EXPLANATORY MEMORANDUM TO

THE CREDIT UNIONS (MAXIMUM INTEREST RATE ON LOANS) ORDER 2006

2006 No. 1276

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This Order enables credit unions to charge interest on loans up to a maximum rate of 2% per month (26.82% p.a.) on the amount of the loan outstanding. Such interest is inclusive of all administrative and other expenses incurred in connection with making the loan. The current maximum rate of interest that a credit union may charge is 1% per month (12.68% p.a.).

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 Credit unions are a form of mutual body which conduct their business for the benefit of their members. The principal purpose of credit unions is to receive deposits from and to make loans to members. They do not serve the general public. Membership is restricted by a membership qualification (known as the "common bond") which all members must meet, such as common employment.

4.2 Credit Unions are subject to the requirements of the Credit Unions Act 1979 ("the 1979 Act") and are registered under the Industrial and Provident Societies Act 1965.The Financial Services Authority acts as the registrar and regulator for credit unions in Great Britain.

4.3 Section 11(5) of the 1979 Act sets a maximum rate of interest on loans made by a credit union at 1% per month or at such other rate as may be specified. Section 11(7) provides for an amount to be specified by order made by the Treasury. This is the first exercise of the power to specify a maximum rate. An Order to be made by the Secretary of State for Trade and Industry will amend the Consumer Credit (Exempt Agreements) Order 1989 (S.I.1989/869) so that credit unions charging up to 2% per month on their loans continue to be exempt from the provisions of the Consumer Credit Act 1974.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 These regulations are subject to annulment and do not amend primary legislation. Accordingly, a certificate that the instrument is compatible with the Convention rights is not required.

7. Policy background

7.1 This instrument is being made to permit credit unions to increase the maximum rate of interest they can charge on loans from 1% per month to 2% per month. Consultation provided evidence that the existing interest rate cap can restrict the ability of credit unions to make loans available to those on low incomes who may currently be dependent on higher cost alternatives for access to credit. Granting loans at higher rates will make credit unions more viable, allowing them, in particular, to offset (against the income from loans charged at higher rates) the administrative costs and the costs of default arising from the small loans which form the vast bulk of their business.

7.2 *Promoting Financial Inclusion*, published alongside the Pre Budget Report in December 2004, outlined the action the Government intends to take on its three financial inclusion priorities of increasing access to banking, free face-to-face money advice and affordable credit. As part of a package of measures to increase access to affordable credit, 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."* The consultation responses indicated support for an increase in the level of the cap from a majority of credit unions, credit union trade associations, and consumer groups, and provided evidence that such a measure will facilitate an expansion in the supply of affordable credit for those on low incomes. There were 40 responses to the consultation of which 31 were in favour of raising the cap or removing it altogether. Of these, 21 were in favour of a cap at the level of 2% per month. A summary of consultation responses is available on the HM Treasury website (http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_odcredit.cfm)

7.3 As financial mutuals, credit unions aim to provide savings and loans facilities at competitive rates for their members. Section 11 of the 1979 Act does not require credit unions to charge the maximum rate; credit unions are free to charge at a lower rate and to charge variable rates for different members.

7.4 Many credit unions are strongly embedded in their local communities and they are committed to assisting those on low incomes. Research indicates that credit unions often appeal to low income consumers as bodies which are local, accessible and convenient and which are community-based. Many credit unions also offer debt advice and encourage those on low incomes to develop their savings. Giving credit unions greater flexibility on their lending policies and allowing them to charge higher interest rates to reflect the risks and costs associated with different clients is intended to enable credit unions to expand their role in serving the financially excluded.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this explanatory memorandum.

8.2 There is unlikely to be an impact on the Financial Services Authority's role as a regulatory body and there will be no other impact on the public sector as the instrument only applies to credit unions.

9. Contact

9.1 Robin Newnham at HM Treasury (Tel: 020 7270 4572 or email: Robin.Newnham@hm-treasury.x.gsi.gov.uk) can answer any queries regarding the instrument.

