

The credit union interest rate cap

Consultation document

March 2005



HM TREASURY



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INTRODUCTION

Access to affordable credit

1.1 *Promoting Financial Inclusion*¹, published alongside the Pre Budget Report in December 2004, outlined the action the Government intends to take on its three financial inclusion priorities of increasing access to banking, to free face-to-face money advice and to affordable credit. To this end, the Government announced it would establish a Financial Inclusion Taskforce and a Financial Inclusion Fund of £120m.

1.2 In recent decades, the majority of households have seen a dramatic rise in the availability, flexibility and affordability of credit. However, while the majority borrow using mainstream credit cards, bank loans and overdrafts at relatively low rates of interest, those on the lowest incomes often have to borrow to make ends meet, at interest rates many times those charged by mainstream lenders. Alternative credit products can have Annual Percentage Rates (APRs²) of over 100%, many times the APRs of standard mainstream credit products.

1.3 As outlined in *Promoting Financial Inclusion*, costs in this market may be higher for consumers because of the way in which the alternative lending market operates and also because of the preferences of low-income groups themselves. For example, research³ indicates that lower income consumers typically value credit agreements that offer small cash loans, allow repayments in regular small instalments and take a flexible approach to deferral of payment and rescheduling. If loans are smaller, this may result in the fixed costs of provision being proportionally higher whilst small repayments, often in cash, may be more expensive to collect.

1.4 The Government wants to ensure that those on low incomes, excluded from mainstream sources of credit, are able to borrow at affordable rates. The Government therefore intends to take action to increase the availability of low cost options for those seeking access to credit, recognising that increasing the provision of credit for those on low incomes – even if specifically designed to be more affordable – must ensure that it does not simply lead consumers into patterns of unsustainable debt.

The role of credit unions

1.5 Credit unions are mutual financial organisations, offering savings and loans facilities to their members. The Government recognises that not-for-profit or ‘third’ sector lenders have an important role to play in the provision of affordable credit. Credit unions, as community based mutuals, are already active in this area, operating, as many do, in areas of high financial exclusion. To support the valuable work of credit unions and to boost the coverage, capacity and sustainability of the sector, *Promoting Financial Inclusion* announced that the Government would:

- set up a growth fund for third sector lenders, from within the Financial Inclusion Fund and subject to any necessary state aids clearance;
- map the location of third sector lenders to ensure that support provided to such organisations is appropriately targeted; and

¹ Available on the Pre Budget Report 2004 section of HM Treasury website at http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adexclusion.cfm

² APR refers to the interest rate that would be charged over a whole year on a loan and generally takes into account all additional costs incurred in taking out a loan.

³ There is considerable research on these preferences. For example, *In or Out? Financial exclusion: a literature review*. FSA. July 2000.

- invite the Financial Inclusion Taskforce to consider other ways in which the capacity and skills of volunteers and staff within third sector lenders can be enhanced.

The interest rate cap **1.6** In addition, it was also announced that:

“The Government will consult on the costs and benefits of raising the cap on interest that credit unions can charge on loans, in particular, to ascertain the likely impact on existing credit union members and the communities they serve.”

1.7 Credit unions incorporate under the Credit Unions Act 1979 (the “1979 Act”) which places a number of requirements on how credit unions operate. One such restriction, contained in section 11(5) of the 1979 Act, states that a credit union may not charge interest on loans at a rate exceeding 1% a month. It also requires that such interest must be inclusive of all administrative costs and other expenses associated with making the loan. As financial mutuals, credit unions aim to provide savings and loans facilities at improved rates for their members. The interest rate cap can therefore be seen as contributing to the realisation of a benefit for members. It is important to emphasise that this provision **does not require** credit unions to charge 1% a month; credit unions are free to charge at a lower rate below the cap and to charge variable rates for different members.

1.8 The 1979 Act also gives HM Treasury the power to amend this cap using secondary legislation⁴. The Government is aware that some believe that this cap restricts the ability of credit unions to make loans available to those who may currently be dependent on higher cost alternatives, disadvantaging them in comparison with other lenders. However, the Government is also aware that other have concerns and alternative views about the impact of this proposal. Before considering this issue further, the Government wishes to ensure that the benefits of raising the credit union interest rate cap and any associated potential risks are fully understood. Chapter 2 looks at the potential benefits of this proposal. Chapter 3 discusses possible concerns and risks. Chapter 4 looks at a number of legal and practical issues. Throughout the consultation document, respondents are asked to carefully consider this issue and to give views on the following questions:

⁴ The procedure is a statutory instrument made by negative resolution. Draft Regulations would be laid before Parliament and would become law if no objection had been raised by MPs or Peers within a 21 day period.

- 1. What effect, if any, would raising the interest rate cap have on the ability of credit unions to offer loans to a wider spectrum of borrowers, including low income consumers?**
 - 2. What effect, if any, would raising the interest rate cap have on the ability of credit unions to become more sustainable?**
 - 3. What effect, if any, would raising the interest rate cap have on credit unions' business and lending practices?**
 - 4. Are there any other potential benefits associated with raising the interest rate cap?**
 - 5. How serious is the risk that loans may become more expensive for existing credit union members?**
 - 6. How serious is the risk of potential greater loan delinquency?**
 - 7. Are there any other concerns or risks associated with raising the interest rate cap? What is your view of the seriousness of such risks?**
 - 8. If you consider there are serious risks associated with raising the interest rate cap, would requiring credit unions to hold a vote be an effective way of mitigating this risk?**
 - 9. In considering the issue of the interest rate cap, should the Government:**
 - a) do nothing;**
 - b) raise the cap to 2% a month; or**
 - c) raise the cap beyond 2% a month? (if so, to what level?)**
 - 10. If you believe the cap should be raised, should credit unions be required to hold a vote on whether to charge higher interest rates under a new cap (bearing in mind that primary legislation may be needed to introduce this restriction)?**
 - 11. Do you agree that the current exemption from the Consumer Credit Act 1974 should be maintained if the interest rate cap were to be raised?**
 - 12. If the cap is raised and if applicable, would you consider making use of the greater flexibility on loan rates? In what ways do you anticipate your lending practices would change?**
 - 13. If the cap is raised and if applicable, can you:**
 - a) identify any costs or benefits for your organisation or more generally resulting from these proposals?**
 - b) quantify these costs or benefits?**
- See Annex A for details on these costs and benefits.**

