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Dear Stephen Sweeney

FINANCIAL SERVICES COMPENSATION SCHEME (FSCS) EXTRAORDINARY LEVY ON THE DEPOSIT-TAKING CLASS

As you may be aware, since my meeting with the Scottish League of Credit Unions on 18 November 2009, a number of credit unions and their members have written to the Treasury with questions about this levy and about the FSCS more widely. I am therefore publishing this letter on the Treasury website (www.hm-treasury.gov.uk) to provide information for the sector as a whole, including some information relevant to the establishment of a separate subclass for credit unions within the FSCS levy structure.

The Government recognises the important work done by credit union volunteers, and is committed to ensuring that the mutuals sector in the UK remains thriving and vibrant. Since 2005 the Government has committed £80m to a financial inclusion growth fund that has enabled third-sector lenders such as credit unions to make over 160,000 affordable loans to financially-excluded customers. At Budget 2009 the Government made available an extra £18.75m that will enable another 85,000 loans to be made in the next two years.

An important part of ensuring the security of the mutuals sector, and indeed the financial services sector as a whole, is the provision of properly-funded deposit guarantee arrangements, to ensure that depositors can receive compensation if a firm is unable, or likely to be unable, to pay claims against it. Accordingly, the FSCS is the UK's statutory fund of last resort for customers of authorised financial services firms. Under the current rules, eligible claimants (including members of credit unions) are eligible for up to £50,000 compensation in the event of failure of each authorised deposit taker.

The FSCS is funded by levies on authorised firms. These levies are allocated according to rules made by the Financial Services Authority (FSA), which are set out in the FEES



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section of the FSA handbook. Under the current arrangements, credit unions fall within the deposits class, along with banks and building societies. This means that where a credit union fails, the whole deposit-taking class is levied in order to pay compensation to the members of the credit union. Similarly, where a bank or building society fails, the whole deposit-taking class will be levied. In all circumstances, the contribution required of credit unions is in proportion to their small size within the class.

As you are aware, sums are currently being levied on the deposit-taking class as a result of the five banking defaults that occurred in 2008. Arising from those defaults, the Government had to make loans to the FSCS to ensure that depositors could be compensated or otherwise protected. Levies are raised to meet the annual interest costs of those loans.

The Scottish League of Credit Union (SLCU) has expressed concerns about the impact of these additional levies on credit unions, and more widely about the appropriateness of the current levy structure. I understand that SLCU are proposing the establishment in 2011 of a new credit union subclass, with a low threshold for cross-subsidy, and an assurance that after the establishment of this subclass, credit unions would have no further liability to contribute to levies in respect of the bank and building society defaults of 2008-2009. Further, under this system the SLCU suggests that credit unions' liability to contribute under the current FSCS levy structure would be capped at £1m.

This letter sets out information relevant to some of the specific points that the SLCU and others have raised. However, at the outset I would emphasise that revision of the levy structure, and any transitional arrangements in the event of such a revision, are a matter for the FSA, which is independent of Government. The FSA is carrying out a review of the funding arrangements of the FSCS. Credit unions and their representative bodies may, if they wish, respond to that consultation to express their views and give evidence as to the suitability of the current arrangements. The FSA would also be happy to receive any representations from the SLCU early in the process so their views can be taken into account when developing any proposals.

The FSA consulted in 2007 on allocation of FSCS levies between different classes of firms. As a result of this consultation, five classes of levy-payers were defined: deposit-takers, general insurance, life and pensions, investments and home finance. At the outset of the consultation, the FSA proposed establishing a separate sub-class for credit unions within the deposit-takers class, with a £500,000 annual threshold. The FSA felt that setting a suitably low threshold for the sub-class would give a degree of protection for credit unions, while ensuring that they would receive appropriate levels of cross-subsidy from banks and building societies in the event of defaults in the credit union sector. At the time, the majority of credit unions responding to the consultation disagreed with this proposal, arguing that this would be unfair and would lead to significant additional costs. They also argued that the potential contribution costs in a