1 FINAL REGULATORY IMPACT ASSESSMENT

1. PROPOSAL

1.1 Amend section 11(5) of the Credit Unions Act 1979 to increase the maximum rate of interest that may be charged on loans to members of a credit union from 1% per month to 2% per month.

2. PURPOSE AND INTENDED EFFECT OF MEASURE

Objective

1.2 This final Regulatory Impact Assessment considers the costs and benefits of a proposal to raise the cap on interest that credit unions can charge on loans to members. The Government has consulted on what impact giving credit unions greater flexibility on the interest that can be charged on loans would have on the ability of credit unions to lend to low income consumers, and to ascertain the likely impact on existing credit union members and the communities they serve. Responses to the consultation suggested that an increase in the level of the cap to 2% a month will enhance the ability of many credit unions to lend to those on low incomes.

Devolution

1.3 Credit union legislation is an area which is reserved to Westminster under the Scottish and Welsh devolution legislation and therefore any rise in the interest rate cap would apply to credit unions in Great Britain. In Northern Ireland, matters arising from the proposal would normally be the responsibility of Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

Background

1.4 Credit unions are mutual financial organisations, offering savings and loans facilities to their members. The objects of a credit union are set out in the Credit Unions Act 1979, and include "the creation of sources of credit for the benefit of the members of the society at a fair and reasonable rate of interest". The Government recognises that credit unions can have an important role to play in promoting financial inclusion and in providing for greater choice and diversity in the financial services sector.

1.5 Credit unions are subject to a risk-based supervisory regime under the FSA, which sets the requirements for prudential capital and liquidity. They have their own specialist handbook, tailored to the needs of the sector. As a result of being regulated under the Financial Services and Markets Act (FSMA) their members have access to the Financial Ombudsman Service in respect of complaints against the credit union. They also fall within the Financial Services Compensation Scheme.

1.6 Currently, credit unions are required under the Credit Unions Act 1979 to charge no more than 1% a month (12.7% APR[1]) in interest. Some academics and credit union practitioners have argued that raising the interest rate cap may better enable credit unions to offer loans to low-income consumers. The Government consulted on a proposal to raise the level of the interest rate cap to 2% a month in order to assess whether such a change will enable credit unions to play a more sustainable role in promoting financial inclusion.

[1] APR stands for Annual Percentage Rate. It refers to the interest rate, which would be charged over a whole year on a loan and generally takes into account all additional costs incurred in taking out a loan.

1.7 This Final Regulatory Impact Assessment follows the publication of the consultation document 'The credit union interest rate cap' and a partial Regulatory Impact Assessment in March 205. The Government's intention to consult was announced in *Promoting Financial Inclusion*[2], published alongside the Pre Budget Report in December 2004. This announced a number of measures to increase the availability of affordable forms of credit for low-income consumers, including a growth fund to boost the coverage, capacity and sustainability of credit unions and community development finance institutions (CDFIs).

Rationale for Government intervention

1.8 Research indicates that the risk and costs associated with offering loans to low income consumers can be higher than with other consumers. Evidence submitted in the consultation indicated that the requirement that credit unions charge no more than 1% a month on interest on loans can in some cases make it difficult to offer loans to low income consumers on a sustainable basis. Unless action is taken, this may mean that credit unions will find it more difficult to become sustainable and/or that those needing access to credit may have little alternative to high cost lenders. However, the Government was concerned to identify any potential risks resulting from the proposal, such as greater administrative costs for credit unions, the potential for loans becoming more expensive for members in general and potential difficulties arising from greater loan delinquency. The evidence submitted in the consultation suggests that although these risks require consideration, they are manageable, and offset by potentially considerable benefits from increasing the maximum rate that credit unions may charge on loans.

3. CONSULTATION

Within Government

1.9 The Treasury consulted with the Department for Trade and Industry, the Financial Services Authority and the Small Business Service.

