

CREDIT UNION – Adequacy of resources – Value of Credit Union’s assets less than value of its liabilities – Whether removal of permission to accept deposits and imposition of requirements not to make new loans, redeem members’ shares or repay any deposits is appropriate – Yes

FINANCIAL SERVICES AND MARKETS TRIBUNAL

ROTTON PARK/WINSON GREEN CREDIT UNION LTD Applicant

- and -

FINANCIAL SERVICES AUTHORITY The Authority

**Tribunal: STEPHEN OLIVER QC
 MAURICE BATES
 PETER LAING**

Sitting in public in London on 24 July 2006

Michael Blake, president of the Credit Union, for the Applicant

Adrian Berrill-Cox, counsel, instructed by the Authority, for the Authority

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DECISION

1. The Applicant in this reference is Rotton Park/Winson Green Credit Union Ltd. We refer to the Applicant as “the Credit Union”. The Credit Union has referred to the Tribunal the Authority’s Second Supervisory Notice (“the Supervisory Notice”). The Supervisory Notice, shortly summarized, removes the Credit Union’s permission to accept deposits and places requirements upon the Credit Union that the Credit Union should not make new loans, redeem members’ shares or repay any deposits.

2. The Credit Union was represented by its President, Michael Blake. Ethan Jolly, the administrator of the Credit Union for some eighteen years attended and gave evidence. Adrian Berrill-Cox represented the Authority. He called as witnesses Roger Marshall, manager of a supervisory team in the Mortgages and Credit Unions Department of the Authority’s Small Firms Division and Richard Quinnell, employed by the Authority as a case officer in the Threshold Conditions Team of the Enforcement Division.

Background circumstances

3. On 23 November 2005 the Authority issued its First Supervisory Notice to the Credit Union. Under paragraph 1.2 of that Notice the Authority varied the Credit Union’s permission under Part IV of the Financial Services and Markets Act 2000 (“the Act”) by, effectively, making requirements that the Credit Union should not make any new loans, should not redeem any members’ shares, should not repay any deposits and should otherwise only reduce its assets in accordance with legitimate business expenses. Further, under paragraph 1.1, the Authority removed the regulated activity of accepting deposits from the Credit Union’s permission under Part IV (this being their only such permitted activity).

4. The Credit Union wrote to the Authority’s Regulatory Decisions Committee on 19 December making representations which amounted in effect to the seeking of a waiver on the basis that the restrictions would be very detrimental to it and would almost certainly mean its closure. The letter requested that the Credit Union should carry out a plan to maximise current income and reduce expenditure, raising profit to some £12,000 in a year, to collect outstanding loans with interest and to merge with a neighbouring credit union. The response of the Authority was that there appeared to be inadequate evidence of any prospective improvement in the Credit Union’s financial position and that the remedial steps proposed by the Credit Union had not yet materialized despite earlier indications that they could be put in place.

5. The Credit Union persevered and, in a telephone conversation of 19 January 2006, made further proposals to maximise income and reduce expenditure. In particular it suggested that substantial money could be saved by staff not taking wages and by the Credit Union negotiating a rent-free agreement over its premises for three years. At the same time it was suggested that the Credit Union would employ two

debt collectors who were expected to collect arrears of £4,000 a year realising an “income” of £12,000 over three years (of which it would receive £9,000). Another proposal of the Credit Union was that when it became feasible on a reduction of their current deficit the Credit Union would transfer its engagements to Handsworth Credit Union. The point was further made by the Credit Union that the effect of the requirements in the Supervisory Notice and the removal of its permission to accept deposits would frustrate the Credit Union’s abilities to remedy the situation and in particular the inability to make new loans would impact upon their interest income. The reaction of the Authority was that it would be inappropriate to allow further loans to be made when the Credit Union had insufficient assets to repay its existing depositors.

6. On 7 February 2006 the Authority issued the Supervisory Notice to the Credit Union. The action taken at paragraph 1.1 of the Notice is effectively identical to that taken in the First Supervisory Notice and summarized above. The Credit Union referred the Supervisory Notice to the Tribunal on 3 March 2006. The grounds for the reference were-

- Not enough credence was given to the recovery plan outlined during the oral representations made during the telephone discussion of 19 January.
- The Regulatory Decisions Committee had stated that other credit unions might be put at a disadvantage if the Second Supervisory Notice were not issued. The Credit Union said this was unfair as each credit union should be treated on its own merits.
- Not enough weight had been given as to how detrimental the Supervisory Notice was to the Credit Union and its ability to recover.

