House of Commons

Regulatory Reform Committee

# Draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010

## Second Report of Session 2009–10

*Report, together with formal minutes and written evidence*

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## The Regulatory Reform Committee

The Regulatory Reform Committee (previously the Deregulation and Regulatory Reform Committee) is appointed to consider and report to the House on draft Legislative Reform Orders under the Legislative and Regulatory Reform Act 2006. Its full remit is set out in S.O. No. 141, which was approved on 4 July 2007.

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### Criteria against which the Committee considers each draft legislative reform order

Paragraph (3) of Standing Order No.141 requires us to consider any draft legislative reform order against the following criteria:

… whether the draft legislative reform order —
(a) appears to make an inappropriate use of delegated legislation;
(b) serves the purpose of removing or reducing a burden, or the overall burdens, resulting directly or indirectly for any person from any legislation (in respect of a draft Order under section 1 of the Act);
(c) serves the purpose of securing that regulatory functions are exercised so as to comply with the regulatory principles, as set out in section 2(3) of the Act (in respect of a draft Order under section 2 of the Act);
(d) secures a policy objective which could not be satisfactorily secured by non-legislative means;
(e) has an effect which is proportionate to the policy objective;
(f) strikes a fair balance between the public interest and the interests of any person adversely affected by it;
(g) does not remove any necessary protection;
(h) does not prevent any person from continuing to exercise any right or freedom which that person might reasonably expect to continue to exercise;
(i) is not of constitutional significance;
(j) makes the law more accessible or more easily understood (in the case of provisions restating enactments);
(k) has been the subject of, and takes appropriate account of, adequate consultation;
(l) gives rise to an issue under such criteria for consideration of statutory instruments laid down in paragraph (1) of Standing Order No 151 (Statutory Instruments (Joint Committee)) as are relevant;
(m) appears to be incompatible with any obligation resulting from membership of the European Union.

## Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/regrefcom. A list of Reports of the Committee in the present Session of Parliament is at the back of this volume.

## Committee staff

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## Report

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# Summary

The draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010 and Explanatory Document were laid before Parliament on 8 March 2010 by HM Treasury under section 14(1) of the Legislative and Regulatory Reform Act 2006 (LRRA). The draft Order contains a total of 14 proposals for reform of the law relating to industrial and provident societies (IPSs) and credit unions, six relating to IPSs and eight relating to credit unions.

This draft Legislative Reform Order would substantially reform the law relating to industrial and provident societies (including such organisations as housing associations and farming co-operatives) and credit unions (which are a type of IPS but are subject to additional legislation). It has been laid under the super-affirmative procedure, which enables the Committee to suggest modifications.

There are two groups of proposals. The first (proposals A1 to A6) relates to industrial and provident societies in general and extends to credit unions except in two cases where credit union law is already different (proposals A2 and A5). We fully endorse the intention behind these proposals which in broad terms is to bring IPS law more closely into line with the position for companies and building societies. We welcome in particular proposal A2, which would allow greater scope for IPSs to source capital from their own membership.

The second group of proposals (B1 to B8) applies only to credit unions. We broadly welcome these proposals too, recognising that they will allow credit unions to compete more effectively in the marketplace and consolidate their membership. However, we believe some caution should be exercised before extending reform any further than is currently envisaged. Credit unions need to maintain a distinctive identity and should avoid taking the same direction of travel as other financial service providers if it results, for instance, in overexpansion leading all too quickly to overexposure.

We have suggested some changes to proposals B4 and B6. On B4, we believe that any future change to the caps on corporate membership and lending should be the subject of an affirmative procedure instrument rather than negative procedure as HM Treasury proposes. On B6, we believe that the changes should be subject to approval of credit union members.

# 1 Introduction

1. The draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010 and Explanatory Document were laid before Parliament on 8 March 2010 by HM Treasury under section 14(1) of the Legislative and Regulatory Reform Act 2006 (LRRA). The draft Order contains a total of 14 proposals for reform of the law relating to industrial and provident societies (IPSs) and credit unions, six relating to IPSs and eight relating to credit unions. They are as follows:

### *Industrial and Provident Societies Acts 1965 and 1968*

- A1 Modify the provisions on minimum age for membership of an IPS and minimum age for becoming an officer of an IPS
- A2 Modify the rules on IPS share capital to remove the cap on maximum transferable capital
- A3 Modify the provision on fees chargeable for copies of an IPS's rules so that members are entitled to a free first copy of the rules, with an increase in the fee cap for provision of other copies
- A4 Facilitate easier dissolution of dormant registered societies
- A5 Give societies the flexibility to choose their own accounting year end
- A6 Remove the requirement on societies to have interim accounts audited

### *Credit Unions Act 1979*

- B1 Replace the "common bond" requirement for credit unions with a "field of membership" test
- B2 Reform the requirements relating to membership qualifications and rename them "common bonds"
- B3 Reform the restrictions on non-qualifying members of credit unions remaining members after they cease to meet qualifying criteria
- B4 Allow credit unions to admit bodies corporate, unincorporated associations and partnerships to membership subject to caps on the extent of such membership and on loans to such members
- B5 Allow credit unions to offer interest on deposits, provided certain liquidity requirements are met
- B6 Abolish the 8 per cent per annum limit on dividends
- B7 Amend the "attachment" requirement, which restricts withdrawal of shares

- B8 Allow credit unions to charge the market rate for providing ancillary services to their members (such as payment of bills on members' behalf)

# 2 Background and procedure

## Industrial and Provident Societies and Credit Unions and legislative background

2. Industrial and provident societies are legally recognised organisations which operate for the benefit either of their members (co-operatives) or the community ("benefit of the community societies", or "bencoms"), rather than having external shareholders, as is the case with legally constituted companies. They cannot be created primarily for the purpose of providing a financial return for their members. Examples would be a farming co-operative or a housing association. Credit unions are a type of industrial and provident society that are, in effect, financial co-operatives taking deposits from, and lending to, their members.

3. The main legislation for IPSs is the Industrial and Provident Society Act 1965, which is the key statute permitting registration of credit unions and of co-operatives and bencoms, while the Friendly and Industrial and Provident Societies Act 1968 makes further provision in relation to accounts.[1] The Credit Unions Act 1979 (the 1979 Act) provides an additional legislative framework for matters relating specifically to credit unions. The 1979 Act applies only to credit unions, while some provisions of the 1965 and 1968 Acts apply to both credit unions and IPSs.

4. Importantly in the present context, the 1979 Act was designed to permit a large degree of self-regulation by credit unions—a position which since 1 December 2001 has been superseded by Financial Services Authority (FSA) regulation. The FSA monitors matters such as credit union liquidity and the suitability of those appointed to manage credit unions. The FSA took over as regulator from the Registry of Friendly Societies, whose role given the intended high degree of self-regulation under the 1979 Act involved a substantially lower level of scrutiny. The self-regulation regime that essentially applied under the 1979 Act is particularly relevant to certain of the statutory restrictions proposed to be changed by the present legislative reform order (LRO); for example, those on dividend levels and interest payments. Such restrictions are arguably no longer so significant in ensuring liquidity, given that there is now full external regulatory oversight of such matters.

5. It is important to note that although credit unions are a type of industrial and provident society, not of all the "A" proposals apply to credit unions because the latter are already the subject of a separate legal regime in relation to the areas covered by those proposals (specifically, the provision on capital caps (A2) and year ends (A5)).

1 Co-operatives may also register as companies, partnerships, unincorporated associations or limited liability partnerships. These are governed by other legislation.

6. The proposals should be seen in the light of earlier amendments to the law. The Deregulation (Credit Unions) Order 1996, considered by our predecessor committee, the Deregulation Committee,[2] made the following changes:

a) Removed the prohibition on residents and employees joining the same credit union;

b) Alleviated some of the burden of proving a common bond and substituted a statutory declaration procedure whereby the statutory declaration could be provided as evidence of the existence of a common bond;

c) Relaxed the limits on credit union member shareholdings;

d) Relaxed the prohibition on credit union shareholdings being used as security;

e) Removed the prohibition on loans exceeding shareholdings;

f) Relaxed the limits on borrowings;

g) Relaxed the maximum repayment periods.

Thereafter, the Regulatory Reform (Credit Unions) Order 2003 was considered by a later predecessor Committee[3] and made the following further changes:

h) Relaxed the common bond qualifications for membership so that qualification for admission under section 1(4)(e) of the Credit Unions Act 1979 could be combined with any other qualifications, so long as in consequence a common bond existed;[4]

i) Imposed restrictions on use of the name “credit union”;

j) Permitted “at cost” charging for ancillary services such as payment of bills on behalf of members.

## The Explanatory Document and Summary of Consultation Responses

7. In our view, neither the ED nor the summary of consultation responses contains the level of detail of analysis that might have been expected for a draft Order of this magnitude. It is notable that several of the proposals for credit unions might have considerable economic impact, for instance with regard to the competitiveness of credit unions, and their size and market penetration. Although it is clearly difficult to predict the precise effect of matters such as expanded membership or corporate membership, it should have been possible for the ED to include an indication of likely patterns of take-up together with a number of case studies. The ED lacks any detailed information on what might be considered a good “critical mass” for a credit union to sustain itself, or any data on the spread of sizes of credit unions and what the likely demand or desirability of mergers will be.

