



Credit Unions: A Solution to Poor Bank Lending?

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Community Finance

The community finance sector is made up of not-for-profit institutions which lend primarily on the basis of social gains. They exist to improve the financial welfare of their clients and the overall health of the local economy. Credit Unions are among a more established and recognised set of 'ethical lenders'. Uniquely, they serve a specific group of people or region (or both) by sourcing funds - in the form of member deposits and savings – from the community to lend to other members, reinvesting inactive money in the same community.

The Government, in its bid to tackle poor bank lending, is currently promoting alternative sources of finance like credit unions. As part of this push, the Department for Work and Pensions (DWP) has drawn up a project called the Credit Union Expansion Project (CUEP) to speed up development of the sector over the coming years. While the aim is laudable, the plan itself is limited, focusing on a select few credit unions and neglecting the potential of the vast majority. This is because of a failure to find a model of expansion that would benefit all credit unions without simply injecting them with large amounts of tax-payer money.

This report examines credit unions' place in the finance market and their potential to alleviate some of the current pains caused by Britain's struggling mainstream financial sector (described below). It will show that where the CUEP does address some crucial problems facing credit unions, it will not remove the greatest barriers to them becoming a recognisable force in the finance sector. That real expansion will require further empowerment of credit unions to tailor their lending models to their needs. And that this can be done without endangering the ethos of the credit union sector. This report advocates:

- easing regulatory restrictions on credit unions, in particular, raising the interest rate cap, to allow them to pass the small costs of loan processing to the customer;
- Switching focus from providing Jam Jar accounts to developing a better range of current account and savings products to attract and create a broader membership base;
- Encouraging credit unions to lend to business by:
 - Developing training for credit union staff to manage risks in business lending;
 - Creating partnerships between credit unions and Community Development Finance Institutions;
 - Redefining the terms of membership for businesses so as to remove restrictions on deposits greater than £10,000 or 1.5% of a credit union's total share holding.

Credit unions were founded on the principles of promoting thrift and financial literacy among communities. Yet, a primary barrier for many medium and smaller size credit unions to realising this aim is their struggle to

find a sustainable lending model, to build a sufficient resource base to service more people. To be effective charities, they must first be effective financial institutions.

The Need for Alternative Finance

Lending conditions have remained poor since the financial crisis in 2008. The coalition government, from day one of their tenure, has championed small and medium business as central to economic recovery, expending exhaustive amounts of time and money to persuade banks to increase lending to SME's and start-ups. These efforts included the Business Growth Fund, the Enterprise Finance Guarantee, and lately, the Funding for Lending Scheme (now 'on steroids'). This latest scheme – aimed at incentivising banks to lend to businesses with rewards of cut-price loans from the Bank of England - has been widely criticised. Project Merlin - the agreement between the Government and the 'big four' banks, Lloyds Banking Group, HSBC, Royal Bank of Scotland and Barclays, to increase small business lending - has been discredited by the Bank of England's own 'Trends in Lending' reports: the last two, accounting for the six months to April 2013, have shown continual contractions in the rate of bank lending to business, and stagnant levels of lending to individuals.¹ This situation has been further aggravated by new requirements for major banks to increase their capital reserves, encouraging them to sit on any extra funds they can find.

In a damning display of the banks' failure to cater for low earners, the payday lending market has rapidly expanded to reach a value of over £2 billion, leaving many people with no option other than loans with extortionate rates of interest (sometimes called a 'poverty premium'). As a reaction to these and more widespread banking scandals, public dissatisfaction with mainstream banking has ballooned: movements such as Moveyourmoney.com – which helps people to move their money from the big four banks - have grown in popularity, while 'alternative banks', the Co-operative Bank and the Nationwide Building Society, have seen their personal account holdings rapidly increase.²

In the business lending market, alternative finance has also had to be found. Some of the slack left by banks has been picked up by companies like: the peer to peer lending company, the Funding Circle, now responsible for over £100 million worth of investment in businesses;³ crowdcube (responsible for £8.2million of investment),⁴ and Seedrs (just over £1 million),⁵ which both showcase start-ups to investors; and Crowdbnk, a crowd sourcing website for start-ups allowing anyone to invest in a business they find interesting.⁶ All seek to help small business bypass the high street banks.

However, they are all relatively small schemes, and, according to a report by the Community Finance Development Association, the supply of finance to SMEs and individuals is still falling dramatically short of demand. 'Mind the Financing Gap: Evidencing Demand for Community Finance' estimates £1.3 billion of

unmet business demand with nearly 103,000 under-served business customers. For personal finance it found 8 million individuals are in need of better access to affordable credit.⁷ The Department for Work and Pensions (DWP) reports a similar failure in commercial finance, estimating that 850,000 people a year incur financially crippling levels of bank charges because they need help to manage their money, and up to 7 million people use sources of high cost credit e.g. home credit, pay day lenders and pawnbrokers.

Credit Unions

Credit Unions are co-operative financial institutions which operate on a not-for-profit basis, their aim being to foster financial health in a community. They are sometimes described as community banks, social lenders or local savings groups because they are owned and managed by their members. The UK credit union sector has existed for roughly 25 years, though many credit unions have clear connections to other long established mutual, self-help organisations including industrial and provident societies. A note from the House of Commons Library states 'the main public advantage of credit unions is the fostering of thrift within a community environment'.⁸

Traditionally this ethos of 'self-help' (or financial independence) has been underpinned by the legal requirement that members of a credit union share a 'common bond' to strengthen the security of the union, with members connected by more than financial ties. The bond may be occupational (with members working for the same employer), geographical (living or working in a certain area), or associational (belonging to a particular, perhaps religious, organisation). Manchester-based No1 CopperPot, for example, 'exclusively' services members of the police forces in England and Wales.⁹

Credit Unions were originally founded as an alternative means of providing credit to underserved communities. In the US, for example, they became established in the wake of the Great Depression, with the creation of federally chartered CUs and the founding of the Credit Union National Association.¹⁰

UK credit unions began by offering simple savings accounts and loans, but during the past 25 years they have evolved into other markets, such as mortgages and current accounts, to a point where they now provide many of the services high street banks provide.

