

The credit union interest rate cap: a summary of consultation responses

May 2006



HM TREASURY



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a summary of
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INTRODUCTION

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

1.2 Credit unions are mutual financial organisations, offering savings and loans facilities to their members. 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
- 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.

1.3 In addition, it was 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.”

1.4 The consultation document was published on 16 March 2005, and responses were invited by 16 June 2005.

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SUMMARY OF RESPONSES

2.1 There were 40 responses to the consultation, which closed on 16 June 2005. Responses were received from a large number of credit unions and credit union trade associations, a number of consumer groups, and the Financial Inclusion Taskforce. A full list of consultation respondents is provided at Annex A.

2.2 31 of the 40 respondents were in favour of raising or removing the interest rate cap. Of these, 21 were in favour of a cap at 2% per month, 3 favoured a cap at 2.5 or 3% per month, and 7 supported the removal of the cap altogether. The main reasons cited in support of raising or removing the cap were:

- Easier to lend to the financially excluded by developing a more risk-based approach
- Possibility of offering instant loans to new members (i.e. removing the requirement to save before borrowing)
- Greater flexibility for credit unions to adjust to a high interest rate environment
- A level playing field with other financial institutions

2.3 8 respondents opposed a raising of the cap. The main reason cited in these cases generally focussed on the threat to the ethos of the credit union movement.

2.4 A number of other points were raised by respondents:

- Almost all the respondents were opposed to the credit union membership having a vote to approve raising the cap. Rather such a decision should be taken by the Boards.
- Many respondents were concerned that raising the cap might result in credit unions losing their exemption from the Consumer Credit Act.
- A number of respondents suggested that raising the interest rate cap for lending should be coupled with raising the 8% cap on dividends so as to better enable credit unions to balance cash flow.
- The Financial Inclusion Taskforce recommended that raising the cap should be combined with the financial education of credit union staff to enable risk-based pricing.

Government Response

2.5 As announced at the 2005 Pre-Budget Report, to give flexibility to better serve low-income groups, and following consultation, the maximum rate of interest that credit unions can charge on loans will be increased from 1 per cent a month to 2 per cent a month.

Implementation

2.6 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 legislation. The procedure is a statutory instrument made by negative resolution. Draft regulations

will be laid before Parliament and will become law if no objection has been raised by MPs or Peers within a 21 day period. It is anticipated that the change can be implemented in April 2006.

3

SPECIFIC COMMENTS

QUESTION 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?

3.1 The majority of respondents were of the view that raising the cap would enhance the ability of credit unions to lend to the financially excluded, by

- Facilitating a more risked-based approach to lending.
- Allowing credit unions to dispense with savings requirements, and offer 'instant loans'.
- Enhancing the ability of credit unions to build bad debt reserves.
- Allowing credit unions to offer more attractive terms to savers.

3.2 A small number of credit unions responding felt they would not change who they lent to. A variety of reasons were offered:

- Already serve those on the lowest incomes
- All members should be charged the same rate
- A rise in the cap now might lead to demands for further cap rises in the future
- Credit Unions would still not be able to compete with the doorstep service offered by home credit companies

3.3 Only one respondent felt that the effect of raising the cap would be that the poorest would pay more for their loans.

The Government Response

3.4 The Government considers that the current level of the interest rate cap is a restriction for some credit unions in providing affordable loans to those on the lowest incomes. Raising the cap will enable credit unions to better manage the costs and risks of these loans, and the Government hopes that credit unions will use the new flexibility to dispense with requirements to save before borrowing and extend their reach to those in the greatest need of affordable loans.

QUESTION 2

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

3.5 A majority of the respondents (21) were of the view that raising the interest rate cap would have a positive effect on the sustainability of credit unions, by:

- Enabling them to charge more realistic rates that cover the costs of providing small high-risk loans.
- Allowing credit unions to generate more income and reduce dependency on grants.
- Increasing flexibility and the capacity to manage risk.

3.6 Six respondents raised concerns that raising the interest rate cap would not guarantee sustainability for the sector. The reasons cited were:

- The costs associated with small value loans in deprived communities mean that grant funding will always be necessary
- High-risk loans could wipe out any surpluses
- A cap rise would equate to a compromise of principles

The Government Response

3.7 The Government considers there to be strong evidence that, by allowing credit unions to meet the cost of administering small-value loans, a rise in the interest rate cap to 2% a month will make it easier for credit unions committed to serving those on the lowest incomes to achieve sustainability. In addition the Government has established a £36 million Growth Fund for credit unions and other third sector lenders designed to enhance the sustainability of successfully bidding institutions by providing capital and revenue support that will allow them to operate greater loan volumes.