2 See its Eleventh Report of 1996-96

3 See First Report of 2002-03

4 Section 1(4)(e) is the so-called “associational common bond” qualification; see paragraphs 43ff below for how this relaxation is now proposed to be further extended

8. An attempt has been made to address this shortcoming through questions to HM Treasury, the answers to which are annexed hereto. However, even now, the answer to the question concerning the potential risk of a two-tier credit unions system and/or of market dominance by larger credit unions consists of a ten-line response,[5] which, under the circumstances, is not sufficient.

9. It is noteworthy in this context that the then Regulatory Reform Committee's First Report of 2002–03 deprecated the quality of the explanatory statement that accompanied the 2003 Order and expressed the hope that future such documents would deal more fully with the statutory tests for what were then regulatory reform orders.[6]

## The consultation process

10. Initial consultation on the proposal for reform took place in 2007, and subsequent consultation on a draft LRO took place in 12 weeks between July and October 2008. The Treasury expressly solicited responses from a large group of interested parties, including 69 credit unions (some 15% of the total number of credit unions). There were 79 responses to the 2008 consultation, including input from, for example, major industry bodies such as the Association of British Credit Unions Limited (ABCUL) and UK Credit Unions Limited.[7] In addition, a working group has assisted in finalising the proposals. Significantly, the FSA has been part of the working group and is essentially content with the proposals. The other members of the working group are listed in Annex D of the ED. They too are content with the current form of the proposals.

11. The ED observes that those credit unions expressly written to by the Treasury were chosen as being representative of a range of size and experience, and the number of responses is indeed suggestive of a thorough consultation.[8] The one reservation that might be expressed is that the views of credit union members (rather than credit union management and trade representation) seem not to have been specifically sought, which is particularly relevant to Proposal B8 and is further addressed under the section dealing with that proposal. Otherwise, the ED contains an adequate summary of consultation responses and explains how they have been addressed.

12. **Subject to the above comments, we believe that there has been an adequate process of consultation and that the views of consultation respondents have been adequately incorporated into the proposals as now presented.**

## Geographical Extent

13. Legislation governing IPSs and credit unions is devolved in the case of Northern Ireland, but reserved in the case of Scotland and Wales. The draft LRO therefore extends to the whole of Great Britain, but not Northern Ireland.

5 Annex 1, question 17, together with a single paragraph (4.51) in the ED

6 See paragraph 19 of the 2002-03 report

7 Several Treasury documents refer to there being 85 responses. This was a miscalculation resulting essentially from multiple counting.

8 See ED, paragraph 3.5

## Parliamentary procedure

14. HM Treasury has recommended the super-affirmative procedure for this draft LRO on the basis of the relative complexity of some of the proposals. Under the LRRA, the super-affirmative procedure provides for an extended parliamentary scrutiny period of 60 days, together with the opportunity for the Committee and others to suggest changes to a draft LRO.[9]

15. **We agree that the number of proposals and the relative complexity of some of them favour the super-affirmative procedure.**

# 3 What the draft Order proposes and whether the statutory and other tests are met

16. In addition to considering whether proposals remove or reduce burdens, the Committee is charged with assessing whether the proposals meet the other preconditions in the LRRA, and with examining them against various tests (those set out in Standing Order No. 151, appropriateness for delegated legislation, and compatibility with European Union obligations). In the present case it would appear that the LRRA tests that raise matters for substantive scrutiny are:

- whether the proposals are proportionate;
- whether each provision taken as a whole strikes a fair balance between the public interest and the interest of adversely affected persons;
- whether necessary protections are removed; and
- whether the provisions prevent any person from continuing to exercise a right that that person might reasonably be expected to continue to exercise.

It seems that the proposals clearly meet the other LRRA tests as well as those in the Standing Orders, on appropriateness and on EU compatibility.

17. **In our view, the tests requiring full consideration in relation to the present proposals are those of proportionality, fair balance, necessary protection and reasonable expectation of continuance, and that the other tests including tests under its Standing Orders are met.**

9 See section 18

## Proposal A1: Modify the provision on minimum age for membership of an IPS and minimum age for becoming an officer of an IPS

### *Outline*

18. A straightforward reading of the relevant section[10] indicates that the current minimum age for membership of an IPS under the 1965 Act is 16, while the minimum age for holding office as a committee member, trustee, manager or treasurer is 18. In addition, societies can choose to restrict the availability of membership in the 16 and 17-year old age group through their rules. Under section 9 of the 1979 Act, credit unions are allowed to take deposits from those too young to be members, but otherwise the same position applies to credit unions as for IPSs generally.

19. The statutory position is at variance with that for companies, for which the minimum age for directorship is 16, with no minimum age for membership. The Government believes that by restricting the scope for expansion of membership the age restrictions operate as obstacles to the productivity of IPSs when compared with that of companies.

20. The proposal would open up membership of IPSs and credit unions to the entire under-16 age group and would lower the minimum age for being an officer to 16, although societies would have freedom to retain restrictions on membership and holding of office in the case of those under 18. Section 9 of the 1979 Act would remain in amended form to sustain the current position on deposit taking from those too young to be credit union rules members because of express society rules. The Government believes that the proposal would promote greater sustainability of IPS membership by allowing younger people to be involved in the activities of IPSs.

21. HM Treasury has noted the transitional provisions in the LRO by virtue of which the change in the law would not take effect in relation to any individual society until the society's next general meeting, thereby obviating the need for any special meeting to consider rule changes, and minimising the burden arising from any rule change.

### *Views of consultation respondents*

22. Responses from those who participated in consultation showed strong support for the proposal.

### *Preconditions and tests*

23. **We agree that the current age restrictions on IPS membership and holding of office operate as obstacles to productivity by narrowing the possibilities for participation in IPS activities vis-à-vis those that apply to companies. We also agree that it is anomalous for there to be more restrictive age controls on holding of office in an IPS than in a company and that the proposal would not, therefore, remove any necessary protection in terms of quality of governance. We therefore take the view that the proposal meets the requirements of the LRRA.**

10 Section 20 of the 1965 Act

## A2 Modify the rules on IPS share capital

### *Outline*

24. At present, the normal statutory cap on individual shareholdings in an IPS which is not a credit union is £20,000. Although that does not prevent capital being sourced from non-members,[11] the interest rates on such capital tends to be higher. The Government therefore believes that the cap restricts both the productivity and profitability of IPSs by preventing members from providing higher levels of capital themselves.

25. There are two types of IPS share: transferable shares can be transferred only to others who qualify for IPS membership (in line with the co-operative ethic of IPSs), while withdrawable shares are refundable and therefore constitute a type of temporary rather than permanent capital. Raising the cap in relation to withdrawable shares would have effects on the application of European banking rules and money laundering regulations to IPSs.[12] The draft Order therefore seeks to remove the cap only in relation to transferable shares. However, the ED indicates that the treatment of withdrawable shares will be subject to further review.[13]

26. The consultation document and the ED point to the potential greater risk to investors once a higher level of investment is permitted. However, the Government believes that investors will be no less able to monitor the performance of their investment in an IPS than for any other investment, including by way of the accounts required to be included in annual returns. There is in any event no compulsion to invest in an IPS, so in the absence of evidence to the contrary the cap would not appear to be a "necessary protection". Both members and (where applicable) the FSA have powers to call for an extraordinary general meeting of the society if there are concerns about the conduct of society business.

### *Views of consultation respondents*

27. Consultation respondents supported the measure, although some argued that the Government should have a duty periodically to review the remaining £20,000 cap on withdrawable shares. The Consultation Response indicates that the Government intends to increase the cap in line with inflation and will also consider an ongoing periodic review.

### *Preconditions and tests*

28. **We agree that the proposal would remove a burden in the form of obstacles to profitability and productivity and that it meets the requirements of the LRRA.**

11 Such as commercial financial institutions

12 For further explanation of the way in which the LRO avoids this, see the Treasury's response to question 9 in the Annex.

13 ED, paragraph 4.11

## A3 Modify the provision on fees chargeable for copies of an IPS's rules

### *Outline*

29. The 1965 Act requires that a copy of a society's rules must be provided to any person who demands it (not just members), and caps the fee for such provision at 10 pence. It is proposed to change this so that members who ask for a copy of the rules will be entitled to their first copy free of charge, while non-members and members requesting further copies will be required to pay an increased fee of up to £5, as determined by the individual society. Instead of being prescribed in the primary legislation, the maximum fee will in future be variable by means of a statutory instrument introduced via the negative procedure. This change would bring the position into line with that for building societies and friendly societies.

### *Views of consultation respondents*

30. Consultees strongly supported the proposal in principle. However, the original proposal was for a maximum fee of £1 for non-members and further copies, and some respondents considered that that amount would not cover the true cost of production and postage. The cap in the draft Order has therefore been increased so that the current limit will be £5.