Public consultation

1.10 HM Treasury published a consultation document alongside the Budget on 16 March 2005 which was conducted in line with the Cabinet Office's consultation criteria. The consultation document was also available on HM Treasury's website and printed copies were available on request. The deadline for comments was 16 June 2005.

1.11 In total, 40 responses were received to this consultation, of which 31 were in favour of raising or removing the interest rate cap. Of these, 21 were in favour of a cap at 2% a month, 3 favoured a cap at 2.5% or 3% a month, and 7 supported the removal of the cap altogether. 9 respondents opposed a raising of the cap. A summary of responses to this consultation is available on the HM Treasury website.[3]

4. OPTIONS

1.12 We have considered 3 sets of options for the proposed policy. The first set evaluates the implications of not taking any action, the second the implication of an increase in the maximum interest rate payable on loans from 1% to 2% per month, and the third an increase beyond 2% a month. The Credit Unions Act 1979 does not permit the Treasury to remove the cap altogether, which would require primary legislation.

Option A: Do nothing

[2] Available on the Pre Budget Report 2004 section of HM Treasury website at http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adexclusion.cfm
[3] http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_odcredit.cfm

1.13 This option would leave the current interest rate cap at 1%, thereby avoiding any potential risks of loans becoming more expensive in general for existing members, potentially greater administrative costs and and/or greater loan delinquency. However, doing nothing would not address the issue of whether credit unions are able to play a more effective and sustainable role in providing a source of affordable credit to low-income consumers.

Option B: Raise the interest rate cap from 1% a month (12.7% APR) to 2% a month (26.8% APR)

1.14 Raising the interest rate cap to 2%, it is anticipated, will allow for greater flexibility and make it easier for credit unions to recover the costs associated with lending to particular members. However, there are potential risks that loans will become more expensive for existing credit union members and the potential for greater loan delinquency.

Option C: Raise the interest rate cap above 2% a month

1.15 Raising the interest rate cap to a level above 2% would give credit unions the greatest degree of flexibility. However, consultation responses suggest that raising the cap to a higher level would also increase the risks of existing credit union members paying more for access to credit, and potentially result in additional administrative costs for credit unions.

5. COSTS AND BENEFITS

Sectors and groups affected

1.16 As of 2004, there were 597 credit unions in Britain serving approximately 484,000 members and with a total asset base of approximately £426m.4 The credit union sector is very diverse with some drawing their members from a particular place of work, others from a particular area, and many drawing members from both. The largest credit unions have staff and offer a diverse range of services while others offer basic savings and loans and are operated by volunteers.

BENEFITS

Option A

1.17 The benefit to doing nothing would be avoiding any potential risks of loans becoming more expensive in general for existing members, greater administrative costs and greater loan delinquency.

Option B

1.18 The proposal to raise the interest rate cap **does not require** credit unions to charge higher interest; it simply permits them to do so if they judge that the benefits outweigh associated costs. Being permissive, there are therefore no benefits or costs associated with this proposal in itself. However, for those credit unions that would seek to make use of the greater flexibility provided in raising the interest rate cap, the following sections outline some potential benefits.

[4] http://www.fsa.gov.uk/pages/Doing/small_firms/unions/pdf/stats04.pdf

1.19 The consultation respondents in favour of an increase in the level of the interest rate cap identified a number of potential benefits:

- 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 that some credit unions have 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

1.20 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 trade association for three-quarters of UK credit unions, the ability to charge higher interest rates on riskier loans combined with education will give many more credit unions the ability to take those risks, and offer instant access loans that do not require members to first build up savings. 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 offer a range of tailored products, offering different loans to different borrowers.

Impact on the credit union member

1.21 In terms of the credit union member, raising the interest rate cap is intended to make it more likely that low income consumers previously unable to borrow from a credit union and otherwise reliant on higher-cost alternatives will be able to access a loan from a credit union. The average APR for alternative lenders is known to be over 170%. The table below uses an example from a Co-operative Bank report[5] to illustrate the cost of a loan from a doorstep lender[6] compared to a loan from a credit union, charging various weekly rates. It shows that the total interest repayments on a loan of £400 from a doorstep lender generated interest repayments of £236 over 53 weeks. But if an individual were to borrow the same sum from a credit union at a rate of 2% a month, repayable over 53 weeks, the total repaid would be over £180 less. It is not possible to predict the extent to which credit unions would be more able to offer loans to low income consumers but the potential savings for such consumers may be significant.