Devolution 1.9 Credit union legislation is an area which is reserved to Westminster under the Scottish and Welsh devolution legislation and therefore any rise in the interest rate cap would apply to credit unions in Great Britain. In Northern Ireland, matters arising from the proposal would normally be the responsibility of Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

How to respond 1.10 We invite comments by 16 June 2005 at the latest. Earlier responses would be very welcome. We would prefer to receive responses by email though responses may also be sent by post or fax. Contact details are shown below.

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Disclosure of responses 1.11 All responses will be acknowledged. In accordance with the code of practice on open government, comments will be made publicly available unless respondents specifically request otherwise. Any email response sent from a corporate system may carry an automatically generated notice stating that the content of the message should be treated as confidential. These automatically generated messages will be disregarded unless it is made clear otherwise in the email that you wish your comments to be treated as confidential.

1.12 This document is available electronically at www.hm-treasury.gov.uk/consultations. You may also photocopy it if you wish or additional hard copies may be ordered, free of charge, from the HM Treasury Correspondence and Enquiry Unit by email to ceu.enquiries@hm-treasury.gov.uk or by telephone on 020 7270 4558.

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CASE FOR ACTION

Rationale for raising interest rate cap

2.1 Credit unions are currently unable to charge more than 1% a month on interest on loans (though they are free to charge less if they wish to do so). The Government is aware that some in the sector, for a variety of reasons, believe that this cap should be raised. One of the most important reasons often quoted is that the current cap potentially restricts the ability of credit unions to make loans available to those who may currently be dependent on higher cost alternatives for access to credit. This is because offering such loans may come with greater costs. For example, as mentioned earlier, as loans are typically for smaller amounts, fixed costs on making a loan are often proportionately higher. It can also be relatively more expensive to accept repayment in the form of small, regular, over the counter cash payments, whilst offering loans to low income consumers may come with greater costs if credit union volunteers/staff spend more time establishing a repayment plan, providing debt advice and so on.

2.2 Offering such credit may also be riskier. The issue of risk will be an important one to many credit unions given that loans are underwritten by members' savings. An interest rate of 1% a month is seen by some as too low to reflect the potential higher risk of default among low income consumers and to cover the greater costs that come with higher potential loan delinquency. Many credit unions counter the risk of default by requiring a member to establish a savings record with the credit union (often known as the '12 week rule'). However, for various reasons, low income consumers may lack a savings record or may need a loan as a matter of urgency. The same member, however, may still have the capacity to repay any loan from a credit union despite the absence of a savings record. Allowing a credit union to charge a marginally higher rate may therefore better enable a credit union to address the potential risk associated with such cases.

2.3 As making loans to the financially excluded may come with greater costs and with higher risk, many credit unions wishing to play a more active role in promoting financial inclusion may feel unable to offer loans to those who cannot access mainstream provision or to do so on a sustainable basis. This may mean that low income consumers needing access to affordable credit and unable to borrow from mainstream lenders may have little choice than to turn to alternative lenders, which may be more expensive.

2.4 Many credit unions are strongly embedded in their local communities and are committed to assisting those on low incomes. Research indicates that credit unions often appeal to low income consumers as bodies which are local, accessible and convenient and which are community-based.⁵ Many credit unions also offer debt advice and encourage those on low incomes to develop their savings. Giving credit unions greater flexibility on their lending policies and allowing them to charge marginally higher interest rates to reflect the risks and costs associated with different clients, it is argued, may better enable credit unions to recruit potentially loyal members and further cement the role that credit unions play in serving the financially excluded.

⁵ *Would you credit it? People telling stories about credit.* Paul A. Jones & Tina Barnes, Liverpool John Moores University. Published by the Co-operative Bank, February 2005.

“Creating wealth in the West Midlands through sustainable credit unions” research findings

A recent report by Paul Jones of Liverpool John Moores University on ABCUL's⁶ West Midlands action research project, established to assist credit unions to rethink their management and organisation and to take actions designed to maximise growth, made a wide number of observations into how credit unions could grow and serve the financially excluded, including:

*“Financial analysis... has led to the conclusion that the statutory upper limit of 12.68% APR charged on loans is **insufficient to cover the basic costs of certain categories of loans and leads to a restriction rather than an expansion of services to low income groups.** As a result of the statutory upper limit on interest rates charged on loans, many credit unions will remain dependent on external subsidies to serve the financially excluded.”⁷*

The report recommended that the cap be increased.