### *Preconditions and tests*

31. **The proposal to make a reasonable and realistic charge for providing copies of rules to non-members (and further copies to members) seems fair and in line with practice in other areas. It would save money by allowing for proper recovery of the costs of providing such rules. We therefore take the view that the proposal would not prevent the continued exercise of any right that should reasonably be expected to continue, and that this proposal meets the requirements of the LRRA.**

## A4 Facilitate easier dissolution of registered societies

### *Outline*

32. Under the 1965 Act, a solvent society wishing to dissolve itself without the appointment of a liquidator must obtain the signatures of three quarters of its members on an instrument of dissolution. This makes it procedurally difficult for dormant societies to dissolve (because of the problems associated with contacting members) and leaves them with the burden of filing annual returns (and the FSA with the burden of supervision). The proposal is that a two–thirds majority of those who actually vote would in future be sufficient to permit dissolution, provided that the vote is subsequently confirmed by at least a simple majority in a general meeting. In addition, credit unions wishing to adopt the procedure would need FSA clearance. Intention to dissolve must be announced in the London Gazette and in a local newspaper and any party with outstanding claims on the society can apply for the dissolution to be set aside.

### Views of consultation respondents

33. Respondents generally supported the proposal but were concerned that without safeguards a speedier dissolution procedure could be subject to abuse by members wishing to use it as a quick means to procure society assets despite a society being a productive entity. The proposal as laid therefore stipulates that the new procedure would apply only to dormant societies, which would prevent its use in the case of an active society.

### Preconditions and tests

34. It would not be open for individual societies to choose not to make this procedure applicable to them. However, such rules would require adoption by vote, mirroring the safeguards in the dissolution procedure itself. Adequate safeguards would therefore seem to apply.

35. **We agree that the proposal would remove a burden on societies wishing to dissolve and that sufficient safeguards have been included for the proposal to meet the requirements of the LRRA.**

## A5 Give societies the flexibility to choose their own accounting year end

### Outline

36. At present, societies' trading year ends must fall between 31 August and 31 January unless the FSA is satisfied that special circumstances exist. This restriction is burdensome not least in that absent FSA approval it can operate to prevent synchronising of trading years with the tax year. The original basis of the restriction was a requirement on the previous IPS regulator (the Chief Registrar of Societies) to report to Parliament by a certain time each year, which effectively meant that all accounts needed to be prepared by 31 January at the latest. That is no longer relevant, since regulation by the Chief Registrar has been replaced by FSA regulation and the parliamentary report is no longer required. The proposal would bring IPS accounting year law into line with company law.[14]

37. Credit unions are already exempt from the restrictive provision on year end and are instead subject to a separate FSA regime.[15]

### Views of consultation respondents

38. Respondents were unanimous in their support for this proposal.

### Preconditions and tests

39. **We take the view that the proposal would remove a burden and that it meets the requirements of the LRRA.**

14 See Annex, question 16

15 See ED, paragraph 4.34

## A6 Remove the requirement on societies to have interim accounts audited

### *Outline*

40. Under the current legislation, IPSs choosing to publish interim accounts are required to have those accounts audited. Companies are not. Aside from considerations of cost, this requirement operates as a disincentive to preparation of interim accounts that would otherwise assist in keeping members informed about a society's financial status. The Government therefore proposes to remove the requirement on condition that interim accounts are clearly designated as unaudited. The exemption that already allows credit unions to publish unaudited accounts in limited circumstances[16] would be repealed.

### *Views of consultation respondents*

41. Respondents supported this proposal on the basis that auditing interim accounts imposes a costly burden on societies. A small number of respondents suggested bringing the regime into line with that for companies, but in response to a question from the Committee on that point HM Treasury indicated that the benefits of such an alternative are unclear and that the companies regime is inter-related with other aspects of companies accounts that are specific to corporate law.

### *Preconditions and tests*

42. **We agree that the proposal would remove a burden on societies wishing to publish interim accounts, and that it meets the requirements of the LRRA.**

## B1/B2 Replace the current "common bond" requirement for credit unions with a "field of membership" test and designate that test as the means to demonstrate a "common bond"

### *Outline*

43. Under the 1979 Act, admission to credit union membership depends on all members meeting one of a number of certain membership qualifications, namely: following a particular occupation, residing in a particular locality, being employed in a particular locality, being employed by a particular employer, being a member of a bona fide organisation (the "associational common bond" referred to in footnote 5), or either residing in or being employed in a particular locality. The reason why the last qualification exists separately is because normally members must all fulfil the same single qualification. That is, it is not usually possible for a single credit union to have one set of members who all work for the same organisation, and another set of members who live in the area where that organisation is based. The last test therefore allows credit unions to extend membership to people who either work or are employed locally. It was added by the 1996 Deregulation Order referred to above.

16 Credit unions can already produce and display unaudited interim accounts, but only at their registered offices, and on condition that they are clearly marked as unaudited and displayed alongside the most recent audited accounts.

44. There is a further existing statutory exception to this “only one qualification” rule, which is that an individual credit union can also extend membership to members who fulfil either the bona fide membership qualification or any one of the other qualifications.

45. The 1979 Act requires that members share a so-called “common bond” on the basis of fulfilling one of these membership qualifications. However, fulfilling a qualification does not currently lead automatically to a presumption of a common bond. That is, it is evidential, not conclusive. Thus, in deciding whether to accept registration of a credit union, the FSA is only permitted to treat fulfilment of the tests as evidence of the “common bond”, and there remains a requirement to decide whether a common bond has actually been demonstrated, although members of the relevant society can provide a statutory declaration as evidential support. This two-step approach is considered archaic, artificial and confusing, not least because there is a widespread belief that meeting the qualifying criteria is already sufficient to demonstrate the existence of a common bond.

46. The proposal would therefore dispense with the “two-step” approach to demonstrating a common bond and allow the FSA to treat the statutory declaration as conclusive on the existence of a common bond (while retaining scope for the FSA to look behind the statutory declaration and require further evidence if necessary). In addition, it would redesignate the membership qualifications as themselves “common bonds” (consistent with the existing common perception) and remove the requirement for there normally to be only one common qualification shared by members, instead allowing for membership on the basis of several different criteria (provided credit unions decided on this approach by changing their rules).

47. To prevent credit unions becoming too large, however, there would be a cap of two million on potential membership (or such higher figure as the Treasury may specify) in the case of credit unions whose common bonds included one of locality. It would also be a requirement in such cases that every potential member could with reasonable practicability participate in votes, serve on the committee and have access to society services. However, the FSA would have power to lift those conditions and the membership numbers cap if exceptional circumstances existed in a particular case.

48. Most failures in the credit union sector are among smaller bodies. The proposal would allow for a greater degree of growth and/or merger among credit unions and hence greater sustainability. HM Treasury has argued that the power to raise the cap on membership numbers should be exercisable by way of negative instrument.

### *Views of consultation respondents*

49. Consultation respondents supported the proposals. For instance, 77% of ABCUL members favoured replacing the common bond test with a field of membership test and 89% of ABCUL members favoured allowing credit unions to serve more than one group of members. The original proposal was for a cap of one million on membership, but a number of consultation respondents argued for a higher figure and the Treasury acceded to the suggestion that the figure of two million would cover the majority of likely situations. However, it is worth noting that that figure would not cover all examples of

credit unions covering an entire county or metropolitan area[17] and that there was a diversity of views from consultation respondents on an appropriate numerical cap. By a substantial majority (85% of ABCUL members, for instance, and a similar proportion of respondents overall), respondents preferred the option of permitting any combination of qualifying criteria (Option B) rather than restricting the permitted combinations to two only (Option A).

50. UK Credit Unions and its members were among the small minority that expressed serious reservations about credit union expansion, particularly with regard to the risk of inadvertently creating a two-tier system with a small number of super-credit unions based around major conurbations and then "the rest", leading to competitive imbalances.[18]

51. **We endorse HM Treasury's wish as embodied in this and other proposals in the draft Order to put credit unions in a better competitive position. That said, we note that certain proposals, particularly if pursued further, could result in credit unions embarking on a direction of travel that would blur their distinctiveness with respect to other financial service providers. There is a risk that the mutual ethic might be lost and that continual expansion and the unintended consequences that might follow in terms of financial exposure could result in credit unions encountering the same hazards experienced by other providers in recent years. We believe that this should be very carefully borne in mind if any further changes are mooted.**

### *Preconditions and tests*

52. **Subject to the comments in paragraph 7 on the level of analysis on the proposal provided by HM Treasury, and the comments in the foregoing paragraph, we agree that the current demarcation between qualifying criteria and common bonds is burdensome and inconvenient and that allowing greater scope for the growth of credit unions is likely to be beneficial. We agree that the proposal meets the requirements of the LRRA.**

53. **We accept that any instrument changing the membership cap position as proposed in the draft LRO should be a negative instrument.**

## B3 Reform the restrictions on non-qualifying members of credit unions

### *Outline*

54. Currently, credit union members who cease to fall within a qualifying membership category (for instance, if they leave the relevant locality or cease employment with the relevant employer) can remain members, but only if the total of such members does not exceed 10 per cent of the whole. Above that level, any member who no longer falls within a membership category must leave the credit union. HM Treasury believes that the

17 For instance, Castle and Minster Credit Union pointed out that the cap of 2 million would prevent formation of a Yorkshire credit union to parallel the Yorkshire Bank and the Yorkshire Building Society.

