understand and implement the credit risk policies and procedures

6.3.3 Third line of defence: internal audit

The third line of defence provides independent assurance of the effectiveness of risk management processes and controls. Internal audit evaluates the credit union's adherence to policies, identifies gaps, and suggests improvements:

- **Risk Assurance:** Conducting periodic audits to assess whether the credit union's credit risk management processes are operating effectively and in compliance with established policies and regulations
- **Control Testing:** Testing the adequacy and effectiveness of controls put in place to manage credit risk. Internal audit ensures that controls are properly designed and are functioning as intended
- **Reporting and Recommendations:** Providing objective reports to the board of directors and senior management about the results of audits, including findings, recommendations, and areas for improvement in credit risk management practices

Overall, the Three Lines of Defence framework ensures that credit unions manage credit risk comprehensively and effectively by distributing responsibilities among operational units, risk management and compliance functions, and internal audit. This coordinated approach enhances the credit union's ability to identify, assess, and mitigate credit risk while maintaining regulatory compliance and governance standards.

6.4 Management of risks through committee

Credit risk management through committees in a credit union involves a structured approach to assessing, mitigating, and overseeing credit risks associated with lending activities. Committees play a pivotal role in ensuring that credit risk is effectively managed, risks are identified and addressed, and decision-making is consistent and well-informed. Here's how credit risk is managed through committees in a credit union:

1 Credit Risk Committee:

A Credit Risk Committee is a dedicated body responsible for overseeing the credit risk management process. This committee typically includes senior leaders from various departments, such as risk management, lending, finance, and compliance. Its responsibilities include:

- **Policy Development**: The committee establishes and reviews credit risk policies, guidelines, and lending criteria. It ensures that these align with the credit union's risk appetite and regulatory requirements
- **Risk Assessment**: The committee assesses credit risk exposure by reviewing the quality and composition of the loan portfolio. It identifies trends, concentrations, and emerging risks that could impact the credit union's financial health
- **Approval Process:** Higher-risk loans or those falling outside standard criteria are escalated to the committee for review and approval. The committee ensures that such loans are thoroughly

evaluated before granting approval

- **Risk Mitigation Strategies:** The committee collaborates with relevant departments to develop risk mitigation strategies. It may suggest adjustments to lending criteria, recommend changes to loan terms, or propose strategies to diversify the loan portfolio
- **Monitoring and Reporting**: The committee regularly monitors portfolio performance, delinquency rates, and credit quality indicators. It provides reports to the board of directors and senior management, offering insights and recommendations

2 Loan Review Committee:

The Loan Review Committee is responsible for evaluating and assessing individual loans that pose potential credit risks. This committee may include credit analysts, underwriters, and lending officers. Its functions include:

- **Loan Evaluation**: The committee reviews loan applications, assesses borrower creditworthiness, and evaluates proposed loan terms. It ensures that loans adhere to established credit policies and guidelines
- **Credit Scoring and Underwriting**: The committee ensures that credit scoring models and underwriting practices are consistent and aligned with credit risk policies
- **Risk Assessment:** The committee identifies and assesses specific risks associated with individual loan applications. It evaluates risk factors such as borrower financials, collateral, and repayment capacity
- **Decision-making:** The committee makes informed decisions regarding loan approvals, declines, or modifications. It ensures that decisions are based on a comprehensive analysis of credit risk

3 Reporting and communication:

Both the Credit Risk Committee and the Loan Review Committee provide regular reports to senior management and the board of directors. These reports include information about credit risk exposures, portfolio performance, risk trends, and proposed risk mitigation strategies

4 Cross-functional Collaboration:

Committees often involve members from various departments, fostering cross-functional collaboration. This ensures that credit risk management decisions are well-informed, leveraging expertise from different areas of the credit union

In summary, credit risk management through committees in a credit union involves a structured approach to policy development, risk assessment, decision-making, and reporting. These committees play a critical role in ensuring that credit risk is effectively managed, thereby safeguarding the credit union's financial stability and the interests of its members.

6.5 Policy and procedures

Credit unions implement a set of policies and procedures to manage credit risk effectively, ensuring responsible lending practices, minimising potential losses, and safeguarding financial stability. Here are the key policies and procedures that a credit union would typically use for credit risk management:

