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THE ROLE AND CONTRIBUTION OF CREDIT UNIONS IN GREAT BRITAIN

Aidan Stennett

Paper providing insight into the roll and contribution of credit unions in Great Britain through an examination of the movement's development

EXECUTIVE SUMMARY

To understand the current role of credit unions in Great Britain (GB) it is necessary to examine the process transformation and re-branding the movement has undergone in the previous ten years.

This process has aimed at improving the quality and penetration of the movement, although, credit union penetration has risen only slightly since 1999 (from less than 1% to 1.48% in 2007).

The transformation of the movement has seen a shift from *small, local volunteer run community organisations*, with a primary focus on *alleviating poverty,* to *New Model Credit Unions,* characterised by a *professional and business approach* and a greater focus on *financial inclusion.*

Promotion of this *new model* has been based on *'seven doctrines of success':*

- serving the financial needs of the wider population;
- maximising savings by offering attractive interest rates;
- portfolio diversification;
- operating efficiently;
- practicing financial discipline;
- self governance; and
- assimilation.

Acceptance of the new model has not been universal and there has been split amongst trade association, with the Association of British Credit Unions Ltd representing the *new model approach* and the Scottish League of Credit Unions preferring the small-area, poverty-centric model.

In addition, a 2007 report estimated that only 15-20% of credit unions, operating in low income areas, operated, or retained the potential to operate at a standard equivalent to the *new model* benchmark.

In international terms GB credit unions are deemed to be at a transitory point in their development.

The shift in development strategy has been accompanied by legislative reforms. The Financial Services Markets Act (2000) formalised the demarcation of credit union types into Version 1 and Version 2, with the latter enjoying greater powers but *stiffer capital, liquidity and supervision requirements'.*

The combined effect of the Financial Services and Markets Act 2000 and the Regulatory Reform (Credit Union) Order 2003 was to extend the contribution of credit unions, enabling them to: borrow from authorised institutions; provide interest bearing accounts, further basic services and charges; relax their common bond restrictions; increase their membership limit; and extend the time their customers have to repay loans.

With the move from a poverty-centric to a financial inclusion approach the contribution of credit unions has been extended to include:
- providing basic banking and transaction accounts
- new forms of savings accumulation
- higher risk models of affordable credit; and

- financial literacy and money advice

The future of credit union movement will require sustainability and as such, further movement away from the *'poor-persons bank'* image. This will necessitate attracting more affluent members of society.

ABCUL's recommendations for further legislative reforms, intended to enable credit unions to *'scale up'* and *'achieve their potential'*, are largely met by recent HM treasury proposals.

Gaps remain in credit union development, particularly due to the existence of 25 '*red alert'* areas and 56 *'amber alert'* areas, where there is little to no penetration by the movement. The Third Sector Working Group recommends that this be tackled through:

- New provision in 25 areas, lending up to £10 million each year to 25,000 people who, today, have no access to affordable credit;
- An expanded Growth Fund, providing up to £50 million of affordable credit to a further125,000 people p.a.; and
- A total of £60 million of affordable third-sector credit provided to 150,000 people p.a. by 2011.

CONTENTS

1 INTRODUCTION

This paper provides an insight in the role and contribution of credit unions in Great Britain by examining how the movement has evolved in the past ten years. The latter part of the paper looks at the trade association pressures and legislative reforms which are likely to determine the movement's future.

2 EVOLUTION OF THE MOVEMENT

To understand the current role of credit unions in Great Britain (GB) it is necessary to examine the process transformation and re-branding the movement has undergone in the previous ten years. This transformation is, in part, linked with an effort to encourage the movement's growth. In 1999, the HM Treasury estimated a membership rate of less than 1% of the population in GB (rising to 1.48% by 2007[1]), compared to 45% in the Republic of Ireland (ROI).[2] It should be noted, however, that efforts to evolve the movement have not focused exclusively on its size, but have led to a profound (although not universal) shift in the type and focus of credit unions found in GB.