QUESTION 3

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

3.8 Some respondents felt that a cap rise could potentially lead to major changes in the lending practices of credit unions. For example, according to ABCUL, the ability to charge higher risk loans combined with education will give many more credit unions the ability to take those risks, and offer instant access loans.

3.9 Individual credit unions responding to the consultation were evenly split on whether their own lending practices would change. Some credit unions felt they would be able to develop a range of tailored products, offering differing loans to different borrowers. Set against this, one respondent was concerned that negative press reporting of a 100% rate increase would threaten the credibility of credit unions. Another felt the effect of raising the cap would be to make credit unions 'too much like banks' with a confusing variety of different loan structures.

The Government Response

3.10 The Government considers that raising the interest rate cap will enhance the flexibility of credit unions to offer loans to those in the greatest need. Traditionally credit unions have insisted on members' building savings records before they can access loans, and this has tended to restrict access to affordable credit for those with an immediate need. This measure will complement recent moves in the sector towards the pricing of loans according to the level of risk. There is no obligation on any individual

credit union to change their business and lending practices if they do not wish to do so as the legislation is entirely permissive.

QUESTION 4

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

3.11 Three main additional benefits were stressed by respondents (in order of frequency):

- Credit unions will have a greater level of protection should interest rates rise
- Removing the cap would increase the cash-flow of credit unions and enable them to offer more attractive returns on savings
- A raised cap would create a level playing field with the rest of the financial sector.

The Government Response

3.12 The Government notes the additional benefits identified by respondents to the consultation.

QUESTION 5

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

3.13 A considerable majority of respondents did not feel that a cap rise would result in existing customers paying more for their loans. Rather the more expensive loans would largely be for new customers who may be considered too high risk to lend to under the existing cap.

3.14 ABCUL's response stated that their role as a trade association would be to educate members how to use and manage the increased flexibility. They calculate that increasing the interest rate on a £400 loan to 2% a month would add just 50p a week to repayments. The risk that credit unions would raise their interest rates across the board was considered by most respondents to be very low.

3.15 Only one credit union was of the view that the rate rise would be a serious problem for existing credit union members who would have to repay more on their existing loans, though several other respondents considered it likely that interest rates would go up on small loans where administrative costs are high.

The Government Response

3.16 The Government recognises the concerns of some in the sector that existing customers may face higher charges on loans as a result of this change. The Government expects that credit unions will use the new flexibility to expand their membership and does not expect the measure to have any significant effect on the rates charged to existing members.

QUESTION 6

How serious is the risk of greater loan delinquency?

3.17 According to ABCUL, if credit unions continue with lending practices based on share multiples, then there would be no greater risk of loan delinquency. If they offered instant loans on the basis of ability to repay, as demonstrated under the PEARLS project, then loan delinquency should fall. Since credit unions would be able to offer a choice of loans, they would make a greater assessment of risk in order to decide appropriate loan rates.

3.18 A number of credit unions felt that since more expensive loans would be made, there could be a higher risk of default. For example, one credit union felt past experience indicated that lending to those on lower incomes leads to greater delinquency rates, and cited the fact that debt counselling agencies advise debts to be repaid in terms of priority, with credit unions being a very low priority. However, a large majority of respondents felt that the major factor in determining delinquency rates was not the rate of the lending cap itself, but rather the lending practices of credit unions, and measures taken to manage risk.

The Government Response

3.19 The Government considers there to be a low risk that this measure will impact on the loan delinquency rates of credit unions. The Government supports developments towards more commercial lending practices in the sector, and recognises the success of PEARLS in lowering delinquency rates for participating institutions. It is hoped that credit union trade associations can further encourage best practice in the sector in lending responsibly and managing delinquency.

QUESTION 7

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

3.20 ABCUL are of the view that there should be no operational risk as only credit unions that wish to use the flexibility need to increase their interest rate. Rather the only real risk is the maintenance of the exemption of credit unions from the Consumer Credit Act.

3.21 The consumer groups who responded did not identify any additional risks. A significant number of credit unions responding did identify reputational concerns, and the potential for bad press if credit unions begin to charge higher rates. As one respondent put it, rise in the cap could potentially jeopardise the image of credit unions as low cost lenders. Another respondent thought the potential threat to the ethos of the credit union movement could best be handled by producing educational material on risk management for less experienced credit unions.

3.22 Some respondents discussed market impacts of a rise in the cap. One respondent was concerned that the ability to vary rates might lead to competition amongst credit unions. And in their response, the Financial Inclusion Taskforce envisaged the potential for greater consolidation in the market resulting from the cap

rise. However, this would not be a problem provided the remaining credit unions served more people overall.