The core ethos of credit unions was laid out in the 1979 Credit Unions Act. They are:

- 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

- The training and education of members in the wide use of money and in the management of their financial affairs

Configuration

As individual credit unions are controlled by their member-customers, ballots are held to elect their officers, including the Board of Directors, the Credit Committee (tasked with considering loan applications) and the Supervisory Committee (which audits the unions' books and evaluates its operations). As well as paid staff, many Credit Unions rely on volunteers to fill junior roles and run their services.

Loans and savings facilities are offered to members only. Some credit unions charge a small membership fee, but all require the purchase of shares. The minimum initial shareholding tends to be very small, typically a pound; however, most members will hold more shares than the minimum given that shares and deposits are one and the same. The advantages offered by a credit union grow with the size of its deposits. Savers with loans receive loan protection insurance and some credit unions also offer free life insurance proportionate to their members' deposits.¹¹

All credit unions are regulated as deposit-takers by the Prudential Regulation Authority and the Financial Conduct Authority, meaning their savers' deposits are protected up to £85,000 (£170,000 for joint accounts) by the Financial Services Compensation Scheme.¹²

Loans are made at competitive rates, often for small amounts and variable periods. These latter options tend not to be provided by mainstream lenders, whilst the moderate rates of interest help those with poor credit profiles who struggle to obtain credit from mainstream financial institutions.

Size and Distribution

Since the passing of the Credit Union Act, credit unions have grown steadily in size and reach. The table below illustrates their development between 1982 and 2012.

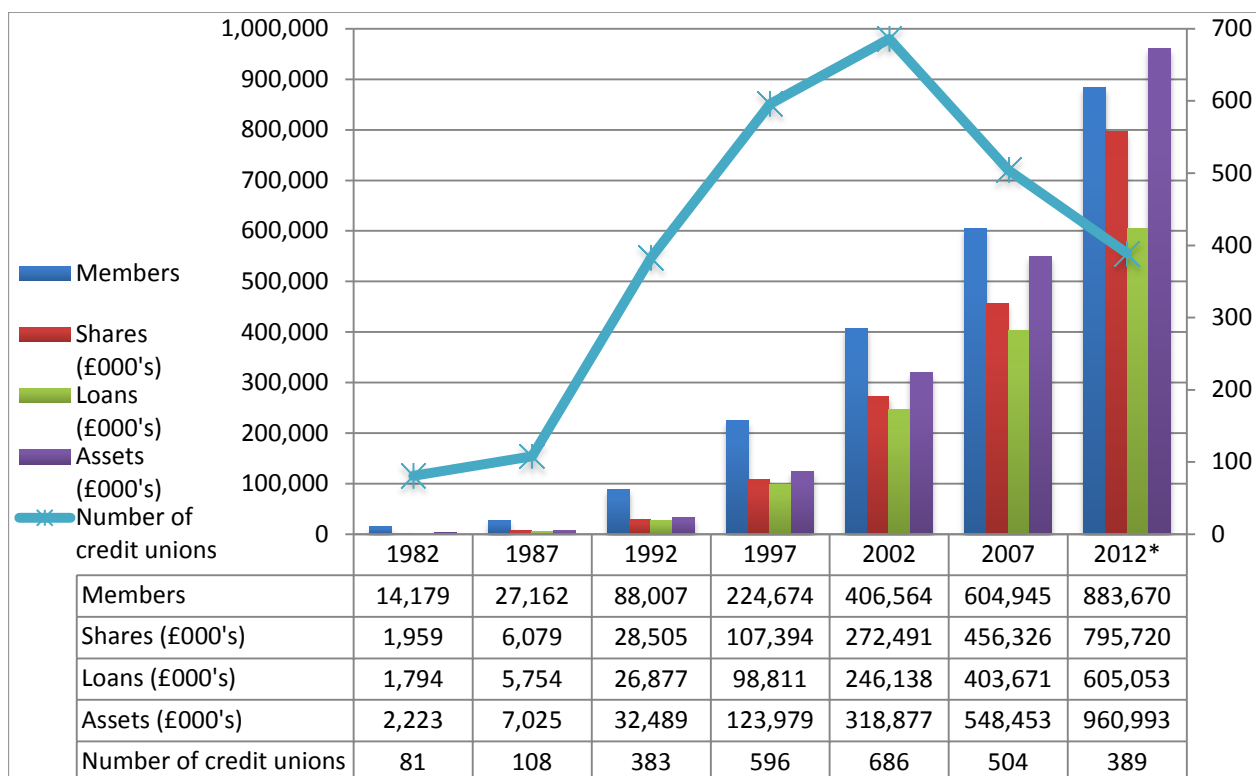


Table provided by Matt Bland, Policy and Communications Officer for the ABCUL.

After 2006, credit union membership expanded by just under 10% every year. According to the most recent unaudited figures by the Association of British Credit Unions Ltd (ABCUL), which represents roughly 70% of Britain’s credit unions, by the end of June 2012, England, Scotland and Wales had:

- roughly 400 credit unions
- 1,025,438 people using credit unions, including over 123,000 junior savers
- £776m saved in British credit unions
- £602m out on loan to members
- Some credit unions offer mortgages, cash ISAs and insurance products¹³

The average membership of credit unions is approximately 2,500 members. However, they are ‘extremely’¹⁴ varied in size: the largest in Britain is currently Glasgow Credit Union with 30,000 members, which is bolstered by a broad range of community and local organisation affiliations, whereas the smallest can have less than a hundred members.

The figures below show the most recent, audited data on credit unions collected by the Financial Services Authority (FSA) (now replaced by two institutions: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)). They cover all registered credit unions in Britain for the years prior to 2012. On the 31 March 2012, the Financial Services Authority also took over regulation of the Northern Irish credit

unions, the responsibility having previously been devolved. As of yet, no data on Northern Ireland (or Great Britain) have been release by the FSA's successors. To give an indication of their size, according to the Irish League of Credit Unions, in September 2010 Northern Irish credit unions had assets of £981 million.¹⁵

