



Financial stability and depositor protection – strengthening the framework

**Response to the Tripartite authorities from the
Association of British Credit Unions Limited (ABCUL)**

April 2008

Introduction

The Association of British Credit Unions Ltd (ABCUL) welcomes the opportunity to respond to this consultation on behalf of our members. ABCUL is the main trade association for credit unions in England, Scotland and Wales. ABCUL represents around 70% of the 513 credit unions throughout England, Scotland and Wales and ABCUL members serve approximately 85% of credit union members.

According to unaudited figures from the Financial Services Authority, in September 2006, credit union members held savings of over £428 million and were borrowing over £363 million from their credit unions.

ABCUL, like its member credit unions, is an Industrial and Provident Society. It is a co-operative owned and controlled by its members. ABCUL is the only British member of the World Council of Credit Unions, the world wide apex body whose members represent 172,000,000 members of 46,000 Credit Unions in 97 countries.

Over the last eight years the Association has played a leading role in reforming and modernising the credit union movement in Britain. As a result the credit union movement is now adopting models of development and offering a range of products which has dramatically improved the scale of many credit unions. Credit unions aim to provide inclusive financial services in the communities and/or workplaces they serve. As a result they offer much more affordable, short term credit and small scale savings products than many other financial services providers and don't aim to serve only the more profitable end of the market. As not-for-profit organisations they invest any surplus in reserves to strengthen the business, in developing services for members or to pay a dividend on members' savings.

Credit union membership has almost doubled since 2002 and British credit unions now serve over 600,000 adult members and 80,000 junior members.

We understand that many of the proposals contained in the consultation document are not aimed at credit unions as their small scale means that failure will not affect overall financial stability.

We do have concerns that there are a number of proposals in the consultation document that will not have an impact on the safety of credit unions or deposits held in them, but will have a negative impact on the financial viability and sustainability of credit unions and their ability to offer affordable credit and a reasonable return on savings to their members. Our response concentrates on the areas that we believe may affect credit unions and their members.

We would be very pleased to provide further information or clarification on any part of this response.

Consultation Questions

Chapter 4 – Special Resolution Regime

- The Consultation Document proposes that credit unions should not be included in a Special Resolution Regime for the time being. We understand that the regime would be used if financial stability is under threat and has not been designed to manage problems in smaller deposit takers, such as credit unions.
- Credit unions will not benefit from a contribution by the FSCS to the running costs of a Special Resolution Regime, yet, as long as contribution groups remain the same, will pay towards this.
- We are keen to see a reduction in the amount of failing credit unions and will be producing a discussion paper which will contain a number of suggestions for reducing the number of failing credit unions. These suggestions will include the following: _
 - The reform of credit union legislation in relation to common bonds. The Government has already pledged a commitment to relaxing common bond requirements for credit unions. We have argued that this is important not only to increase access to credit unions, but also to reduce the amount of failing credit unions by increasing the feasibility of mergers to prevent credit union closure. Allowing credit unions to operate a restricted membership policy but with a range of different groups within its membership also allows a credit union to spread the risk and makes it more able to cope should a local event (such as the closure of a local employer) leads to a financial downturn for members.
 - Improved use of supervisory tools, such as annual returns, by the FSA.
 - A stabilisation fund for credit unions to enable struggling credit unions to benefit from short term funding and assistance to improve governance and management to enable it to continue trading or reach a position where it can transfer assets to another credit union.
- Any costs borne by credit unions towards a Special Resolution Regime which they would not benefit from could reduce the sustainability of credit unions and their ability to take actions to increase safety within the sector.
- Funding arrangements for the SRR should not involve credit unions if they are not to benefit from it.

Chapter Five - Consumer Confidence and Compensation Arrangements

Question 5.1 – How would a higher compensation limit affect consumer confidence?

- For credit union members, we do not believe that a higher compensation limit would affect consumer confidence. The vast majority of credit unions cannot accept deposits above the current £35,000 limit. Those that are able to accept deposits of that size have very few, if any, members whose savings would breach the current limit.
- Credit unions are proud of their inclusion in the FSCS and they communicate this enthusiastically to their members. Research showing that consumers are, in the main, unaware of compensation limits would suggest that the problem is not that the limit is too low but that there is a low awareness of what the limits are. If efforts were taken by all deposit takers to make people more aware of limits then consumers with high levels of savings would be able to take positive action to ensure all their savings were safe.