- **Credit Risk Policy**: The credit risk policy outlines the credit union's approach to managing credit risk within the UK regulatory framework. It defines the credit union's risk appetite, risk tolerance thresholds, and overarching principles for evaluating and managing credit risk in compliance with regulatory requirements.
- **Responsible Lending Policy:** This policy underscores the credit union's commitment to responsible lending practices. It ensures that loans are provided to members who have the capacity to repay and that affordability assessments are conducted in accordance with FCA guidelines
- **Loan Origination and Approval Procedure:** This procedure outlines the steps for originating and approving loans. It includes guidelines for assessing borrower creditworthiness, determining appropriate loan terms, and complying with FCA affordability assessment requirements
- **Credit Scoring and Underwriting Guidelines:** These guidelines detail the criteria and methodologies used to evaluate loan applications. They cover factors such as borrower credit history, income, expenditure, and repayment capacity, ensuring adherence to FCA guidelines on fair lending practices
- **Loan Review and Monitoring Procedure**: This procedure outlines how loans are reviewed and monitored throughout their lifecycle. It includes protocols for tracking borrower behaviour, assessing loan performance, and identifying early signs of credit deterioration
- **Impaired Loan Management and Provisioning Guidelines:** These guidelines establish criteria for classifying loans as impaired and determining appropriate provisioning levels. They ensure compliance with requirements for loan impairment recognition and provisioning
- **Delinquency and Collection Procedures**: These procedures outline the steps for managing delinquent loans and collections in line with FCA guidelines. They include processes for communicating with borrowers, assessing the severity of delinquencies, and initiating compliant collections efforts
- **Credit Risk Reporting and Communication:** These procedures define the frequency and content of credit risk-related reports to senior management, the board of directors, and regulatory authorities. They ensure that reports align with internal and external requirements and provide insights into credit union risk exposure and portfolio quality
- **Compliance with PRA and FCA Regulations and Standards:** Policies and procedures ensure

compliance with regulatory requirements, including affordability assessments, consumer duty principles, anti-money laundering (AML) requirements, and consumer credit regulations (CREDS or CONC)

- **Staff Training and Development**: Policies emphasise the importance of ongoing training for credit union staff responsible for evaluating credit risk. This ensures that employees understand regulatory requirements, credit risk policies, and procedures and can effectively apply them in their roles

In conclusion, credit unions should consider a comprehensive set of policies and procedures to manage credit risk in accordance with PRA and FCA expectations. These measures guide the entire credit risk management process, from loan origination to monitoring and collection efforts, to ensure compliant and responsible lending practices.

6.6 Reporting and MI

A credit union should produce various reports and Management Information (MI) to effectively monitor and manage credit risk. These reports provide insights into the credit union's credit risk exposure, portfolio performance, and risk mitigation strategies. Here are some key reporting and MI that a credit union should consider producing in relation to credit risk:

- **Credit Risk Dashboard:** A credit risk dashboard provides an overview of key credit risk indicators, such as delinquency rates, default rates, and the composition of the loan portfolio. It offers a snapshot of the credit union's risk profile, allowing management to quickly assess the state of credit risk
- **Portfolio Performance Report:** This report provides a detailed analysis of the credit union's loan portfolio performance. It includes metrics such as loan growth, portfolio concentrations, and trends in delinquencies and charge-offs. The report helps identify segments of the portfolio that might need closer monitoring or risk mitigation strategies
- **Delinquency and Default Analysis:** This report delves into delinquency and default rates across different loan types and borrower segments. It helps identify areas of concern and allows for targeted strategies to address potential credit quality issues
- **Impaired Loan Report:** This report is a watchlist that identifies loans that are considered impaired or at risk of becoming impaired. It includes information about the nature of the impairment, potential loss exposure, and provisions set aside for impaired loans
- **Loan Origination and Approval Report:** This report provides insights into the credit union's lending activities by detailing the number of loans originated, the types of loans, average loan amounts, and approval rates. It helps assess the quality of newly originated loans
- **Risk Migration Report:** A risk migration report tracks the movement of loans across different risk

categories (eg performing, non-performing) over time. It offers insights into the trends in credit quality and helps identify shifts in the risk profile of the loan portfolio

- **Early Warning Indicators Report:** This report identifies early warning indicators that might signal potential credit problems. These indicators could include changes in borrower behaviour, external economic factors, or other variables that might impact credit risk
- **Compliance and Regulatory Reporting**: Credit unions need to report credit risk-related information to regulatory authorities, such as the Financial Conduct Authority (FCA). This includes adherence to regulatory requirements related to affordability assessments, loan impairments, and risk management practices
- **Management Information (MI) Pack:** An MI pack provides comprehensive data and analysis on credit risk for management and board review. It includes a combination of the aforementioned reports and additional MI to support decision-making and strategic planning

These reports and MI enable the credit union's management and board to make informed decisions, implement proactive risk mitigation strategies, and ensure compliance with regulatory requirements. By regularly producing and analysing these reports, the credit union can effectively manage credit risk and maintain the financial health of the firm.