On 15 March 2006 the Credit Union applied to the Tribunal requesting the Tribunal to “consider lifting or suspending the Supervisory Notice”. At the hearing on 11 April the Credit Union provided the Authority with an unaudited financial return for the period ended 31 March 2006 (“the March CQ”) indicating a substantial improvement in its financial position (amounting to a reduction in negative capital to £21,941). The Credit Union said it had achieved a £10,000 reduction in expenses by negotiating a three year rent-free period and through a part-time staff member foregoing salary. The Credit Union suggested that the reduction of expenditure with continuing reduction of bad debts and collection of interest would return the Credit Union to positive capital within a year. The Authority undertook to look at this and to obtain further information. Nonetheless the Tribunal decided not to suspend the effect of the Supervisory Notice or any of the requirements contained in it.

The legal framework

7. The Authority’s power to vary the permission of an authorized person derives from section 45(1)(a) of the Act where the authorized person is failing, or likely to

fail, to satisfy the threshold conditions and (c) where it is desirable to exercise the power in order to protect the interests of members or potential members. The power to impose requirements upon a Part IV permission lies under section 43(1) of the Act. Under section 53(3) of the Act, if the Authority reasonably considers that it is necessary, such variations may take immediate effect.

8. The Authority, in exercising its power to vary a permission, will have regard to the Authority's Handbook. In this case the Credit Union Sourcebook ("CRED"), the Threshold Conditions ("COND") and the Enforcement Manual ("ENF") set out the relevant guidance. In particular CRED 5.1.5 provides that the Authority may exercise its powers if one of the threshold conditions is not met (in this case COND 2.4 adequate resources, expressed by COND 2.4.2G(2) to include financial resources, capital, provisions against liabilities, holdings of or access to cash and other liquid assets). In terms of financial resources, a credit union "must at all times maintain a positive amount of capital" (CRED 8.3.1R), and this implements the principle that every pound saved by a depositor with a credit union should always be worth at least a pound (CRED 8.3.3G).

9. CRED 5.2.1(5)R requires the Authority to be satisfied that the Credit Union is fit and proper to be authorized and to be allowed to carry on regulated activities and CRED 5.2.4 allows the Authority to exercise powers under s.45 of the Act where it is likely that the Credit Union is failing or likely to fail to satisfy the threshold conditions (effectively reiterating s.45(1)(a)).

10. Paragraph 3.5 of ENF sets out the Authority's policy on variation of Part IV permissions. This provides that the Authority should have regard to its regulatory objectives and the regulatory tools available to it (ENF 3.5.2G). It provides that relevant circumstances will include where the Authority has serious concerns that the person has breached requirements imposed on it by, or under, the Act and where those breaches are material in number or individual seriousness (ENF 3.5.8G). Where an urgent response to serious concerns may be necessary, the relevant circumstances will include extent of loss or risk of loss or adverse effect to members and the steps taken by the authorized person to address the issue (ENF 3.5.13G).

35 The capital position of the Credit Union

11. Credit unions are required to have positive capital. The reasons for this were explained to us by Roger Marshall. As at September 2005, according to its audited accounts, the Credit Union had negative capital of £36,250 (this had been revised from £31,784). On that basis there was at the time insufficient capital in the Credit Union to return to each of the depositors the entirety of their deposits. The point was made that were further deposits to be accepted, more people would find themselves in that position and thus there would be a risk to potential members as well as, as a consequence of the expansion of liabilities, a risk to existing members. There was no clear evidence as to how any new loans might be funded.

12. It is also significant that where a body such as the Credit Union is on available information insolvent, the repayment of one depositor without repaying all of them effectively amounts to the preference of one creditor over another in circumstances where not all creditors can be repaid in full. That would not be fair. Similarly, in such
5 circumstances, the increasing of liabilities would most likely be prejudicial to the interest of all creditors.

13. Those points were made by the Authority and seem to us, in the circumstances, to be unanswerable.
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Recovery plans of the Credit Union

14. We turn now to examine the recovery plans proposed by the Credit Union. These aim to improve its financial position by more effective debt recovery, reduction
15 of expenses and, ultimately, merger with another credit union.

15. The Authority comments, and we agree, that nothing in the requirements imposed in the Supervisory Notice prevents the Credit Union from taking such steps.