18 See summary of consultation responses, paragraph 3.47

restriction no longer reflects the mobility of modern society and that it operates to restrict desirable growth and profitability of credit unions. When non-qualifying membership is nearing 10 per cent, it acts as a disincentive on new members joining, as there is a risk that they might soon have to leave. Furthermore, leaving members must repay any outstanding loans, which is potentially highly disruptive to them and any business activities in which they are engaged. It could also result in situations where members who cease to qualify in a certain year have to leave, while members who cease to qualify the year after are able to stay. Furthermore, monitoring the membership levels and dealing with members whose only reason for leaving is the restriction arguably constitutes a burden on credit unions.

55. The proposal would remove the statutory limit, but credit unions would remain free to impose limits on non-qualifying members in their rules, should they so wish.

### *Views of consultation respondents*

56. Respondents supported the proposal, many referring to their preference for the principle of "once a member, always a member" over the existing arrangements which date back to when the common bond ethic was considered pre-eminent over other considerations. They believed that members should not have to change their financial services provider merely because they had moved house or job.

### *Preconditions and tests*

57. **We believe that giving credit unions the freedom to permit continued membership is desirable and that the proposal meets the requirements of the LRRA.**

## B4 Allow credit unions to admit bodies corporate, unincorporated associations and partnerships to membership

### *Outline*

58. The current law permits IPSs in general to admit corporate bodies to membership, but with a specific exclusion for credit unions that prevents them admitting corporate members. In addition, credit union membership requirements mean that unincorporated associations and partnerships cannot join by means of an individual acting on their behalf, which excludes them from membership too.

59. HM Treasury's view is that the restriction operates to prevent more effective operation of credit unions in which corporate bodies could contribute to community life by providing a larger credit union funding pool. Local corporate businesses could also benefit from being recipients of credit union services. The proposal is therefore to repeal the restriction, subject to a cap of 10% on the number of corporate members and a cap of 25% on the value of corporate shareholdings, and subject to the rules of a credit union expressly permitting corporate membership. (Rules could also specify lower levels of involvement.) Loans to corporate members would be restricted to 10% of overall loan value. Corporate membership would be defined so that the proposal would cover unincorporated associations and partnerships.

60. The proposal would also create a new class of shares, called "deferred shares",[19] capable of being offered to corporate bodies and carrying rights of repayment only on dissolution or winding up after creditors have been paid in full, or after FSA approval has been obtained. Because of the repayment restriction the 25% cap would not apply to these. However, after consultation it was decided not to restrict corporate members to having only deferred shares.

61. It is important to note that HM Treasury wishes to have freedom to vary the caps on membership and lending by way of a negative procedure statutory instrument.[20] The reason given is "existing policy that where only thresholds or limits are being amended, as opposed to the legislation itself, then the use of the negative resolution procedure is appropriate."[21] However, the summary of consultation responses said: "The Government agrees with the views expressed by some respondents that there is a risk that corporate membership could crowd out individual member involvement. The Government therefore intends to cap the proportion of membership which is not individual to 10% and to limit the proportion of total assets, and of lending, which may be held by corporate members."[22] Given that the cap is therefore not an arbitrary figure but a specific response to a concern raised in consultation, it might be considered that it should be varied only on the basis of the affirmative SI procedure rather than by negative instrument. On the other hand, the decision whether to admit corporate members, and to what extent, remains entirely in the hands of individual credit unions, so it could be argued that the statutory cap is not a critical determinant of corporate involvement—albeit it might be difficult to resist pressure for increased corporate access among all credit unions after one or two took advantage of a future increase in the statutory cap.

### *Views of consultation respondents*

62. A majority of consultation respondents was in favour of the proposal, although as noted a small number (including the representative body UK Credit Unions, for instance) objected on the basis that it might weaken the ethos of credit unions. It is worth noting that the principle of "one member, one vote" will continue.[23] Following consultation, the proposal was also changed so that corporate members will need to demonstrate a "significant connection" with the locality rather than merely a place of business.

### *Preconditions and tests*

63. **We note that the proposal opens up the possibility of credit unions providing loans to unincorporated associations. Whilst we appreciate that in many instances this might be highly desirable, there are risks in lending to such bodies, deriving from the difficulties in defining who is liable for their debts. We asked HM Treasury for its views on this[24] and we are satisfied with their response. We therefore agree that removal of**

19 The definition of which would be amendable by negative SI

20 See original consultation document paragraph 3.72

21 ED, paragraph 4.80

22 Summary of consultation responses, paragraph 3.27

23 See section 5(9) of the Credit Unions Act 1979, which is not affected by the LRO

24 See Annex 2.

**the current restrictions would be beneficial to the effective operation of credit unions and that the conditions of the LRRA are met by the proposal in light of the safeguards it contains in the form of caps on corporate membership.**

64. **However, we recommend that the LRO requires any order varying the membership, shareholding and lending caps to be in the form of an affirmative procedure statutory instrument.**

## B5 Allow credit unions to offer interest on deposits, provided certain requirements are met

### *Outline*

65. Credit unions are currently prevented from offering interest on deposits and instead can offer only a discretionary dividend. The proposal is to permit interest to be offered provided:

a) individual credit union rules allow it;

b) the most recent year-end balance sheet has been submitted to the FSA;

c) the balance sheet shows that the credit union holds reserves of at least £50,000 or 5% of total assets, which is greater (and subject to variation by negative statutory instrument); and

d) the auditors state the credit union's control systems are adequate to manage the payment of interest.

66. HM Treasury's view is that the current restriction puts credit unions at a competitive disadvantage in comparison with banks and building societies and operates as an obstacle to the productivity of credit unions, in particular by restricting innovation and the ability to attract new members.

### *Views of consultation respondents*

67. Respondents supported the proposal, in particular on the basis that it would improve the competitive position of credit unions.

### *Preconditions and tests*

68. **We agree that the proposal will remove a burden within the scope of the LRRA. However, we note that this proposal marks a clear shift away from the simple regulatory regime for liquidity embodied in the 1979 Act toward a system that depends on greater external regulation. Therefore, alongside the safeguards in the proposal there should be diligent monitoring of credit union liquidity by credit unions themselves and by the external regulator, and early intervention when necessary to ensure protection of credit union members. Subject to those observations on proper enforcement and monitoring to complement the auditing and balance sheet requirements and on member consent, we believe that the proposal contains sufficient safeguards to meet the requirements of the LRRA.**

69. **We agree that it is sufficient for any order varying the minimum liquidity protections (the higher of £50,000 or 5% of capital) to be in the form of a negative procedure statutory instrument.**

## B6 Abolish the 8 per cent per annum limit on dividends

### *Outline*

70. The 1979 Act prevents credit unions from paying a dividend in excess of 8 per cent per annum, with analogous effects to those of the interest restriction. For instance, credit unions are prevented from offering shares that carry a higher dividend payment but a more restrictive notice period for withdrawal, which restricts the potential for managing cash flow. It is unlikely that a credit union would choose to award a dividend that would adversely affect is financial position, but in any event the FSA has a statutory responsibility to monitor the liquidity of credit unions.

### *Views of consultation respondents*

71. Respondents supported the proposal. However, the FSA suggested maintaining the limit on dividends on dissolution whereby excess funds over those providing an 8% dividend would continue to be donated to charitable causes, thereby providing a disincentive against financially motivated dissolution. The proposal takes into account and would implement that suggestion.

### *Preconditions and tests*

72. **Subject to the caveats on external regulation above, we agree that the proposal will remove a burden with the scope of the LRRA and that it meets the requirements of the LRRA. However we recommend a modification to the draft Order so that members are required expressly to endorse a decision to abolish the 8 per cent limit.**

## B7 Amend the "attachment" requirement, which restricts withdrawal of shares

### *Outline*

73. The term "attachment" means the procedure under which credit union members are actively restricted (by administrative procedure) from entering a debit position in relation to their credit union by making a withdrawal of shareholding greater than the amount of any loan. The existing law is that such withdrawals are prohibited if the relevant loan is secured,[25] but in other cases may be made at the discretion of the credit union committee. The proposal would change this position so that, in the case of unsecured loans, the decision on whether withdrawal will be allowed would be made at the time of the loan, thereby putting the member in a position of greater certainty about his or her financial position.

25 Under section 11A of the 1979 Act, a secured loan is one for which security is provided on the initiative of the relevant member.

### Views of consultation respondents

74. The original proposal was to remove the statutory restriction and make attachment a matter for the rules of individual credit unions. However, a number of respondents were concerned that members with loans, or members who believed that they might in future need a loan, would have little incentive to vote in favour of a restriction that might operate to their present or future disadvantage. The proposal as presented is therefore one that changes the decision-making time on whether to impose attachment from the time of withdrawal to the time of making of the loan.

75. Respondents were not convinced that the proposal would remove a burden, however. ABCUL has expressed concern that the proposed procedure would not allow emergency withdrawals of attached funds. The Treasury's view (endorsed by the FSA) is that this consideration could be dealt with by an emergency extension of loan and that the advantages of the proposed system would outweigh any such disadvantages.