Table A.1: Comparison of cost of £400 loans

Lender Type	Amount Borrowed	Amount to be repaid	Period in weeks	APR
Doorstep lender	400	£636.00	53	164.08%
Credit Union1%	400	£425.41	53	12.68%
Credit Union 2%	400	£451.80	53	26.82%

1.22 Although it is the case that the cost of a loan would be more expensive than if the interest rate cap remained at 1%, the increase appears relatively marginal compared to the

[5] Source: The 'Access to credit on a low income' report for the Co-operative Bank by Liverpool John Moores University (November 2001).

[6] Also referred to as home credit companies, doorstep lenders provide small, short-term, unsecured cash loans, with weekly repayments traditionally collected from customers' homes by a network of agents.

potential savings made than if the rate charged by an alternative lender applied. Furthermore, it is important to emphasise that, owing to the costs of and risk associated with serving low income consumers, loans charged at the 1% a month rate are often not available to such consumers.

Impact on the credit union

1.23 Using data provided by the Association of British Credit Unions Limited (ABCUL) trade body, which represents over two thirds of British credit unions, the following attempts to illustrate what impact the change might have for individual credit unions.

1.24 As outlined below, profits made on a loan will need to cover a range of important overheads if a credit union is to become sustainable. However, at a minimum and to break even, a credit union needs to ensure that the costs incurred in making a loan do not exceed the total interest payable on the loan. In looking at these costs, two key assumptions are made. Firstly, it is assumed that the credit union will employ a member of staff. Many credit unions are staffed by volunteers and therefore these costs will be lower. However, it is unclear whether a credit union staffed solely by volunteers would be able to expand their capacity sufficiently to serve greater numbers of low income consumers. Another key assumption made is that credit unions do not receive grant funding to assist in their work, though it is clear that many do. However, it is less clear how much credit unions can, or should, rely on grant funding to subsidise their operations. In light of this, the following seeks to identify the direct costs that may be incurred in making a loan to low income consumers:

- Loan interview: Not all credit unions interview loan applicants. However, where an applicant carries more potential risk, it is more likely that an interview would be carried out. This could be done by a volunteer of the credit union or a paid employee. Assuming that a member of staff earns £16,000 a year gross salary7 and that only an hour is needed for an interview, it has been estimated that this would cost approximately £6.30. It may take longer to carry out an interview if this is accompanied with debt advice or discussion of a repayment plan.

- Credit reference: Where a credit check is made, which would appear to be more likely with first time loans and where there is a higher risk, this would appear to cost, at a minimum, £1.54 per online enquiry.8

- Pre-Loan Administration: Costs will be involved in assessing the application, recording the transaction and issuing the funds. Assuming that this is done by a manager of a credit union on a £32,000 salary and that only half an hour is needed to complete this administrative work, it has been estimated that this would also cost approximately £6.30.

- Post-loan administration: Costs will also be incurred in collection of repayments. Significant savings for the credit union can be made if repayment is reliable and by payroll deduction. However, in practice, credit unions lending to low income consumers will more likely be accepting repayments in cash, in small amounts and over the counter[9]. Each transaction may not last more than 5 minutes. However, for a loan being repaid weekly over a year, this would amount to 260 minutes or 4 hours and 20 minutes of a staff member's

[7] When actual net salary (following deductions for, for example, National Insurance and pensions) is taken into account, labour costs will likely be higher.

[8] This rate applies to credit unions that are affiliated with ABCUL

[9] Payments may also be accepted through Paypoint payment cards or through the Post Office. ABCUL estimate that this would result in additional transaction costs of £24.

time. It has been estimated that this would cost approximately £27.30 per loan. For a loan repaid over 6 months, the cost would be £13.65.

