Joint Committee on the draft Financial Services Bill – Call for Evidence

Response from the Association of British Credit Unions Limited (ABCUL)

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1. Executive Summary

1.1 We have significant concerns about the potential impact of the Financial Services Bill on the credit union sector in Britain. As deposit-takers, credit unions are to be dual-regulated by both the Prudential Regulatory Authority and the Financial Conduct Authority along with the major banks and building societies, investment banks and insurance companies. Credit unions are, however, a very small sector in comparison to the other dual-regulated sectors which raises significant questions in terms of ensuring proportionality.

1.2 ABCUL and its members have always been supportive of full prudential regulation of credit unions. The move to the Financial Services Authority from the Registry of Friendly Societies in 2002 led to significant benefits for the sector. However, this regulation is only effective if it properly takes account of the specific nature of the sector and balances any regulatory burden imposed proportionately against the benefit it provides.

1.3 Whilst we would not want to be regulated under a different framework to our fellow deposit-takers, it is vital that the particular features of credit unions as a small, co-operative, not-for-profit sector are taken into account through the development of the new regulatory framework. Otherwise the sector's development could be impeded which would run counter to the express policies of the UK Government who are clear in their support for the development of credit unions as a means for extending fair financial services to everyone in society and for the role that mutual financial services can play in creating a more diverse and therefore more stable financial services industry.

1.4 A recent analysis of the size of ABCUL member credit unions in the year October 2007 – September 2008 (the most recent year for which complete figures are available to us) the following features were found which demonstrate the size and scale of the sector:

1.4.1 56% had less than 1,000 member customers
1.4.2 53% had assets of less than £500,000
1.4.3 32% had no staff at all and relied entirely on volunteers to operate
1.4.4 82% generated less than £200,000 turnover
1.4.5 56% generated a pre-tax profit of less than £10,000
1.4.6 46% were unable to pay their depositors a dividend return on their savings

1.5 Whilst there is a significant minority of credit unions – in terms of number of institutions – that are much larger than this (with many millions of pounds in assets and tens of thousands of members), the figures above demonstrate how the great majority of credit unions are extremely small organisations. Not only, therefore, do they face a significant challenge in dealing with two regulators instead of one they also pose little or no risk to the systemic stability of the financial services industry. Again, therefore, proportionality is the key concern for our sector as the move to the new regulatory structure evolves.

1.6 We have repeatedly made clear our concerns in this regard to HM Treasury in the consultations that have taken place so far. However, HMT's White Paper states the following in its Impact Assessment at point 39:

The PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall [sic] *to be considered as small firms; many credit unions would be very small by any standard. Some investment firms regulated by the PRA may also be small firms although it is likely that they will be parts of groups that include a bank or insurance company. The transitional costs for these firms seem likely to be relatively less depending on the circumstances of the individual firm.*

And further at point 45:

Consultation respondents were concerned that dual-regulated firms would face significantly higher costs and that these would disproportionately on [sic] *smaller dual-regulated firms. In practice, this probably means that the smallest dual regulated firms would (e.g. credit unions) would* [sic] *not be much affected while the largest banks and insurance companies would not face significantly higher compliance costs in comparison with their current compliance costs. The effect could be greatest in smaller banks or proprietary trading firms.*

1.7 It is unclear why HMT assert that the regulatory impact of the new framework on the smallest dual-regulated firms (such as credit unions) would be 'relatively less' or that it 'would not be much affected'. It seems to us, rather, that the economies of scale available to larger firms and the increased resource they are able to dedicate to regulatory compliance will mean that the larger a firm becomes the more equipped it will be to deal with an increased regulatory burden and the practical demands of dealing with two bodies instead of one. This is certainly the experience in our sector.