Number of Credit Unions in Britain

| | 30 th September 2010 | | 30 th September 2011 | |
|--|---------------------------------|------|---------------------------------|-------|
| | Number | % | Number | % |
| Total number of registered credit unions | 485 | 100 | 478 | 100.0 |
| Scotland | 115 | 23.7 | 115 | 24.1 |
| Wales | 27 | 5.6 | 27 | 5.6 |
| England: | 343 | 70.7 | 336 | 70.3 |
| East Midlands | 18 | 3.7 | 17 | 3.6 |
| East of England | 32 | 6.6 | 32 | 6.7 |
| Greater London | 39 | 8.0 | 40 | 8.4 |
| North East | 37 | 7.6 | 37 | 7.7 |
| North West | 81 | 16.7 | 80 | 16.7 |
| South East | 19 | 3.9 | 19 | 4.0 |
| South West | 38 | 7.8 | 36 | 7.5 |
| West Midlands | 42 | 8.7 | 41 | 8.6 |
| Yorkshire and the Humber | 37 | 7.6 | 34 | 7.1 |

Figures from the FSA Annual Returns Statistics: <http://www.fsa.gov.uk/smallfirms/resources/factsheets/pdfs/creditunionstats-10.pdf>

Credit Union Membership for 2009 and 2010

| | Total | | England | | Scotland | | Wales | |
|--|---------|---------|---------|---------|----------|---------|--------|--------|
| | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 |
| Total Number of Annual Returns Submitted | 454 | 439 | 318 | 306 | 112 | 109 | 24 | 24 |
| % of credit unions | 100 | 100 | 72 | 70 | 26 | 25 | 5 | 5 |
| Total number of adult members | 718,322 | 777,454 | 444,865 | 488,227 | 236,750 | 250,394 | 36,707 | 38,833 |
| Total number of juvenile depositors* | 100,081 | 111,617 | 61,629 | 67,841 | 32,184 | 36,119 | 6,268 | 7,657 |
| Number of non | 13,101 | 16,703 | 9,143 | 11,290 | 3,738 | 5,041 | 220 | 372 |

* Juvenile depositors are able to make deposits but are too young to become full members. A credit union can pay interest on juvenile deposits but not a dividend. Nor can it issue shares to juvenile depositors. Previously the minimum age to become a credit union member was 16, but since the LRO under 16s can become full members provided that the relevant credit union has adopted this change in its own rules.

qualifying members

Figures from the FSA Annual Return Statistics: http://www.fsa.gov.uk/smallfirms/your_firm_type/credit/library/index.shtml

Despite British credit unions recently achieving the notable goal of over a million members nationwide, their penetration of the UK market remains low, especially by international standards: the US has roughly 7000 credit unions serving 94 million members (almost a third of the population),¹⁶ the top 100 of which each have more assets than the entire British credit union sector;¹⁷ Australia has 4.5 million members, a quarter of the population; Canada, which has nearly half the population of Britain, holds more than ten times as many credit union members.¹⁸ The Irish credit union sector has one of the highest penetration rates with more than 500 credit unions serving 2.9 million members, or half of the population.¹⁹

According to the House of Commons Library the comparatively poor performance of the British credit union sector can be explained in part by a saturation of the financial market by a wealth of products: a small number of high street banks and building societies providing a very broad range of services that have rendered the perceived need for alternative financial institutions marginal. Historically, the activities of British credit unions have also been tightly constrained by legislation, whilst participation typically requires a higher level of personal commitment from members than do banks.²⁰

Financial Statistics

At present, the most recent audited annual returns available from the FSA also date back to 2010.

Credit Unions' Balance Sheet

| Figures rounded to £'000 | 2009 | 2010 |
|---|----------------|----------------|
| Assets | | |
| Fixed assets | 17,967 | 19,531 |
| Investments | 90,856 | 104,521 |
| Loans to members | 464,186 | 506,364 |
| Loans as a % of total assets | 69% | 67% |
| Total assets | 674,152 | 751,483 |
| Liabilities | | |
| Members' Deposits (including Juveniles) | 581,729 | 648,606 |
| Total liabilities | 604,520 | 674,616 |
| Capital and Reserves | | |
| Total reserves | 65,215 | 73,489 |
| Subordinated debt | 4,416 | 3,380 |
| Total capital | 69,631 | 76,868 |

Figures taken from FSA Annual Returns

Credit Unions' Profit and Loss

| Figures rounded to £'000 | 2009 | 2010 |
|-------------------------------------|--------|--------|
| Income | | |
| Interest from members' loans | 46,346 | 51,084 |
| Income from investments | 2,994 | 2,080 |
| Grants applied | 10,690 | 13,849 |
| Total income | 69,788 | 79,329 |
| Expenditure | | |
| Administrative expenses | 32,398 | 36,671 |
| Bad debt provisions and writes offs | 11,612 | 11,244 |
| Total expenditure | 57,138 | 62,021 |
| Corporation Tax | 619* | 486 |

*In 2008, Corporation Tax paid by credit unions was more than double, £1,277,000.

In the decade to 2011, credit unions in Britain increased their membership by 225 per cent and their savings by more than 300 per cent. The total loan portfolio increased by more than 270 per cent.²¹ According to the ABCUL this has been due to the increasing professionalisation of credit union activity, such as the operation of high street premises with convenient opening hours, employment of professional staff with appropriate qualifications, skills and experience; implementation of a more robust and effective governance structure, and the move away from 'drip feed' grant funding towards targeted investment.

However, these improvements have not taken place across the board and the development of credit unions across the country remains highly uneven. In 2010, 32% of British credit union membership was to Scottish credit unions, Scotland accounting for 5.6% of the population at the time.²²

Investment

Credit Union funding has moved away from Regional Development Agencies (which were abolished in March 2012) and towards core credit union funding. The Government's Growth Fund,²³ set up specifically to invest in and modernise the third sector, instigated a move towards funding based upon results. The DWP Credit Union Expansion Project will inject greater sums of money into credit unions following similar preconditions.

A report produced by policy consultants Policis and Liverpool John Moores University (LJMU) on London-based credit unions demonstrates that previous funding from the DWP Growth Fund has acted as a catalyst for change. Five credit unions delivering the Financial Inclusion Growth Fund more than doubled their membership in the period 2005-2009. In this period savings increased by 81 per cent in Growth Fund unions, compared with 47 per cent in non-Growth Fund unions.²⁴

A select number of credit unions also receive investment from charitable sources like the Barclays Community Finance Fund, but these are small in relation to the amounts needed for meaningful expansion.

