House of Commons

Regulatory Reform Committee

Draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011: Second Stage

Third Report of Session 2010–12

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

The current staff of the Committee are John Whatley (Clerk), John-Paul Flaherty (Inquiry Manager) and Liz Booth (Committee Assistant). Assistance was also provided for this report by Neil Caulfield (former Inquiry Manager to the Committee).

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The revised draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011, voluntary Explanatory Document and Accompanying Statement were laid before Parliament on 19 July 2011 by HM Treasury under section 18(7) of the Legislative and Regulatory Reform Act 2006 (the LRRA). This is the second stage in a two-stage procedure relating to the draft Order, the first stage of which comprised the laying of an initial draft on which the previous Regulatory Reform Committee reported in its Second Report of 2009-10, dated 29 March 2010.

If approved, the draft Order would reform the law relating to industrial and provident societies and credit unions in a total of 14 areas which were set out in the Report of the previous Regulatory Reform Committee.[1]

The revised draft Order responds to recommendations of the previous Regulatory Reform Committee and of the House of Lords Delegated Powers and Regulatory Reform Committee calling for certain limited modifications of the initially laid draft. Those recommendations have been more or less entirely accepted by HM Treasury and on that basis our report concludes that the revised draft Order should be approved.

1 HC–506, Session 2009–10

1 Introduction

1. The first 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) with a recommendation that the super-affirmative procedure be adopted, whereby amendments can be suggested by the relevant parliamentary scrutiny committees, namely, the Regulatory Reform Committee of the House of Commons and the House of Lords Delegated Powers and Regulatory Reform Committee.

The proposals

2. As with the present draft, the first draft Order contained 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 were 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 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)

The first stage of this LRO

3. The first-stage draft Order was considered in our predecessor Committee's Second Report of 2009-10, dated 29 March,[2] which summarised the current law on IPSs and credit unions at paragraphs 2 to 6. In its Report, the Committee criticised certain aspects of the Explanatory Document that accompanied the first draft Order, in particular the lack of economic analysis.[3] However, the Committee recommended that all of the 'A' proposals be proceeded with and also recommended without comment that proposals B3 and B7 be proceeded with.

4. Our predecessor Committee had a number of comments or recommendations on the other 'B' proposals. On B1/B2 (which sit together), the Committee recommended that the proposals be proceeded with, subject to a caveat about the direction of travel of any further change, and in particular the risk of possible dilution of the 'mutual' ethic of credit unions. The Committee accepted proposal B4 but with a recommendation that statutory instruments varying the caps on membership, shareholding and lending be subject to the affirmative procedure rather than the negative procedure recommended by HM Treasury. Proposal B5 was accepted with a note on the need for diligent monitoring of liquidity and for intervention to protect credit union members where necessary.

5. The previous Committee recommended that proposal B6 be proceeded with, but with a modification so that credit union members would be required expressly to endorse a decision to abolish the 8% limit. Proposal B8 was accepted, but on the basis that it be reviewed after two years to take account of any adverse effects on members and of a consultation taking specific account of members' views. The Lords, however, took the view that the proposal should apply only to new members. This is addressed further under the section on proposal B8.[4]

6. The previous Committee concluded:

> "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

2 HC 506, Session 2009–10

3 See paragraphs 7–9.

4 See paragraph 55

IPSs and credit unions and hope that any successor Committee reaches the same conclusion."[5]

The second stage documents

7. In accordance with section 18(7) of the LRRA a second, revised, draft Order has now been laid, on 19 July 2011, together with a 'voluntary' Explanatory Document, a considerably expanded Impact Assessment containing more detailed economic analysis, and an Accompanying Statement setting out the basis of the modifications in this revised draft. Essentially the recommendations of both the previous Commons and Lords committees have been accepted in their entirety.

Expanded impact assessment with additional economic analysis

8. The expanded Impact Assessment has been provided to address the criticisms made by our predecessor Committee's report about the lack of detail, and now includes survey data on take-up rates and on costs and benefits. For the 'A' proposals, one-off transitional costs are identified of £550,000 alongside annual benefits of £4,075,000. The total one-off costs of the B proposals are identified as £2,190,000 to which by far the biggest contributors are proposals B1 and B2 with a one-off cost of £830,000. Benefits (expressed in net present value terms) are estimated at between £6.9m based on 5% profit growth, through £13.9m based on 10% profit growth, to £27.7m based on 20% profit growth.