1.25 Taking these costs into account, the total direct cost of a loan repaid weekly over 6 months can be estimated as being £27.79 and over 12 months as being £41.44. Other costs – such as loan protection insurance (which is mandatory for many credit unions) will also add to the total cost in making a loan but, for simplicity, are not included here.

Table A.2: Lending costs on a loan repaid over 6 and 12 months

	6 Months	12 Months
Loan interview	£6.30	£6.30
Pre loan administration	£6.30	£6.30
Credit check	£1.54	£1.54
Post loan administration	£13.65	£27.30
Total	**£27.79**	**£41.44**

1.26 It is equally difficult to generalise about the total interest payable that a credit union might charge on a loan, given that this will be dependent on the amount offered and the length and form of the repayment periods. However, the table below shows figures provided by ABCUL for the total interest payable on loans of £500 and £1000 over 6 and 12 month periods. It also shows the profit/loss this would generate, if it is assumed that lending costs are £27.79 for a loan repaid over 6 months and £41.44 for a loan repaid over a year.

Table A.3: Total interest payable for various loans

Total interest				
Loan rate	**£500 over 6 months**	**£500 over 12 months**	**£1000 over 6 months**	**£1000 over 12 months**
1% a month	£15.72	£31.16	£31.45	£62.35
1.5% a month	£23.69	£47.18	£47.40	£94.41
2% a month	£31.74	£63.53	£63.49	£127.06

Profit/loss				
Loan rate	**£500 over 6 months**	**£500 over 12 months**	**£1000 over 6 months**	**£1000 over 12 months**
1% a month	-£12.07	-£10.28	£3.66	£20.91
1.5% a month	-£4.10	£5.74	£19.61	£52.97
2% a month	£3.95	£22.09	£35.70	£85.62

1.27 Credit unions are clearly more likely to recoup greater sums on loans if the loan is for a longer period of time and for larger sums of money. However, research indicates that low income consumers prefer to borrow small sums of money for relatively small periods of time such as six months. According to these figures, on a loan of £500 repayable over six

months, a credit union would make a small profit of £3.95 on a 2% loan, compared with a loss of £12.07 under the existing cap.

1.28 These figures obviously need to be treated with caution. As well as the assumptions made and highlighted earlier, counterbalancing these figures are the observations that the lending portfolio of a credit union may allow for economies of scale. Furthermore, many credit unions may be able to cross-subsidise profits made on larger loans to offer less profitable or loss-making loans to the wider community. On the other hand, it is important to remember that the profit on a loan must also cover overheads; simply being able to cover the direct lending costs will obviously be insufficient. One important overhead is the cost involved in credit control; following up defaults on loan repayments and rescheduling the loan. It would not be unreasonable to speculate that the cost of this particular overhead would increase were credit unions to take on potentially riskier loans. There are also other important overheads to consider such as dividends repayable on savings (a factor recognised as increasingly important to establishing sustainable credit unions), office premises and maintenance, marketing, insurance, FSA fees, staff/volunteer training and so on. When these overheads are taken into account, a lower interest rate cap may make it more difficult for a credit union to serve low income consumers whilst investing towards future sustainability.

Option C

1.29 Ten consultation respondents were in favour of raising the level of the cap beyond 2% per month. Raising the cap to a higher level would have the same benefits as Option B, but would provide additional flexibility for credit unions, and provided delinquency rates did not increase, allow credit unions to offer a wider range of loan rates according to the size and risk of particular loans.

COSTS

Option A

1.30 There would be no direct financial costs associated with not raising the interest rate cap for credit unions. However, responses to the consultation suggests that the present restriction imposed by the 1% a month cap is restricting the extent to which some credit unions are able to provide loans to those on low incomes. The cost of not increasing the cap would therefore be a continuing restriction on the role that some credit unions are able to play in providing an affordable alternative to the use of high-cost lenders.