7 Examples of credit risk governance

7.1 Credit risk governance in a credit union

An effective governance structure for credit risk in a credit union involves clearly defined roles, responsibilities, and reporting lines to ensure that credit risk is managed comprehensively and in alignment with the organisation's goals and regulatory requirements. Here's an example governance structure for credit risk in a larger (£10m+ in assets) credit union:

1 Board of Directors:

The Board of Directors holds ultimate accountability for credit risk management and oversees the credit union's strategic direction. It is responsible for setting the credit risk appetite, approving credit risk policies, and ensuring that effective risk management practices are in place.

2 Risk Management Committee:

The Risk Management Committee is a sub-committee of the Board of Directors and focuses on overseeing various risk management aspects, including credit risk. It plays a key role in setting risk policies, reviewing credit risk exposures, and ensuring that risk management practices are consistent with regulatory requirements.

3 Credit Risk Committee:

The Credit Risk Committee is a sub committee of the risk management committee and is responsible for specifically overseeing credit risk management within the credit union. It consists of senior executives and experts from relevant departments. The committee's primary responsibilities include:

- **Policy Development and Approval:** Developing, recommending, and obtaining approval for credit risk policies, guidelines, and lending criteria that align with the credit union's risk appetite and regulatory requirements
- **Risk Assessment and Approval:** Reviewing and approving loans that exceed predefined thresholds or fall outside standard criteria. Ensuring that comprehensive risk assessments are conducted for each credit exposure

- **Risk Monitoring**: Regularly monitoring the credit union's loan portfolio performance, delinquency rates, and credit quality indicators to identify potential risks and trend
- **Risk Mitigation Strategies**: Collaborating with operational teams to develop and recommend risk mitigation strategies, such as adjustments to lending criteria, diversification strategies, and collateral requirements
- **Reporting to the Board:** Providing reports to the Board of Directors, highlighting credit risk exposures, portfolio performance, risk trends, and risk management strategies

4 Credit Risk Management Department:

The Credit Risk Management Department is responsible for the day-to-day execution of credit risk management activities. It includes the following functions:

- **Credit Underwriting:** Evaluating loan applications, conducting credit assessments, and determining creditworthiness of borrowers based on established criteria
- **Credit Monitoring**: Continuously monitoring the loan portfolio, identifying early signs of credit deterioration, and recommending actions to mitigate risk
- **Risk Reporting:** Generating and disseminating regular risk reports to senior management, the Credit Risk Committee, and the Board of Directors

5 Compliance Department:

The Compliance Department ensures that credit risk management practices adhere to regulatory requirements and industry standards. It reviews and validates that credit risk practices align with affordability assessments, consumer duty principles, and relevant regulations.

6 Internal Audit:

The Internal Audit function provides independent assurance on the effectiveness of credit risk management processes. It conducts periodic audits to assess compliance with policies, controls, and regulatory requirements.

This example governance structure illustrates how a credit union can establish a hierarchy of roles and committees dedicated to managing credit risk effectively. Each component plays a distinct role in ensuring that credit risk is assessed, monitored, and mitigated in accordance with the credit union's goals and regulatory obligations.

7.2 Example terms of reference (ToR) for a credit committee

This section provides an example ToR that could be applied to a credit committee in a credit union. The structure would also be similar to other committees required by a credit union (ie board or remuneration), but this focuses on the most important credit risk specific committee.

1 Purpose and Objectives:

The Credit Committee (the "Committee") is established to provide oversight, guidance, and decision-making related to credit risk management within the organisation. The Committee's primary objective is to ensure the prudent assessment, approval, and ongoing monitoring of credit exposures while adhering to established policies and regulatory requirements.

2 Composition:

The Committee shall consist of a diverse group of senior executives and experts from relevant departments, including risk management, lending, compliance, finance, and legal. The number of members and their specific roles shall be determined by the Board of Directors.

3 Meetings and Quorum:

The Committee shall meet regularly, with the frequency determined by the Chairman. A quorum shall be achieved when a majority of the Committee members are present. Meetings may be held in person, virtually, or through teleconference, as deemed appropriate.

4 Responsibilities:

4.1 Credit Risk Policy and Guidelines:

Review, recommend, and approve updates to the credit risk policy, ensuring alignment with the organisation's risk appetite, regulatory requirements, and industry best practices.

Establish and oversee credit risk guidelines, including risk tolerance thresholds, concentration limits, and portfolio diversification strategies.

4.2 Loan Approvals and Review:

Evaluate and approve credit exposures that exceed predefined thresholds or fall outside standard criteria, based on comprehensive risk assessments and analysis.

Conduct regular reviews of high-risk or impaired loans, ensuring appropriate actions are taken to address credit quality concerns.

4.3 Risk Assessment and Analysis:

Oversee risk assessments of borrower creditworthiness, including financial statements, credit histories, and other relevant data, to ensure accurate evaluation of potential credit risks.

Review and assess the effectiveness of credit scoring models, underwriting practices, and risk assessment methodologies.

