HM TREASURY

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Contents

1 Introduction

1.1 This is a consultation about raising the maximum interest rate that can be charged by credit unions from 2 per cent[1] to 3 per cent[2] per month, as part of a modernisation and sustainability project.

Credit Unions and the Feasibility Study

1.2 Credit unions are mutual financial organisations that take deposits and make loans to their members. They can be based around a geographical area, profession, or local corporate body, and some are visible in areas of high financial exclusion. The interest credit unions can charge is capped at 2 per cent per month, which is a significantly lower rate than is often applied to other forms of short-term credit available to financially excluded people.

1.3 In May 2012, the Department for Work and Pensions (DWP) published a study which looked at the feasibility of the credit union model and how it could achieve sustainability (accessible at http://www.dwp.gov.uk/docs/credit-union-feasibility-study-report.pdf), and in June 2012 the Government declared its support for the findings. The study established that there is a market and demand from low income consumers for affordable banking products and services, and that credit unions are the only organisations in the financial sector realistically placed to meet this demand.

1.4 Following the recommendations of the study, DWP have developed a project to help credit unions to modernise and become sustainable. The objectives of the DWP Credit Union Expansion Project (CUEP) are to:

- enable credit unions joining the CUEP to reduce costs and become financially sustainable by March 2015;
- eliminate the need for further government funding of credit unions after March 2015;
- increase access to financial services (including affordable credit, bank and savings accounts) to 500,000 more people on low incomes by March 2015;
- increase access to financial services (including affordable credit, bank and savings accounts) to 1 million more people on low incomes by March 2019; and
- save low income consumers £1 billion in loan interest repayments by March 2019.

1.5 The DWP Feasibility Study also found that, due to the interest rate cap at 2 per cent, credit unions are currently unable to break even on small, short-term loans. This leads to a lack of stability in the sector, which is damaging for the long-term future of credit unions. It therefore recommended increasing the interest rate cap to 3 per cent in order to enable credit unions to become more stable over the long term. A more stable credit union sector will mean that low income consumers will have greater access to reliable, affordable credit, without having to resort

[1] Equivalent to APR 26.8 per cent
[2] Equivalent to APR 42.6 per cent

to more expensive means, such as home credit or payday lenders, or worse, illegal lenders. Even with a 1 per cent increase in the monthly rate of interest, credit union loans will still be substantially cheaper than the alternatives for consumers with no mainstream options.

1.6 The Government is aware that some credit unions believe the 2 per cent interest rate cap restricts the ability of the sector to offer loans to those who may currently be dependent on higher cost alternatives (because of the cost to the credit union of making a loan at an unsustainably low rate of interest). However, the Government is also aware that others have concerns and alternative views about the impact of this proposal. Chapter 2 sets out the options that the Government has considered. Chapter 3 assesses the potential benefits of raising the interest rate cap. Chapter 4 looks at the risks associated with raising the cap. Chapter 5 looks at the Consumer Credit Act exemption. Throughout the consultation document, respondents are asked to carefully consider these issues and to give views on specific questions.

1.7 To inform the policy decision making process, the Government is interested in the potential take-up of the increased interest rate from within the credit union sector. If respondents are replying on behalf of an individual credit union, we are particularly interested in the direct impact on you of this proposal and how you would anticipate making use of the proposed greater flexibility on lending policies.

2 The interest rate options

2.1 The maximum rate of interest that a credit union can charge is defined in the 1979 Credit Union Act, section 11(5), applicable to Great Britain. The Act gives HM Treasury the power to amend this cap using secondary legislation. This rate is currently set at 2 per cent[1], and includes all administrative costs and expenses incurred when making the loan. The maximum interest rate of 2 per cent does not require credit unions to charge 2 per cent a month: credit unions are free to charge at a lower rate below the cap and to charge variable rates for different sizes of loan.

2.2 The DWP Feasibility Study recommended that for credit unions to become sustainable, alongside other modernisation proposals, the maximum interest rate cap should be raised. The Feasibility Study considered three options:

- remove the interest rate cap entirely;
- increase the interest rate cap to 3 per cent per month; and
- increase the interest rate cap to a fixed amount, higher than 3 per cent per month.

2.3 The Government's preferred option is to increase the interest rate cap to 3 per cent. The rationale for preferring this option is set out in Chapter 3. The reasons for not recommending the other options are outlined below.