The transformation of the movement has seen a shift from *small, local volunteer run community organisations*, with a primary focus on *alleviating poverty,* to *New Model Credit Unions,* characterised by a *professional and business approach* and a greater focus on *financial inclusion.*[3] Promotion of this new model has been central to the Association of British Credit Unions Ltd (ABCUL) development strategy since 2002.[4]

Given ABCUL's position as the largest credit union trade association in GB, it is possible to conclude that new model credit union promotion has been the defining factor of the movement's development. This does not presume universal acceptance of the notion however. It has been noted that the Scottish League of Credit Unions (SLCU) prefer to see the movement as incorporating *small area-based, poverty alleviating initiatives*. A similar trade association split has been noted in Northern Ireland, with the Irish League of Credit Unions closer to ABCUL's strategy and the Ulster Federation of Credit Unions broadly falling in line with SLCU's vision.[5]

The new model adopted by ABCUL is considered by commentators to correspond to seven *'doctrines of success':*[6]

- serving the financial needs of the wider population;
- maximising savings by offering attractive interest rates;
- portfolio diversification;

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[1] McKillop D and Wilson J (2008) *Credit Unions in Scotland* Scottish Government Social Research

[2] HM Treasury (1999) *Credit unions of the future* http://archive.treasury.gov.uk/docs/1999/creditunion.html

[3] Jones, Paul A (2006) *Giving credit where it's due: Promoting financial inclusion through quality credit unions,* Local Economy 2:1, 36 – 48

[4] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

[5] Goth P, McKillop and Ferguson C (2006) *Building better credit unions* Joseph Rowntree Foundation (published by The Policy Press)

[6] Jones, Paul A (2006) *Giving credit where it's due: Promoting financial inclusion through quality credit unions,* Local Economy 2:1, 36 – 48

- operating efficiently;
- practicing financial discipline;
- self governance; and
- assimilation.

Assimilation is used here to describe a credit union's capacity to enfranchise the financially excluded. ABCUL has gone as far as applying the moniker *quality credit unions* on members adopting the *new model* methodology. [7]

ABCUL's *new model* approach to credit unions has been by no means universally applied. As suggested above, a significant number of GB credit unions belong to a trade association preferring a more traditional approach. Even amongst ABCUL membership full incorporation of the *new model* ethos has been limited to a minority of credit unions. In 2007, a report by the HM Treasury's Financial Inclusion Taskforce found that 15-20% of credit unions, operating in low income areas, operated, or retained the potential to operate at a standard equivalent to the *new model* benchmark. The same report found 28% retained *some* potential to meet this standard, while 55% had no or limited capacity to do so.[8]

In international terms GB credit unions are deemed to be at the central point of the typical evolution process. Commentators argue that there are three distinct phases of credit union growth Nascent (birth), Transition and Mature. Nascent credit unions are defined by their small asset size, restrictive common bond, basic portfolio and reliance upon volunteers. Transition credit unions, which typify the GB movement, have larger asset sizes, fewer common bond restrictions, greater product diversity, professional trade associations, less volunteers, and a greater emphasis on growth and efficiency. Mature credit unions are commonly defined by their loose common bond, large asset size, diversified portfolios, professional senior management, centralised services, adoption of technologies and deposit insurance schemes. [9] The credit union movement in ROI is deemed to be in this latter stage of development.[10]

ABCUL's strategy change was accompanied by increased government interest in the role of credit unions (particularly in connection with tackling financial exclusion) and a succession of reforms intended to liberalise the legislative framework. There have been two significant reforms of the Credit Unions Act 1979 since 2000: the Financial Services and Markets Act 2000 (FSMA); and the Regulatory Reform (Credit Union) Order 2003.

The major effect of the FSMA and subsequent regulation of credit unions by the Financial Services Authority (FSA) was to formally recognise, within legislation, the *New Model* form of credit union organisation. This was achieved through the demarcation of

[7] Jones, Paul A (2006) *Giving credit where it's due: Promoting financial inclusion through quality credit unions,* Local Economy 2:1, 36 – 48

[8] HM Treasury (2007), *Mapping the demand for, and supply of third sector affordable credit. Research for the Third Sector Credit Working Group of the Financial Inclusion Taskforce* http://www.financialinclusion-taskforce.org.uk/PDFs/working_group_experian_research.pdf

[9] Although credit unions in GB have benefited from the FSA's savings protection scheme since 2002, it their short comings in meeting other criteria and this list which prevent the majority of credit unions reaching the *mature* stage of development.