Option B

1.31 Through option B, credit unions are given greater flexibility to charge marginally higher rates on loans to members. It is possible that loans might become more expensive in general for existing credit union members. This is particularly the case if administrative costs for a credit union in selecting an interest rate to apply to different members, according to an assessment of the risk involved, proves to be costly and credit unions instead opt for administrative simplicity.

1.32 Raising the interest rate cap also raises the possibility that credit unions will come to adopt more diverse lending portfolios, composed of ‘riskier’ loans than before. Such loans may come with a greater risk of default and delinquency although there will be greater compensating income to cover this. As outlined above, credit unions are required to

comply with a number of provisioning and capital requirements set out in CRED, the FSA rulebook for credit unions. If loan delinquency rates were to rise, credit unions would, under the existing requirements, have to make higher provisions for loss. In making such provisions, this may have an impact on a credit union's profitability and ability to meet the FSA's capital requirements. If the rise in loan arrears became significant this poses an ultimate risk that a credit union may become insolvent. It is difficult to predict the significance of this potential risk and to quantify the costs associated with the risk of greater loan delinquency in the absence of practical experience on how the proposal is being implemented. Consultation respondents were asked for their views on the likeliness of this risk and what costs it may impose. A number of credit unions felt that since more expensive loans would be made, there could be a higher risk of default. However, a 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.

1.33 Credit unions are currently exempt from the Consumer Credit Act (CCA) 1974 under the Consumer Credit (Exempt Agreements)(Amendment) Order 1989. This exemption applies to "a debtor-creditor agreement where the creditor is a credit union and the rate for the total charge for credit does not exceed 12.7%" (1% per month). The consultation asked respondents for their views on maintaining the exemption if the level of the cap was increased. 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. In order to avoid this potential cost, the Government will introduce parallel 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. The Department of Trade and Industry (DTI) have published a separate Regulatory Impact Assessment to consider the costs and benefits of maintaining this exemption.

Option C

1.34 Responses to the consultation identified a number of potentially serious costs to increasing the level of the credit union cap beyond two per cent a month. A higher cap could potentially damage the ethos of credit unions as ethical lenders offering loans at affordable rates, and could also bring them more directly into competition with other lenders in the sub-prime credit sector. This is turn could affect the regulatory regime for credit unions and potentially result in additional administrative burdens. There may also be risks of existing credit union members paying more for their loans, and a danger of increased delinquency for loans at the higher rate. Although these factors all apply to some extent for Option B, a cap at a higher level than 2% a month would significantly increase these risks.

6. EQUITY AND FAIRNESS

1.35 As the proposal is permissive, we do not consider that the proposal in itself will bring any disproportionate benefits or have disproportionate effects on particular credit unions. The increased maximum rate on loans will be available to all credit unions.

1.36 There is significant evidence that those on low incomes pay far more for access to credit. Increasing the maximum rate that credit unions can charge on loans is intended to contribute to an increase in the availability of affordable credit for this group.

7. SMALL FIRMS IMPACT TEST

1.37 This measure affects credit unions, who are small businesses. However we do not anticipate any adverse impacts on small businesses. Indeed, the proposal will better enable smaller credit unions to be a sustainable source of affordable credit to low income consumers by giving them greater flexibility to charge interest rates on loans that allow them to recoup their lending costs. The consultation document was sent to a large number of credit unions and also to the FSA Small Business Practitioners Panel. The Small Business Service is content that a Small Firms Impact Test is not needed for this Regulatory Impact Assessment.

8. COMPETITION ASSESSMENT

1.38 Credit unions are a source of credit in a market with a wide range of providers. This competition analysis has focused on credit unions and the alternative lending market given that the aim of the proposal is to better enable credit unions to be a source of affordable credit and to offer loans to individuals who are generally not able to access mainstream sources of credit and who would otherwise have been reliant on high-cost alternatives.