2.5 Another, related, consideration is that as the current interest rate cap may make it difficult for credit unions to recoup their lending costs (with the effect, as discussed above, of discouraging loans to particular clients who may be costlier or riskier to serve), credit unions may struggle to become sustainable and continue their valuable work in the communities they serve. A range of factors have been identified as leading to sustainable credit unions, including trained staff and volunteers, an appropriate common bond and successfully attracting savers to that credit union with a competitive dividend. However, for credit unions at an early stage of development or who operate in particularly deprived areas where it may be difficult to attract savers, sustainability may be a difficult objective to achieve. It may be impossible if credit unions make a loss or a marginal profit only on loans made to members. The ability to charge higher interest rates may therefore in some cases better enable credit unions to recoup lending costs and cover various overheads, releasing funds to allow the credit union to expand and become sustainable.

“Affordable credit for low-income households” research findings

Elaine Kempson and Sharon Collard, from the Personal Finance Research Centre, set out to analyse the credit products used by those on low incomes and to investigate the scope for reducing the costs of lending and widening access to more affordable credit. In looking at credit unions, one of the conclusions of the study was:

*“A...hurdle for credit unions is the fixed APR of 12.68%. Even given the fact that loans are generally underwritten by members’ savings, **credit unions that want to become more financially self-sufficient, and have paid staff, will be unable to do so while charging this rate of interest.** They would certainly not be able to provide ‘instant access’ loans without heavy subsidy... if credit unions (indeed, community-based loans schemes generally) are to compete seriously with commercial lenders, they will have to do so from a position of financial sustainability.”⁸*

⁶ Association of British Credit Unions Limited.

⁷ *Creating wealth in the West Midlands through sustainable credit unions: an action research project.* Paul A. Jones. Undertaken by the Association of British Credit Unions Limited and in collaboration with Liverpool John Moores University. February 2005.

2.6 A further related consideration is that raising the interest rate cap may encourage and provide greater flexibility for credit unions. The Government supports the work done by the sector to modernise credit union business practices by, for example, offering loans on the basis of the ability to repay, rather than the amount held in savings. The Government recognises that modernisation of business practices, financial discipline and greater professionalism will widen the appeal of credit unions and bring many credit unions closer to sustainability. Raising the interest rate cap and encouraging lending flexibility may form part of this agenda insofar as it may give credit unions greater flexibility to offer variable rates to different members and to respond more effectively to market developments.

PEARLS

The PEARLS project, launched in April 2002 by Barclays bank, ABCUL and the Office of the Deputy Prime Minister, is a financial monitoring and business-planning tool that focuses on achieving sustainability and growth. Credit unions that participated in the pilot project made a number of observations about the impact of using PEARLS, as documented in the report⁹:

*“One of the most dramatic changes that a number of the pilot credit unions have made is the move from ratio-based lending to capacity based lending. Most British credit unions lend money to members as a multiple of the amount of shares they have amassed. Capacity based lending involves assessing a members’ borrowing request based on their ability to repay, regardless of their savings with the credit union. **Moving to this approach has led not only to reduced delinquency levels, but has also brought in new members attracted to instant loans at attractive rates of interest.**”*

One participating credit union saw their lending ratio increase from 55% to 89% and the membership increase by 104% during the two year long project.

2.7 This chapter has sought to outline the main points put forward by those seeking greater flexibility for credit unions on their ability to lend to members. The Government would welcome any other thoughts or perspectives on the case for raising the level of interest that credit unions can charge on loans.

1. What effect, if any, would raising the interest rate cap have on the ability of credit unions to offer loans to a wider spectrum of borrowers, including low income consumers?

2. What effect, if any, would raising the interest rate cap have on the ability of credit unions to become more sustainable?

3. What effect, if any, would raising the interest rate cap have on credit unions’ business and lending practices?

4. Are there any other potential benefits associated with raising the interest rate cap?

⁸ *Affordable credit for low-income households*. Elaine Kempson & Sharon Collard. Joseph Rowntree Foundation. February 2005.

⁹ *An introduction to PEARLS in Britain*. A report published by the Association of British Credit Unions Limited and Barclays Bank. October 2004.

3

CONCERNS AND RISKS

3.1 Although there are several potential benefits associated with this proposal, the Government is also aware that there are a number of potential risks and that some in the sector have alternative views and concerns about raising the interest rate cap. Further consideration of this issue will follow a careful analysis of how the benefits and risks balance and an analysis of the views from across the credit union sector.

Impact on cost of loans?

3.2 Changing the interest rate cap would not **require** credit unions to charge at a higher rate or to offer different rates to different clients; it simply permits them to do so. However, the Government is aware that some in the sector may have concerns about this proposal on the basis that it runs contrary to a perceived co-operative 'ethos' of credit unions. For example, some in the sector believe that, as a matter of principle, all credit union members should be charged at the same rate and/or at a figure of 1% a month.

3.3 As a result, or for administrative simplicity, some credit unions may wish to take advantage of an increase in the interest rate cap to increase the cost of loans across the board, including for existing credit union members. This could be the case if the administrative costs associated with charging different rates for different clients prove to be high for some individual credit unions. The loan would likely still be cheaper than alternative providers. A report for the Co-operative Bank by Liverpool John Moores University¹⁰ gave an example of a doorstep loan of £100 over 26 weeks, which generated an interest payment of £30. At the current cap, the same loan would not generate interest of more than £6. If the cap was raised to 2%, it would generate an interest payment of around £13. Nevertheless, it would be relatively more expensive for existing members than if the cap had not been raised.

5. How serious is the risk that loans may become more expensive for existing credit union members?

Financial risks

3.4 Raising the interest rate cap also raises the possibility that credit unions will come to adopt more diverse lending portfolios, composed of 'riskier' loans than before. Such loans may come with a greater risk of default and delinquency. Credit unions are currently required to comply with a number of provisioning¹¹ and capital¹² requirements, as outlined in CRED, the Financial Services Authority (FSA) rulebook for credit unions. If loan delinquency rates were to rise, credit unions would, under the existing requirements, have to make higher provisions for loss. Making such provisions may have an impact on a credit union's profitability and ability to meet the FSA's capital requirements. Furthermore, if the rise in loan arrears became significant this poses an ultimate risk that a credit union may become insolvent.