Products

Many credit unions now offer a range of products and services to customers. Most importantly, all offer affordable sources of credit to their members. Interest rates are currently capped at 2 per cent per month on the reducing balance or 26.9 per cent APR, meaning credit unions offer interest charges for small sum, short-term credit that are typically a tenth of what borrowers would pay elsewhere. Credit unions can also beat high street rates for larger, longer-term loans and several are beginning to offer mortgages.

All offer a range of savings accounts, including Christmas savings accounts, ISAs and junior savers' accounts. Members can pay in directly by payroll deduction or through benefit direct accounts, through retail payment networks including PayPoint and Pay Zone, by standing order or direct debit, and in cash at local offices and collection points (including Post Office branches in some instances).

More recently, however, the ABCUL has developed a current account with ATM machine access, direct debits, standing orders and a VISA debit card. The account also avoids the uncertainty of high default charges by charging a small, regular, transparent fee for the account e.g. the London Mutual CU charges 95p per week. In addition, there is now A Credit Union Prepaid Card (also developed by ABCUL), which incurs no monthly or annual fees and low everyday fees (50 pence to load; free at point-of-sale, 75 pence ATM fee) and is intended to make it easier to manage personal finances.

Recent Legislative Changes to Credit Unions

Important and fundamental changes to the 1979 Credit Unions Act came into force on 8 January 2012. These changes were intended to make credit union services available to a far greater number of people. The Legislative Reform (Industrial & Provident Societies and Credit Unions) Order 2011 (LRO) removes

restrictions that were a heavy restraint on the sector's progress. According to the ABCUL the LROs allow credit unions:

- To engage with new groups by serving more than one group of people [i.e. loosening the definition of 'common bond'].
- To borrow money from external sources, other than a select few authorised banks and credit unions.
- To provide services to businesses, social enterprises and community groups.
- To offer interest on savings, rather than a dividend.
- Greater flexibility in charging for additional services.
- To continue to offer services to more people who move jobs or home.
- To lower the age restrictions on becoming a member.

It should be noted that these changes only apply should individual credit unions choose to adopt them in their own rules, which involves a vote of approval by their members (and must be registered with the Financial Conduct Authority). The legislative framework for credit unions prior to the passage of the LRO was described by the World Council of Credit Unions (WOCCU) as among the most restrictive in the world.

The redefinition of the 'common bond' requirements was among the more controversial changes as credit unions, though keen to grow, have remained nervous about losing their local identity. Specifically, the change means a credit union no longer has to prove *all* its members hold something in common, such as working for the same company, but can service different groups of people. According to the ABCUL, the common bond still requires a 'field of membership test' which makes sure it is possible for all potential members to be served by the credit union. Credit unions whose 'common bond' includes a geographical area are limited to two million potential members.

The LRO also allows credit unions to set their own limits on 'non-qualifying members' (NQMs): members who move house or job and leave a credit union's common bond are known as. NQMs were limited to 10 per cent of a credit union's membership. A credit union's registered rules may also restrict the entitlement of NQMs to its services.

Offering credit union services to corporates

Another potentially ground-breaking change has been the extension of membership qualification to groups and corporates. These include unincorporated associations and corporate bodies such as companies, partnerships and social enterprises.

Individual credit unions can choose between offering ordinary shares, with all the benefits of membership, or deferred shares, which count towards the credit union's capital and are only repayable in restricted circumstances. This allows local businesses to support the local community whilst also accessing affordable capital.

More importantly for the sector as a whole, the change in legislation also means it is now possible for a credit union to frame its membership qualification in such a way as to allow other credit unions to join. This would allow credit unions to pool their resources, potentially leading to many new benefits.

However, the terms of their membership are heavily restrictive: 'non-individuals can only make up a maximum of 10% of a credit union's total membership hold a maximum of 25% of shares in the credit union and be granted a maximum of 10% of loans'.²⁵

Offering interest payments on savings

Credit unions can also now choose to pay a guaranteed rate of interest on savings in addition to dividends. Previously credit unions had only been able to pay a discretionary, retrospective dividend to their members as a return on savings, now they can offer a guaranteed rate of interest to savers, allowing them to compare the benefits of saving with banks or credit unions (particularly useful for consumers of competitive products such as Cash ISAs and Child Trust Funds). Those wishing to pay a contractually-guaranteed rate of interest must demonstrate that they have the necessary systems and controls in place and hold reserves of at least £50,000 or five per cent of total assets, whichever is the greater (these can easily and quickly be changed by secondary legislation).

The guarantee on interest-bearing shares, however, is only met if a credit union continues to meet the minimum requirements to offer interest rates. If, for example, a credit union's year end sheet displays its reserves have fallen below £50,000 or five percent of the total assets, or it fails to meet the standards of the financial authorities, the shares will be converted back to non interest-bearing shares.²⁶

Currently, however, most credit unions still only offer a dividend (which vary but are usually no more than 1 or 2%), with loans remaining their most competitive products, particularly small value, short-term loans.

DWP Feasibility Report

“The challenge to credit union expansion is not one of demand.”²⁷

The Feasibility Report commissioned by the Department for Work and Pensions was released in May last year. The report looked to examine ways the customer base of credit unions could be expanded by a million. Its main findings were as follows:

- Many consumers are currently underserved by the market:
 - 1.4 million people in Britain have no transactional bank account
 - 4 million people regularly incur bank charges
 - 850,000 incur financially crippling levels of bank charges because they need help to manage their money
 - Up to 7 million people use sources of high cost credit e.g. home credit, pay day lenders, pawnbrokers
- The credit union sector is already holding borrowings of £25 billion and savings of £30 billion. However, more than 80 per cent of the 95 credit unions consulted recognised the necessity of fundamental change in their organisation and wanted to offer a wider range of modern financial services to consumers.
- **Only 13 per cent of the 4500+ people consulted had previously heard of credit unions but 60 per cent said that they would use credit union services.**
- ‘We considered the alternatives for serving low income customers and concluded that realistic options are limited. The banks have already opened nearly 4 million basic bank accounts (British Banking Association data) since 2003 and it is considered unlikely that further significant expansions will occur in the absence of mandation. Credit Unions appear to be the only other realistic option.’²⁸

To modernise and become sustainable, credit unions need to:

- Achieve cost reductions of approximately 40%
- Automate loan decision making to improve the speed of decisions, further reduce operating costs, and reduce the costs of bad debt
- Introduce IT support systems/platforms to provide the online banking, jam jar accounts, and automated savings and credit products that people want
- Deliver a national image

- Work with the Post Office to increase membership²⁹

Credit Union Modernisation and Expansion Project

The project's overall aims are to assist credit unions to sustainably provide services to a million more people and to develop a collaborative business model in order to provide an expanded and modernised service across the country.