The Government Response

3.23 The Government notes the risks identified by respondents to the consultation. The Government will work with the sector to ensure that the rationale for this measure is clearly presented, and to ensure that an increase in the level of the cap does not result in unmanageable administrative burden through loss of CCA exemption.

QUESTION 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?

3.24 Very few respondents (4) to the consultation viewed a vote held by the membership as an effective way of mitigating risk. Arguments against holding a vote (15 respondents) included:

- The time and cost of such an exercise
- A vote would undermine the authority of the board
- The membership could not be expected to fully understand the issues involved

3.25 With one or two exceptions, there was a consensus that boards of credit unions were far better placed to take decisions on raising lending rates than the membership.

The Government Response

3.26 The Government recognises the strong support of the sector for decisions on interest rates to be taken by the boards of credit unions rather than by votes amongst the membership, and will not require any credit union intending to change its lending practices to hold a vote.

QUESTION 9

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

- a) do nothing
- b) raise the cap to 2% a month
- c) raise the cap beyond 2% a month (if so, to what level)

3.27 31 of the 40 respondents were in favour of raising or removing the interest rate cap. Of these, 21 were in favour of a cap at 2% per month, 3 favoured a cap at 2.5 or 3% per month, and 7 supported the removal of the cap altogether. The main reasons cited in support of raising or removing the cap were:

- Easier to lend to the financially excluded by developing a more risk-based approach

- Possibility of offering instant loans to new members (i.e. removing the savings requirement)
- Greater flexibility for credit unions to adjust to a high interest rate environment
- A level playing field with other financial institutions

3.28 7 respondents, almost all individual credit unions, were opposed to a raising of the cap. The main reason cited in these cases was a threat to the ethos of the credit union movement.

3.29 One respondent had concerns that the effect of raising the cap would be that existing customers would pay more for access to credit.

The Government Response

3.30 A majority in the credit union sector are in favour of raising the interest rate cap to 2% a month. The consumer groups responding and the Financial Inclusion Taskforce consider that a change of this nature will benefit disadvantaged consumer encountering exclusion from basic financial services, including affordable forms of credit. The Government recognises the case for a cap rise, and has announced the intention to adopt the change. However, the Government appreciates that the issue is finely balanced and recognises concerns that raising the level of the cap beyond this, or even removing it altogether, could threaten the ethos of credit unions, and potentially result in a heavier administrative burden. The Government believes that a cap at 2% a month strikes the right balance between the flexibility required for credit unions to serve new members, safeguards for consumers, and appropriate to regulatory requirements. The Credit Unions Act 1979 does not permit the Treasury to remove the cap altogether, which would require primary legislation.

QUESTION 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 the restriction)?

3.31 Four respondents were of the view that credit unions should be required to hold a vote of their membership when deciding whether to charge higher interest rates. However, a considerable majority of respondents (24) felt that such decisions should be taken by the boards of credit unions, rather than the membership, partly due to factors of cost, timing, and the necessity of further primary legislation, but also the perception that the membership were not likely to take a holistic view of the financial needs of the credit union as a whole. A typical response stated that it would not be appropriate to vote at an AGM because the temptation would be to maintain low charges without considering the effect on business, while the Board had been mandated to serve the best interests of the members' finances by making the business as strong as possible.

The Government Response

3.32 The Government recognises that obliging credit unions to hold votes on whether to charge higher interest rates would be considered unduly restrictive by the sector. Whilst it is important to protect the interests of existing members of credit

unions, the Government believes that the best way of achieving this is through sound financial management by boards and education of credit union staff to use the new flexibility appropriately. The Government expects the credit union trade associations to actively support their members in how to make effective use of a cap increase in the best interests of all credit union customers.

QUESTION 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?

3.33 The consultation responses were heavily in favour of maintaining the exemption (27 respondents). The arguments in favour focussed on the costs of regulation outweighing any benefits gained from the rise in the interest rate cap. One respondent suggested that this exemption should be kept under review as credit unions compete to expand with other lenders. Two respondents felt that credit union members should be afforded the same level of protection as other borrowers (and thus be brought within the consumer credit act).

The Government Response

3.34 The Government recognises concerns in the credit union sector that loss of exemption from the Consumer Credit Act could result in an additional administrative burden that would be difficult for smaller credit unions to meet. The Financial Services Authority (FSA) have developed a bespoke regulatory regime for credit unions which allows the interests of consumers to be protected without placing a heavy compliance burden on institutions with limited staff resources. The Government will therefore seek to introduce secondary legislation to ensure that credit unions wishing to charge some loans at higher rates under the new cap are not penalised by loss of exemption from the CCA.