1.8 Similarly, there have been no guarantees given as to the fee increases that are likely to be required to fund the new regulatory framework. Already, between the original HMT consultation and the White Paper, cost estimates for implementing and transitioning to the new system have almost doubled from £400 million to £770 million. Similarly, even with the considerable thought that has been put into co-ordination between the new bodies and avoidance of duplication it would seem that there is little chance – with two sets of fixed-costs to cover and a halving of the institutional scale of the successor bodies – that the overall direct cost to financial services in regulatory fees will not have to increase. At present the FSA affords credit unions and small friendly societies a lower minimum fee than other firms in consideration of the inclusive services they provide and their diminutive scale but it would appear likely that this will come under threat with drastically increased transitional and ongoing costs for the new regulators to cover.

1.9 With these concerns in mind we have a series of specific recommendations that we would like to put forward which we feel would enhance the proportional treatment of credit unions as small, dual-regulated firms:

1.9.1 It is important that CREDS the specialist regulatory sourcebook which is to be implemented alongside the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order which is currently before Parliament is retained. This has been developed specifically for credit unions and is constructed in a rules-based format which is more suitable than principle-based regulations which are more suited to larger, more complex organisations.

1.9.2 We propose that mechanisms are not only retained but strengthened for smaller firms – such as credit unions – to hold the new regulatory bodies to account. The Practitioner Panels should be retained for both bodies, the Smaller Businesses Panel should be put on a

statutory footing for both and smaller firms should be given a voice in the governance structures of the new regulators.

1.9.3 A greater emphasis should be placed upon Cost Benefit Analysis (CBA) and this should be provided for in statute. Not only should individual regulatory developments be subject to CBA but regular, sector-wide assessments should be conducted to assess the overall impact of regulatory developments rather than ad hoc piecemeal assessments which only take account of one specific issue. This would put the statutory obligation to proportionality on a directly measurable footing.

1.9.4 A single point of contact is needed for dual-regulated firms to deal with both bodies. At present there are very complex proposals in place for different regulatory approvals and processes – approved persons authorisations, for example – which will be very difficult for small firms especially to negotiate and deal with without the creation of a single port of call through which all such issues are communicated and behind which the regulatory split is co-ordinated by the two bodies themselves. This would alleviate the resource-strain of dealing with two regulatory bodies.

1.9.5 Fees must not be allowed to rise significantly from the level that they are at present outside of reasonable incremental increases. It should not be the case that fees increase more rapidly than under the FSA. Regulatory fees are one of the key expenditures credit unions are required to meet and major increases brought on through the division of the FSA and behind-the-scenes duplications of function would add no value but put significant strain on the financial position of many small credit unions.

1.9.6 The costs of funding the Financial Services Compensation Scheme must be kept under control and set up such that they are proportionate to the risk that various sectors pose to the stability of the financial system as a whole. We have benefitted greatly from the FSCS's protection but current proposals under discussion – such as the EU proposal to pre-fund guarantee schemes – could leave our sector facing very serious difficulties.

1.10 We appreciate that HMT have stated their view that some of these proposals – such as the creation of a single point of contact for dual-regulated firms – are operational matters for the new bodies to decide. We do however feel that statutory measures could be taken to implement these recommendations in the interests of embedding the principles of proportionality throughout the statutory framework within which the new regulatory bodies will operate.

1.11 Credit unions play an invaluable role in providing fair access to financial services to the whole of society and in providing much-needed diversity of ownership having the effect of stabilising the financial system. Their promotion and development is Government policy. We therefore urge the committee and HMT to consider closely our concerns of proportionality and our recommendations to alleviate the risks that credit unions could be unduly burdened at present.

2. Introduction

2.1 We welcome the opportunity to respond to this consultation. ABCUL is the main trade association for credit unions in England, Scotland and Wales, and our members serve around 80% of Britain's credit union membership. Credit unions are not-for-profit, financial co-operatives owned and controlled by their members providing safe savings and affordable loan facilities. Increasingly a small number of credit unions offer more sophisticated products such as current accounts, ISAs, Child Trust Funds and mortgages.

2.2 At the end of March 2011, credit unions in Great Britain were providing financial services to 808,686 adult members and held more than £682 million in deposits with more than £586 million out on loan to members. An additional 114,709 young people were saving with credit unions.[1]

2.3 At 30 September 2010, the 325 credit unions belonging to ABCUL were managing around £512 million of members' savings on behalf of over 611,037 adult members.