Question 5.3 – How would a higher compensation limit affect consumer perception of other financial products?

- As we perceive many of the plans for scaling up the capacity of the FSCS to have little relevance to the increased safety of credit unions, we have considered how a two-tier system would affect credit unions and public confidence in the sector.
- “Your money is as safe as it would be in a bank or building society” is an easy to understand and easy to communicate message which credit unions can pass on to members and potential members. This message coupled with provisos about different compensation limits, time frame etc could have the potential to cause confusion and raise questions in the eyes of consumers. We would be very keen to have a simple parity between all deposit takers in terms of arrangements for compensation.
- If credit unions are to be able to carry on providing inclusive financial services to increasing numbers of people, and assist the Government with their work towards financial inclusion, they need to attract increasing numbers of savers. The Government’s response to the first stage of the review of credit union legislation accepts the need for credit unions to serve more affluent members and accepts the case for some credit unions to be able to choose to pay interest on deposits, rather than a retrospective dividend. This will help credit unions attract deposits from more sophisticated savers – something they need to do in order to be able to make more affordable credit available. A separate regime for deposits held in credit unions may hamper credit unions’ ability to attract savings in this way and restrict their growth.

Question 5.7 – What are your views on a one-week target for FSCS payment.

- Credit union members are unlikely to gain significantly from changes in scale designed to allow a payout within 7 days. The proficiency of the FSCS's staff, coupled with the relative simplicity of credit union records, means that members can receive a payout as early as 9 days after a credit union has been declared in default, even allowing for a member having to submit a claim for their savings and for an offset to be calculated.
- We are concerned however, that any scaling up of the FSCS to enable such a target to be achieved would result in higher costs for credit unions for the compensation scheme.

Question 5.9 – Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques.

- Pre-payment cards may provide an alternative solution as money would be instantly available to the consumer once they received their card. These are becoming increasingly common in the UK not just for the gift voucher market but for local authorities and charities wanting to make payments safely and securely to customers and beneficiaries.

Question 5.10 – How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week?

- This could be invaluable, especially to lower income consumers and people who have no second account which they would be able to access if their main financial services provider collapsed.

Question 5.18 – What are your views on the link between FSCS gross payment and set-off?
and

Question 5.20 – What are your views on the removal of the formal claims process? What risks would be involved in the FSCS automatically sending out cheques and how can they be mitigated?

- We understand the reasons why gross payout is being considered, but we would like to raise the suggestion that, when handling credit union defaults, this may not be the most efficient way to operate.
- Large numbers of credit union members, especially in less modernised credit unions which, it could be argued, are more at risk of insolvency, use their savings as informal security, even on unsecured loans. Some credit unions still require members to save before they borrow and their loan policies only allow credit to be granted in certain multiples of the amount saved. A lien may be held over the savings while a loan is outstanding, and the depositor understands that their savings are being used in this way.
- It is possible therefore that this change could increase the collection costs and write-offs for the FSCS as it works to recoup money it has paid out to

members of a failing credit union. The FSCS would be able to assess the scale of such an issue based on historic defaults.

- Low income consumers who may not find it easy to quickly open another account to pay a cheque into may fall into the trap of using a cheque cashing agency and lose some of their savings through high rates of commission. This could potentially put them at severe economic disadvantage as they would lose money on savings through high commission from a cheque cashing service and face subsequent demands for payment of a loan which they perceived as being secured against their loan (if the credit union operated in this fashion).

Question 5.21 – What are your views on the introduction of an element of pre-funding into the FSCS?

- Introducing an element of pre-funding into the FSCS to increase its capacity could, if introduced in a relatively short space of time, put financial pressures on credit unions to such an extent that they could become unviable and at risk of closure.