2.4 Removing the interest rate cap entirely would give rise to a number of practical and regulatory problems:

- if the cap was removed, then the credit union sector would, for the first time, have to comply with the Consumer Credit Act (CCA).[2] The CCA places a number of requirements on lenders which are primarily designed to ensure that they lend responsibly and that consumers are protected effectively. For example, the CCA requires the lender to provide an adequate explanation and pre-contract information which, in most cases, must be provided in a standard format before granting a loan. Complying with the CCA would introduce unnecessary new regulation and significantly increase the cost base for credit unions, which would be likely to significantly increase interest rates for their borrowers. Compliance with the CCA is viewed by many in the sector as unnecessary, as the existence of a rate cap, combined with the non-profit making status of credit unions, ensures that they are already incentivised to lend responsibly and that consumers receive effective consumer protections; and
- removal of the cap would also bring credit unions within scope of the EU Capital Requirements Directive which, among other things, sets out the minimum capital any deposit taking institution must hold. This would mean that each credit union

[1] The Credit Unions (Maximum Interest Rate on Loans) Order 2006 No1276

[2] Unless the Consumer Credit (Exempt Agreements) Order 1989 is also amended (see paragraph 5.3)

would need to hold capital of 5 million Euros, and very few would be able to meet this requirement.

2.5 Increasing the interest rate above 3 per cent also has a number of drawbacks:

- it was deemed unnecessary by the Feasibility Study. The study looked at what rate credit unions would need to charge in order to operate on a stable basis, and found that 3 per cent would strike the right balance between increasing borrowing costs and securing the long term future of the sector. Combined with the other modernisation recommendations, the Feasibility Study concluded that credit unions could break even by 2015-16, if they had the flexibility to apply a 3 per cent interest rate; and
- a cap set any higher than necessary would be against the ethos of credit unions, who do not aim to make a profit beyond the level of surplus required to pay dividends or interest on member's savings and meet all of their business development and expansion costs.

2.6 Therefore, the Government's preferred option is to raise the maximum interest rate to 3 per cent. The benefits of this approach are outlined in the following chapter.

3 The case for raising the interest rate cap to 3 per cent

3.1 As set out in paragraph 2.1, the monthly interest that credit unions are allowed to charge on their loans is currently capped at 2 per cent per month, although they may charge less if they wish. As the DWP Feasibility Study showed, this level of interest means that credit unions are often unable to break even on small, short-term loans. This leads to a lack of stability, which is bad for the long-term future of credit unions. The Feasibility Study found that the average unit cost to a credit union to deliver a £500 loan over 12 months is around £108. The maximum income a credit union makes on a £500 loan over 12 months is £68. This demonstrated that the average gross income from an average loan does not currently match the costs involved in making that loan.

3.2 One aspect of the credit union model that significantly contributes to the unit cost is the cost of giving financial advice, which is a key part of assisting borrowers on low incomes. Financial advice can include information about how to budget and how to save. Charging a slightly higher rate of interest on loans would help to cover the cost of providing this advice.

3.3 It can also be relatively expensive to accept repayment in the form of small, regular, over the counter cash payments, in addition to the costs of credit union staff or volunteers in establishing a repayment plan and providing financial advice. Having the ability to charge more would enable credit unions to serve a larger number of people, reducing the need for other forms of more expensive borrowing.

3.4 Allowing the maximum rate of interest to increase to 3 per cent will enable credit unions to become more stable over the long term. This means that low income consumers will have greater access to reliable, affordable credit, without having to resort to more expensive means, such as home credit or payday lenders, or worse, illegal lenders. Even with a 1 per cent increase in the monthly rate of interest, credit union loans will still be substantially cheaper than alternatives for consumers with no mainstream credit options. Many credit unions are strongly embedded in their local communities and are committed to assisting those on low incomes. Research undertaken with low income consumers showed that credit unions often appeal to low income consumers as bodies which are local, accessible and convenient, and which are community based. Giving credit unions more flexibility in their lending will enable them to recruit new members, and further establish their role in helping the financially excluded.

3.5 The following box illustrates example repayment rates from different types of lenders.[1]

[1] Figures taken from Credit and low income consumers: *A demand-side perspective on the issues for consumer protection*, Friends Provident Foundation, 2011.

A typical **home collected credit** loan charges 254.5 per cent APR, on a £400 loan over 50 weeks. This works out as a total repayment of £700, and a cost to the customer of £75 per £100 borrowed.