[10] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research

two tiers of credit union: Version 1; and Version 2. Version 2 credit unions have the capacity to lend greater amounts for longer periods of time and may offer a wider range of services. These, extended powers, were balanced against *'stiffer capital, liquidity and supervision requirements'.* FSA regulation also enabled credit unions to avail of the authority's savings protection scheme. The scheme was extended in 2007 following concerns about financial system solvency and stability.[11]

Beyond the above, the combined affect of these two pieces of legislation, upon the role of credit unions was to enable them to: borrow from authorised institutions; provide interest bearing accounts, further basic services and charges; relax their common bond restrictions; increase their membership limit; and extend the time their customers have repay loans.[12]

Some concern has been voiced at this top-down approach to legislation as it argued that the legislation is evolving in advance of the credit union movement.[13]

To date, the combined affect of a trade association strategy decisions and legislative reform has been to widen the potential of credit unions and afford them with the opportunity to realise this potential. Since 2000 there has been an effort to alter the role of credit unions, from alleviating poverty to tackling financial inclusion. This has been more than a nominal change in perspective.

The switch from poverty to financial inclusion saw credit unions moving away from simple low-cost lending to a holistic strategy of mainstreaming those excluded from the financial system. The HM Treasury financial inclusion strategy defines the concept as ensuring access to financial services in: *their day-to-day money management; planning for the future and coping with financial pressure; and the effective treatment of financial distress.*[14] To this end, the role of credit unions now incorporates:

Providing basic banking and transaction accounts – developed by the ABCUL in conjunction with the Cooperative Bank. Since 2006 credit unions have been able to offer current accounts, with Visa ATM and debit cards, and direct debit, standing order and money transfer facilities.[15]

Savings accumulation – the traditional poverty-centric approach adopted by credit unions limited their operations to providing low-cost loans to members, in a bid to tempt them away from high-cost door-step lending. With the switch to financial inclusion there has been recognition that, while a short-term fix, lending may encourage counter productive debt spirals. The new strategy has been to introduce new types of deposit accounts, which facilitate speedy withdrawal when required. Saving has been promoted

[11] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research
[12] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research
[13] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research
[14] HM Treasury – Financial inclusion the way forward, 2007 http://www.hm-treasury.gov.uk/d/financial_inclusion030407.pdf
[15] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

on the basis that it promotes *planning for the future, health and well-being and increased participation in the community.*[16]

Access to affordable credit – the promotion of saving as a step towards financial inclusion has occurred in tandem with a restructuring of the credit facilities on offer. Previously, creditors were required to save within the credit union for twelve months prior to taking out a loan. Loans were limited to twice or three times the amount saved. Rather than 'lending linked to borrowing', *new model* credit unions have introduced lending based upon capacity to pay (coupled with easier access to savings). This has required a minimising of risk, including the raising of interest rates on riskier loans, from 12.68% APR (1% per month) to 25.4% APR (2% per month).[17]

Financial literacy and money advice – the link between financial inclusion and financial capability is widely accepted. Increasing the availability of advice to the financially excluded and improving their financial capability forms one of the three building blocks of the Treasury's financial inclusion strategy.[18] In recent years credit unions have developed a significant foothold in the advice 'market'. To this end a number of credit unions have developed partnerships with the Basic Skills Agency, the FSA and the Citizens Advice Bureau to offer a range of face-to-face and in-school advice and education programmes.[19]

In addition to the above, a number of credit unions in GB have expanded their portfolios into areas such as Life Insurance, Mortgages and Christmas Savings Clubs.[20]

3 The Future of the movement

Commentators agree that for credit unions to maximise their potential as professional bodies, promoting financial inclusion, further changes, in the movement's culture and its governing legislation are required.

The transition from old to new model credit unions represents a break from the perception that credit unions are the *'poor person' bank'.*[21]Yet it is suggested, that to fully break from this image and to ensure long-term *sustainability,* credit unions must

[16] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

[17] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

[18] HM Treasury – Financial inclusion the way forward, 2007 http://www.hm-treasury.gov.uk/d/financial_inclusion030407.pdf

[19] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

[20] ABCUL (2008) *Ten ways to survive the recession with a credit union* *http://www.abcul.org/page/news.cfm#550*

[21] Jones, Paul A (2008) *From tackling poverty to achieving financial inclusion – The changing role of credit unions in low income communities,* The Journal of Socio-Economics 37, 2141 – 2154

'embrace a broad section of the population.[22]It is further argued that *'circulating the money of the poor within the poor community creates exclusion ghettos'* and *'to be successful in the longer term, credit unions must mobilise the money of the rich as well*'.