Using the latest published full credit union statistics from the FSA (taken from 2005 annual returns) we have calculated that an upfront charge of 1.5% of deposits would represent: -

- **140%** of the amount transferred to reserves in that year
 - **167%** of the amount paid out in dividends to members in that year
 - **13%** of the total capital in the movement (this proportion would be much higher for newer credit unions).
- Even if a contribution of 1.5% of protected deposits were to be paid over a few years, this element of pre-funding would still have a drastic effect on the sustainability and viability of credit unions. If credit unions are required to pay such a proportion of capital towards a pre-funded scheme the following negative effects could be seen: -
 - reduction in capital leading to inability to provide a wider range of services to their members
 - reduction in credit union's ability to pay returns on savings leading to a reduction in deposits in the credit union and a consequent reduction in affordable credit to the community the credit union serves
 - decreased sustainability of credit unions and increased risk of credit unions failing
 - Unlike other sectors involved in deposit taking in the UK, credit unions are still developing; new credit unions are being formed and many credit unions which are successfully tackling financial exclusion in credit unions around the country have been formed within the last five years and still have low levels of capital. There are also gaps in credit union coverage and the appetite around the country to fill these gaps. While some gaps will be filled by existing credit unions expanding, it is likely that new credit unions will continue to be created

for some years to come. New credit unions start with virtually no capital and would struggle if they had to contribute to such a pre-funded FSCS.

- Credit unions, especially young credit unions, already find it difficult to build capital and achieve a capital asset ratio sufficient for them to be able to apply to be a Version 2 credit union. A Version 2 credit union is able to offer a wider range of products to its members, attract more members and have more of an impact on its community. The extra expenditure necessitated by the contribution to a pre-funded scheme would make it even less likely that credit unions could successfully make the transition to Version 2.

Question 5.30 – What would be the best way for DWP and HMRC to make payments in the event that consumers did not have access to their bank accounts?

- In the small number of cases where credit unions which have been accepting direct benefit payments have been declared in default, benefit agencies have, we understand, paid recipients by giro-cheque. The much larger scale of a bank failure would of course cause problems of scale but we understand that this has worked quite smoothly when credit union members have lost access to their account and therefore their benefits.

Question 5.31 – What are your views on the proposed changes to increase FSCS management flexibility?

- Members of failing credit unions are unlikely to benefit from a scaling up of the FSCS to increase capacity in the event of the failure of a major bank or building society but we are concerned that they will have to pay their share of the increased management costs for such a scaling up.
- We should also remember that in the case of credit unions the cost of returning deposits is small compared to the management costs of the FSCS in administering that return.

Question 5.33 – What are your views on the use of risk-based levies or on the introduction of behavioural factors on the calculation of levies?

- This raises concerns that credit unions – as the only deposit takers which have had the need to call upon the compensation scheme in recent years – would be penalised for what they couldn't have prevented.
- The vast majority of credit unions are solvent and do not pose a risk; the credit union movement is growing and is taking many internal steps to increase its safety and sustainability. With a lack of up to date information on credit unions available from the FSA it would be extremely difficult to calculate levies based on risk for individual credit unions. It would be unfair for all credit unions to bear the cost of flawed development models and inadequate regulation which has led to the collapse of a small number of inefficient credit unions.

Conclusion

- We understand that the consultation paper is seeking solutions to scenarios which are far bigger than the collapse of a small number of credit unions and that proposals have not been designed with credit unions in mind.
- As we see the current proposals, credit unions will face the burden of cost of a scaled up FSCS and the costs of a Special Resolution Regime which they and their members will not benefit from. This does not seem to us to be fair or proportionate.
- Members of failing credit unions are unlikely to benefit from a scaling up of the FSCS to increase capacity in the event of the failure of a major bank or building society, or speed up the process for payout; they are unlikely to benefit from a rise in the level of compensation but they will have to pay their share of the increased costs through decreased dividends on their savings and/or a decrease in the availability of affordable credit.
- Introducing an element of pre-funding to the FSCS could have a drastic effect on credit unions ability to provide inclusive and sustainable financial services to the communities and workplaces in which they operate.
- Whilst this consultation is taking place and a review of credit union legislation is also taking place at HM Treasury, we believe this is an ideal opportunity to discuss ways in which the safety and sustainability of credit unions can be improved.
- Over the coming months we are planning on producing a discussion paper on these issues which will include these and other suggestions for reducing the number of credit unions being declared in default by the FSCS.
 - flexible common bond to allow more mergers and rescues
 - better regulation from FSA in terms of reporting standards
 - considering the total cost of the FSCS for credit union failure and whether that could have been better used in terms of mergers.