¹⁰ *Access to credit on a low income: a study into how people on low incomes in Liverpool access and use consumer credit*, Paul A. Jones. Co-operative Bank, 2001.

¹¹ www.fsa.gov.uk/vhb/html/CRED/CRED10.5.html

¹² www.fsa.gov.uk/vhb/html/CRED/CRED8.3.html and www.fsa.gov.uk/vhb/html/CRED/CRED8.4.html

3.5 Many credit unions will reasonably be able to adapt their lending procedures accordingly. Furthermore, it can be argued that raising the interest rate cap better enables the credit union to address the risk of loan delinquency in the first place. Nevertheless, the proposal comes with the risk that, especially in the early stages of such a change, credit unions may run into difficulties. It is difficult to predict the significance of this potential risk in the absence of practical experience on how the proposal is being implemented. The Government would therefore welcome views on the probability of such risks occurring.

3.6 The Government would also welcome thoughts on whether there are any other potential concerns and risks associated with raising the interest rate cap for credit unions.

6. How serious is the risk of potential greater loan delinquency?

7. Are there any other concerns or risks associated with raising the interest rate cap? What is your view of the seriousness of such risks?

**Managing
these
potential risks**

3.7 If respondents believe there is a serious risk of loans becoming more expensive for existing credit union members or of greater loan delinquencies, the Government is interested in views on whether there are ways of mitigating such risks and what impact such measures would have. A number of possible measures to mitigate such risks have been identified:

- require credit unions to hold member votes before being able to charge loans at a new rate below a higher cap. This would ensure that members of credit unions were fully consulted about the impact of a higher cap on their individual credit union. Many credit unions may undertake a vote anyway if the cap were raised; however, this measure would make a vote a statutory requirement rather than a voluntary option.
- only allow the higher cap to be applied to the first loan that a member has with a credit union. Assuming that those most in need of affordable credit are those that have not borrowed from a credit union before, having previously been reliant on high cost alternative providers, this measure would potentially enable credit unions to assist some of those in particular need whilst avoiding the potential risks that the cost of a loan will rise for existing members.

The Government would welcome suggestions on any other potential measures to mitigate such potential risks.

3.8 In considering whether it would be sensible to proceed with measures to mitigate the potential risks of the proposal, two general issues should be taken into account. Firstly, complicating the ability to charge marginally higher interest may potentially constitute a burden on credit unions and discourage them from taking advantage of the new proposal. Requiring a vote may be a costly lengthy procedure for some credit unions (though not necessarily if this is done at an AGM). Furthermore, it may make it harder for credit unions to play a role in promoting financial inclusion. For example, restricting the higher rate to first loans would not be of assistance to those who need subsequent loans. For this reason, the Government does not believe that restricting the ability to charge higher interest to first loans only would be sensible. However, the Government is interested in views on whether requiring a member vote

would be a sensible measure to mitigate potential risks associated with raising the interest rate cap.

3.9 A second significant issue is that, as mentioned previously, the enabling power in the 1979 Act only allows the Treasury to change the figure of the cap using secondary legislation. To do anything more complicated than this, such as introduce a restriction on the ability to charge higher interest, would require primary legislation or, possibly, what is known as a Regulatory Reform Order. This is discussed in more detail in chapter 4.

8. If you consider there are serious risks associated with raising the interest rate cap, would requiring credit unions to hold a vote be an effective way of mitigating this risk?

4

LEGAL ISSUES AND OTHER CONSIDERATIONS

4.1 The previous chapters have sought to outline the costs and benefits of raising the interest rate cap for credit unions. This chapter looks at a number of legal and practical issues, asking respondents for a view on which of the following is their preferred option:

- a) do nothing;
- b) raise the cap to 2%; or
- c) raise the cap beyond 2%.

For simplicity, the figure of 2% is presented as an option. The Government would be happy to consider an alternative figure should consultation respondents have a strong view on the figure. Where respondents believe the interest rate cap should be raised, respondents are then asked to provide a view on whether credit unions should be **required** to consult members before charging higher interest under a new cap.

Impact on cost of loan

4.2 In considering whether to raise the cap, the impact on the cost of loan is an important factor. Assuming that a typical amount borrowed by a member is £500, repaid weekly over a year, the below table shows what impact a cap at levels between 1 and 3% a month would have on such a loan.

Table 4.1: Cost of interest

Cap on monthly interest	APR	Cost of interest on a loan of £500 repaid over a year
1%	12.68%	£31.16
2%	26.82%	£63.53
3%	42.58%	£97.02

As already noted, many alternative lenders charge loans with APRs in excess of 100%.

Legislative mechanisms for raising the interest rate cap

4.3 As mentioned previously, the Credit Unions Act 1979 contains a power that enables the Treasury to substitute the existing cap for a new higher or lower figure using secondary legislation¹³. This power does not restrict the extent to which the cap could be raised or lowered. However, it does not enable the Treasury to do anything more complicated, such as introduce a restriction on the ability to make use of the option to charge higher interest. Therefore, requiring a member vote before higher interest could be charged or any other type of restriction, would require primary legislation or, possibly, what is known as a Regulatory Reform Order.¹⁴

¹³ The procedure is a statutory instrument made by negative resolution. Draft Regulations would be laid before Parliament and would become law if no objection had been raised by MPs or Peers within a 21 day period.