On 27 June 2012 the DWP announced it would be taking forward the findings of the Feasibility Study with the aim of rendering the credit union sector sustainable. The department is now set to make a further investment in credit unions of up to £38 million over the next three years. This investment is conditional upon the credit union industry meeting a number of agreed targets for collaboration, modernisation and expansion. Achievement of the following Key Performance Indicators will result in milestone payments throughout the project until March 2015:

- membership growth
- loan value and volumes
- deposits / savings totals

To be accepted onto the project, consortia of 15 or more credit unions must bid to receive funding from the DWP. Bids must be led by credit unions, representatives from the sector or other not-for-profit financial organisations who offer financial services to tier 2 and tier 3 customers. Potential suppliers must demonstrate how the project will expand to include a minimum of a further 25 credit unions, with no fewer than 120,000 adult members, and that they possess an organisational structure with the capacity and skills to manage a group of partners and stakeholders.

ABCUL is in the process of putting together a consortium, with roughly 70 credit unions signed up so far. ABCUL's Shared Business Model is being developed by its subsidiary Cornerstone Mutual Services Ltd and will include:

- A bespoke credit-scoring platform
- A debt collection service
- Treasury management
- A 'jam jar' budgeting account
- A common banking platform

As of May 2013, the ABCUL has chosen the first 31 credit unions to take part in the project (yet to be announced at the time of writing).³⁰

Policy

Personal Current Account Fees

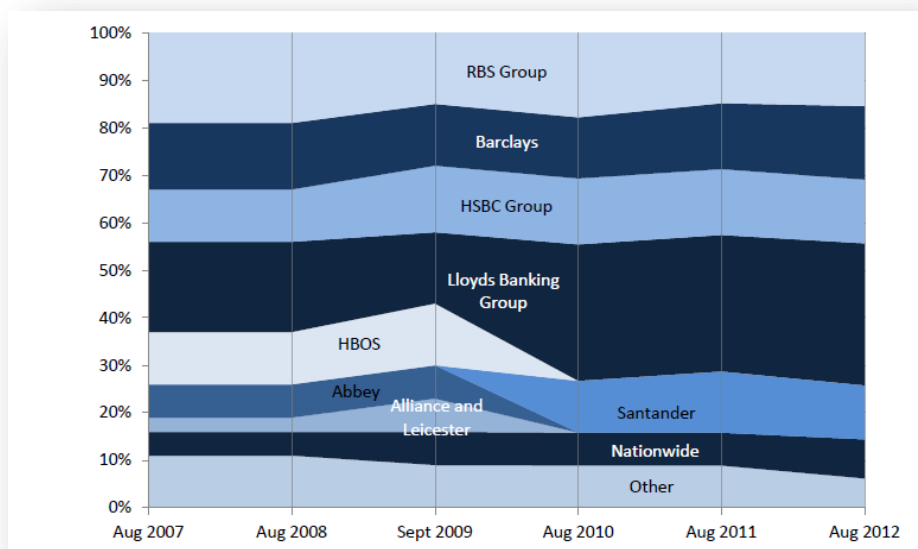
The fundamental challenge to the future of credit unions is to expand in a sustainable manner. The redefinition of the common bond freed credit unions to serve whomever they wish. But fundamentally, they need to attract more depositors than borrowers. As Barrow district CEO, Rob Cairns, summarises in an interview with *The Guardian*, 'We need people who have some spare cash to provide the funding for those that don't'.³¹ Though the ethical dimension of credit unions is a compelling attraction to many people, the wider consumer market needs more incentives, such as ease of access to their money and quick transfers. Credit unions therefore need to offer a more competitive or similar range of products to mainstream financial services.

In 2007, the ABCUL recognised this problem by putting together the first current account for credit union members. Currently, 25 credit unions provide the account to more than 34,000 people.³² In other words, 6% of credit unions provide the account to 3% of the entire British credit union membership. The cost for credit unions to run the service - costs that must be paid by the credit unions or passed on to the members - has significantly stifled take-up of the account, costs that are incurred because 'no UK Credit Union is able to offer its own current account running on its own software'.³³ Current IT systems are not sophisticated enough, or able to interact with each other, or talk directly to the banks (with which many of their members will transact their current CA business). The ABCUL account is run by the Cooperative Bank.

London Mutual, one of the larger and more successful credit unions, charges 95p a week to run a current account, £5 for a copy statement, and £5 for a replacement debit card.³⁴ Bristol Credit Union charges its customers a weekly fee of £1.30 when the account has been accessed in any way during that week.³⁵ Glasgow Credit Union, with the largest membership of 30,000, decided to discontinue the account. They suffered from a lack of demand among their customers after it was found to be 'very costly to administer for an account which didn't provide as fully functional a service as others available to them'.³⁶ The few that do offer the current account tend to 'view it as a cost of acquisition for savings accounts on which they can generate income'.³⁷

The problems for breaking into the personal account market are not unique to credit unions. A recent study by the Office for Fair Trading (OFT) reported 'significant concerns'³⁸ about the lack of competition in the personal accounts market, especially after significant mergers between banks. The study notes, 'while the

share of the four largest providers fell from 74 per cent in 2000 to 64 per cent in 2008, it then rose to 77 per cent in 2010.³⁹ The table below shows the most recent figures on market share of personal current accounts between 2007 and 2012:



Taken from: OFT, 'Review of the Personal Current Account Market', January 2013, p46.

The report also points out that 'regulatory requirements and processes; access to essential inputs, such as IT systems, payment schemes, information and finance needed to offer retail banking products; the ability of new entrants to attract customers and achieve scale', were considerable barriers to expansion into the market for all smaller finance institutions.⁴⁰

A report by the consultancy firm, Tusmor, advocates creating a 'level playing field' so smaller providers can offer a real choice of personal accounts to customers. The OFT will revisit its options for action if there is no improvement by 2015.⁴¹ But at the same time, without a competitive current account package, the credit union sector stands no chance of competing in the market. The situation may even be counterproductive to credit unions as many feel compelled to offer the account regardless of the cost, considering it 'in [their] DNA to offer education, support, and training to help people become financially literate and self-managing'.