16. We note in this connection that the Credit Union's audited accounts show negative capital of £36,250 as at September 2005. This is a deterioration from the negative capital position of £33,922 as at September 2004 which, in its turn, was a deterioration in the negative capital of £29,344 shown in September 2003. Looking at
20 the position from a historical viewpoint, it seems to us that the Credit Union has failed to achieve any, and certainly not any significant, improvement in its financial
25 position. We mention that on 11 February 2005 the Authority asked the Credit Union to provide an action plan by 14 March of that year. The action plan, when submitted, stated that the Credit Union intended to recoup all bad debts by 31 January 2006, to obtain a subordinated loan by April 2005 and to reduce its deficit to "an appropriate
30 amount" by 31 March 2006. In the events no subordinated loan has been arranged. No satisfactory evidence has been presented indicating any significant reduction in recovery of bad debts.

17. Looking at the past history of the present matter, it seems to us that the
35 Authority, in dealing with the Credit Union, has given it all reasonable opportunities to effect the necessary remedial measures prior to taking enforcement action.

The enforcement action and its consequences

18. Mr Michael Blake, the president of the Credit Union, suggested that the effect
40 of the Authority's action was so detrimental that it would force the Credit Union to close down. However, if (as the Credit Union has consistently contended) it had been open to it to take steps to return itself to solvency prior to the Supervisory Notice, it has remained open to the Credit Union to do so. It is, we think, significant that it has
45 so far failed to do so. It has failed to maintain a positive amount of capital since September 2003. This falls short of the requirements of COND and CRED and poses a risk to members. But that risk to members continues and would not, we believe, be

made worse if the Credit Union were to close down. In those circumstances the Financial Services Compensation Scheme could become involved and members would recover at least most, and probably all, of their savings.

5 19. The Credit Union has, we think, had sufficient opportunity to rectify its financial position prior to the issue of the Supervisory Notice. The steps now proposed by the Credit Union, even if taken at face value and if implemented, would take at least three years to bring the Credit Union to a positive capital position. Moreover they could still be carried out notwithstanding the restrictions imposed on
10 the Credit Union.

Developments since 11 April 2006

15 20. On 11 April 2006 the Tribunal heard the Credit Union's application to suspend the terms of the Supervisory Notice. At that hearing the Credit Union produced the March CQ. This indicated a reduction of £9,843 such that negative capital was reduced to £21,941. The Authority asked a number of questions arising from the March CQ; these were addressed to the Credit Union. The Authority drew attention to reported reductions in total membership shareholdings and to total membership which
20 would have resulted in using members' savings to repay loans and the redemption of their shareholdings (both of which would have contravened the terms of the Supervisory Notice). The Authority also drew attention to the increase in cash and bank balances of £38,208, a rise in interest receivable of £12,138 suggesting overall lending of £400,000; this would have been well in excess of reported lending. Also
25 noted by the Authority was a rise in interim net profit for the quarter of £7,769 despite reported write-offs of bad debts of £10,481. On the basis of the audited accounts for September 2005 the Credit Union's negative capital figure at 31 March 2006, leaving aside any other queries on the CQ, would have been £26,407 rather than £21,941. The Authority asked for further information.

30 21. Taking into account information subsequently received and documents inspected, Mr Marshall, in evidence to us, suggested that the total for loan provisioning should be £70,000 higher than reported. He conceded that the position was insufficiently clear for any great reliance to be placed on it; but on the basis that a
35 provision of £70,000 were made, the resulting loss to the Credit Union would have reduced capital by at least £70,000. The under-provisioning could, in his view, have been nearer £85,000. On that basis the negative capital position of the Credit Union would be at the very least £26,407, as at the latest return, and could be as much as £101,000. Nothing said and no information provided by the Credit Union has tended
40 to displace these concerns.

22. Another feature to take into account in determining the appropriate action for the Authority to take in relation to the matter referred arises from the fact that on 22 February and 3 March the Credit Union asked the Authority for permission,
45 notwithstanding the terms of the Supervisory Notice, to release members' funds. Those requests had, Mr Quinnell explained, been refused. However, according to Mr Quinnell's evidence, in April and May 2006 the Authority had received telephone

calls from members of the Credit Union who had not been able to access their savings and had not been informed why. Further, the Authority have been informed of at least two members who had continued to contribute to their savings accounts by means of a standing order notwithstanding the withdrawal of the Credit Union's permission to accept deposits.