¹⁴ A Regulatory Reform Order (RRO) is a legislative procedure whereby the Government may seek to reform 'burdensome' legislation, providing that no 'necessary protections' are removed. It avoids the need for primary legislation, which can be difficult to secure, but is still a lengthy procedure, potentially taking up to 12 months to complete, and is subject to a number of safeguards.

4.4 Given that a Regulatory Reform Order and primary legislation are both lengthy costly procedures, the Government would need to consider very carefully whether to proceed if this proved to be the preferred approach of consultation respondents. In particular, a strong case would need to be presented to establish that the risks of this proposal are sufficiently serious and the mitigating measures demonstrably effective to merit a more complex legislative procedure. This is particularly the case in light of the fact that many credit unions may hold a vote anyway on whether to charge higher interest, regardless of whether there was a statutory requirement to do so. The Government would welcome views from respondents on whether this is the case.

Options 4.5 In light of the preceding chapters and the above considerations, the following table summarises the options available for going forward.

Table 4.2: Options for going forward

Option	How?	Benefits	Costs/risks
a) Do nothing	No legislative action needed	Avoid risks of more expensive loans and difficulties arising from potentially greater loan delinquencies (see paras 3.3 and 3.4).	Credit unions may be unable to play greater role in promoting financial inclusion.
		No implementation / administrative costs.	
b) Raise cap to 2%	Secondary legislation (statutory instrument using the negative resolution procedure)	Gives credit unions ability to reflect greater costs and risks associated with low-income customers in interest rate.	Risk of more expensive loans in general and difficulties arising from potentially greater loan delinquencies. Implementation / administrative costs.
c) Raise the cap beyond 2%	Secondary legislation (as with option b)	Gives credit unions even greater flexibility to reflect costs and risks associated with low-income customers in interest rate.	Risks in option b are more serious. Greater risk of being in conflict with ethos of credit unions. Implementation / administrative costs.

4.6 Where respondents believe that the interest rate cap should be raised, the following table highlights costs and benefits of requiring credit unions to hold a vote amongst members before charging interest under a higher cap.

Table 4.3: Further option

Option	How?	Benefits	Costs/risks
Allow credit unions to raise cap if members have voted in favour	Primary legislation or, if possible, a Regulatory Reform Order	As with option b but ensuring that cap is raised only if members accept the potential risks.	Potential costs in undergoing a vote in addition to implementation / administrative costs. Legislative procedure more difficult.

9. In considering the issue of the interest rate cap, should the Government:

a) do nothing;

b) raise the cap to 2% a month; or

c) raise the cap beyond 2% a month? (if so, to what level?)

10. If you believe the cap should be raised, should credit unions be required to hold a vote on whether to charge higher interest rates under a new cap (bearing in mind that primary legislation may be needed to introduce this restriction)?

Consumer Credit Act 4.7 Credit unions currently enjoy an exemption from the Consumer Credit Act 1974 by virtue of the Consumer Credit (Exempt Agreements) Order 1989 (subsequently amended in 1999). One of the bases for this exemption is that credit unions do not charge more than 12.7% APR (or 1% a month). If the cap were raised and if credit unions made use of the option to charge higher interest rates, credit unions would lose the current exemption and would have to comply with the requirements of the Consumer Credit Act. The Government recognises that this would be of concern to credit unions and, if consultation respondents were in favour of raising the cap, the Treasury will work with the DTI to maintain the current exemption. This could be done using secondary legislation (by a statutory instrument using the affirmative resolution procedure¹⁵). However, the Government would welcome the views of respondents on this issue, and would be interested to know whether there could be any detriment to consumers - from a competition or consumer protection point of view - in maintaining the exemption were the interest rate cap to be raised.

10. Do you agree that the current exemption from the Consumer Credit Act 1974 should be maintained if the interest rate cap were to be raised?

Practical aspects 4.8 To inform the policy discussion relating to the interest rate cap issue, the Government is interested on potential take-up within the credit union sector. If respondents are replying on behalf of an individual credit union, we are particularly interested in your direct interest in this proposal and how you would anticipate making use of the proposed greater flexibility on lending policies.

¹⁵ This requires the statutory instrument to be debated in both Houses of Parliament before being passed. This is unlike a negative resolution which passes if no objection is raised by MPs or Peers within a 21 day period.

4.9 The preceding chapters have outlined the potential costs and benefits of raising the interest rate cap. The attached partial Regulatory Impact Assessment in Annex A seeks to quantify these costs and benefits in further detail. The Government would welcome views from the sector on these figures, particularly in terms of anticipated costs and benefits for individual credit unions.

I 1. If the cap is raised and if applicable, would you consider making use of the greater flexibility on loan rates? In what ways do you anticipate your lending practices would change?

I 2. If the cap is raised and if applicable, can you:

a) identify any costs or benefits for your organisation or more generally resulting from these proposals?

b) quantify these costs or benefits?

See Annex A for details on these costs and benefits.

A

PARTIAL REGULATORY IMPACT ASSESSMENT

I. PURPOSE AND INTENDED EFFECT OF MEASURE

Objective A.1 This partial Regulatory Impact Assessment considers the costs and benefits of a proposal to raise the cap on interest that credit unions can charge on loans to members. The Government is interested in views on what impact giving credit unions greater flexibility on the interest that can be charged on loans would have on the ability of credit unions to lend, on a more sustainable basis, to low income consumers.