If a **credit union** could charge 3 per cent per month interest (equivalent to 42.58 per cent APR) on a £400 loan over one year then this would result in a total repayment of £477.36, and a cost to the consumer of £19.34 per £100 borrowed.

A typical **payday lender** (which is not directly comparable, as payday loans tend to be made over one month, rather than one year) would charge the equivalent of 1,410.3 per cent APR on a loan, which works out at a £25 cost per £100 borrowed over the course of one month. However, if the loan is rolled over only once, the cost doubles to £50 per £100 borrowed over the course of two months.

3.6 Increasing the maximum rate of interest charged to 3 per cent will allow credit unions to earn the money they need to meet their operating costs, and the costs of developing and modernising. This in turn will allow credit unions to operate more efficiently, ensuring that they can continue to serve people in the future. Without at least making a small surplus on most loans, credit unions cannot develop other products, or offer dividends or interest on savings, which help to attract new members.

3.7 Allowing the maximum rate of interest to increase will also enable the sector to achieve financial stability and end dependence by credit unions that rely upon grant or government funding. Low income consumers will also have access to ongoing affordable credit.

3.8 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 to 3 per cent 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 to 3 per cent have on the ability of credit unions to become more sustainable?
3. What effect, if any, would raising the interest rate cap to 3 per cent have on credit unions' business and lending practices?
4. Are there any other potential benefits associated with raising the interest rate cap to 3 per cent?

4 Risks of raising the interest rate cap to 3 per cent

4.1 While there are many benefits to the proposal to raise the interest rate cap on credit unions, the Government is also aware that there are potential risks. This chapter considers the potential risks and asks for responses to inform the Government's assessment of these.

4.2 It is important to note that raising the interest rate cap would not require credit unions to change the rate of interest that they charge. It is a permissive change, meaning that it allows credit unions to charge up to 3 per cent per month, but does not make it compulsory for them to do so.

4.3 However, there are two specific risks in relation to increasing the interest rate cap to 3 per cent. The first is the risk that credit unions could increase the rate on all loans, regardless of the cost of delivering them. While the intention is to give credit unions the flexibility to charge more for the most administratively expensive, small, short term loans (generally defined as under £1000), there is no legislation in place to ensure this happens. However, many credit unions currently charge less than maximum of 2 per cent per month, and the strong mutual ethos of the sector will help to ensure that the higher interest rate is used only to prevent a credit union from making a loss on a loan.

4.4 The second risk is that an increase in repayments could make it harder for consumers to repay their loans. The effect of varying the amounts of interest charged on smaller short-term loans is shown below. This shows the effect of a change in interest rate on the weekly repayment.

Table 4.A: Impact of different interest rates on a £400 loan repaid weekly over one year[1]

Monthly interest rate	APR	Loan amount	Each repayment	Total amount repaid
2%	26.8%	£400	£8.67	£450.84
3%	42.6%	£400	£9.18	£477.36
4%	60.1%	£400	£9.71	£504.92

4.5 Increasing the amount of interest on loans could make them harder to pay back for those who are already struggling. This means that the likelihood of repayment default may increase if consumers cannot afford the higher weekly payments. However, a significant increase in defaults is unlikely, as the extra amount to be paid is relatively small (shown in the table above), particularly when compared to alternative lenders. In addition, it would be possible to extend the repayment period for these loans to make the repayment more manageable. Furthermore, raising the interest rate cap will allow credit unions to serve a wider range of consumers and may encourage the use of credit unions as a substitute for higher cost borrowing from payday lenders, pawnbrokers or home credit.

[1] Figures taken from Paul A Jones and Anna Ellison, *Community Finance for London, Scaling up the credit union and social finance sector*, 2011

5 How serious is the risk that credit unions could apply the 3 per cent interest rate to all loans?

6 How serious is the risk of potential greater default?

7 Are there any other concerns or risks associated with raising the interest rate cap?

4.6 If respondents believe that there is a serious risk of greater defaults, or any other potential risks, the Government is interested in ways in which these risks can be mitigated.

8 Considering the case for action and the potential risks, should the interest rate cap be raised to 3 per cent?

9 If the cap is raised to 3 per cent would you consider making use of the greater flexibility on loan rates? In what ways do you anticipate your lending practices would change?

