Consultation Response
HM Treasury:
Credit Union Maximum Interest Rate Cap

March 2013

Who we are

Toynbee Hall has worked on the frontline in the struggle against poverty for 130 years. Based in the East End of London we give some of the UK's most deprived communities a voice, providing access to free advice and support and working together to tackle social injustice.

Toynbee Hall helps over 13,000 people a year. Our years of experience in providing people with the skills to improve their financial health, means that we are in an ideal position to help others improve their financial health policies and practice. We have used this understanding to create the Financial Health Exchange.

The Financial Health Exchange is committed to creating a fairer, more financially healthy society and our aim is to improve financial health in the UK. We help policy-makers and practitioners stay up to date on the latest financial health thinking and ensure that financial health good practice is followed in all of their work with clients and service users.

We are at the forefront of shaping the future of financial health in the UK. Our publications, research, good practice examples and expert opinion pieces are accessible to all those who want to improve the financial health of others.

Executive Summary

We welcome the drive to modernise and expand the credit union sector, recognising that such a service is often more capable of addressing the needs of those who are financially excluded than the wider financial sector. We wholeheartedly agree that raising the interest rate cap will better allow credit unions to approach self-sufficiency, while remaining a competitive and viable alternative to other forms of credit used by those on low incomes, such as payday lenders and home loans. Raising the cap will give credit unions the opportunity to boost revenues, improving the chances of creating a sustainable sector, while also aiding institutional transparency by reducing the need to charge extra administration costs on short-term small loans.

However, we have a number of concerns. The balance between credit unions increasing their revenue by raising their risk appetite and taking on new clients, and the potentially detrimental impact of taking on new members with low incomes and high risk profiles, is one that needs to be managed carefully. Furthermore, it is possible that in order to mitigate the impact of offering loans to high risk clients, credit unions might set an interest rate of 3 per cent across all of their products. As such, we believe that a higher maximum interest rate cap should be considered, in order to enable greater flexibility in the interest rates credit unions offer, to improve the short-term, small loan 'payday' market for consumers, and to allow credit unions to approach sustainability more easily.

Responses to Individual Questions

Q1. What effect, if any, would raising the interest rate cap to 3 per cent have on the ability of credit unions to offer loans to a wider spectrum of borrowers, including low income consumers?

Raising the interest rate cap, in conjunction with the institutional reforms that are a prerequisite for funding, would allow credit unions to greatly increase their geographic scope and membership, including to those or low and middle incomes. The increased revenue from the 3 per cent cap would mean that, should a credit union choose, they could raise their risk appetite and lend to more risky clients. Revenue could be invested in advertising to higher income, lower risk consumers, further expanding their market and providing a stable revenue stream. However, it is of concern that in both raising the cap, and with the explicit wish of the Government, credit unions are being encouraged to lend to riskier clients. We know that credit unions often aren't sustainable, and taking on more bad debt could tip them into deficit. It is therefore important that this concern is at the forefront when any change is implemented.

Q2: What effect, if any, would raising the interest rate cap to 3 per cent have on the ability of credit unions to become more sustainable?

It is clear from the Credit Union Expansion Project Feasibility Study that a raise in the interest rate cap would give credit unions a far greater ability to approach sustainability than if the change were not made. However, the Government's proposal to eliminate the need for further funding of credit unions after March 2015 is only possible if the interest on all low-value loans below £1000 is raised to 3 per cent, as indicated by the table on page 15 of the feasibility study.[1] This move would serve to undermine institutional flexibility and prevent credit unions from aiding those most in need. Raising the interest rate cap can therefore only be seen as part of a longer process leading to the sector's sustainability, rather than as an end in itself.

Q3: What effect, if any, would raising the interest rate cap to 3 per cent have on credit unions' business and lending practices?

It is our opinion that lending practices could be improved through raising the interest rate cap, as the greater flexibility offered by the move would allow credit unions to reduce interest rates on longer term

[1] Department for Work and Pensions, *Credit Union Expansion Project Feasibility Study Report* (2012), p. 15.

loans, or provide those in tier III with more favourable rates. The move may allow credit unions to make small, short-term loans a sustainable proposition, which would help credit unions to access and financially include those on low incomes. However, the evaluation of the Growth Fund found that, based on average operating costs, the APR required to break even on an operating cost of £60 is 39.6 per cent, rising to 48.1 per cent for loans costing £75 to administer.[2] As such, raising the cap to 3 per cent, equivalent to 42.58 per cent APR, may not allow credit unions to offer small, short term 'payday' loans without losing money, and could force them to raise the interest rate to 3 per cent across all loans. Also of concern is the need for credit unions to balance an increase in their risk appetite in order to increase revenue with an awareness of the detrimental affect in taking on high-risk customers, to ensure that they do not take on too much bad debt. Furthermore, the move to organisational streamlining and modernisation, along with the requirement that credit unions automate 30 to 50 per cent of the decision making process for customers who have previously had a loan approved, may lead to credit unions spending less time with members and rejecting customers who may otherwise have been accepted. We therefore call on the Government and credit unions to carefully manage this change, to ensure that the poorest in society are able to access a stable, ethical and competitive financial provider.