2.4 The Credit Unions Act 1979 sets down in statute the objects of a credit union; these are four-fold:

- The promotion of thrift among members;
- The creation of sources of credit for the benefit of members at a fair and reasonable rate of interest;
- The use and control of their members' savings for their mutual benefit; and
- The training and education of members' in the wise use of money and in the management of their financial affairs.

2.5 Credit unions in Britain are small, co-operative financial institutions often extending financial services to those unfairly excluded from the financial services the majority take for granted. They are owned and controlled by a restricted membership and are operated for the sole benefit of this membership. The Credit Union Act 1979 sets down these operating principles in law.

2.6 In the past decade, British credit unions have trebled their membership and assets have expanded four-fold. As this growth has taken place, the role that credit unions can play – both in providing equitable financial services to the whole of their communities and providing diversity in the financial services sector – has been increasingly recognised by government and policy-makers.

3. Questions

3.1 We have chosen to answer only a selection of the questions put in the call for evidence – those that are directly relevant to credit unions and our concerns under the proposed regulatory structure.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

3.2 We have no objection in principle to the creation of a "twin peaks" model of regulation and feel that it may well have the effect of increasing the overall stability of the financial services industry and averting the potential for a repeat of the financial crisis.

3.3 Our key concern, however, is not the effectiveness of "twin peaks" as a means of improving regulation at a macro-level but, instead, is its impact on those small firms which have not contributed to the financial crisis but which may suffer as a result of the new framework.

3.4 As we have explored above and come back to later, we feel that the "twin peaks" model of regulation – alongside the more intrusive regulatory philosophy proposed – whilst perhaps increasing financial stability will also have the effect of multiplying the burden of regulation. This is especially true for credit unions as a sector of very small firms which will be 'dual-regulated'.

3.5 Proportionality is vital to ensuring that whilst the new system has the desired effect of increasing the regulatory scrutiny of those firms which are systemically important to financial stability due to their size and complexity, it does not unduly burden small firms which pose little or no threat to financial stability, had no hand in creating the financial crisis and upon whose continued

[1] Figures from unaudited quarterly returns provided to the Financial Services Authority

development the creation of a diverse and therefore more stable financial services industry depends.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

3.6 We are primarily concerned here with the PRA and the FCA's governance structures.

3.7 We feel that the mechanisms for industry to have a voice and hold the PRA to account should be covered by statute. As with the FCA currently, the PRA should be required by statute to set up the practitioner panels and a smaller business panel should be given statutory powers under this setup.

3.8 These practitioner panels should be given more powers to hold the regulators to account by having a power to force them to reconsider proposals which are damaging and in certain specified circumstances should be allowed to pass decisions upwards – perhaps to the FPC – for a ruling.

3.9 Similarly, small firms should be afforded a statutory voice in the governance framework of the regulators to ensure that their needs are taken full account of.

11. Are the PRA's objectives clear and appropriate?

3.10 The PRA's objectives and principles are clear. Our key concern, though, is how the PRA's statutory obligation to proportionality is both applied and assessed. At present it seems that whilst the proportionality principle is in place at a high-level, more practical arrangements for ensuring truly proportional regulation and supervision which could be dealt with through statute (a single point of contact, strong accountability to firms or wider application of CBAs, for example) are currently left to operational decisions which we feel is inappropriate and inconsistent.

3.11 We also support the PRA's obligation as proposed to ensuring that any new regulations do not unfairly disadvantage mutuals.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

3.12 In principle we have no issue with 'judgement-based' regulation which should have the effect of enhancing the robustness of regulatory supervision.

3.13 We do, however, feel that there are certain risks which might arise from this. First, there needs to be a robust, independent and accountable system for challenging judgements that are made without overly legalistic protocols being required. This way, judgements that are considered unfair or disproportionate can be fairly reviewed. Second, there is a concern that should 'judgement-based' regulation extend too far into the minutiae of regulatory and supervisory activity it could result in serious problems of clarity and understanding for small firms such as credit unions and could cause significant barriers to their development of new, innovative products. 'Judgement-based' regulation should be founded upon the same principles of proportionality as the regulatory bodies themselves.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

3.14 Whilst it is right to focus on the 'orderly' wind down of large, systemically important firms we have some specific concerns relating to the position of failing credit unions.