4.7 To inform the policy discussion relating to the interest rate cap issue, the Government is interested in the opinions from credit unions within the sector. If respondents are replying on behalf of an individual credit union, we are particularly interested in the direct impact on you of this proposal, and how you anticipate making use of the proposed greater flexibility.

5 Consumer Credit Act

5.1 The previous chapters of this consultation outline the potential benefits and negative impacts of raising the interest rate cap to 3 per cent. This chapter looks at the related legal and practical issues, asking respondents for a view on which of the following options is the preferred course of action:

1. increase the cap to 3 per cent; or
2. do nothing.

5.2 Currently, the Government is only looking at the possibility of raising the cap to 3 per cent, as recommended in the Feasibility Study. The power to do this is outlined in the 1979 Credit Union Act, and gives the Treasury the power to change the figure using secondary legislation.

Consumer Credit Act

5.3 Credit unions are not currently regulated by the Consumer Credit Act 1974, due to an exemption from the Consumer Credit Directive 2008 which is effected through a provision of the Consumer Credit (Exempt Agreements) Order 1989. This means that credit unions do not need a licence in order to carry out consumer credit business and do not need to carry out their business in accordance with the provisions of the Consumer Credit Act. The Consumer Credit (Exempt Agreements) Order 1989 provides that credit unions which have a total charge for credit under 26.9 per cent are not regulated by the Consumer Credit Act 1974.

5.4 If the Government decides to raise the maximum interest rate that credit unions can charge from 2 per cent to 3 per cent under the Credit Union Act 1979, then the Government also proposes to raise the total charge for credit level to 42.6 per cent in the Consumer Credit (Exempt Agreements) Order 1989.

5.5 This is because if the limit for the total charge for credit percentage remained at 26.9 per cent under the Consumer Credit (Exempt Agreements) Order 1989, and credit unions utilised the ability to set interest rates at 3 per cent under the amended Credit Union Act 1979, their interest rate would mean that they charged above the 26.9 per cent. They would therefore lose their exemption from complying with the Consumer Credit Act regime.

5.6 The Government recognises the importance of the exemption from the Consumer Credit Act regime for ensuring minimum regulatory burdens on credit unions. Having to comply with the additional regulatory provisions of the Consumer Credit Act would place additional regulatory burdens on credit unions. At the same time, the Government believes that credit union borrowers receive effective consumer protections under the existing provisions of the credit union regime.

5.7 The flexibility to exempt credit unions from the Consumer Credit Act is set out in the exemption provided in the Consumer Credit Directive. Credit unions can only be exempt from the Consumer Credit Act if they meet the criteria set out in Article 2(5) of the Consumer Credit Directive. The criteria are:

1 where the total value of all existing credit agreements entered into by the organisation is insignificant in relation to the total value of all existing credit agreements in the Member State in which the organisation is based; and

2 the total value of all existing credit agreements entered into by all such organisations in the member States is less than 1 per cent of the total value of all existing credit agreements entered into in that Member State.

5.8 The increase in the interest rate cap will not impact these criteria.

10 Are there any risks related to raising the CCA exemption limit?

6 How to respond

Summary of views requested

6.1 The Government would welcome written submissions on any of the issues raised in this document, and on the following specific requests for views and information.

1. What effect, if any, would raising the interest rate cap to 3 per cent have on the ability of credit unions to become more sustainable?
2. What effect, if any, would raising the interest rate cap to 3 per cent have on the ability of credit unions to become more sustainable?
3. What effect, if any, would raising the interest rate cap to 3 per cent have on credit unions' business and lending practices?
4. Are there any other potential benefits associated with raising the interest rate to 3 per cent?
5. How serious is the risk that credit unions could apply the 3 per cent interest rate to all loans?
6. How serious is the risk of potential greater default?
7. Are there any other concerns or risks associated with raising the interest rate cap?
8. Considering the case for action and the potential risks, should the interest rate be raised to 3 per cent?
9. If the cap is raised and applicable, would you consider making use of the greater flexibility on loan rates? In what ways do you anticipate your lending practices would change?
10. Are there any risks related to raising the CCA exemption limit?

How to respond

6.2 Responses to this consultation should be sent to HM Treasury by 15 March. Please address to Claire Porter, Banking and Credit Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ. Responses can also be emailed to creditunion.interestrate@hmtreasury.gsi.gov.uk.

6.3 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

6.4 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice. It would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

6.5 HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

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