QUESTION 12

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

3.35 Responses from credit unions fell into three categories:

1. Those credit unions who did not envisage changing their lending practices (six respondents)
2. Those credit unions who did not envisage major changes to their lending practices in the short-term, but would welcome the flexibility in the future (three responses)
3. Those credit unions that envisaged considerable changes to their lending practices (nine responses), specifically the possibility of:
 - Offering a variety of tailored products at different rates
 - Lending at higher rates for first-time (high risk) borrowers, then reducing rates for subsequent loans

- Marketing loans specifically to the financially excluded

3.36 ABCUL's response to this question focussed on the need to couple changes in lending practices with education and support for credit union staff, ideally with support from the Financial Inclusion Fund.

The Government Response

3.37 The Government recognises that some credit unions already play an active role in meeting the needs of those encountering financial exclusion, and that others will not wish to change their lending practices. This measure is entirely permissive, and no credit union will be obliged to offer different rates to any members if they do not wish to do so. However, the Government also considers that there are a significant number of credit unions keen to expand their provision of affordable loans to those on the lowest incomes that have up until now been deterred by the difficulty of meeting the costs of lending to these groups, particularly those who are unable to build up a savings record before taking out a loan. The Government anticipates that this measure will contribute to a wider degree of choice for those consumers dependent on high cost alternative credit products.

QUESTION 13

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

- Identify any costs or benefits for your organisation or more generally resulting from these proposals?**
- Quantify these costs or benefits?**

3.38 Several potential costs were identified by respondents:

- The risk of taking on low-income, high-risk borrowers, and the potential bad debt problems that that would entail.
- Administrative costs associated with making the necessary changes to literature, computer programs etc.
- The potential damage to the public perception of credit unions as ethical lenders
- The potential development of a two tier movement, where small credit unions would have limited use for the cap

3.39 Potential benefits focussed on the cash-flow/ revenue effect for credit unions. For example, one respondent noted that raising the cap would reduce limits on the credit union's borrowing capacity and make sustainability more achievable.

3.40 The response of ABCUL attempted to quantify the reduction in funding investment required for new start credit unions as a result of a permissive rise in the interest rate cap:

	Start up period	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total Investment Required
1% per month	10,030	60,400	56,897	41,388	20,844	0	0	189,560
1.5% per month	10,030	59,951	49,632	14,567	0	0	0	134,181
2% per month	10,030	59,502	42,367	0	0	0	0	111,899

3.41 ABCUL’s response also quantified the impact of an interest rate change on the cost of a £400 loan repaid over 53 weeks:

Percentage rate per month on the reducing balance	Weekly repayment	Total interest paid	%APR
1%	£8.02	£25.41	12.7
1.5%	£8.27	£38.47	19.6
2%	£8.52	£51.80	26.8

The Government Response

3.42 The Government recognises that the credit union sector is not unanimous in its support for a rise in the level of the interest rate cap, and appreciates the potential costs identified by some. However, the strong support from the majority of the sector and from consumer groups suggests that there will be significant benefits for those currently unable to access affordable forms of credit by permitting credit unions to charge interest rates of up to 2% a month for particular loans if they wish to do so. The Government is satisfied that these benefits outweigh potential costs and will introduce the necessary secondary legislation to implement the change.

A

LIST OF CONSULTATION RESPONSES

Copper pot credit union

St Macher credit union

South Tyneside credit union

Partners credit union

Llandudno & District credit union

Birmingham Inner Circle credit union

Portsmouth Savers credit union

Combined response of Association of British Credit Unions Limited (ABCUL) and UK Credit Unions Limited

Institute of Credit management

East Manchester credit union

Hatfield credit union

Glasgow Council credit union

Moneyspinner credit union

Scotwest credit union

FSA Small Business Practitioner Panel

Capital credit union

Castle & Minster credit union

Holdfast credit union

Personal Finance Research centre (University of Bristol)

Watford credit union

Credit union network

Fortress credit union

ACTS credit union

Kirkless credit union forum

Scottish League of Credit Unions (SLCU)

Lodge Lane & District (Liverpool) credit union

MGR credit union (Bristol)

Which?

Financial Inclusion Taskforce

Scottish Postal Workers credit union

Rainbow credit union Ltd

Cowie community credit union

Cumnock & Doon Valley credit union

Colchester credit union

Broomlands & Bournreehill credit union

Hull and East Yorkshire credit union

South Wales chapter of ABCUL

Bedford credit union

Tower Hamlets community credit union

London borough of Hillingdon credit union