Q4: Are there any other potential benefits associated with raising the interest rate to 3 per cent?

If the change allows for credit unions to make small, short-term sustainable loans to those on low incomes, then this move can only be welcomed. Growth in the credit union sector arising from the interest rate raise and the accompanying organisational benefits would also result in greater opportunities for employment in the communities in which the credit unions are based. As these are often amongst the most deprived areas in the country, such steps would surely serve to help the economy, making the government investment in credit unions an engine for economic revival. The move may also result in increased transparency. We believe this to be the case because, as credit unions income must increase to reach sustainability, that boost in revenue must be achieved somehow and if it is not through a greater interest rate it would need to be through administration fees and charges. We believe that achieving this through increasing the APR is more transparent.

Q5: How serious is the risk that credit unions could apply the 3 per cent interest rate to all loans?

The risk that credit unions could apply the 3 per cent interest rate across all loans is large. Our concern is that credit unions, already squeezed financially and seeing no other choice, may resort to universally charging 3 per cent interest in order to sustain their operations. While the credit union movement has a strong sense of self-identity as one that provides a personalised and ethical service to its members, opening up the sector to those with greater risk profiles may force unions to weaken their distinctive provision and raise interest rates on all loans in order to recoup any losses sustained through offering loans to high risk, low-income clients.

Q6: How serious is the risk of potential greater default?

[2] Sharon Collard, Chris Hale and Laurie Day, *Evaluation of the DWP Growth Fund Revised Final Report* (2010), p. 7.

It is our opinion that the potential for greater default amongst consumers is high. In raising the risk appetite of credit unions to encompass individuals who would have previously been refused a loan, the likelihood of customers defaulting increases correspondingly. Any increase in risk would also see a matching increase in the cost of making loans, and this cost would be passed on to the consumer. However, it is worth noting that even with the raise in the interest rate cap credit unions will remain some of the most competitive financial service providers in the market, especially in comparison with the alternative providers most likely to be accessed by those on lower incomes, such as payday lenders, pawnbrokers or home credit. Loan repayments, too, will only see a modest increase – a £400 loan repaid weekly over a year will cost an extra 51p per instalment at a rate of 3 per cent compared to an interest rate of 2 per cent.[3]

Q7: Are there any other concerns or risks associated with raising the interest rate cap?

Yes. While it is the best option available within the parameters of the consultation, an interest rate cap of 3 per cent does not allow credit unions the optimum level of flexibility that is needed in order for them to offer short-term, small loans to a range of customers and compete effectively in the 'payday' market. Our concern is that, if 3 per cent is the maximum allowed rate, credit unions might charge interest of 3 per cent on all of their loans in order to cover the losses resulting from the need to lend to low income clients with higher levels of risk. Research from the Growth Fund evaluation estimated that an APR of 71.2 per cent would be required to cover operational costs and financial risks associated with Growth Fund lending.[4] Given that credit unions are expected to target this same demographic as part of the Credit Union Expansion Project, which includes this consultation, it is therefore clear that, in order to reach sustainability, Credit Unions need to be able to charge rates as high as 71.2 per cent APR. However, a rate of 3 per cent is only equivalent to 42.58 per cent APR. Based on 2010 average operating costs, the APR required to break even at an operating cost of £60 per loan is estimated to be 39.6 per cent, and 48.1 per cent to break even at an operating cost of £75 per loan.[5] These figures therefore suggest that a maximum rate of 3 per cent would be insufficient to cover the operating costs of these shorter, higher risk loans, and therefore credit unions would have no choice but to spread the costs across all products, thus raising all interest rates to the permitted maximum, rather than pricing each product on its own merits. Thus we judge that 3 per cent is not enough to enable credit unions to compete effectively in the payday market. We suggest that in order to create a market which supports competition between credit unions, and between credit union products and products from other providers, consideration should be given to raising the cap as high as 5 per cent, equivalent to 60.17 per cent APR. This would enable credit unions to offer different financial products at different rates, promoting greater competition both internally and with other credit unions. In doing so it is more likely that credit unions would offer a range of rates, not just a blanket 3 per cent, allowing the provision of sustainable short term small loans to low income consumers and improving the payday market for consumers.

Q8: Considering the case for action and the potential risks, should the interest rate be raised to 3 per cent?

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[3] HM Treasury, *Credit Union maximum interest rate cap* (2012), p. 9.
[4] Collard *et al*, *Growth Fund Revised Final Report*, p. 7.
[5] Ibid.

Given the potential benefits of the interest rate cap, and taking into account the concerns we have outlined, we believe absolutely that the interest rate cap should be raised to 3 per cent.

Toynbee Hall
28 Commercial Street
London
E1 6LS
Tel: +44 (0) 20 7247 6943
Email:info@financialhealthexchange.org.uk
Website: financialhealthexchange.org.uk

FINANCIAL HEALTH EXCHANGE