HM Treasury

Raising the maximum interest rate cap:

response to consultation

June 2013

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Contents

1 Introduction

1.1 This document is the Government response to the consultation on raising the credit union interest rate from 2 per cent to 3 per cent per calendar month. The consultation was issued on 18 December 2012, was open for three months, and closed on 15 March 2013. The vast majority of respondents were in favour of raising the interest rate.

1.2 Chapter 1 of this document outlines the background to the consultation and the wider context. Chapter 2 outlines the responses to each of the questions asked in the consultation. Chapter 3 discusses the wider themes from the consultation responses and the next steps.

1.3 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. Credit unions currently have a maximum cap on the interest rate they can charge set at 2 per cent per calendar month. This 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.

The background to the consultation

1.4 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.

1.5 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.

1.6 The DWP Feasibility Study also found that, due to the interest rate cap at 2 per cent per calendar month, many 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 per calendar month 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. 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 borrowing options.

1.7 There were 43 responses to the consultation. These came from a number of different types of respondents, including credit unions, individuals, their trade bodies, and consumer groups. A full list of respondents is included in chapter 4.

1.8 The majority of the responses, 34 out of 38 who answered this question directly, were in favour of raising the interest rate from 2 per cent to 3 per cent per calendar month. There were seen to be many benefits, including credit unions becoming more sustainable, being able to reduce cross subsidisation between loans, and being able to use the increased income to offer better products. The responses are discussed in more detail in chapter 2.

2 The responses

1. What effect, if any, would raising the interest rate cap to 3 per cent per month have on the ability of credit unions to offer loans to a wider spectrum of borrowers, including low income consumers?

2.1 Credit unions identified a number of benefits that raising the interest rate would have on their ability to lend to a wider spectrum of borrowers. Firstly, it would reduce the losses that are generally made on the smallest loans. A number of credit unions commented that they use higher loan rates than should be necessary on their larger loans to cross subsidise the smaller ones. Increasing the interest rate charged on smaller loans would minimise the rates charged on larger loans. These lower rates could attract a wider range of borrowers who would otherwise use alternative sources of finance.

2.2 Other credit unions commented that they would be able to offer a wider range of products with the increased income, therefore attracting new members. Some credit unions said that they would lend to borrowers that they had previously turned away due to their higher risk profile. The higher interest rate would allow them to test whether loaning to higher risk members was worthwhile, or likely to lead to substantial losses. A few credit unions thought that this would enable them to lend to people who would otherwise use payday lenders. The link between credit unions and payday lenders is discussed further in chapter 3.

2.3 Some credit unions mentioned negative effects of raising the interest rate in terms of attracting new members. One credit union felt that the increased amount was not high enough to recoup the losses and to be able to attract new members. Others were more concerned with the risk that the higher interest rate may increase the perception of credit unions as a 'poor man's bank', and that this may put off potential higher income members. How these risks will be mitigated is discussed in chapter 3.

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?

2.4 A majority of respondents to this question (19 out of 35) thought that increasing the interest rate would make the credit union sector more sustainable. They felt that it would provide more choice in the type of loans that credit unions could offer, and enable them to reduce their losses. One credit union emphasised that credit unions need to be able to cover their costs to compete with other forms of lending. Several credit unions emphasised that the additional income would allow them to invest in infrastructure, staff training, and be able to have money in capital reserves.

"Raising the interest rate cap to 3 per cent would have a dramatic, almost immediate impact on London Plus Credit Union's sustainability. Our modelling shows that the credit union would become self-sustaining six months after the introduction of the higher rate for short-term, low value loans. If introduced as planned in April 2014, the credit union would be self-sustaining by October 2014. Moreover, within a year we would no longer require service provision funding from housing organisations to support our core service. Overall the sustainability of the credit union would be brought forward by about three years."

London Plus Credit Union response to *Credit union maximum interest rate cap*

2.5 Seven other credit unions said that while they thought that the increased interest rate would help sustainability, the increase itself would not be sufficient. They emphasised that this would only be effective as part of a wider process of modernising operations, and improving management and governance. A number of these respondents felt that it was positive that the interest rate rise was happening alongside the wider Credit Union Expansion project, run by the Department of Work and Pensions.

"From Oct 12 – Dec 12 (Financial Qtr 1) of 938 loans totalling £687,479 Moneywise granted 354 loans of less than £500 totalling £90,671. At an average cost of £108 to administer each loan this equates to £38,232 costs. Potential income from these loans is £12,924 (repayable at 26.8 per cent over 52 weeks).

