Social Investment Scotland

Subordinated Loan Q&A

We know that subordinated debt is a relatively unused product within the credit union sector. A subordinated loan can be used to help a credit union maintain an adequate capital position as it can be counted towards its overall capital holding. We'd like to signpost you to things you need to think about when taking a subordinated loan from SIS.

Who can a credit union take a subordinated loan from?

Individuals or corporates.

Are there restrictions on this type of loan from an individual?

If borrowing from an individual, the loan would need to qualify as capital under the PRA Rules. It is worth remembering that a credit union cannot require its members to make subordinated loans to the credit union.

What kind of loans can credit unions takes from corporates?

Credit unions can take both ordinary loans and subordinated loans from corporates. When it comes to a subordinated loan, the loan needs to be providing regulatory capital under the PRA Rules.

Why would a credit union look at a subordinated loan instead of an ordinary loan?

A subordinated loan can be used to enable a credit union to meet the ratio requirements in terms of the capital that it needs to hold under the PRA Rules.

What are the PRA Rules and where do we find them?

The PRA Rulebook for Credit Unions can be found here.

What other rules should a credit union have in mind?

The Credit Unions sourcebook in the FCA Handbook (CREDS).

Where can we check the rules on capital?

PRA Rule 8.2 is a useful starting point. It makes clear from the outset that the credit union must have adequate capital taking into account the nature, scale and complexity of the business.

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How does the subordinated loan fit into capital?

A subordinated loan that meets certain conditions can be classed as capital.

What are those conditions?

There are eight conditions set out in PRA Rule 8.2(5):

1. the loan must be for more than five years;
2. the claims of the subordinated creditors rank behind the unsubordinated creditors, this includes the credit union's shareholders;
3. as far as possible, creditors waive their rights to set off amounts they owe the credit union against subordinated amounts owed to the credit union;
4. the only events of default are non-payment of any interest or principal under the loan agreement or the winding-up of the credit union;
5. the actions the subordinated creditor can take when there is an event of default are limited to petitioning for the winding up of the credit union or claiming in the liquidation of the credit union;
6. the subordinated loan must not become due and payable before the maturity date unless there is an event of default;
7. the terms of the subordinated loan must be set out in a written agreement that contains the conditions stated above; and
8. the debt must be unsecured and fully paid up.

What does all this mean in the context of a subordinated loan from SIS?

SIS will draft a loan agreement to meet the conditions of the PRA Rules. The SIS subordinated loan can be for a period of up to 8 years, the minimum will be 5 years. The loans will be interest free and unsecured. The terms on claims, ranking, payment and events of default will be drafted to cover the conditions highlighted above.

I've heard people talk about a write down, where does this fit in?

The write down comes from PRA Rule 8.4. The PRA require that subordinated lending, which qualifies as capital, must be written down by the credit union by 20% of the amount of the loan per year. The credit union should do this from the fourth year of the loan.

How does this work in terms of the SIS subordinated loan?

From the fourth year the loan is reduced by 20% per annum from the capital calculation. This doesn’t mean the loan is repaid by 20% per annum: it can remain unpaid until the redemption date. The credit union needs to plan adequately to ensure their overall capital meets the PRA's capital holding requirements once the reductions start to kick in.