The format of this report

9. Although certain of the 'B' proposals are unchanged since Stage One, we have chosen to deal with them all, and sequentially, so that they can be seen in context and so that we can respond to certain comments of HM Treasury made in the Accompanying Statement in relation to unmodified proposals. The 'A' proposals remain unchanged and we do not believe that they call for further comment or decision beyond that expressed by our predecessor Committee. Before dealing with the proposals, however, we set out the tests for application under the LRRA.

2 Preconditions and tests

10. Under House of Commons Public Business Standing Order No. 141, the Committee is charged with assessing whether the proposals meet conditions broadly mirroring those in the LRRA together with various other tests (those set out in Standing Order No. 151, appropriateness for delegated legislation, and compatibility with European Union obligations).

11. The tests in the LRRA are essentially that:

- there is removal of a burden;
- there is adequate consultation;

5 Paragraph 83 of its Report, *op. cit.*

- the policy objective could not be satisfactorily secured by non-legislative means;
- the effects of the proposed changes to the law are proportionate to the policy objective;
- the proposed changes strike a fair balance between public and private interests;
- the proposed changes to the law do not deprive anyone of a necessary protection;
- the proposed changes will not prevent anyone from continuing to exercise a right or freedom that they might reasonably expect to continue to be allowed to do;
- the proposals are not of "constitutional significance."

3 The proposals for modifying the law on IPSs (the 'A' proposals)

12. As stated, our predecessor Committee approved these in their entirety, as did the House of Lords Delegated Powers and Regulatory Reform Committee. The proposals were uncontroversial. The revised draft LRO does not contain any changes to the proposals.

13. **We agree with the previous Committee that these proposals meet the requirements of the LRRA and we recommend that they be approved.**

4 The proposals for modifying the law on credit unions (the 'B' proposals)

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"

14. This proposal remains the same as at Stage One, but the outline from the earlier Report is included because certain aspects of the proposal were commented on by our predecessor Committee and by the Delegated Powers and Regulatory Reform Committee.

Outline

15. 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"), 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 a single credit union to extend membership both to

people who work locally and to people who are employed locally. It was added by a Deregulation Order of 1996.[6]

16. 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 those who fulfil either the bona fide membership qualification or any one of the other qualifications.

17. 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 Financial Services Authority (FSA) (which is the relevant regulator) 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.

18. The proposal would therefore dispense with the "two-step" approach to demonstrating a common bond and allow the Financial Services Authority (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).

19. 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.

20. 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 proposed that the power to raise the cap on membership numbers should be exercisable by way of negative instrument.

Views of consultation respondents

21. Consultation respondents supported the proposals. For instance, 77% of Association of British Credit Unions Limited (ABCUL) members favoured replacing the common bond test with a field of membership test and 89% of ABCUL members favoured allowing credit

6 The Deregulation (Credit Unions) Order 1996

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. 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).

22. 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.[7]

23. Our predecessor Committee was concerned 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. That Committee believed that there was a risk of the 'mutual' ethic being 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 agree that this should be very carefully borne in mind if any further changes are mooted. In the Accompanying Statement[8] the Treasury has reiterated the Government's commitment to mutuality as set out in the Coalition Agreement.[9]

24. **We agree with our predecessor Committee that this and other proposals in the draft Order would serve to put credit unions in a better competitive position.**

Preconditions and tests

25. **Subject to the comments in the foregoing paragraph, we agree with our predecessor Committee 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 therefore also agree that the proposal meets the requirements of the LRRA.**

26. In the initial draft, the cap on membership was proposed to be modifiable by negative instrument. At stage one of the LRO's consideration, the Lords Committee drew attention to this, while not itself raising any actual objection. Our predecessor Committee, however, accepted that a negative instrument would be appropriate. At this second stage, HM Treasury has proposed retaining the negative procedure.