Based on these figures, an increase to 3 per cent per month (APR 42.6 per cent) would provide a further £8,121 income.

If the loan amount granted in Qtr 1 was repeated over the 4 quarters of the financial year, based on applying 3 per cent per month on loans of less than £500, Moneywise would generate an additional income of £32,484. This in itself would return a loan income/expenditure ratio of 71 per cent putting the credit union on path to meet its business objectives."

Moneywise Credit Union response to *Credit union maximum interest rate cap*

2.6 Two credit unions felt that increasing the interest rate would be bad for the stability of credit unions. They thought that it risked attracting only lower income members and putting off more affluent customers.

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

2.7 A number of credit unions commented that losing money limits how many loans they can make. Reducing the loss that they make on the majority of their loans (for example, 87 per cent of the loans that London Plus Credit Union issue are under £1000) would allow them to offer a greater number of loans. Several credit unions also commented that they would reduce the rate of interest that they charge on larger loans, to attract a wider set of members and more accurately reflect the cost of issuing them. Two credit unions commented that they would use the extra income to expand and develop the credit union, including training staff and opening new premises, and also to increase their capital reserves.

2.8 Five credit unions responded saying that if the interest rate was increased, it would not have any impact on their lending practices, but that it would lower the losses they make. One credit union said that they would consciously not make any riskier decisions, while two others said that they would use the increased rate to trial lending to members with a higher risk profile. One credit union said that they would consider using the higher interest rate for new borrowers, with the incentive of a lower rate for future loans.

4. Are there any other potential benefits associated with raising the interest rate cap to 3 per cent?

2.9 There were a variety of responses to this question. Three credit unions emphasised how the increased interest rate would allow them to offer more loans in the future, which will increase the amount of affordable credit in a community. Another credit union felt that the additional loans could help to stimulate the economy in a community.

2.10 Several credit unions mentioned that the extra income would allow them to develop a greater variety of products, and invest in better infrastructure and services. Others emphasised how the greater income could increase the amount of time the staff spent with members, rather than searching for subsidies, and one credit union said they would use the increased opportunity for growth to increase their common bond, enabling them to serve a greater number of members.

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

2.11 Of the 31 respondents that answered this question directly, 20 felt that the risk of the higher interest being applied to all loans was low. The most popular reason for this was that credit unions have a strong mutual ethos, and do not operate for profit. This was thought to mitigate any risk of the rate being used inappropriately. In addition, members can vote against the interest rate at their AGM, if they feel it is being used inappropriately. One respondent said that if the higher rate is used too much and loans are too expensive, the number of members applying for loans will decrease which would signal to the credit union that they had set the interest rates too high, and would therefore need to decrease the interest rate.

> "In a survey of credit union websites- representing a full cross section of the sector – conducted by ABCUL on 11 and 12 March 2013, of 70 credit union websites visited only 7 (or 10 per cent) appeared to charge the upper rate of 2 per cent per calendar month or 26.8 per cent APR as their minimum rate – though it is possible that a lower rate was available in these credit unions, but was not advertised. So evidence from the current broad range of loan rates that credit unions currently offer to their members demonstrates that the increased rate will not apply to all credit union loans."
>
> Association of British Credit Unions response to *Credit union maximum interest rate cap*

2.12 Five respondents thought that the risk of the rate being applied to all loans was medium. The main reasons given for this were that it is dependent on the loan book of the credit union. If the organisation focuses on smaller loans, then it is likely that the interest rate will be applied to the majority of loans. One respondent said that they thought the risk was initially very low, but that it may become higher over time after the rate is introduced and it becomes more common.

2.13 Two respondents thought that the risk was high, and noted that they have no intention of applying the higher interest rate.

6. How serious is the risk of potential greater default?

2.14 The majority of respondents (19 out of 29) who answered this question thought that the risk of defaults rising was low. The main reason given for this was that if the weekly repayments are too high for someone, the repayment period can be extended to reduce the weekly repayment rates to something more manageable.

> "The interest rate charged on our average short-term loan of £626 is currently 2 per cent and on average is repaid in just over 27 weeks with instalments of £24.46 per week and total interest paid of £46.50. If the interest rate charged were increased to 3 per cent per month the weekly instalments would be £25.24 if repaid within the same time with the total interest increasing to £70.34. The most important figure for people taking out these types of loans is the weekly repayment amount. The 78p increase in the weekly payment is not likely to have a significant impact on the affordability of these loans. If the increase were a factor the alternative would be to keep the loan repayment the same and increase the loan term by one week."
>
> London Plus Credit Union response to *Credit union maximum interest rate cap*

2.15 In addition, a number of respondents said that just because there is a higher rate of interest, the same evaluation of a borrower should still take place. Credit unions pride themselves on the relationship that they build with their members, and the rigorous assessment that is undertaken before offering a loan. One credit union said that the increased income could be used to employ more staff, and increased training, to improve loan evaluations and reduce the risk of default.