### Preconditions and tests

76. **We agree that the current law causes an administrative inconvenience to credit union members by creating uncertainty about their financial position and by requiring members to make ad hoc applications for withdrawals and/or credit union boards to make ad hoc decisions on withdrawals. We believe that the proposal therefore meets the tests in the LRRA.**

## B8 Allow credit unions to charge the market rate for providing ancillary services to their members

### Outline

77. Under the 1979 Act credit unions may charge only on a cost-recovery basis for services ancillary to accepting deposits or making loans, such as paying bills on behalf of members. This amounts to a restriction on profitability and impedes the ability of a credit union to dedicate a higher funding level to core business activities such as the granting of cheaper loans.

### Views of consultation respondents

78. Those consulted supported the proposal, with some strongly argued views in favour and no expressly articulated views against. However, support was not numerically unanimous: for instance, among ABCUL members 79% were in favour. This is an area in which more could have be done by way of active consulting of credit union members per se rather than the credit unions to which they belong (and the trade representative bodies), as the is proposal is one on which there might well have been a divergence of views between those two constituencies. **We would have preferred to have the views of a cross-section of credit unions members as well as of credit unions.**

79. We note the position taken in our predecessor Committee's First Report of 2002–03 on the 2003 Regulatory Reform Order, that levying charges on a cost-recovery only basis was

proportionate[26] and struck a fair balance between different interests.[27] That Committee said:[28]

> The Department…simply states that, because any charges for an additional service would be limited to the actual cost of providing the service, credit unions would be prevented from overcharging their members. [W]e can extrapolate from this point that protection of credit union members against paying for the cost of additional services is not a necessary form of protection because such charging does not affect the fundamental objects of credit unions, as set out in section 1(3). Credit unions can choose whether to provide such services, and members can choose whether to take up such services and to pay the cost of doing so.

80. That Committee took the view that the only one of the three proposals in the draft 2003 Order that arguably prevented continued exercise of a right or freedom was that restricting use of the "credit union" name, not that relating to cost-recovery basis charging of members. However, it also said: "The Department believes that credit unions should not be able to make a profit when they charge for ancillary services; as indicated above, we agree with this principle."[29]

### *Preconditions and tests*

81. This change in the law is not irreversible in that it would not create rights that would be difficult to unravel. However, there is at least an argument that lower-income credit union members who for one reason or another cannot use alternative saving, deposit-taking or lending facilities might reasonably expect to continue obtaining ancillary credit services from their credit union "at cost", rather than at a market rate which subsidises other members' use of the credit union, and that such an argument applies more strongly in the case of "for profit" charges than for "cost recovery" charges. There is essentially no economic analysis of the likely effect of the proposal in the ED or the accompanying impact assessment. Given the position taken in relation to the 2003 Order, **we recommend that the proposal therefore be approved but that its implementation be reviewed after two years to take account of any adverse effects on members and of a consultation taking specific account of members' views.**

# 4 Conclusion

82. We recommend acceptance of the proposals in the draft Order but with a recommendation that the power to make further delegated legislation in relation to the caps in proposal B4 be subject to affirmative parliamentary procedure. We recommend post-implementation review of proposal B8 on the basis set out in the body of this document.

26 See paragraph 24 of that Report

27 See paragraph 30, ibid.

28 See paragraph 35, ibid.

29 See paragraph 46, ibid.

83. Given the timing of this draft Order, it is highly likely that consideration of any amended or final draft will need to be undertaken by a successor Committee to ourselves. Subject to our recommended changes, we believe the proposals in the draft Order will achieve several highly desirable changes to the regulatory framework for IPSs and credit unions and hope that any successor Committee reaches the same conclusion.

# Annex 1

## Response by HM Treasury to written questions (dated 23 December 2009)

### *General*

**Q 1 To what extent will the changes proposed in the LRO interact with those in the Co-operative and Community Benefit Societies and Credit Unions Bill currently before Parliament?**

The measures in the LRO are designed to remove or reduce restrictions that hinder the growth and development of credit unions and IPSs. The Co-op Bill provides for the future development of the legislation governing mutuals, in particular improving governance and administrative arrangements, by enabling the Treasury to apply aspects of company law to industrial and provident societies and building society law to credit unions. The two pieces of legislation work together to create an integrated reform package.

In brief, the Co-op Bill:

- provides that societies wishing to register under the Industrial and Provident Societies Act 1965 shall be registered as co-operative societies or community benefit societies and changes the names of the Industrial and Provident Societies Act 1965;

- applies the Company Directors Disqualification Act 1986 to officers of industrial and provident societies, as it applies to officers of companies, building societies and friendly societies The Company Directors Disqualification Act 1986 provides for the disqualification of officers of companies and various bodies when such officers have seriously mismanaged those bodies. Under the law as it currently stands, officers of industrial and provident societies who have mismanaged the society cannot be disqualified;

- gives the Treasury powers to apply to industrial & provident societies, with appropriate modifications, company law on investigation of companies, company names, dissolution and restoration to the register;

- enables provisions corresponding to building society law to be made for credit unions. Building society law has been tailored to deal with issues specific to institutions which accept deposits. This is therefore a suitable model to allow credit union law to keep pace with credit unions' expanding membership and operations.

**Q 2 Please provide a summary of the legal and practical distinctions between friendly societies, co-operatives, credit unions and other similar bodies.**
Building societies, friendly societies and industrial and provident societies (IPSs), including credit unions each have their own dedicated legislation:

Building Societies Act 1986
Friendly Societies Act 1974 and Friendly Societies Act 1992
Industrial and Provident Societies Act 1965
Credit Unions Act 1974 (although credit unions are registered under the 1965 Act as a special class of society)

The Building Society Act and Friendly Society Acts are geared to the specialist needs of those types of society as financial services providers. The 1965 Act provides for a mutual alternative to the company format for IPSs.

Co-operatives and societies for the benefit of the community are types of IPSs (a co-operative conducts its business for the mutual benefit of its members whereas a community benefit society operates for the persons other than its own members). In broad terms an IPS can do anything a company can do with the exception that if it has withdrawable share capital it cannot provide banking services[30]. (In fact very few IPSs provide financial services.) IPSs cannot be created primarily for the purpose of creating a financial return for their members[31]. Members of an IPS, and indeed building and friendly societies, have equal rights in their societies on the basis of one member one vote regardless of financial commitment.

Credit unions are a form of financial cooperative, where members' shares in the form of deposits create a pool of funds for lending to those members who wish to take out loans. All profits in mutuals are either added to reserves or returned to members as there are no third-party shareholders. Credit Unions are regulated as deposit-takers by the FSA and subject to the rules set out in the FSA's specialist handbook CRED.

**Q 3 How many credit unions were actively written to in the consultation process and, if the number written to was less than the total of 600, what the criteria were for selection.**

Sixty-nine of the largest credit unions were written to (around 15% of the total number of credit unions in Great Britain). There was some selection to try to ensure that different types and size of credit union were selected. The major trade bodies were also written to. The consultations were discussed at our working group meetings and were published on the HMT website. In addition both Treasury and FSA officials spoke at various credit union events, discussing the proposed changes and their impact.

**Q 4 The consultation on the proposals took place in mid-2008. Did the subsequent financial crisis and in particular concerns regarding liquidity safeguards for financial institutions have an impact on the proposals, and especially those proposals that could potentially change the capital base of affected institutions? Has any attempt been made to re-consult in the light of recent events in the financial sector? To what extent do Government liquidity and deposit guarantees apply to the affected institutions?**

The financial crisis did not have a particular impact on our proposals and it was not necessary to re-consult in light of it. Industrial and Provident societies, whether cooperatives or community benefit societies, were not subject to concerns about the same concerns as the financial sector generally, as the vast majority of IPSs do not carry on regulated financial business. Credit unions are much smaller both individually and collectively than other deposit takers. The total assets of the GB sector amounts to around £550 million and the largest credit union has assets of around £60 million. Credit unions may only take deposits from and lend to their members. Their membership is usually drawn from a local geographic or employment base. There have been failures in the sector since the FSA took over regulation in 2001 (over 40 societies have failed calling on the Financial Services Compensation Scheme to the tune of £4 million). There have been six failures this year, but these are not necessarily related to the financial crisis. The small scale of many credit unions and limited access to skilled management has been a challenge for GB credit unions for some time. It should be noted that in Northern Ireland where credit unions have been longer established and are generally larger in terms of assets and membership, there have been no failures since 2001.

**Q 5 What has been the extent of credit union failure? To what extent would the proposals have affected such failures had they been in place at the time?**

It is not possible to say whether the proposals would have prevented failures had they been in place at the time. The proposed increased flexibility of the common bond means that when credit unions do fail it will be easier for them to merge with another credit union. It will also mean that credit unions will be able to attract a more diverse range of members enhancing the ability to grow more quickly and provide a wider range of skills to help with the running of the credit union. The ability to allow corporate members should increase funding opportunities and help increase the diversity of the business. There will be additional safeguards to prevent credit unions over extending themselves in unfamiliar business areas, such as lending to corporate bodies, with the attendant higher levels of risk – for example limiting the percentage of corporate members and the amount, as a percentage of total lending, that may be lent to corporates. Other measures in the Order should help credit unions to operate more efficiently thereby helping to reduce overall risks to businesses, for

30 1965 Act, s7.