27. **We agree with the view of the previous Regulatory Reform Committee that it is satisfactory for any instrument changing the membership cap position as proposed in the draft LRO to be a negative instrument.**

7 See summary of consultation responses, paragraph 3.47

8 See paragraph 47

9 See section 27 of the Coalition Agreement

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

28. This proposal is unaltered since Stage One. It would allow members who have ceased to meet the qualifying criteria for membership to remain as members despite their changed status, avoiding the resultant disruption to them and their credit union. It is uncontroversial.

29. **We agree 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

30. This proposal has been amended since Stage One and therefore the outline from the earlier Report is included by way of background.

Outline

31. The current law permits IPSs in general to admit corporate bodies to membership, but with a specific exclusion for credit unions that prevents them from 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.

32. 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.

33. The proposal would also create a new class of shares, called "deferred shares",[10] 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.

34. At Stage One, HM Treasury proposed that the caps on membership and lending could be varied by way of a negative procedure statutory instrument.[11] The reason given was "existing policy that where only thresholds or limits are being amended, as opposed to the

10 The definition of which would be amendable by negative SI

11 See original consultation document paragraph 3.72

legislation itself, then the use of the negative resolution procedure is appropriate."[12] 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."[13] 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

35. 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.[14] 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

36. Our predecessor Committee noted that the proposal opens up the possibility of credit unions providing loans to unincorporated associations and partnerships and that there are risks in lending to such bodies, deriving from the difficulties in defining who is liable for their debts. However, it was satisfied with the response it received from HM Treasury to a question on this specific point and therefore accepted the principle of the proposal. Nevertheless, it recommended that the LRO require any order varying the membership, shareholding and lending caps to be in the form of an affirmative procedure statutory instrument. The Delegated Powers and Regulatory Reform Committee took the same view.

37. **The Government has accepted that the LRO should be modified as recommended by the relevant parliamentary scrutiny committees. On that basis we recommend that the proposal be approved.**

38. Our predecessor Committee also expressed some dissatisfaction with the lack of detailed economic analysis in the original Explanatory Document (ED) in relation to Proposal B4 (and B1/B2).[15] The Accompanying Statement seeks to address this point at paragraphs 91–93 and in an updated impact assessment which goes some way to

12 Original ED, paragraph 4.80

13 Summary of consultation responses, paragraph 3.27

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

15 See paragraph 7 of the First Stage Report

addressing the point. **We acknowledge the efforts made by HM Treasury to address the criticisms made by our predecessor Committee on the lack of detailed economic analysis on proposals B1/B2 and B4 and welcome the cost-benefit assessment made in the revised documents.**

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

39. This proposal is unaltered since Stage One, but has been commented on in the Accompanying Statement. The outline from the earlier Report is therefore included by way of background.

Outline

40. 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, whichever 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.

41. 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.

Preconditions and tests

42. Our predecessor Committee noted that this proposal marked 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. It took the view that 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. However, ultimately it believed that the proposal contained sufficient safeguards to meet the requirements of the LRRA. The Accompanying Statement says:

> The Treasury is mindful of the importance of liquidity and sound regulation. The FSA currently monitors both the liquidity and capital positions of credit unions - against the requirements of the FSA's rules on these matters, as set out in the Credit Unions sourcebook (CRED). In future, the FSA will also monitor compliance with the reserves requirement for the issue of interest-bearing shares - £50,000 or 5% of

total assets – referred to as "minimum liquidity protections" in paragraph 69 of the Committee's report.[16]

43. **We agree with the position taken by the previous Committee and note the comments from HM Treasury in the Accompanying Statement. We recommend that the proposal be approved.**

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

B6 Abolish the 8% per annum limit on dividends

45. This proposal has been amended since Stage One.

Outline

46. The 1979 Act prevents credit unions from paying a dividend in excess of 8% 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

47. 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

48. Our predecessor Committee recommended that the proposal be proceeded with but with an eye on liquidity considerations suggested a modification whereby members be expressly required to endorse a decision to abolish the 8% limit. HM Treasury has accepted that members should have a right under the appropriate rules to endorse the abolition of the 8% limit at an annual or special general meeting.