4.4 Reporting and Communication:

Provide regular reports to the Board of Directors, senior management, and relevant stakeholders, summarising credit risk exposure, portfolio performance, and proposed risk mitigation strategies.

Communicate key credit risk trends, emerging risks, and notable changes in credit quality to ensure informed decision-making.

4.5 Risk Mitigation Strategies:

Collaborate with operational teams to develop risk mitigation strategies for specific credit exposures, including adjustments to lending criteria, collateral requirements, and loan terms.

Recommend actions to address concentration risks and potential vulnerabilities identified in the loan portfolio.

4.6 Compliance and Regulatory Adherence:

Ensure that credit risk management practices adhere to all relevant regulatory requirements, including affordability assessments, consumer duty principles, and data privacy regulations.

5 Reporting and Accountability:

The Committee shall report its findings, recommendations, and actions to the Board of Directors. The Committee is accountable for ensuring that credit risk management practices are aligned with the organisation's strategic goals and regulatory obligations.

6 Review and Amendment:

These Terms of Reference shall be periodically reviewed and updated as necessary to reflect changes in the organisation's structure, regulations, or risk management practices.

7 Confidentiality:

All discussions, deliberations, and materials related to the Committee's activities shall be treated as confidential and shall not be disclosed without appropriate authorisation.

8 Chairperson:

The Committee shall appoint a Chairperson who shall be responsible for leading meetings, setting the agenda, and ensuring effective communication among members.

9 Conclusion:

These Terms of Reference outline the roles, responsibilities, and governance framework of the Credit Committee. The Committee's activities shall be conducted with the highest ethical standards and in alignment with the organisation's mission and objectives.

7.3 Example of poor governance leading to an impact

Enterprise Business Credit Union Ltd (EBCU) was a credit union that experienced a high-profile failure in 2015. The failure was primarily attributed to a series of governance issues and mismanagement practices that undermined the credit union's financial stability and member trust. It led to sanctions against 4 of the directors. Sam Woods, the Deputy Governor for Prudential Regulation and Chief Executive Officer of the

PRA said:

"Our first enforcement action against individuals involved in a credit union highlights the importance of strong governance within credit unions. Senior managers who fail to act with integrity in their roles at credit unions can expect to be held to account."

Some of the key governance issues that contributed to the failure of EBCU include:

- **Inadequate Risk Management:** The Board failed to exercise proper oversight of the firm's risk management processes. There was a lack of proper due diligence in assessing risks, leading to inadequate risk identification, assessment, and mitigation
- **Misreporting of Financial Information:** The Board submitted financial information that contained material inaccuracies and misrepresentations. This failure in accurate reporting undermined the integrity of financial reporting and affected the firm's ability to make informed decisions
- **Lack of Compliance and Internal Controls:** The firm had inadequate compliance and internal control mechanisms in place. This resulted in a failure to identify and rectify breaches of regulatory requirements and internal policies
- **Weaknesses in Governance Structure:** The governance failings included a lack of clear lines of responsibility and accountability within the firm's governance structure. This lack of clarity compromised the effectiveness of oversight and decision-making processes
- **Ineffective Communication**: The Board failed to establish effective communication channels within the firm. This lack of communication hindered the dissemination of key information to relevant parties, including the firm's board and regulators
- **Failure to Address Issues:** The Board did not adequately address the issues raised by regulators and external auditors. This lack of responsiveness demonstrated a disregard for regulatory concerns and failed to address potential risks
- **Breach of Fundamental Principles:** The Board's actions resulted in a breach of the Fundamental Principles for regulated individuals, which include integrity, skill, care, diligence, and the requirement to cooperate with regulators
- **Inadequate Control Environment**: There was an inadequate control environment within the firm. This included weak operational controls and a lack of oversight, potentially exposing the firm to operational and financial risks. The culmination of these governance issues resulted in EBCU's financial instability, operational inefficiencies, and member dissatisfaction. In 2015, the credit union was placed into administration, and ultimately, its failure led to the loss of members' savings (with £7m covered by FSCS) and the closure of the firm

The failure of EBCU serves as a cautionary tale highlighting the critical importance of strong governance practices, robust risk management, effective board oversight, and compliance with regulatory requirements in ensuring the success and sustainability of credit unions. It underscores the potential consequences of neglecting these fundamental aspects of credit union operations.

8 Acronyms and abbreviations

Acronym/abbreviation	Term
AML	Anti Money Laundering
CRAS	Credit Risk Appetite Statement
CREDS	Credit Union Sourcebook
EBCU	Enterprise Business Credit Union
F4A	Fair 4 All Finance
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FSCS	Financial Services Compensation Scheme
MI	Management Information
PRA	Prudential Regulation Authority
RAS	Risk Appetite Statement
ToR	Terms of Reference