Devolution A.2 Credit union legislation is an area which is reserved to Westminster under the Scottish and Welsh devolution legislation and therefore any rise in the interest rate cap would apply to credit unions in Great Britain. In Northern Ireland, matters arising from the proposal would normally be the responsibility of Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

Background A.3 Credit unions are mutual financial organisations, offering savings and loans facilities to their members. The Government recognises that credit unions can have an important role to play in promoting financial inclusion and in providing for greater choice and diversity in the financial services sector.

A.4 Currently, credit unions are required under the Credit Unions Act 1979 to charge no more than 1% a month (12.7% APR¹⁶) in interest. Some academics and credit union practitioners have argued that raising the interest rate cap may better enable credit unions to offer loans to low income consumers. This proposal, it is argued, may therefore better enable credit unions to play a more sustainable role in promoting financial inclusion.

A.5 This partial Regulatory Impact Assessment and related consultation document follows *Promoting Financial Inclusion*¹⁷ which was published alongside the Pre Budget Report in December 2004. This announced a number of measures to boost the coverage, capacity and sustainability of the credit union sector in providing a source of affordable credit to low income consumers.

Risk assessment A.6 Research indicates that the risk and costs associated with offering loans to low income consumers can be higher than with other consumers. The requirement that credit unions charge no more than 1% a month on interest on loans means, it is argued, that credit unions may find it more difficult to offer loans to low income consumers on a sustainable basis. Unless action is taken, this may mean that credit unions will find it more difficult to become sustainable and/or that those needing access to credit may have little option but to turn to alternative high cost lenders. On the other hand, raising the cap introduces risks of greater administrative costs for credit unions, of loans becoming more expensive for members in general and difficulties arising from greater loan delinquency.

¹⁶ APR stands for Annual Percentage Rate. It refers to the interest rate that would be charged over a whole year on a loan and generally takes into account all additional costs incurred in taking out a loan.

¹⁷ Available on the Pre Budget Report 2004 section of HM Treasury website at http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adexclusion.cfm

2. OPTIONS

A.7 For simplicity, this partial Regulatory Impact Assessment looks at two options: do nothing and raise the interest rate cap to 2% a month.

Option A: Do nothing

A.8 This option would leave the current interest rate cap at 1%, thereby avoiding any potential risks of loans becoming more expensive in general for existing members, greater administrative costs and greater loan delinquency. However, doing nothing would not address the issue of whether credit unions are able to play a more effective and sustainable role in providing a source of affordable credit to low income consumers.

Option B: Raise the interest rate cap from 1% a month (12.7% APR) to 2% a month (26.8% APR)

A.9 Raising the interest rate cap to 2% would allow for greater flexibility and may make it easier for credit unions to recover the costs associated with lending to particular members. However, there is a risk that loans would become more expensive for credit union members in general and that credit unions could run into serious difficulties through greater potential loan delinquency.

3. BENEFITS

Business sectors affected

A.10 As of 2003, there were 665 credit unions in Britain serving over 463,000 members and with a total asset base of over £406m. The credit union sector is very diverse with some drawing their members from a particular place of work, others from a particular area, and many drawing members from both. The largest credit unions have staff and offer a diverse range of services while others offer basic savings and loans and are operated by volunteers.

Option A

A.11 The benefit to doing nothing is that it avoids any potential risks of loans becoming more expensive in general for existing members, greater administrative costs and greater loan delinquency.

Option B

A.12 The proposal to raise the interest rate cap **does not require** credit unions to charge higher interest; it simply permits them to do so if they judge that the benefits outweigh associated costs. Being permissive, there are therefore no benefits or costs associated with this proposal in itself. However, for those credit unions that would seek to make use of the greater flexibility provided in raising the interest rate cap, the following sections outline some potential benefits.

A.13 Given that the credit union sector is very diverse and the general lack of data available, this partial Regulatory Impact Assessment makes a number of assumptions in an attempt to illustrate the potential benefits of this option. Therefore, the following paragraphs on the potential impact for the credit union member and the credit union itself should be taken to be illustrative rather than definitive. The Government would welcome any further data or predictions from individual credit unions on the impact of any change for their credit union that would assist in refining the figures provided in this document.

Impact on the credit union member

A.14 In terms of the credit union member, raising the interest rate cap may make it more likely that low income consumers who were previously unable to borrow from a credit union and who were otherwise reliant on higher-cost alternatives will now more likely be offered a loan. The average APR for alternative lenders is known to be over 170%. The table below uses an example from a Co-operative Bank report¹⁸ to illustrate the cost of a loan from a doorstep lender¹⁹ compared to a loan from a credit union, charging various weekly rates. It shows that the total interest repayments on a loan of £400 from a doorstep lender generated interest repayments of £236 over 53 weeks. But if an individual were to borrow the same sum from a credit union at a rate of 2% a month, repayable over 53 weeks, the total repaid would be over £180 less. It is not possible to predict the extent to which credit unions would be more able to offer loans to low income consumers but the potential savings for such consumers may be significant.

Table A.1: Comparison of cost of £400 loans

Lender Type	Amount Borrowed	Amount to be repaid	Period in weeks	APR
Doorstep lender	400	£636.00	53	164.08%
Credit Union 1%	400	£425.41	53	12.68%
Credit Union 2%	400	£451.80	53	26.82%

A.15 Although it is the case that the cost of a loan would be more expensive than if the interest rate cap remained at 1%, the increase appears relatively marginal compared to the potential savings made than if the rate charged by an alternative lender applied. Furthermore, it is important to emphasise that, owing to the costs of and risk associated with serving low income consumers, loans charged at the 1% a month rate are often not available to such consumers.