2.16 A few respondents thought that the risk of higher rates of default was medium. The respondents said that all lending inherently carries risk, and that effective risk management procedures still need to be followed.

> "It's not the interest rate that would matter; it's the potential of bad decisions when making both saving based and instant loans that could cause greater default. If you make the wrong decision in the first place the amount of interest charged is irrelevant."
>
> Liverpool City Region Financial Inclusion Forum response to *Credit union maximum interest rate cap*

2.17 Four respondents thought that there was a significantly greater risk of increased defaults. Some thought this was problematic, while others felt that the increased income would mitigate this.

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

2.18 Twelve credit unions thought that there were no other risks to raising the interest rate cap. The main risk highlighted was the risk of damaging the reputation of the sector. This was highlighted by 11 credit unions, with various degrees of severity. Some credit unions were concerned that raising the interest rate would emphasise the misconception of credit unions as a 'poor man's bank', and look as if the poorest in society are being charged the most for credit. There was also a concern raised by one respondent that there would be an increased comparison with door step lenders. A final risk raised was that allowing credit unions to make additional income on loans may work as a disincentive for credit unions to reduce their costs and modernise.

2.19 Several credit unions highlighted how there is no requirement to use the increased interest rate if the membership is not in favour, and it was felt by two respondents that it was up to credit unions to communicate the change to their members and wider community. How these risks can be mitigated is discussed further in chapter 3.

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

2.20 The vast majority of respondents were in favour of raising the cap. Thirty four respondents who answered this question directly replied asking for the interest rate to be raised, with four respondents against. All consumer groups were in favour of raising the interest rate, as were all but one trade body.

> "All 20 respondents to our online survey agreed that the interest rate cap for credit union loans should be raised."
>
> Association of British Credit Unions response to *Credit union maximum interest rate cap*

2.21 Two credit unions said that while they supported raising the interest rate, they would like controls or guidance about when it should be used. This is discussed further in chapter 3.

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?

2.22 Nineteen credit union respondents said that they would use the increased interest rate. Some credit unions specified that they would only use 3 per cent on loans below £500, or below £1000.

2.23 An additional three respondents said that while they had no use for the increased interest rate, they still thought that the level should be raised, as it would be a positive step for the sector.

> "At the present time the Board can not foresee the circumstances where this Credit Union would use or advertise a 3 per cent per month loan interest rate.
>
> However, in principle, the Board have no major objection to the introduction of a higher maximum interest rate provided there is no element of compulsion involved to use or advertise such a rate. We also suggest that there should be no constraint on credit unions in its use, i.e. each credit union should be free to choose the size and length of loan to which a 3 per cent per month rate might apply."
>
> St Albans District Credit Union response to *Credit union maximum interest rate cap*

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

2.24 Of those that responded to this question, 21 respondents thought that the exemption limit should be raised, and that there were no or only low risks related to this.

> "This is low risk as it isn't really an option. In not raising the CCA exemption limits, a credit union would become CCA regulated which would in turn cause more issues."
>
> Glasgow credit union response to *Credit union maximum interest rate cap*

2.25 Two respondents were not sure whether the limit should be raised, saying that this was a decision for government. Two other respondents thought that the limit should not be raised, because credit unions are deposit takers, are exposed to the same risks as other financial institutions, and should have to follow the same regulations.

2.26 The next steps for the CCA exemption are discussed in chapter 3.

3 Key themes and next steps

Government decisions

3.1 Following the responses that were received to this consultation, the Government will proceed with raising the interest from 2 per cent to 3 per cent per calendar month.

3.2 The vast majority of respondents to the consultation were in favour of the rise, and the Government thinks that the benefits outlined in chapter 2 outweigh the risks.

Mitigating reputational risk to the sector

3.3 A number of respondents raised a concern that raising the interest rate cap to 3 per cent may cause a risk to the reputation of the sector. The Government understands the concerns that have been raised by respondents, and will take steps to mitigate these risks.

3.4 This is a permissive change and there is no requirement for any credit union to use the new interest rate. Credit unions are largely based around a community, and the reputation of the credit union in that area is unlikely to be damaged because other credit unions are using the higher rate.