In consultation between ABCUL and their member credit unions it was concluded that this could be achieved through: offering interest rather dividends; offering products that appeal to more affluent members; and enhancing their creditability through offering group membership.[23]

With regard to legislation, ABCUL currently seek the following reforms:

- further relaxation of common bond restrictions;
- institutional membership;
- membership for those under 16;
- increase the limit imposed on dividends;
- to enable credit unions to offer interest instead of a dividend;
- to charge for auxiliary services;
- provisions for individual to retain membership upon leaving the common bond; and
- further clarification on the objects[24] of credit unions.

The trade association argue that these reforms will allow credit unions to *'scale up and… achieve their potential'* and *'to react flexibly to the changing financial needs of their communities'.* Furthermore ABCUL state:

> *Barriers to stop credit unions developing innovative services, expanding into areas without access to credit union services and mobilising savings through convenient methods are presently enshrined in legislation.*[25]

These comments, made in response to the consultation document *Review of the GB cooperative and credit union legislation: a consultation,* have influenced the HM Treasury to put forward a number of proposals aimed at removing the legislative barriers to credit union growth. In its latest publication on these issues the Treasury[26] has outlined eight proposals.[27] All of ABCUL's points of contention have been addressed with the notable exception of membership for those under 16 and clarification of the objects of credit unions. In addition to ABCULs recommendations the Treasury also

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[22] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research

[23] ABCUL (2007), *Review of the GB cooperative and credit union legislation: a consultation* http://www.abcul.coop/lib/liDownload/794/ABCUL%20Response%20to%20the%20Review%20of%20the%20GB%20co-operative%20and%20cr..pdf

[24] Objects refers to "objective functions"

[25] ABCUL (2007), *Review of the GB cooperative and credit union legislation: a consultation* http://www.abcul.coop/lib/liDownload/794/ABCUL%20Response%20to%20the%20Review%20of%20the%20GB%20co-operative%20and%20cr..pdf

[26] HM Treasury (2008) Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain, http://www.hm-treasury.gov.uk/media/0/D/consult_lro230708.pdf

[27] For more information on these proposals please see Research & Library Services Paper *Financial Inclusion, Credit Unions & Hm Treasury Latest Proposals For Credit Union Reform* November 2008

proposes to *repeal the "attachment" requirement, which restricts withdrawal of shares.* Implementation of these proposals is expected in 2009. [28]

As mentioned above, the legislative and trade association led push to modernise the role and contribution of credit unions has not been universally accepted by all credit unions, nor is it possible for all credit unions. In addition there are still areas of GB which have little or no credit union penetration. These 'gaps' have been identified by the Third Sector Working Group. Out of the 450 Local Authority Areas in GB, 25 have been identified as *red alert* areas due to their lack of credit union penetration, while a further 56 have been labelled as *amber alert* areas. The Working Group has also estimated *demand for affordable credit from financially excluded clients at £1.2 billion* per annum. In response, the Working Groups recommendations regarding *accelerated momentum* for third sector lenders included:

- New provision in 25 areas, lending up to £10 million each year to 25,000 people who, today, have no access to affordable credit;
- An expanded Growth Fund, providing up to £50 million of affordable credit to a further125,000 people p.a.; and
- A total of £60 million of affordable third-sector credit provided to 150,000 people p.a. by 2011.[29]

These recommendations have been made with the express aim of expanding the coverage and capacity of credit unions in order to strengthen their role in tackling financial exclusion.

The movement may also have to address the perceived lack of *inspirational leadership* evidenced by the historical need for such an overwhelmingly top-down process of development.[30]

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[28] HM Treasury (2008) Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain, http://www.hm-treasury.gov.uk/media/0/D/consult_lro230708.pdf

[29] he Financial Inclusion Taskforce (2008), *Towards a step-change in third sector lending – Report of the third sector credit Working Group of the Financial Inclusion Taskforce* http://www.financialinclusion-taskforce.org.uk/PDFs/working_group_presentation.pdf

[30] McKillop D and Wilson J (2008) *Credit Unions in Scotland,* Scottish Government Social Research