31 1965 Act, s1.

example being required by the legislation to achieve certain minimum levels of capital before being authorised to pay interest on members' shares, which covers the risk inherent in the contract to pay interest.

**Q 6 Please provide a synopsis of the comparison between existing credit unions laws in this country and those in other major jurisdictions also having credit unions, and of how that comparative analysis would change on adoption of the proposals. To what extent would the proposals bring the law in this country into line with elsewhere, and to what extent would they go further?**

In proposing the current amendments, legislation in the United States and Canada, as well as the Republic of Ireland was reviewed. In these countries credit unions are far more advanced than in the United Kingdom and the legislative framework is more flexible. For example in the United States credit unions act as financial intermediaries for insurance and pensions business as well as being mortgage providers. Canada has a similar legal framework to the US, with much greater flexibility in the common bond. The current proposals for GB are broadly similar to the Canadian model but modified for the stage of development in GB and the GB legal system. The Republic of Ireland provides for less flexibility in the common bond, but given that it has market penetration of around 100% (bearing in mind that it is common to be a member of more than one credit union) there has been little need to expand the constitutional framework.

## Proposal A1

**Q 7 Are society rules able to override the statutory position and admit members under 16 or does the language of section 20 operate the other way round, i.e. to allow societies to impose restrictions going further than that in statute (the consultation document indicated the former).**

Section 20 does not expressly prohibit the admission of members under 16. However, the sector has interpreted it as preventing them from admitting members under 16 on the basis that the words "a person under the age of 18 but above the age of 16 may be a member… unless contrary provision is made by the society's registered rules" imply that those under the age of 16 cannot be members whatever the rules say. The provision read as a whole certainly makes more sense if interpreted in that way. The "*Registry of Friendly Societies, Guide to the Law Relating to Industrial and Provident Societies*" (HMSO, 1978), written by the Chief Registrar of Friendly Societies, takes this view. It is also supported by the fact that the legislation for Friendly Societies clearly provides for the membership of minors (including those under 16), suggesting that had this been the intention for IPSs, similar provision would have been made in the 1965 Act.

Section 20 makes clear that societies can provide for the contrary in their rules (i.e. not allow 16 and / or 17 year olds to become members).

**Q 8 What proportion of institutions might elect to retain age limits notwithstanding the change in the law, with a concomitant need for a potentially burdensome rule change?**

Responses from credit unions and discussions at working meetings and other events have indicated that credit unions are keen to establish access to younger members in terms of attracting savings and building long-term involvement with the sector. Many credit unions are involved with local schools and help develop a savings cards but are restricted in terms of access to junior members. It is not possible however to provide precise figures.

The transitional provision in article 20 of the LRO reduces the burden on those societies which wish to retain age limits by keeping the existing law in force until the next general meeting of a society, so they will not need to call a meeting specifically to change rules as a result of this provision.

## Proposal A2

**Q 9 Paragraph 4.8 of the ED refers to potential "unintended consequences" were the proposal to remove the limit on shareholding extended to withdrawable shares. Paragraph 2.33 of the consultation document refers to use of existing powers causing a potential "increase in the risk of societies being classed as 'credit institutions' for the purposes of the EC Banking Consolidation Directive" and the**

**possibility that the Government would have to consider the applicability of money laundering regulations. How will the LRO avoid these pitfalls?**

The difficulty with extending the limit on withdrawable shares is to keep the level of maximum shareholding at such a level that it does not fall within the requirements for regulation as a deposit taker under FSMA. There is a tension between the need for members, particularly of agricultural societies, to be able to invest in capital machinery without their investment being seen as deposits. Removing the limit on transferable shares helps to some degree by giving a further route to investment, but there is a wider issue about the treatment of withdrawable shares as deposits that will be subject to further review. The current measures will help societies in the medium term whilst a balance is sought between the need for regulation of financial services and the ability of members of IPSs to invest in their own societies.

### *Proposal A3*

**Q 10 Although the law allows charging for provision of copies, is it correct that organisations are free not to charge if they so wish? What is the typical or average actual cost of providing a set of rules, taking into account copying costs, administration time and delivery? Are society rules typically available on the internet? What will happen if a non-member requests an email copy of rules, in relation to which the administration costs would be minimal? Finally, is there any plan to remove the potential anomaly that building societies may charge only £1 for provision of copies as against the £5 proposed for IPSs?**

The current law allows societies to charge up to 10 pence, but does not require them to do so. The draft LRO, while prohibiting societies from charging members for copies of rules, will allow (but not require) societies to charge up to £5 for non-members.

Generally speaking societies' rules are not available on the Internet. There may be exceptions to this in cases such as the Cooperative Group, but many societies are very small and do not have a website. The provisions of the Electronic Communications Act 2000 has not yet been applied to IPSs, but it is hoped to do so as part of the current round of reforms.

There are no proposals to equalise the charges for rules between building societies and IPSs. The businesses of, and degree of cost to, respective societies are different and not all societies necessarily make a charge, whether building societies or IPSs.

### *Proposal A6*

**Q 11 What statistics are available on the number of societies that publish interim accounts?**

We are not aware of any statistics on this.

### *Proposal B1*

**Q 12 The support for this proposal was not overwhelming among ABCUL members (33% disagreed compared with 60% in favour). How is a liberalisation of the requirements around commonality of interest between credit union membership consistent with preserving the underlying ethic of credit unions? Please provide at least three examples of how combinations of two or more types of membership interest will on balance (i.e. taking into account and addressing possible downsides of the specific cases) be of practical benefit.**

It has been noted by the World Council of Credit Unions (WoCCU) that GB has the most restrictive credit union legislation in the world. Both the US and Canada have significantly broader membership criteria and have a thriving and competitive credit unions sector, with membership in each country at around 30% of the adult population.

The perception of some credit unions, particularly those that are small and wish to remain so, is that large credit unions are a threat to their existence. In terms of the long-term development of the sector, and looking at how it has developed in other countries, there is some truth to this. Nonetheless for the sector to grow and offer a wider range of services that its members want it must be given the facility to reach into a wider community.

The underlying ethos of credit unions is to provide a member owned and run savings and loan service that is run on cooperative principles. The proposed amendments reduce the exclusivity of membership making larger and more flexible credit unions possible as well as allowing credit unions to merge where they have similar common bonds, something which is not possible under the current legislation. This flexibility might well have prevented some of the failures that have been seen in recent years.

One particular area where greater flexibility has been specifically sought by the sector is in allowing housing associations to affiliate to a specific credit union, rather than a number of credit unions, as would be necessary under the current law, with the attendant administrative complexity. The LRO will broaden membership potential allowing a wider range of members than is currently possible.

**Q 13 The figure of 2 million for maximum potential membership was not the figure originally proposed. Given the point that was made by Castle and Minster Credit Union that there is logic in a Yorkshire-wide credit union but that such a credit union would have potential membership nearer to 4 million than 2 million, why was the figure of 2 million selected in preference to other figures (such as 3 million, for instance, which would cover every English county and metropolitan area other than London)?**

The reasons for limiting the maximum potential membership, where the common bond is geographically based, is to ensure that credit unions will remain member-based rather than open to the public generally. The risk otherwise is that they would be subject to full banking regulation, with minimum capital requirements that are outside their reach. Research carried out by one of the trade bodies, ABCUL, indicated that this was the lowest reasonable level that would be workable and meet the need for wider membership.

It should be noted that there is the possibility of increasing the maximum membership limit and as the sector grows it may be appropriate to extend or even remove the limit, depending on the ability of the sector to cope with more demanding regulation.

## Questions arising from specific points made by consultees

### *Proposal A4*

**Q 14 Co-operatives UK and CASE-DA observed that proxy voting had caused concerns with the transfer of engagements procedure on which this proposal is modelled. How does the LRO address this concern?**

The use of proxy voting is not dealt with by the LRO. Societies' rules should deal with the issue of whether members can appoint proxies to vote on their behalf. It is not something that is governed by legislation.

**Q 15 Co-operatives UK and Ian Snaith of Leicester University Law School (inter alia) made the point that the consultation document was incorrect, and that there is already an alternative dissolution procedure to that which the Treasury argues is burdensome, namely that of winding up under the Insolvency Act. Is this a valid point and, if so, does the proposal remain justifiable?**

We agree that the consultation document was incorrect in that it stated that there was only one option for dissolution. In fact solvent societies also have the option of a members' voluntary winding up under the Insolvency Act 1986, which requires a special resolution at a general meeting, but not the turnout threshold required by the existing s55. However the society is required to appoint a liquidator under this procedure.

Voluntary winding up under the Insolvency Act will remain an option alongside the new dissolution procedure in the LRO.