A DWP solution to this problem, supported by the credit unions, has been to create a relationship with the Post Office. The DWP report observed that Post Office Ltd is looking at options for working with credit unions and developing own brand banking products, but notes that it may have different target customers.⁴² A report produced by Consumer Focus in May 2012 argues that a partnership between credit unions and the Post Office would help to secure widespread coverage for credit unions and offer them "a significant commercial and development opportunity".⁴³ This suggestion is based on findings that low-income

customers trust and value the Post Office network but often do not feel comfortable using High Street banks for transactional accounts, savings products or loans. The report argues that such a partnership would help address a number of the major obstacles which limit take up of credit union services including low awareness of credit unions and their purpose; and their limited and uneven geographical distribution. It would also enable credit unions to offer their services through a convenient and trusted channel.⁴⁴ The Post Office has an advanced infrastructure for handling money and transactions with some 11,000 branches nationwide.

However, some in the sector have expressed scepticism towards the ability of the Post Office to provide effective banking services at a cost more affordable to credit unions than they currently incur. What is more, it is increasingly unlikely that the Post Office will want to strike a deal given that it has announced they are to offer their own current account to customers. From the view of Post Office Ltd, providing a cheap clearing service to credit unions will only increase competition over the lower income target market both are seeking to gain a bigger share of. A better solution for credit unions would be for the ABCUL to develop its own network, to develop the abilities of a clearing bank and make transactions themselves.

The Interest rate cap

During the consultation, Experian found 'the third most popular means quoted by credit unions for achieving sustainability, after improving processes, systems and marketing, was to increase the maximum rate at which interest can be charged.'⁴⁵ The current rate (2% per calendar month on the receding balance of loans), 'does not allow even the most cost effective [credit unions] to break even on smaller loans'.⁴⁶ The cap includes a prohibition on service charges on loans, meaning the 2% cap is a complete restriction on the amount credit unions can make on a loan. When operational costs of a loan are considered, credit unions are forced to make a loss on short term loans.

The third option espoused by the DWP for the Expansion Project was to raise the interest rate cap for credit unions to 3% alongside the DWP's programme of modernisation. A 3% interest rate cap 'still compares very favourably' to the rates charged by leading home credit lenders. It is also assumed (as credit unions use lower rates for larger loans) that this would only apply to loans of below £1,000 and would still amount to a saving of more than £200 for consumers on a typical loan of £400 over 12 months. The report predicts that this legislative change combined with the modernisation of credit unions would enable them to become sustainable within 5 to 7 years.⁴⁷ The rate cap can be altered with secondary legislation.

The Tusmor report calls for a rise along with greater flexibility in credit union restrictions on charges, maintaining a 1% raise in the interest rate cap would still create 'a no-win scenario for Credit Unions'.⁴⁸ On a

loan of £300 for one month, a credit union can charge a maximum of £6 with the 2% cap (providing the loan is paid back in a lump sum at the end of the loan period). Processing plus credit referencing costs for a loan typically cost a credit union £8, sometimes more, leaving the credit union with a net loss of £2 on the loan. Consequently, many credit unions avoid issuing many short term loans to avoid losses. A raise to 3% would allow for only one pound profit on the loan, still leaving poor incentives for credit unions to push the product. Instead, the report suggests (alongside a raise in the rate) credit unions be allowed to pass on the £8 origination costs for a loan to the customer in full, rather than having to absorb them in the interest calculation.⁴⁹ Even with an added £8, short term loans would remain very affordable and far cheaper than any those currently offered by other lenders. Ultimately, credit unions cannot be expected to combat payday lenders (shown in more depth below) if they are continually forced to make a negative or non-existent return on the same loans.

Serving Low Income Customers

The DWP *Feasibility Report* categorised a significant part of the credit union consumer market into two tiers:

- Tier II consumers - those with incomes in the 11% to 40% bracket, generally with household income below £30,000, a record of failed banking transactions, and likely to be in employment but use home credit and live in deprived areas or in social housing. This tier therefore excludes people on middle or average earnings, but includes those on a mix of benefit and wages, as well as those on lower wages
- Tier III consumers - those with incomes in the lowest 10% bracket, the majority of which are benefit claimants.⁵⁰

During the consultation for the report, Experian discovered that ‘around 50% of the [credit union] target group have had difficulty keeping up with their bills and credit commitments’.⁵¹ Typically, the alternative for credit-poor people are payday lenders who offer quick access to small, short term loans for very high rates of interest. Rates of interest on a typical short-term loan offered by two of the biggest payday loan companies, Wonga and the Money Shop, are shown below:

Cost of a Loan of £400 for 41 days from Wonga.com: £169.48

We can deposit up to **£400** in your bank account by **11:20 today**.
Existing customers may be able to borrow up to £1,000, depending on your current trust rating.

money sent in 5 minutes >
GUARANTEED

how much cash do you want? **400** Max £400



how long do you want it for? **41** Days

(Repayment date: Mon Jun 10 2013)

Borrowing **£400** + Interest & fees* **£169.48** = Total to repay **£569.48**

Apply now >>

Representative APR 4214%
*See representative example
APR is not the same as actual interest charged [find out more](#)

[Enter promocode](#)  

www.wonga.com accessed on 30th April 2013.

Cost of a loan of £500 for 31 days from The Money Shop: £139.95

The Money Shop Cash for Life's Little Emergencies

How much would you like to borrow?

Borrow: **£500.00** + Total interest: **£139.95**
You repay*: £639.95 **Apply Now**

*Repaid on your next payday

www.moneyshop paydayloans.co.uk/apply-for-a-payday-loan-today accessed 30th April 2013.

The same loan of £500 for 31 days from Bristol Credit union costs £9.63 in interest.⁵² From Leeds City Credit Union, it cost precisely £10.⁵³ Perhaps more astonishingly, according to averages of credit union lending rates (and by law), it is cheaper to take out a loan of £500 for a year with a credit union than it is to borrow £500 for one month from either of the above payday lenders.