Impact on the credit union

A.16 Using data provided by the Association of British Credit Unions Limited (ABCUL) trade body, which represents over two thirds of British credit unions, the following attempts to illustrate what impact the change might have for individual credit unions. However, and given that a large number of assumptions have been made, we would welcome further data or predictions from individual credit unions on the impact of the change for their credit union.

A.17 As outlined later, profits made on a loan will need to cover a range of important overheads if a credit union is to become sustainable. However, at a minimum and to break even, a credit union needs to ensure that the costs incurred in making a loan do not exceed the total interest payable on the loan. In looking at these costs, two key assumptions are made. Firstly, it is assumed that the credit union will employ a member of staff. Many credit unions are staffed by volunteers and therefore these costs will be lower. However, it is unclear whether a credit union staffed solely by volunteers would be able to expand their capacity sufficiently to serve greater numbers of low income consumers. Another key assumption made is that credit unions do not receive grant funding to assist in their work, though it is clear that many do. However, it is less clear how much credit unions can, or should, rely on grant funding to subsidise their operations. We would welcome views from respondents on both these points. In light of

¹⁸ Source: The 'Access to credit on a low income' report for the Co-operative Bank by Liverpool John Moores University (November 2001).

¹⁹ Also referred to as home credit companies, doorstep lenders provide small, short-term, unsecured cash loans, with weekly repayments traditionally collected from customers' homes by a network of agents.

this, the following seeks to identify the direct costs that may be incurred in making a loan to low income consumers:

- **Loan interview:** Not all credit unions interview loan applicants. However, where an applicant carries more potential risk, it is more likely that an interview would be carried out. This could be done by a volunteer of the credit union or a paid employee. Assuming that a member of staff earns £16,000 a year gross salary²⁰ and that only an hour is needed for an interview, it has been estimated that this would cost approximately £6.30. It may take longer to carry out an interview if this is accompanied with debt advice or discussion of a repayment plan.
- **Credit reference:** Where a credit check is made, which would appear to be more likely with first time loans and where there is a higher risk, this would appear to cost, at a minimum, £1.54 per online enquiry.²¹
- **Pre-Loan Administration:** Costs will be involved in assessing the application, recording the transaction and issuing the funds. Assuming that this is done by a manager of a credit union on a £32,000 salary and that only half an hour is needed to complete this administrative work, it has been estimated that this would also cost approximately £6.30.
- **Post-loan administration:** Costs will also be incurred in collection of repayments. Significant savings for the credit union can be made if repayment is reliable and by payroll deduction. However, in practice, credit unions lending to low income consumers will more likely be accepting repayments in cash, in small amounts and over the counter²². Each transaction may not last more than 5 minutes. However, for a loan being repaid weekly over a year, this would amount to 260 minutes or 4 hours and 20 minutes of a staff member's time. It has been estimated that this would cost approximately £27.30 per loan. For a loan repaid over 6 months, the cost would be £13.65.

A.18 Taking these costs into account, the total direct cost of a loan repaid weekly over 6 months can be estimated as being £27.79 and over 12 months as being £41.44. Other costs – such as loan protection insurance (which is mandatory for many credit unions) will also add to the total cost in making a loan but, for simplicity, are not included here.

Table A.2: Lending costs on a loan repaid over 6 and 12 months

	6 Months	12 Months
Loan interview	£6.30	£6.30
Pre loan administration	£6.30	£6.30
Credit check	£1.54	£1.54
Post loan administration	£13.65	£27.30
Total	£27.79	£41.44

²⁰ When actual net salary (following deductions for, for example, National Insurance and pensions) is taken into account, labour costs will likely be higher.

²¹ This rate applies to credit unions that are affiliated with ABCUL.

²² Payments may also be accepted through Paypoint payment cards or through the Post Office. ABCUL estimate that this would result in additional transaction costs of £24.

A.19 It is equally difficult to generalise about the total interest payable that a credit union might charge on a loan, given that this will be dependent on the amount offered and the length and form of the repayment periods. However, the table below shows figures provided by ABCUL for the total interest payable on loans of £500 and £1000 over 6 and 12 month periods. It also shows the profit/loss this would generate, if it is assumed that lending costs are £27.79 for a loan repaid over 6 months and £41.44 for a loan repaid over a year.

Table A.3: Total interest payable for various loans

Total interest payable				
Loan rate	£500 over 6 months	£500 over 12 months	£1000 over 6 months	£1000 over 12 months
1% a month	£15.72	£31.16	£31.45	£62.35
1.5% a month	£23.69	£47.18	£47.40	£94.41
2% a month	£31.74	£63.53	£63.49	£127.06
Profit/loss				
Loan rate	£500 over 6 months	£500 over 12 months	£1000 over 6 months	£1000 over 12 months
1% a month	-£12.07	-£10.28	£3.66	£20.91
1.5% a month	-£4.10	£5.74	£19.61	£52.97
2% a month	£3.95	£22.09	£35.70	£85.62

A.20 Credit unions are clearly more likely to recoup greater sums on loans if the loan is for a longer period of time and for larger sums of money. However, research indicates that low income consumers prefer to borrow small sums of money for relatively small periods of time such as six months. According to these figures, on a loan of £500 repayable over six months, a credit union would make a small profit of £3.95 on a 2% loan, compared with a loss of £12.07 under the existing cap.