49. **On the basis that the concerns of our predecessor Committee have been met by HM Treasury's modified position, we recommend that the revised proposal be approved.**

16 See paragraph 60

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

50. This proposal is unchanged since Stage One, but the background from the earlier report is included by way of completeness as this is a complex proposal.

Outline

51. 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,[17] 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.

Views of consultation respondents

52. 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.

53. Respondents were not convinced that the proposal would remove a burden, however. ABCUL 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

54. **We agree with the previous Committee 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 vis-à-vis the tests in the LRRA the proposal therefore removes a burden.**

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

55. This proposal has been amended since Stage One.

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

Outline

56. Under the 1979 Act (as amended) 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 operates as 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

57. 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. Our predecessor Committee believed that this was 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 proposal is one on which there might well be a divergence of views between those two constituencies. On this, the Accompanying Statement merely notes that it is for individual credit union members to decide whether they wish to participate in consultation, that the technical nature of the issues might have discouraged responses, and that some members might have contributed to the response of their credit union.[18]

58. **We believe that HM Treasury has somewhat missed the point in relation to our predecessor Committee's observations on consultation on proposal B8. That Committee took the view that proposal B8 might have merited active consultation of individual members. An appropriately designed active consultation could have avoided all of the problems noted by the Treasury and at the same time might have established whether there was a constituency of low-income credit unions for whom the replacement of cost-recovery charging with market rate charging would be a genuine issue.**

Legislative history

59. Cost-recovery based charging was introduced by a Regulatory Reform Order of 2003. In its scrutiny of the draft Order, the then Regulatory Reform Committee took the view that that basis of charging was proportionate[19] and struck a fair balance between different interests.[20] That Committee said:[21]

> 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

18 See paragraph 85, Accompanying Statement

19 See paragraph 24 of the First Report of 2002–03

20 See paragraph 30, ibid.

21 See paragraph 35, ibid.

> 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.

It added: "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."[22]

60. The significance of this is that HM Treasury has shifted its position to one that favours profit-based charging even though essentially the same arguments would have applied in 2003.

Preconditions and tests

61. In its conclusion on proposal B8, our predecessor Committee said:

> 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.

62. The Delegated Powers and Regulatory Reform Committee believed that the proposal would remove a significant and longstanding right from existing members which those members have a reasonable expectation should continue, thereby conflicting with the requirements of section 3(2)(e) of the LRRA. The Lords Committee therefore recommended that the proposal be amended to apply only to new members. It also questioned the wording of the first draft LRO which would have permitted a credit union to charge "such fees as it considers appropriate".

63. In a submission to us dated 9 September 2010 and reproduced as an Appendix, ABCUL argued the case against continuing with cost-recovery charging for two main reasons. The first reason was that credit unions are prevented from generating a fair and reasonable income from service provision and using it to build the reserves and capital of the credit union and/or to cross-subsidise other parts of the business. ABCUL argued that this was important to the objective of strengthening credit unions finance base.

64. The second reason was that in ABCUL's view it is unclear how to calculate costs of the relevant services objectively, which might disincentivise credit unions from providing a useful service. ABCUL observed that a significant minority of credit unions had not

22 See paragraph 46, ibid.

developed new services for members either because they were unable to make a fair and reasonable income or because of difficulties in calculating costs.

65. In response to the concerns of the Committees, ABCUL argued that, as financial co-operatives, credit unions do not seek to exploit users of their services, that credit unions operate on a one member, one vote basis, and that restricting market-based charging to new members would restrict the scope for innovation and product development. ABCUL further argued that proposal B8 was only ever optional, not mandatory, that it would be unlikely for credit unions ever to wish to develop services charged at a market rate only for new members, and that the relevant services would probably be offered at a lower cost than by other market providers of for example cheque accounts.

66. Although these arguments from ABCUL do not entirely address the problem of a minority membership for whom charging could remain a problem, nor the fact that difficulties in calculating costs were presumably as evident in 2003 as they are now, it was (no doubt) for these reasons that our predecessor Committee recommended acceptance of the original proposal but with a two-year post-implementation review. **We stand by the view that this approach would have been a preferable option.**

67. However, that option has not been adopted by HM Treasury and is therefore not currently available for discussion. In response to the combined concerns of the respective Committees, HM Treasury has instead agreed to restrict the application of the proposal to new members, and to conduct a review of implementation two years after coming into force in which one of the issues to be addressed will be that of whether fees are being charged at market rates.