Many credit unions charge less, some may charge more but by law this cannot be more than 2% a month on the reducing balance (an APR of 26.8%). This table illustrates what you would repay if you borrowed £500 over 1 year.

| Rate | Loan Amount | Interest | Total Repayable |
|-------|-------------|----------|-----------------|
| 12.7% | £500 | £34.06 | £534.06 |
| 26.8% | £500 | £69.55 | £569.55 |

Illustration only - check directly with your credit union

www.abcul.org/credit-unions/borrowing-from-a-credit-union.

The DWP acknowledged ‘people on low incomes are often forced to pay a high price for credit when they need to borrow. This is commonly referred to as ‘paying a poverty premium’. About 7 million people on the lowest incomes are affected by the problem.’⁵⁴ Payday lenders are now under review by the Office of Fair Trading (OFT), after ‘widespread irresponsible lending and failure to comply with the standards required of them’.⁵⁵ The OFT has ordered the 50 largest payday lenders to improve their practices or risk losing their credit licences. The sector, now worth over £2billion has been widely condemned as exploitative and stands accused of ‘failing to conduct adequate assessments of affordability before lending or before rolling over loans; failing to explain adequately how payments will be collected; using aggressive debt collection practices, and not treating borrowers in financial difficulty with forbearance’.⁵⁶

Credit unions offer precisely the same services as payday lenders without a ‘poverty premium’. When announcing the beginning of the Expansion Project, Lord Freud, Under-Secretary of State for Work and Pensions referred to them as ‘the antidote to predatory loan sharks or high-interest lenders’. However, this remains unrealistic as credit unions have far fewer resources to promote their products to the same extent as Wonga or The Money Shop. The CUEP does hope to combat this by including funding for a marketing campaign, but, as described above, credit unions cannot be expected to be a real alternative to payday lenders until they are equipped to offer short-term loans on an economical basis. A sensible balance needs to be found for the interest rate cap, where credit unions still offer cheap levels of credit without suffering losses that may ultimately weaken smaller credit unions. Only this, along with a sophisticated promotional campaign to educate people about credit unions will enable them to be the antidote to payday lenders.

Universal Credit and Jam Jar accounts

A key area of interest for the DWP in commissioning the feasibility study was to see how credit unions could support benefit claimants once they were moved onto Universal Credit. Universal Credit amalgamates six

major benefits into one monthly payment with the hope of replicating working pay to 'mirror the world of work'.⁵⁷ It is intended the reform will encourage claimants to budget their income by teaching financial discipline and thrift.

As credit unions serve nearly 4% of the lower income population⁵⁸ and promote the same ethos, it was hoped they could help to provide specially designed bank accounts to support claimants during the transition. The basic bank accounts designed are called Jam Jar accounts. They:

- Allow customers to split their account balance into Jam Jars for spending, saving and bill payment;
- Support customers to improve their budgeting and bill payment behaviour through low balance alerts and automated transfers of funds between Jam Jars;
- And give customers access to trained Money Managers that can provide budgeting advice and referrals to specialist consumer services (e.g. debt advice or Citizens Advice Bureau) where necessary.⁵⁹

However, as shown with current accounts above, the cost of running any kind of high service account remains far too high for credit unions. One suggestion has been for the DWP to meet the cost but this is very unlikely given the ongoing cuts to the DWP's budget. The DWP also hoped larger banks could provide the accounts for claimants, but, even after a £145million incentive offer from the DWP to help set up the accounts, no deal was struck. In some cases, housing associations are paying for the accounts for their tenants⁶⁰ as Registered Social Landlords (RSLs) tend to have tenants who will be affected by the introduction of Universal Credit. But for the majority of low-income and benefit claimants the accounts have remained unappealing because of the costs, leaving a big question mark over the viability of the Jam Jar Accounts scheme. Until the accounts can be offered to very low-income people for free, it is likely uptake will remain very poor. Before credit unions can be in a position to make such an offer, they need to broaden their middle income membership and accrue more savings. CEO of United Savings and Loans, Geoff Brown, has suggested that, with the right marketing, the accounts might have a future as a product for people in the middle to low-income bracket. They could act as an assurance of avoiding discrepancies such as unauthorised overdraft fees.⁶¹

Small Businesses Lending

The LROs' removal of restrictions on credit union lending to businesses opened up an entire new market for the sector. The decision to lend to business must still be decided by individual CUs, requiring a vote among its members which must then be registered with the FCA.

The ABCUL pointed to the initiatives of the Obama administration to indicate the potential for development in this area. In a bid to tackle the investment gap for SMEs, the US Government has supported a private members' bill that will enable credit unions to increase their business lending: those nearing the statutory 12.25 per cent cap on business lending as a percentage of assets will be permitted to apply to extend this, if they can demonstrate that they meet certain prudential standards. However, it should be noted that the scale of the US credit union movement is much larger than that of the UK.

Given that credit unions in the UK have only been able to operate in this market since July 2012, the scale of business engagement is still very small. However, some have effectively been supporting businesses through sole traders for a number of years; for example, five years ago Bristol Credit Union delivered a scheme with the Local Authority which gave the unemployed the opportunity to trial self-employment through 'test trading', after which any profits made by participants could be accessed for their continuation in self-employment. St. Albans District Credit Union has also offered loans of up to £5000 to individuals wanting to invest in businesses (typically at 1% per month on the declining balance) for some time.⁶²

Some are beginning to offer business loans, such as Hampshire's United Savings and Loans, which has roughly 7,000 members accounting for £750,000 savings, and offers a competitive rate of 11.1% on loans of up to £25,000:

| | | | | |
|-----------------------------------|--------------|---|---|--|
| United Savings & Loans | 11.1% | Representative example: If you borrow £25000 over 7 years at a representative APR of 11.1% fixed and an annual interest rate of 10.6% you would pay: | | |
| | | Payment per month £422.83 | Total Charge for credit £10,516 | Total amount you repay £35,516 |
| Natwest Personal Loan | 11.9% | * Representative example: If you borrow £25000 over 7 years at a representative APR of 11.9% fixed, and an annual interest rate of 11.9% you would pay: | | |
| | | Payment per month £431.97 | Total Charge for credit £11,285 | Total amount you repay £36,285 |
| Halifax Personal Loan | 15.4% | * Representative example: If you borrow £25000 over 7 years at a representative APR of 15.4% fixed and an annual interest rate of 15.4% you would pay: | | |
| | | Payment per month £474.17 | Total charge for credit £14,830 | Total amount you repay £39,830 |

Table taken from <http://usal.org.uk/smallbusinessloans.php>

Partners Credit Union in Liverpool offers loans of up to £15,000 with varying rates. A number are preparing to offer business loans such as Bristol and Leeds City credit unions, but are yet to decide on what rates and amounts they will offer, or the time periods over which they are willing to lend.