3.5 The interest rate rise will not be happening in isolation. Alongside it, the Department for Work and Pensions (DWP) are running a project to provide services for up to one million more consumers on lower incomes. It will enable credit unions to modernise, expand and become financially sustainable. The project will provide access to affordable credit, bank and savings accounts, and save consumers up to £1 billion in loan interest repayments by March 2019.

3.6 Even with the higher interest rate, credit unions will still be the most affordable form of credit for many people. The Government is supportive of credit unions and the valuable work that they do within communities. The rise in interest rate will ensure that they are able to continue to serve their members, and be able to grow and serve a wider population.

3.7 HM Treasury and DWP will work with the credit union trade bodies to put together guidance on the interest rate rise and the Expansion Project as a whole.

An alternative to payday lending?

3.8 A number of respondents discussed the potential relationship between credit unions and payday lending. Some respondents wanted credit unions to be able to compete with payday lenders and prevent people from needing to use them. These credit unions felt that increasing the interest rate would enable them to offer more short term loans, as the increased income would minimise the loss on these loans. However, they would still need an element of cross subsidisation from larger loans.

3.9 However a similar number of credit unions stressed that they did not see themselves as comparable with payday lenders, and do not want to offer payday loans. Credit unions are not able to offer such short term loans without making substantial losses. One respondent stressed that credit unions should not be seen as a 'magic wand' that will solve all of the problems created by payday lenders. However, several credit unions said that a number of their members have previously had problems with payday lenders.

"In order for credit unions to offer a viable alternative to home credit and payday loans they need experienced paid staff (not volunteers); acceptance that administrative and credit control costs will be much higher and that bad debt rates will increase. Currently, the increased costs and professional expertise needed for credit unions to compete with the home credit model are too high. There is no possibility of matching 30 day pay day loans for a 3 per cent interest charge increase despite the fact that they remain exempt from much of the regulations applied to commercial short-term lenders."

Consumer Finance Association response to *Credit union maximum interest rate cap*

3.10 As set out in a recent policy paper[1], the Government is concerned about the evidence of the scale of consumer detriment in the payday lending market and is working together with the regulators to tackle the problems identified. The Government wants low income consumers have greater access to reliable affordable credit without having to resort to more expensive means, but acknowledges that credit unions cannot be seen as a direct substitute for payday lenders.

Consumer Credit Act Exemption

3.11 The Government recognises the importance of continuing the exemption from the Consumer Credit Act regime for ensuring minimum regulatory burdens on credit unions and agrees with the vast majority of respondents that there are no or only few risks to raising the CCA exemption limit. Due to the Government's decision to transfer responsibility for the regulation of consumer credit to the Financial Conduct Authority as of 1 April 2014, the increase in the cap on the total charge for credit will be effected by means of a new section regarding exempt agreements being inserted into the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, instead of amending the Consumer Credit (Exempt Agreements) Order 1989. The Consumer Credit (Exempt Agreements) Order 1989 will be revoked as part of the consumer credit regime transfer.

Next steps

3.12 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. The legislation for the credit union interest rate rise will be introduced in Parliament in the autumn. Credit unions will be able to use the new rate from 1 April 2014.

3.13 DWP will be working with ABCUL, the supplier delivering Credit Union Expansion, to introduce business efficiencies in credit unions and develop a range of products and services to attract new members. These changes, together with the interest rate increase, will support credit unions to become financially sustainable and end the need for government funding.

[1] Ihttps://www.gov.uk/government/publications/high-cost-credit-report-by-bristol-university-government-response

4 List of respondents

2 Shires credit union

ACE Credit Union Services & UK Credit Unions

Andrew Mullineux, University of Birmingham

Association of British Credit Unions

Big Society Capital

Bristol Credit Union

Capital Credit Union

Citysave Credit Union

Consumer Finance Association

Consumer Panel, Financial Services Authority

Credit Action

Dalmuir Credit Union

East Kilbride Credit Union

Financial Services Authority

Genevieve Hibbs

Glasgow Credit Union

Hull and East Yorkshire Credit Union

Ian Gorman

Johnstone Credit Union

Kernow Credit Union

Leeds City Credit Union

Lewisham Plus + Bromley

Liverpool City Regional Financial Inclusion Forum

Lodge Lane Credit Union

London Plus Credit Union

London Capital Credit Union

Moneywise Credit Union

NHS Credit Union

North Wales Credit Union

Partners Credit Union

Police Credit Union

Prince Bishops Community Bank

Scottish Law Society

Scottish League of Credit Unions

Scotwest Credit Union

St Albans Credit Union

SurreySave Credit Union

Transact, Toynbee Hall

Vale of Leven credit union

Welsh Government

West Sussex credit union

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