A.21 These figures obviously need to be treated with caution. As well as the assumptions made and highlighted earlier, counterbalancing these figures are the observations that the lending portfolio of a credit union may allow for economies of scale. Furthermore, many credit unions may be able to cross-subsidise profits made on larger loans to offer less profitable or loss-making loans to the wider community. On the other hand, it is important to remember that the profit on a loan must also cover overheads; simply being able to cover the direct lending costs will obviously be insufficient. One important overhead is the cost involved in credit control; following up defaults on loan repayments and rescheduling the loan. It would not be unreasonable to speculate that the cost of this particular overhead would increase were credit unions to take on potentially riskier loans. There are also other important overheads to consider such as dividends repayable on savings (a factor recognised as increasingly important to establishing sustainable credit unions), office premises and maintenance, marketing, insurance, FSA fees, staff/volunteer training and so on. The Government would welcome any figures from the sector on the extent to which profits made on a loan must also cover overheads, as well as direct lending costs. However, when these overheads are taken into account, a lower interest rate cap may make it more difficult for a credit union to serve low income consumers whilst investing towards future sustainability.

4. COSTS

Option A

A.22 There will be no direct financial costs associated with not raising the interest rate cap for credit unions. The long term indirect costs may be regarded as the lost benefits of not pursuing option B, that credit unions may be unable to play a long-term sustainable role in providing a source of affordable credit, potentially resulting in low income consumers having to borrow at higher rates from alternative lenders.

Option B

A.23 Through option B, credit unions are given greater flexibility to charge marginally higher rates on loans to members. It is possible that loans might become more expensive in general for existing credit union members. This is particularly the case if administrative costs for a credit union in selecting an interest rate to apply to different members, according to an assessment of the risk involved, proves to be costly and credit unions instead opt for administrative simplicity. As is it difficult to quantify this risk, the Government would welcome views on the potential administrative costs associated with charging variable rates.

A.24 Raising the interest rate cap also raises the possibility that credit unions will come to adopt more diverse lending portfolios, composed of 'riskier' loans than before. Such loans may come with a greater risk of default and delinquency although there will be greater compensating income to cover this. Credit unions are currently required to comply with a number of provisioning and capital requirements, as outlined in CRED, the FSA rulebook for credit unions. If loan delinquency rates were to rise, credit unions would, under the existing requirements, have to make higher provisions for loss. In making such provisions, this may have an impact on a credit union's profitability and ability to meet the FSA's capital requirements. If the rise in loan arrears became significant this poses an ultimate risk that a credit union may become insolvent. It is difficult to predict the significance of this potential risk and to quantify the costs associated with the risk of greater loan delinquency in the absence of practical experience on how the proposal is being implemented. Consultation respondents have therefore been asked to provide views on the likeliness of this risk and what costs it may impose.

5. EQUITY AND FAIRNESS

A.25 As the proposal is permissive, we do not consider that the proposal in itself will bring any disproportionate benefits or have disproportionate effects on particular credit unions.

6. CONSULTATION WITH SMALL BUSINESS

A.26 Although there are some potential risks that are difficult to quantify without practical experience, it does not appear that this proposal would have a negative impact on small business. Indeed, the proposal will better enable smaller credit unions to be a sustainable source of affordable credit to low income consumers by giving them greater flexibility to charge interest rates on loans that allow them to recoup their lending costs. The Small Business Service is content that a Small Firms Impact Test is not needed for this partial Regulatory Impact Assessment. However, we would welcome views of small businesses and their representative organisations on this point as part of the formal consultation process.

7. COMPETITION ASSESSMENT

A.27 Credit unions are a source of credit in a market with a wide range of providers. This competition analysis has focused on credit unions and the alternative lending market given that the aim of the proposal is to better enable credit unions to be a source of affordable credit and to offer loans to individuals who are generally not able to access mainstream sources of credit and who would otherwise have been reliant on high-cost alternatives.

A.28 There are a range of credit sources available to low income households, including:

- Home credit companies / Doorstep lenders: provide small, short-term, unsecured cash loans with weekly repayments traditionally collected from customers' homes by a network of agents.
- Sale and buyback shops: buy second hand goods and give the seller the option to buy them back after 28 days at a higher price.
- Mail order catalogues: provide a wide range of goods on credit and often operate through a network of credit-assessed agents, on commission, who either buy for themselves or for a number of customers. Customers can make small weekly or monthly payments over a set period.

A.29 A competition filter test was performed and it was agreed that a more detailed assessment is not necessary given that the competition implications do not appear to be serious. For example, no individual credit union, as far as the Government is aware, occupies more than 10% market share of the alternative lending market. Furthermore, it was not considered that the proposal would restrict the ability of firms to choose the price, quality, range or location of their products or lead to higher set-up costs for new or potential firms. Indeed, it was considered that any impact on competition may be positive in enabling credit unions to compete more effectively with alternative providers and to the benefit of low income consumers who may otherwise be dependent on high cost alternatives.

8. ENFORCEMENT AND SANCTIONS

A.30 Credit unions are currently subject to a number of regulatory requirements, compliance with which is monitored by the FSA. The proposal to raise the interest rate cap is in itself permissive and does not come with any new regulatory requirements.

9. MONITORING AND REVIEW

A.31 The Government would consider what, if any, mechanisms are needed to monitor the ongoing effectiveness of the proposal to raise the interest rate cap in light of consultation responses. At the very minimum, however, if legislation was put forward, the Government would expect to carry out a review after two years. This would allow sufficient time for the effects of any legislation to be realised and understood.

10. CONSULTATION

Within Government **A.32** HM Treasury has consulted with the FSA, the Department for Trade and Industry and the Small Business Service.

Public consultation **A.33** On 16 March 2005, HM Treasury published a consultation document on the credit union interest rate cap. The consultation document is available on the HM Treasury's website and printed copies are available on request. The deadline for comments is 16 June 2005.

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