68. The Accompanying Statement notes that ABCUL is agreeable to the compromise position proposed by HM Treasury.[23] Although it might not be ideal, we recognise the value of this compromise in allowing matters to proceed. It might be that a further opportunity for evidence-based reform will present itself, and we would encourage efforts in that direction. The proposal as revised would not in our view appear to present any problem from the point of view of compliance with the LRRA.

69. **On the basis that the concerns of our predecessor Committee and of the House of Lords Committee have been addressed, we recommend that the revised proposal be approved. However, for the reasons given above we recommend that in its post-implementation review HM Treasury consult actively with members of credit unions to establish a firm evidence base for whether market rate charging of existing members presents an issue.**

5 Delay in laying of the second stage draft Order

70. The delay in the second stage procedure cannot pass without some comment. Our predecessor Committee dealt with the original proposals in March 2010. It has taken a

23 See Accompanying Statement, paragraph 98

further 16 months to lay second stage documents—partly, of course, because of election disruption, but also because an intervening change to the law occurred to permit electronic communication between credit unions and their members and to allow fulfilment of statutory obligations by electronic means.[24]

71. However, even after allowance is made for an intervening election, the additional change to the law, and the preparation of expanded documents, including a more detailed impact assessment, it is regrettable that the second stage of this LRO has taken so long.

6 Conclusion

72. **We note that the revised draft Order has sought to incorporate the significant recommendations made by the parliamentary scrutiny committees in early 2010 and therefore recommend that the proposals in the revised draft Order be approved.**

24 See paragraph 2.6 of the Accompanying Statement

Appendix

Memorandum submitted by the Association of British Credit Unions Limited (ABCUL)

Introduction

ABCUL is the main trade association for credit unions in England, Scotland and Wales. We represent around 70% of credit unions in Great Britain, which in turn provide services to around 80% of credit unions.

Securing legislative change for credit unions is a key objective of the Association. We have worked closely with HM Treasury over the past 3 ½ years, consulting with our members to prepare comprehensive responses to HM Treasury consultations and Mark Lyonette and Abbie Shelton have been part of the HM Treasury Working Group established to advise on the legislation.

We have been appreciative throughout the process of the efforts taken by both Ministers and civil servants to help build a legislative regime for the credit union sector which will help credit unions to meet the needs of their members and bring inclusive financial services, including affordable credit and safe savings to many more people.

We read with interest the reports from both the Regulatory Reform Committee and the Delegated Powers and Regulatory Reform Committee and welcome the general support for these important changes. We understand that with key changes such as these the important role of the committees in providing scrutiny in the LRO process will raise some concerns that have not been brought up during the consultation process.

We would like to take this opportunity to respond to some of the valid concerns raised by the committees during their examination of the LRO and attempt to alleviate some of these concerns.

Background to the proposed change

In response to the HM Treasury review of GB co-operative and credit union legislation in the Summer of 2007, we put forward a case for removing the restriction placed on credit unions in section 9A of the Credit Unions Act 1979:

> *A credit union which provides an ancillary service to a member or any other person from whom the credit union has accepted a deposit may charge a fee to cover the cost of providing that service.*

The specification that a fee may only be charged to cover the cost of the services has caused problems for a number of credit unions and we raised this issue on their behalf.

In our response to the review we said:

> *At present, credit unions can only charge for auxiliary services to cover the cost of providing that service. This causes problems for two main reasons:*
>
> - *Credit unions are prevented from generating a fair and reasonable income from the provision of services. This prevents them using that income to build the reserves and capital of the credit union..This income could be used to cross subsidise other, less income generating, parts of the business If credit unions are to strengthen themselves they have to generate income to build reserves and capital and pay dividends.*
>
> - *It is unclear what costs can be charged for in practice and how this is to be calculated Costs such as heat and light could be factored in, but how this would relate to an individual's use of a service is difficult to calculate. A percentage charge for, e.g., a home collection service, could not be used as this is not directly related to the cost of collection. The true cost of providing a service is very*

> *difficult to objectively calculate and verify. Credit unions may be put off providing a useful service to members because they find it difficult to calculate the costs and because they cannot generate any income from the service.*

A significant minority of credit unions told us that they had not developed new services for members either because they weren't able to make a fair and reasonable income from the provision of this service (24%) or because of difficulties in calculating the exact cost of providing this service.