3.15 At present, where a credit union is failing and there is no immediately neighbouring credit union which is in a position to save it, the only option remaining to the credit union and the FSA is to allow the credit union to default and draw down upon the FSCS. This situation should be

somewhat improved with the advent of the Legislative Reform (Industrial & Provident Societies and Credit Unions) Order – currently before Parliament – which will allow credit unions not operating in directly adjacent areas to step in and save failing credit unions. It will be further improved by the FSA acting more quickly in the case of a credit union starting to fail.

3.16 Despite the advantages of these legislative reforms, we feel that there is a case for considering the feasibility of a Stabilisation Fund for credit unions in Britain. ABCUL recently commissioned research by Liverpool John Moores University which looked at credit union stabilisation regimes around the world – many of which are very successful at reducing the call on deposit guarantee schemes.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

3.17 We feel that the Bill is effective in demonstrating the change in culture and the more proactive approach desired by Government.

3.18 We are concerned, however, that whilst there are detailed and significant provisions made within the Bill regarding its more proactive culture, there are not sufficient provisions made to ensure that its activity and regulatory developments are proportionate. There is an overarching principle which makes proportionate treatment a regulatory obligation but practical measures could also be included which would benefit the implementation of this:

- 3.18.1 an obligation to retain specialist regulatory sourcebooks – such as CREDS – for at least the period of transition
- 3.18.2 a statutory voice for smaller firms within the PRA and in the governance structures of both bodies
- 3.18.3 a statutory obligation to conduct regular cost benefit analyses for the overall regulatory burden on different sectors rather than individually in relation to specific proposals
- 3.18.4 a single point of contact for dual-regulated firms to communicate with both regulators
- 3.18.5 an obligation to ensure that regulatory fees do not rise above a certain rate to ensure efficiency and minimum duplication between the two bodies.

3.19 As regards the skills of regulatory staff, it is vital that those staff responsible for credit unions within both the PRA and FCA are familiar with the credit union sector through experience in the FSA and elsewhere. As has been demonstrated above, credit unions present a unique challenge to the new regulatory framework and without a solid understanding of the sector's particular needs as small, community-based, mutuals we foresee significant problems for the credit union sector's transition to and ongoing supervision by the new regulatory bodies. We should say that we have a high degree of confidence in the current FSA team dealing with credit union supervision and policy.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

3.20 We feel that the FCA's primary objectives, as with the PRA, are appropriate but feel that more could be done to ensure the proportionate treatment of all firms but particularly smaller firms. Ways in which this could be achieved have been explored extensively already.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

3.21 We feel that the proposals for co-ordination between the PRA and FCA must be toughened to ensure that the new bodies minimise duplication and avoid a ballooning in fees and costs to firms.

This might be achieved by restricting the level of annual fee increases which the two bodies are able to enact by statute.

3.22 As earlier set out, we strongly support a single point of contact for dual-regulated firms. This is especially important for smaller dual-regulated firms such as credit unions who are likely to find it very difficult to deal with two separate regulators. Were there to be a single point of contact in place credit unions would be much better able to understand how they need to fulfil their regulatory obligations and would not need to concern themselves with the subtleties of the split between PRA and FCA and the Memorandum of Understanding that will dictate this. As resource-poor organisations credit unions are likely to see their compliance costs rocket should they need to deal with two separate bodies and this will impede or even stifle-permanently their growth into the future.

3.22 A joint rulebook is an interesting concept and is likely to make it easier for credit unions to deal with two regulators therefore we would support it. However, of more acute concern is that the CREDS regulatory sourcebook be retained. This has only recently been developed with the proportionate treatment of credit unions as its key concern. Similarly, we feel that a single point of contact and behind the scenes co-ordination between the two bodies is a key priority to ensure that the new framework treats our sector proportionately. A joint rulebook would be a secondary concern behind the retention of CREDS and the creation of a single point of contact for firms.

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