### *Proposal A6*

**Q 16 How does the Treasury answer the point made by several consultees (including, for example, Co-operates UK and Plymouth and South West Co-operative Society) that it would have been more appropriate and/or far-sighted to change the law on IPS interim accounts to bring it in line with company interim accounts rather than that for credit unions?**

S838 of the Companies Act 2006 sets out the requirements for company interim accounts. These are specific to companies and cross-refer to other aspects of the accounting regime for companies. Aligning the law for IPSs with that for credit unions achieves the policy goal in a straightforward manner. It is not clear what benefit there would be for societies to following the requirements for companies.

### Credit Union Proposals in general

**Q 17 How does the Treasury answer the concern raised (inter alia) by UK Credit Unions Limited that "the proposals as a whole could encourage the creation of a relatively small number of super-credit unions based in and around urban conurbations, in effect creating a two-tier movement in Britain similar to that operating in the USA"? This is raised in the Treasury summary of consultation responses but there is no real analysis of the merits of the allegation beyond a statement that the Government disagrees. A similar concern was raised by Chryston and District Credit Union. How will a tendency toward merger be avoided, if indeed avoidance is the intention? If payment of interest and other reforms are permitted, what will prevent larger credit unions using their greater financial power to make offerings that will attract the bulk of investment and displace smaller credit unions from the market?**

It is fair to say that there is some truth in the comments quoted above. Nonetheless not all credit unions can or should be small and they should be able to serve large populations in direct competition with the banking sector. The measures proposed are voluntary and there is no requirement on small societies to adopt powers that they do not wish to embrace. The smaller societies referred to can and do provide a valuable service in small communities and there is nothing to prevent them continuing to do so beyond their ability to run the credit union efficiently in the service of their members. It should be noted however that the greatest number of failure is amongst small credit unions that are able to attract and retain board members with the ability and time to run what is a financial service.

**Q 18 What reassurance can the Treasury give that the proposals will not conflict or otherwise be inconsistent with measures that the FSA might take after its current consultation on financial prudential rules? (See FSA consultation response of 9 October 2008)? What was the outcome of the further discussions between the Treasury and FSA that were requested in the FSA consultation response letter of 9 October 2008, and what is the FSA's current position in relation the revised proposals? The FSA does not appear to be in the list of bodies that were actively consulted. Were they?**

The FSA has been part of the working group from the beginning and has actively engaged with the Treasury in the development of the legislation so that it is reform of the regulatory rules for credit unions fully take account of the legislative proposals. Communication on specific areas has been on a daily basis and there has been a clear understanding between the two bodies of what each other is trying to achieve.

The FSA's consultation takes account of the proposed changes in the LRO and the amendments to the rules will not be made until the LRO has been made. The FSA has consistently sought clarity in the legislation so that it can best carry out its registration and regulatory functions with clarity and minimise the costs to credit unions that greater complexity would bring. The FSA would have preferred the Treasury to go further by making the list of common bonds in s1A(2) an indicative rather than exhaustive list i.e. in effect allowing any reasonable common bond, in order to reduce the difficulty for the FSA in interpreting and applying those common bonds to the membership criteria put forward by potential credit unions. The FSA would also prefer the limit on the number of potential members of a society to apply to all of the common bonds, not just those relating to locality. This would simplify the role of FSA as registrar, but was considered to be unnecessarily limiting on credit unions.

### *Proposal B1*

**Q 19 Blackburn, Seafield & District Credit Union make the point that not all existing large credit unions will be able to meet the requirement that it be reasonably practicable for all potential members to be able to take part in society activities. Where does this leave a credit union whose existing members might not be able to participate in committee activities because they live too far away from where the credit union conducts committee business?**

The purpose of the reform proposed is precisely that credit union members must be able to engage with the credit union and the credit unions must be clear that it can provide the services that it has committed to, to all members. Otherwise there is a risk of some members in larger credit unions being marginalised. Existing credit unions will be unaffected by the amendments and will not have to change their rules unless they seek to take advantage of the new flexibility for combinations of common bonds. It is implicit in the current law that a credit union should be able to meet all the needs of its members and that they should be able to participate. The amendments create wider boundaries and it is appropriate for there to be safeguards to protect the mutual and democratic nature of these bodies.

We are not aware of any existing credit unions which would be required to meet the additional requirements in new section 1B once the LRO comes into force but would not in fact be able to do so.

### *Proposal B4*

**Q 20 Do the proposals allow for FSA approval of corporate membership as suggested by Glasgow Credit Union? If not, was this considered and what substitute reassurances apply? What is the position on FSA involvement in the approval process in general? Will the FSA approve individual credit unions admitting corporate members, or will they also have a say in which corporate members are permitted to join?**

There are safeguards built into the LRO by way of limits on corporate membership. It is up to the individual credit union how it manages its business and it should know its own business better than the FSA. If members vote in favour of corporate membership, it is not clear on what basis the FSA should be able to withhold approval.

### *Proposal B6*

**Q 21 Blackburn, Seafield & District Credit Union observe that staff and directors could help themselves to higher dividends and that auditing might not reveal that for some time. How is this addressed by the LRO?**

None of the provisions in the LRO makes fraud on the part of staff or directors easier to accomplish. Directors would be liable in the usual way for any breaches of their fiduciary duties, but this is not something the LRO attempts to address.

### *Proposal B7*

**Q 22 Blackburn, Seafield & District Credit Union observe that staff and directors could give themselves a large loan one day and remove their shares the next. If the decision on attachment is to lie in the hands of directors, how is this point addressed in relation to directors by the LRO?**

Decisions on attachment are currently in the hands of directors. The amendment made by the LRO is to require directors to make the decision at the time of issuing a loan rather than when a member later seeks to withdraw shares. Directors would be liable in the usual way for any breaches of their fiduciary duties, but this is not something the LRO attempts to address.

### *Proposal B8*

**Q 23 Glasgow Credit Union was concerned about credit unions entering into hire purchase agreements. Will Proposal B8 permit this and if so what analysis has been performed of the consequences?**

Proposal B8 allows a credit union to charge such fees as it considers appropriate for providing ancillary services. Currently, credit unions can only cover their costs. We presume that Glasgow Credit Union is concerned that credit unions could enter into hire-purchase agreements as an "ancillary service". Ancillary services is defined in the existing s9A of the 1979 Act as *"any service which is ancillary to the activity of accepting a deposit or making a loan, and includes: (a) the making or receiving of payments, made by way of standing order, direct debit or any other means, as agent for a member or any other person from whom the credit union has accepted a deposit; (b) issuing and administering means of payment (for example, chequebooks and debit cards); (c) money transmission services; and (d) giving advice on the services specified by paragraphs (a) to (c) above*". We do not think that hire purchase agreements would fall within this definition.

# Annex 2

### Response by HM Treasury to further written questions (dated 19 March 2010)

**Q1 In relation to Proposal B4, what are the risks associated with lending to unincorporated associations and/or partnerships compared with those involved in lending to individuals, sole traders, and incorporated bodies? If there might be greater risks inherent in lending to unincorporated associations than for individuals, sole traders and incorporated bodies, do those risks extend to partnerships, or is the liability of partnership members sufficiently clear in law to reduce any risk to levels comparable with that for companies?**

### Liability of members of unincorporated associations

1. The law in relation to the liability of members of unincorporated associations to third parties is complex and what is written below is intended to be a broad summary rather than a detailed analysis.

2. An unincorporated association is not a legal person and therefore cannot sue or be sued. Nor can a contract be made so as to bind all persons who from time to time become members of such an association.

3. 'Corporate member' is defined in new s5A (inserted by article 11 of the draft LRO) as including "an individual who is a member of the credit union in his capacity as a trustee for an unincorporated association".

4. The member of the credit union will therefore be an individual who has joined in his capacity as a trustee[32] of the unincorporated association. Any loan for the benefit of the association would be made to that individual member.

5. Contractual liability rests on those who authorised the contract in accordance with ordinary principles of agency. If a member signs a contract for the purchase of property on the management committee's authorisation, the committee members will be contractually liable: the committee is normally contractually liable for all contracts made in the course of business. A member will be personally liable if he enters into contracts on behalf of the association without authority or acts in excess of authority given to him.

6. Where the association is a club, the liability of members is usually expressly or impliedly restricted to the amount of the subscription or membership fee due from them[33]. So no member of a member's club is liable to

32 Any property held by an association is usually held in the name of a trustee or trustees.

33 Wise v Perpetual Trustee Co Ltd [1903] AC 139

a creditor except to the extent that he has expressly or impliedly authorised some official of the club to pledge his personal credit.

7. If a trustee of an association enters into the loan in his capacity as trustee of the association's funds, he would be personally liable for the loan, subject to an express term in the loan agreement to the contrary, although he may be entitled to an indemnity from the trust fund depending on the terms of the trust.

### *Liability of partners*

8. Again, it will be an individual partner rather than the firm which is a member of the credit union and to whom any loan would be made. Every partner is an agent of the firm and his other partners for the purpose of the business of the partnership. The general rule is that the acts of partners in carrying on, in the usual way, business of the kind carried on by the firm bind the firm. This would not apply if the partner has no authority to act for the firm in a particular matter, and the person with whom he is dealing knows that he has no authority, or does not know or believe him to be a partner[34]. Thus the authority of a partner to act, and bind other partners is more clearly circumscribed in law than is the case for unincorporated associations.