1.39 There is a range of credit sources available to low income households, including:

- Home credit companies / Doorstep lenders: provide small, short-term, unsecured cash loans with weekly repayments traditionally collected from customers' homes by a network of agents.
- Sale and buyback shops: buy second hand goods and give the seller the option to buy them back after 28 days at a higher price.
- Mail order catalogues: provide a wide range of goods on credit and often operate through a network of credit-assessed agents, on commission, who either buy for themselves or for a number of customers. Customers can make small weekly or monthly payments over a set period.

1.40 A competition filter test was performed and it was agreed that a more detailed assessment is not necessary given that the competition implications do not appear to be serious. For example, no individual credit union occupies more than 10% market share of the alternative lending market. Furthermore, it was not considered that the proposal would restrict the ability of firms to choose the price, quality, range or location of their products or lead to higher set-up costs for new or potential firms. Indeed, it was considered that any impact on competition may be positive in enabling credit unions to compete more effectively with alternative providers and to the benefit of low income consumers who may otherwise be dependent on high cost alternatives.

1.41 Credit unions operate under a system in which members need to have a 'common bond of membership'. The common bond may require members to live or work in the same area, work for the same employer, or be a member of some other special interest group.

Customers of other sub-prime or alternative lenders cannot simply switch to the products of credit unions unless they have such a common bond.

1.42 The Competition Commission are currently conducting an inquiry into the Home credit market. Whilst the final outcome of this inquiry is not yet known, published 'Emerging Thinking' and 'Provisional Findings' indicates that neither credit unions nor other 'alternative' credit products are close enough substitutes to home credit to impose a significant competitive constraint on home credit providers.[10]

9. ENFORCEMENT, SANCTIONS AND MONITORING

1.43 Credit unions are currently subject to a number of regulatory requirements, compliance with which is monitored by the FSA. The proposal to raise the interest rate cap is in itself permissive and does not come with any new regulatory requirements.

1.44 The Financial Inclusion Taskforce, established in February 2005 to monitor Government initiatives on financial inclusion, has a term of reference to monitor any increase in the availability of affordable credit by third sector lenders, including credit unions.[11] As such, the Taskforce will have a role in evaluating the impact this measure alongside other policies designed to assist third sector lenders, such as the £36 million Growth Fund to boost the coverage, capacity and sustainability of credit unions and community development finance institutions (CDFIs).

10. IMPLEMENTATION AND DELIVERY

1.45 The intention is to implement the change in April 2006. This will allow credit unions bidding to the £36 million Growth Fund to plan on the basis that the new maximum rate will be available before funding commences in June. The procedure is a Statutory Instrument introduced by the negative resolution procedure. This passes if no objection is raised by MPs or Peers within a 21 day period.

11. POST-IMPLEMENTATION REVIEW

1.46 As outlined above, the Financial Inclusion Taskforce will have a role in monitoring the impact of this measure. However the Government would also expect, at a minimum, to carry out a review of this legislation after two years. This would allow sufficient time for the effects of any legislation to be realised and understood.

12. COMPENSATORY SIMPLIFICATION MEASURES

1.47 The preferred option does not impose any additional regulatory burdens on either credit unions or other credit providers.

13. SUMMARY AND RECOMMENDATIONS

[10] http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm

[11] http://www.financialinclusion-taskforce.org.uk

1.48 The Government recommends Option B. 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 regulatory requirements.

14. DECLARATION AND PUBLICATION

'I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs'

Signed by the responsible Minister:

Ivan Lewis
Economic Secretary to the Treasury
3 May 2006

Contact Point:

Robin Newnham

General Insurance, Mutuals and Inclusion Team
1 Horse Guards Road
HM Treasury
London SW1A 2HQ

Email: robin.newnham@hm-treasury.gsi.gov.uk
Tel: 020 7270 4572

1.49 This Regulatory Impact Assessment is available on the HM Treasury website.[12] Copies have also been placed in the libraries of both Houses of Parliament.

[12] http://www.hm-treasury.gov.uk/consultations_and_legislation/ria/consult_ria_index.cfm