separate sub-class would be unaffordable, unsustainable and unfair given their non-profit making status. It was argued that the financial impact could be significant, and that the approach would be inconsistent with the Treasury's policy of encouraging support of the credit union sector by banks and building societies, as part of a wider policy of financial inclusion. On this basis, these credit unions confirmed that they would prefer to remain part of a single deposits class. This is discussed in more detail in paragraphs 3.29 – 3.32 of the FSA's paper FSCS Funding Review (November 2007) (32 PS07/19), which is available from the FSA website (www.fsa.gov.uk). On this basis, the FSA accepted the position expressed by credit unions and maintained a single broad deposits class.

Clearly, whatever the structure of the FSCS levy, there will be risks and benefits. Under the current levy structure, the amounts paid out by the FSCS to customers of credit unions have significantly exceeded the contributions that are being levied on the sector. Over the last four years, the FSCS has paid out over £3m to customers of failed credit unions. During financial year 2008/09, three credit unions failed, resulting in FSCS payouts to their members of around £200,000. As credit unions are part of the general deposits class, this sum was raised through levies on deposit takers as a whole: credit unions' share of this was around £100 (0.05% of the total). The credit unions' share of the levy arising from the banking defaults amounted to about £192,000. The overall amount levied on credit unions has therefore been substantially less than the FSCS compensation paid out to credit union members. And during the first half of this financial year, a further six credit unions failed resulting in FSCS payouts to their customers of more than £250,000.

Credit unions will also be liable to contribute to payment of the outstanding principal of the loans made to the FSCS by the Government, after recoveries received. As set out in the letter from Thomas Huertas and Loretta Minghella to trade bodies of 29 July 2009, to the extent that the Facilities have not been repaid in full by 31 March 2012, HM Treasury and the FSCS will agree amortisation schedules in respect of the Facilities and the principal will be payable on the basis of those schedules. FSCS will levy accordingly. The size of the levy cannot be calculated at the moment, but the amount that credit unions will be required to pay will be in proportion to their small size within the deposit-taking sector, consistent with previous levies.

I would also like to take this opportunity to set out the Government's position on a number of other points that have been raised by credit unions and their representatives around the FSCS levy.

First, it has been suggested that the extraordinary levy is comparable to an additional tax on credit unions. However, FSCS levies are not collected by or on behalf of the Government: the FSCS is independent, and is wholly funded by industry for the purposes of compensating or otherwise protecting depositors. The credit union movement and



the financial services industry as a whole benefits from the increased confidence this provides. As explained above, credit union customers have been net beneficiaries of the FSCS.

Second, it has been suggested that the current levy structure leads to 'double counting' of credit union members' monies for the purposes of calculating the levy, as some credit unions hold a proportion of their funds in banks or building societies, and these banks and building societies themselves pay FSCS levies, based on the amount of protected deposits. However, credit unions are eligible claimants under the FSCS, provided they meet the eligibility criteria. In the event of a bank or building society failure, the FSCS may pay compensation to credit unions that had monies deposited in the firm, which is paid for by their bank or building society in their contributions to the levy. Members of credit unions are themselves FSCS eligible, and similarly it is appropriate that credit unions should be liable to pay FSCS levies. This does not amount to 'double counting'.

Third, some have argued that credit unions should be regulated by the Registrar of Friendly Societies, as was the case prior to the establishment of the FSA in 2001. The Government believes that the transfer in 2001 of the functions of the Registry of Friendly Societies to a single financial regulatory body, the FSA, was and remains the right approach. As I have noted, the FSA consults closely with credit unions when it makes changes that may affect them, for example when it sets the levy structure.

Finally, some have expressed a view that the FSA should supervise credit unions more closely. However, even given very close supervision it is inevitable that some credit unions will fail. The existence of the FSCS means that when this happens, members of credit unions can be confident that they will be compensated up to the FSCS compensation limit (currently £50,000).

I hope you find this information useful.

Kind regards

Sarah McCarthy-Fry

SARAH MCCARTHY-FRY MP