9. Each partner is personally liable for all the debts of the partnership, regardless of any internal agreements reached by the partners as to the allocation of the firm's obligations. Liability of partners is joint and several, which means that claims against all or any of the partners can be contemporaneous or successive.[35]

### *Risk of lending to clubs or partnerships*

10. The specific risks associated with lending to a club trustee or a partner will depend on the particular circumstances, which are for the credit union board (or lending committee) to establish. The risk does not seem to be any greater than lending to an individual in the normal way, and is arguably less as in the event of default there would be more people who could be called upon to meet the debt. This is a benefit not available if the loan were purely to an individual or corporate entity where only the borrower's assets will be available to repay the loan, unless other people have given personal contractual guarantees as part of the deal.

11. Not all risk can or should be mitigated and boards have to exercise due diligence in making lending decisions. As a professional lender, a credit union will take the appropriate steps when deciding whether to lend and to deal with issues of security for a loan, whether it is lending to individuals, trustees, partners or corporate bodies.

12. Legal enforceability is only part of the risk that the credit union will have to take into account. Prior to that comes the credit union's assessment of the likelihood of the debt being repaid. Credit unions are used to making that assessment in respect of individuals and will be well placed to carry out assessments on individuals in partnership or in unincorporated associations as part of the decision making process in granting a loan. They take into account factors like savings record, repayment record, affordability and creditworthiness.

13. It is worth noting that unincorporated associations and partnerships would be made up of individuals who would themselves probably qualify for membership of the credit union and would be likely to be individual members already. They would be based in the community/workplace/association the credit union serves so would have a similar tie to the common bond as an individual. Therefore on one view they would be less likely to default on repayments than a purely commercial corporate body.

34 S5 Partnership Act 1890.

35 The position is different for limited partners, who are not liable for anything exceeding the amount they have contributed to the firm. A limited partnership must consist of at least one 'general partner' who is liable for all debts or obligations of the firm.

14. The LRO limits corporate membership and the aggregate of their loan balances to ten per cent of the whole - so the overall risk to the credit union is mitigated in that way. The share attachment concept can be applied to them, just as it can to other members.

15. Credit unions will need to deal with lending to corporates in the lending policy statement required by FSA rules. In relation to lending, FSA rules treat corporates in the same way as other members. These restrict Version 1 credit unions with capital of less than 5% to lending no more than £7,500 above a member's attached shares, Version 1 credit unions with 5% capital or more to lending no more than £15,000 above the member's attached shares and Version 2 credit unions to lending no more than (1) £15,000 in excess of the attached shares held by that member; or (2) an amount equivalent to 1.5% of total non-deferred shares in the credit union in excess of the attached shares held by that member; whichever is the greater.

16. In addition, loans would be subject to normal large exposure limits, which must be monitored by the board.

17. Before a credit union would start lending to unincorporated associations or partnerships, they would be required to go through the following steps:

- Seek agreement from the membership at an Annual General Meeting or Special General Meeting to a rule change which will allow the credit union to accept bodies corporate and/or partnerships and/or unincorporated associations into membership

- Register these rule changes with the FSA

- Have in place an up to date lending policy which reflects the change to a wider potential membership

- Inform the FSA (separately from the rule change) that it will begin to accept corporate members

18. It is the Treasury's view that the benefit of this change to the law in terms of the flexibility it provides credit unions outweighs any increase in risk, which will need to be managed by credit unions taking advantage of this. It is also worth noting that other financial services providers already have these powers without such restrictions.

### *Views of consultees*

19. No concerns were raised by consultees regarding the risks involved in credit unions making loans to clubs or partnerships. We have put this specific question to the working group this week. They remain supportive of the proposal and the comments we received have been incorporated into this response.

# Appendix

### Response from the FSA (dated 4 January 2010)

On question 12:
Two examples of how combination of common bonds may be of practical benefit.

The first relates to credit unions that get into difficulties. Larger, and hopefully more robust, credit unions will be possible under the new criteria. They may be able to take over credit unions with management problems (that would otherwise fail). The more robust credit unions may still be unwilling or unable to take over credit unions with negative reserves, preferring to allow the FSCS to compensate the members. However, they might choose to expand their common bonds, so they could admit the members of the failed credit unions, meaning that those persons wouldn't lose access to credit union services. The FSA is proposing rule changes that are intended to reduce the incidence of negative reserves, so the takeover of credit unions themselves (rather than taking on their ex-members) should become more practicable in future.

The second relates to housing associations. Under current law, it's difficult to establish a membership qualification for housing associations, given the different relationships that people may have with them (various kinds of tenancies, shared ownership schemes, employment). It's especially problematic where the association has national scope, and there's no interaction between the various groups of people involved. The associations want to link up with established credit unions, rather than being involved in the setting-up of new ones. They want to offer the same service, provided by the same credit union, to all their tenants etc, which cannot be done without the freedom to combine qualifications.

A third example might relate to changing employment structures. Where there was once a single employer, there are now group structures involving separate companies - plus sub-contractual arrangements, consultancy and self-employment. It's sometimes impossible to cover all these elements without combination of qualifications.

On question 10:

The new maximum charge for providing a copy of the rules is not specific to credit unions. [We do not] have any figures for the actual cost of doing this, which probably varies considerably according to the volume of requests and the nature of the copies provided. The £5 maximum strikes me as a compromise figure - to protect societies against frivolous requests, and consumers against prohibitive pricing. I don't know whether the higher maximum for IPSs (compared with building societies) can be justified except on a "times-move-on" basis.

On question 18:
[It] would be fair to say that the FSA is content with the "attachment of shares" proposal.

What we wanted from the attachment provisions were clarity and certainty (as a basis for our rules). We wanted to avoid a situation in which shares were nominally "attached", but in practice "unattached". We were content with what we understood was the policy intent behind the drafting of article 18(2) of the LRO (the new section 11(1C) of the Credit Unions Act): that the credit union and member should agree, at the time that the loan was made, which shares were withdrawable and which non-withdrawable. If the parties agreed that particular shares were non-withdrawable, they would remain so for the life of the loan. If the credit union wanted to increase its exposure to the member, it would have to do so by an additional loan, not a withdrawal of shares. We drafted the rules in our consultation paper on the basis of that interpretation of the LRO.

# Formal Minutes relating to the report

## Tuesday 23 March 2010

Members present:

Andrew Miller, in the Chair

Gordon Banks
John Hemming
Judy Mallaber
Dr Doug Naysmith
Phil Wilson

Draft Report (*Draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010)*, proposed by the Chair, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 83 read and agreed to.

Annexes and Summary agreed to.

Papers were appended to the Report as Annexes and an Appendix.

*Resolved*, That the Report be the Second Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

[Adjourned till Tuesday 30 March at 9.30 pm

# List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

**Session 2009-10**

| | | |
|---|---|---|
| First | Draft Legislative Reform (Dangerous Wild Animals) (Licensing) Order 2010 | HC 288 |
| Third | Draft Legislative Reform (Licensing) (Interim Authority Notices etc) Order 2010 | HC 507 |

**Session 2008-09**

| | | |
|---|---|---|
| First | Draft Legislative Reform (Insolvency) (Advertising Requirements) Order 2009 | HC 181 |
| Second | Draft Legislative Reform (Minor Variations to Premises Licences and Club Premises Certificates) Order 2009: Second stage | HC 209 |
| Third | Draft Legislative Reform (Supervision of Alcohol Sales in Church and Village Halls &c.) Order 2009 | HC 210 |
| Fourth | Draft Legislative Reform (Local Government) (Animal Health Functions) Order 2009 | HC 399 |
| Fifth | Draft Legislative Reform (Minor Variations to Premises Licences and Club Premises Certificates) Order 2009 | HC 400 |
| Sixth | Draft Legislative Reform (Limited Partnerships) Order 2009 | HC 794 |
| Seventh | Draft Legislative Reform (Dangerous Wild Animals) (Licensing) Order 2009 | HC 795 |
| Eighth | Draft Legislative Reform (Insolvency) (Miscellaneous Provisions) Order 2009 | HC 883 |
| Ninth | Themes and Trends in Regulatory Reform | HC 329-I and III (597) |
| Tenth | Draft Legislative Reform (Revocation of Prescribed Form of Penalty Notice for Disorderly Behaviour) Order 2009 | HC 1108 |
| Eleventh | Draft Legislative Reform (Insolvency) (Miscellaneous Provisions) Order 2009 | HC 1111 |

**Session 2007-08**

| | | |
|---|---|---|
| First | Draft Legislative Reform (Local Authority Consent Requirements) (England and Wales) Order 2007 | HC 135 |
| Second | Draft Legislative Reform (Health and Safety Executive) Order 2008 | HC 398 |
| Third | Draft Legislative Reform (Consumer Credit) Order 2008 | HC 939 |

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|---|---|---|
| Fourth | Draft Legislative Reform (Local Authority Consent Requirements) (England and Wales) Order 2008 | HC 940 |
| Fifth | Getting Results: the Better Regulation Executive and the Impact of the Regulatory Reform Agenda | HC 474-I and II (1186) |
| Sixth | Draft Legislative Reform (Lloyd's) Order 2008 | HC 1090 |