Changes to remove this restriction were proposed when HM Treasury published proposals for a draft legislative reform order in 2008.

In our response to proposals to remove this restriction, we said the following -

> *"We strongly support this proposal as it will mean that credit unions are more easily able to develop new products to meet the needs of their members. Credit unions can currently be put off developing innovative new products to meet the needs of their members and attract new members because of the difficulties of calculating the cost of providing this service. Credit unions do not want to charge excessive rates for any service but making a small surplus on products which members can choose to purchase and will value will enable credit unions to cross subsidise the development or provision of other services and will enable credit unions to develop new ways of generating income. All income from the credit union is used to run and develop the credit union or is returned to members as a dividend so no member will be exploited through this change and members will benefit from a wider range of products to meet their diverse and changing needs."*

79% of members agreed with the proposal to remove these restrictions and the following comments received from our member credit unions illustrate the fact that credit unions do want to innovate to meet the needs of their members (which is all that they exist to do), and are put off doing so by current legal restrictions. The comments also illustrate that making large profits out of services provided to members is not the intention of any credit unions which would seek to develop new products to help their members to better manage their financial affairs.

> *"I think it is against the ethos of credit unions to seek to make excessive profit from providing any services However, I believe that the rates charged should be on a full cost basis and should make an appropriate contribution to the surplus."*

> *"The lack of being able generate a profit from ancillary services is holding back product development at this stage."*

Concerns raised by Regulatory Reform Committee and Delegated Powers and Regulatory Reform Committee

Concerns from members of the Regulatory Reform Committee and Delegated Powers and Regulatory Reform Committee have centred on the potential for members to be exploited by the credit union charging high rates for extra services.

We would like to take this opportunity to provide our response to the concerns raised

Concerns raised by Regulatory Reform Committee

> *"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."*

Concerns raised by Delegated Powers and Regulatory Reform Committee

> "Under the 1979 Act credit unions may only charge on a cost-recovery basis for services which are ancillary to accepting a deposit or making a loan, such as making or receiving payments, issuing and administering chequebooks and money transactions. Proposal B8 is described as being to allow credit unions to charge the market rate for providing ancillary services to their members (e.g. ED paragraph 2.14). The Treasury say (ED paragraph 4.112) that they consider the impact on those who have to pay more for ancillary services is outweighed by the public interest of giving credit unions an additional source of funding and encouraging them to offer ancillary services where they do not do so already. However, in removing a member's right to pay for ancillary services at only a cost recovery rate, proposal B8 does remove a significant and longstanding right from existing members which, it seems to the Committee, those members have a reasonable expectation that they should continue to receive. As such, it appears that the proposal fails to satisfy the precondition set out in section 3(2)(e) of the 2006 Act. **The Committee therefore concludes that proposal B8 should be amended so that it applies only to new members, and not to the existing members of credit unions.**
>
> *"The ED describes proposal B8 as being to allow credit unions to charge "the market rate" for ancillary services (e.g. paragraph 2.14). But the draft LRO itself actually proposes to allow a credit union to charge "such fee as it considers appropriate for" providing ancillary services (article 20).* ***The Committee draws to the attention of the House the apparently very broad discretion given to credit unions by article 20."***

Our response

We understand that committee members may have concerns about the effect on credit union members of removing this restriction. We would like seek to reassure committee members that the effect of this change would not disadvantage credit union members or exploit low income consumers in any way:

Credit unions do not seek to exploit the people who use their services

- As financial co-operatives credit unions exist only to meet the needs of their members. Their democratic structure means that each member has a say in the running of the credit union, on a one member, one vote basis. Credit union members elect directors to run the credit union on their behalf. Each director is a volunteer elected from the membership of the credit union.