23. Mr Quinnell said that the Authority had been informed that a relatively small number of members had continued to contribute by standing order but that the Credit Union would send a reminder to them. By 5 June 2006 the Authority had become aware of further members continuing to make deposits and that no notice had been on display at the Credit Union's office concerning the restrictions. Mr Jolly refuted this and said that notices had been displayed. We are inclined to accept his evidence on the point. However when the cash book arrived with the Authority and was analyzed it became clear that the Credit Union had continued to accept deposits from members and to allow withdrawals of savings by members from 23 November 2005 until at least 30 April 2006. That discovery had resulted in the Authority's decision to issue a Supplemental First Supervisory Notice. The effect of this Supplemental Notice had been to vary the Credit Union's permission by prohibiting it from disposing of any of its assets without the written consent of the Authority, to require the Credit Union to notify its members of the effect of both the Supervisory and the Supplemental Notices and to provide the Authority with written details of the arrangements by which it would notify its members.

The case for the Credit Union

24. Mr Blake acknowledged that the Credit Union was in deficit. But, he said, a viable plan had been presented which, if implemented, should eliminate deficit. Moreover the Credit Union was taking more effective action to get borrowers to pay off outstanding loans. In all the circumstances the notices were causing unnecessary hardship to the Credit Union's members: and this was the main thrust of the Credit Union's case. The notices should not be allowed to harm those whom it was intended to protect. Thus the appropriate action would be to require the Authority to waive the restrictions contained in the Notice.

Conclusions

25. Our function is to determine what is the appropriate action to take in relation to the matters comprised in the Supervisory Notice. We are, for this purpose, entitled to take into account evidence of events that have happened since the decision comprised in the Supervisory Notice was taken. In this connection we accept the evidence of Mr Quinnell that the Credit Union has continued to accept deposits from members and to allow withdrawals of savings until at least 30 April 2006. We therefore take into account the fact that there has been an element of non-compliance on the part of the Credit Union with the effect of the Supervisory Notice. Taken alone, however, those features would not require us to determine this matter against the Credit Union.

26. The figures show that on any view of the matter the Credit Union has a substantial negative capital position both absolutely and relative to liabilities to members. This negative capital position has not in our view been adequately addressed for at least the last three years. The consequence of that negative capital position is that the Credit Union is not in a position to repay all of the depositors should repayment be requested. Moreover the negative capital position of the Credit Union has presented and still presents a continuing risk to members and to potential members. The scale of the negative capital position may not have been fully determined. Nonetheless, on the strength of the evidence of Mr Marshall, it seems to us that the Authority has every reason for expressing serious concern at the Credit Union's solvency position.

27. The Credit Union has failed to implement earlier action plans for remedial action. And nothing in its conduct thus far indicates a significant possibility of any satisfactory action plan being proposed and properly implemented within an acceptable time frame.

28. Looking at the consequences of the Supervisory Notice, it seems to us that the removal of the Credit Union's permission to accept deposits and the other requirements placed upon it do not prevent the Credit Union from implementing the remedial measures that it has already proposed or indeed any other such measures. But even if the action of the Authority did prevent the implementation of some or all of the proposed remedial measures, the action as set out in the Supervisory Notice is, we think, still necessary and proportionate given the legal position and the seriousness of the Authority's concerns. We refer, once again, to the evidence of Mr Marshall in this connection.

29. We are conscious of the hardship suffered by some members of the Credit Union as a result of the Supervisory Notice. It is nonetheless reasonable and proportionate for the Authority to have imposed the requirements set out in the Supervisory Notice. These, it seems to us, fall fairly within the Authority's statutory objectives with particular reference to its obligation to protect members and potential members. We cannot see what other action is appropriate in all the circumstances.

30. Taking all those factors into account we think that it is reasonable for the requirements and restrictions contained in the Supervisory Notice to have effect. We conclude that we should not direct the Authority to lift or suspend the Supervisory Notice and that the requirements and variation of permission contained in it should continue to have effect. We mention in this connection that should remedial action by the Credit Union demonstrably rectify the Credit Union's capital position, then the Authority has acknowledged that it would review the necessity to maintain the requirements and might restore the permission.

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31. For all those reasons we dismiss the reference.

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**STEPHEN OLIVER QC
CHAIRMAN**

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