Branching out into business lending could significantly increase revenues for credit unions, bringing more returns on loans and larger deposits for onlending to individuals, ultimately helping them to realise their social aims. At the moment, however, many simply do not have the reserves to lend large amounts and of those that do, most remain nervous about the substantial risks involved in writing bigger loans. The CEO of USAL, Geoff Brown, commented, 'The killer is acquiring requisite skills to manage the risk, I don't believe that there are any others apart from the will to do it'.⁶³

A possible solution for the ABCUL would be to offer training courses similar to those they offer for other aspects of credit union business, to help find experienced consultants to plug the knowledge gap.⁶⁴ Seconding talent from other financial institutions could also be an option if the right incentives for talent-sharing were found.

Working with Community Development Finance Institutions

Seconding people from Community Finance Development Institutions (CDFIs) could be a viable option given that they share the same social aims as credit unions. These are investment companies that also lend for social as well as profitable returns. Unlike credit unions, they do not take deposits or savings. They exclusively offer affordable loans to businesses and people struggling to obtain loans from mainstream lenders, predominantly in more impoverished areas.

CDFIs have good experience in managing risk on large loans and knowledge of the local business economy in the regions they operate in. Credit unions are in an advantaged position compared with CDFIs in having a reliable source of revenue to lend locally by being able to raise capital through their members' deposits. Some credit unions are trying to actively engage with CDFIs, but for others, 'unfortunately there is a degree of competition between the two sectors'.⁶⁵ A closer relationship between the ABCUL and the Community Development Finance Association (the trade body for the CDFI sector) would lead the way to communication between credit unions and CDFIs.

Deposits cap

Currently, a credit union can only accept deposits of £10,000 or 1.5% of its share holding from any one member. A business, no matter its size, counts for one member. This situation acts as a disincentive for larger corporates who may want to deposit and borrow larger sums of money. There is scope for redefining the terms of membership for businesses in credit unions, allowing a greater level of manoeuvrability for businesses, which cannot be treated the same as an individual member. A cap is important in acting as a

safeguard for smaller credit unions against more risky lending, but for larger and more capable credit unions, such a low cap will be a considerable barrier in the future. It removes the choice of entering into business with larger corporations from the individual credit union, which is in a far better position to understand its own financial limitations.

A Bank Referral Scheme

The British Banking Association is currently developing a referral system between the banks, credit unions and CDFIs. The aim is to create a mechanism where banks can pass on business and personal loan applicants they have rejected on to credit unions to service. However, there are some large questions hanging over the practicalities of any such system, namely whether banks are likely to pass on any applicants other than those who are the highest risk. Non credit-worthy customers are more of a risk for credit unions than banks given their comparative size. There is a danger that any such referral scheme is likely to unbalance a credit union's membership by giving them an influx of only financially risky people.

Ideally a bank's referral scheme would offer a mixture of people on middle and low income. One option is for a system which refers only small and short term loan applicants to credit unions, loans most banks do not offer in any case. These are also loans that typically fall to payday lenders instead of credit unions. Such a referral system would not have a conflict of interests and restrain the growth of the payday lending market.

Public Image – Are they safe?

Public faith in credit unions (and smaller financial institutions in general) remains a barrier to their growth. This hasn't been helped by the liquidation of five credit unions this year, including South Warwickshire Credit Union with roughly 1,200 members (according to the number of claims to the Financial Services Compensation Scheme)⁶⁶, and Cornish Community Banking, with 2,100 saver members. Six were lost in 2012 and seven in 2011. Overall there are 300 fewer credit unions than there were in 2002.⁶⁷

However, the closures were largely confined to the small credit unions and could be considered a part of the modernising process. Mark Lyonette, chief executive of ABCUL, responding in *The Guardian*, commented, '[credit unions] are as safe to put your money into as any bank or building society'⁶⁸ which also noted that all deposits of up to £85,000 with credit unions are protected by the Financial Services Compensation Scheme. Unfortunately, more successful credit unions are still tarnished by the failings of inefficient ones, and given that there will always be closures because of the diversity of size and quality of credit unions sector, more needs to be done to improve their public image.

It is hoped this can be in part rectified by the large-scale promotion campaign mentioned above in the DWP feasibility study. Given that competition with payday lenders is a significant contributing factor to some of the credit union closures, a campaign directed at the better-quality offers of credit unions should bring new membership, and with it, greater stability to the sector. Experian noted, 'a new brand image and brand would be required if they are to attract more tier II customers needed to balance their deposits and loans... however, any national marketing strategy will need to wait until there is a coherent group of credit unions who offer similar services.'⁶⁹

Conclusions: The Future for Credit Unions

The UK credit union sector has grown slowly but steadily since the 1980s. Now it is moving into uncharted territory with its first major expansion project and much greater freedom to operate in different ways.

Yet, certain barriers do remain. Most of these stem from an attitude, which is slowly dying, where credit unions have been treated as a homogenous mass in the past, with similar modes of operation and needs. However, they serve a wide range of communities and operate at dramatically different standards. To take account of this, the interest rate cap should be increased, allowing credit unions to recoup the costs of issuing what would still be very cheap loans and they should be given the option of passing on loan processing costs to customers.

To truly modernise the sector and make it sustainable a more competitive range of products outside of current loan packages is needed to encourage a broader range of members to credit unions, including:

- More offers of guaranteed interest rate savings accounts. Too many credit unions still only offer a dividend for shares
- Current Accounts free from charges

The potential to lend to business, largely ignored by the DWP Expansion Project, needs to be explored and encouraged by the ABCUL. Hopefully, with the added sustainability the Expansion Project aims to bring to the sector, a greater number of credit unions will become more confident and willing to enter the market.

A stronger credit union sector will help to bolster the financial market against future market failure and it is important to do this while the impetus is still there. Whether or not the Expansion Project will have a definitive effect on the long term development of credit unions remains to be seen. But the above issues need to be addressed if they are ever to become a widely recognised source of alternative finance.

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