- Any surplus generated by the credit union is either reinvested in the credit union for the benefit of members, goes towards building capital to support the financial stability and sustainability of the credit union or is distributed to members as a dividend. This is at odds with commercial banks' needs to generate a profit to satisfy the investment expectations of external shareholders.

- Credit unions do, however, need to become sustainable over a period of time in order to safely serve their communities and not remain dependant on grant funding. The ability to generate income from developing services their members are willing to pay for and are only able to access at a higher cost elsewhere will contribute towards credit unions' financial health. This will ultimately benefit the credit union members.

A change to restrictions that could only be applied to new members would not affect credit unions ability to innovate and develop new products to meet the needs of their members

- Removing this restriction for products for new members would still discourage credit unions from innovating and developing new products. Credit unions are put off developing new products because of the burden of calculating the exact cost of delivering this service, and ensuring that they do not inadvertently charge more. If the restriction still applied to existing members, credit unions would still have the burden of deciding what costs - staffing/premises/utilities etc – to include in any calculation and are likely to continue to not develop services as the burden would remain the same.

- It is highly unlikely that a credit union would wish to develop a new product just for new members which they would have to prevent other members from accessing because of continuing legal restrictions. This would not be fair to existing members who would be unable to access new products developed in response to member needs.

Any new product developed as a result of this change would be an option for credit union members, and not a requirement of membership

- Ancillary services are not linked to membership of the credit union or to the availability of core services such as savings or loans. Any member offered any ancillary product would have the choice whether or not to purchase this service.

- The possible products which could be offered by credit unions which would qualify as ancillary services would include cheque cashing or budgeting accounts. These services are available elsewhere but at a very high cost. Credit unions that may consider offering these services, should the restrictions on calculating costs be removed, would be offering these services at a lower cost, bringing choice to consumers and seeking to meet the needs of their members.

- If a credit union did charge rates for ancillary services which were higher than other offerings in the market and at a considerably higher charge than it cost them to provide, checks and controls in the governance of the credit union would ensure that this was adjusted to a fairer level. It is likely that minimal numbers of members would use the product, the democracy of the credit union would ensure that through the board structure and yearly democratic process, members had a chance to raise concerns about this. Unlike commercial organisations, the people who control and own the credit union are the same people as those who use its services.

- As most credit unions do not innovate because of the restrictions, ancillary products offered to exiting members and new members would be brand new and as a result would not result in any existing members suffering any disadvantage as they would not be able to access these services at the moment, so would not face higher charges.

Conclusion

We appreciate the reasons behind the concerns raised by the committee but we believe that the existing democratic and governance structures of a credit union will prevent any exploitation of lower income members. Credit unions seek to sustainably meet the needs of all their members and react to the needs of their members.

The majority of credit unions do not innovate because of the current restrictions and will not be encouraged to further meet the needs of their members through a change which would only apply to new members of the credit union.

No core services such as savings or loans would be affected by this change. The experience of other credit union sectors around the world has been that freedom to develop new products does not result in high charges but in the ability of credit unions to offer much better value alternatives to commercial suppliers and ultimately benefits the members of the credit union and the wider community.

We would be delighted to provide any further information which would assist the committees in their scrutiny.

September 2010

Formal Minutes relating to the report

Tuesday 18 October 2011

Members present:

Mr Robert Syms, in the Chair

Heidi Alexander	Gordon Henderson
Mr David Anderson	Valerie Vaz
Andrew Bridgen	

The Chair declared a non-pecuniary interest in relation to the draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011: Second Stage as a member of the Bournemouth and Poole Credit Union.

Heidi Alexander declared a non-pecuniary interest in relation to the draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011: Second Stage as a member of the Sydenham Credit Union.

Gordon Henderson declared a non-pecuniary interest in relation to the draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011: Second Stage as a member of the Kent Savers Credit Union.

Draft Report (*Draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011: Second Stage*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to72 read and agreed to.

Appendix and Summary agreed to.

A Paper was appended to the Report.

Resolved, That the Report be the Third Report of the Committee to the House.

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

[Adjourned to a date and time to be fixed by the Chair

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	Draft Legislative Reform (Civil Partnership) Order 2010	HC 595
Second Report	Draft Legislative Reform (Epping Forest) Order 2011	HC 963