DWP Credit Union Expansion Project

Project Steering Committee

Feasibility Study Report

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DWP Credit Union Expansion Project

Project Steering Committee (PSC)

Feasibility Study Report to:

the Minister for Welfare Reform

the Minister for Pensions and copied to

the Secretary of State for Work and Pensions

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Contents

1 Introduction and Terms of Reference 4
2 Executive Summary 4
3 Background - The Problems to be solved – financial exclusion and lack of access to affordable credit 8
4 Responding to the Gap 8
5 Other Options 9
6 Feasibility Study Research 9
The Market for Credit unions 9
Consumer Research 10
Credit Union Research 12
7 Financial Modelling and Sensitivity Analysis 13
The ‘do nothing’ scenario 13
Estimated project costs from financial modelling 15
The impact of other factors on the credit union sector 16
Credit Union interest rates 16
Sensitivity testing of the model 18
8 The Case for investment 18
9 The way forward 21
Selecting credit unions that will perform and provide value for money 21
10 Managing highly focussed change and expansion 22
11 Recommendations 22
ANNEX A Financial Modelling and Sensitivity Analysis 24
ANNEX B Interest Rate Increase 37

1 Introduction and Terms of Reference

1.1 This is the report of the Project Steering Committee (PSC) commissioned by the Secretary of State to examine the feasibility of expanding and modernising credit unions.

1.2 The report is submitted, as requested, to Lord Freud, the Minister for Welfare Reform and Steve Webb, the Minister for Pensions.

1.3 The Terms of Reference (ToR) for the study were: ‘to advise whether it is possible to provide suitable financial services for up to a million more consumers on lower incomes in a way that will enable credit unions to modernise, expand and become sustainable within five years’.

1.4 We have identified a number of opportunities and challenges from the study that have been discussed with Ministers and are detailed in this report.

2 Executive Summary

2.1 We commissioned Experian to research:

- The consumer market for credit union services in Great Britain.
- The consumer need for the services that modernised credit unions could offer, and
- The capability and appetite of credit unions for offering the services you require to be delivered.

2.2 We found that a market exists amongst people on lower incomes for locally provided banking, savings deposit and loan services from trusted providers such as credit unions:

- 1.4 million have no transactional bank account at present
- 4 million incur bank charges
- up to 7 million use sources of high cost credit, and
- more than 60% of the over 4500 people consulted said they would use credit union services if such were available.

2.3 We found that more than 80% of the 95 credit unions consulted said they recognised the need for fundamental change in their organisation and that they wanted to offer a wider range of modern financial services to the consumers you wish them to serve.

2.4 We considered the alternatives for serving low income consumers and concluded that realistic options are limited. The banks have already opened nearly 4 million basic bank accounts (British Bankers Association data) since 2003 and it is considered unlikely that further significant expansion will occur in the absence of mandation. Credit unions appear to be the only other realistic option. This movement has expanded with DWP support but their costs are high, some of their processes and their systems are not currently fit for your purpose, and a major programme of cultural and behavioural change would be required to achieve the modernisation and expansion needed.

2.5 We also considered whether it might be possible to leave credit unions to grow without further financial support but concluded that, as their costs currently exceed earned income by some margin, they are more likely to contract or cease to operate altogether.

2.6 We considered the prospects for the sector to achieve external investment in the long term. We think that it should press ahead with plans to develop its own financial wholesale operation so that after achieving the publicly funded change we propose it can speak to the Big Society Bank and other funding organisations as one 'organisation' large enough and financially stable enough for investors to be interested in. However, until real change has been achieved there is no realistic opportunity for it to achieve commercial or social investment because it lacks the capacity to repay.

2.7 Whilst the credit union business model as currently operated will not sustain the growth ambition set-up in the ToR, it could, with the benefit of a major programme of holistic change and modernisation, form a platform for growth in the medium-term. However, it needs to be recognised that such a major programme of change carries with it some significant risks which will need to be managed very carefully and intensively for there to be a realistic chance of success, and that the process of change at this level will take a minimum of three years to fully embed.

2.8 To deliver the proposed modernisation strategy successfully, and to mitigate the risk and cost of failure, we would propose a phased approach to managing the change programme required. This would involve Government investment being made in stages on a payment by results basis, with the next stage not approved for commencement until the objectives of the previous stage had been achieved. To mitigate risk further we propose that credit unions could be brigaded into small groups so that progression can be managed in phases to allow effective testing, and dissemination of lessons learnt.

2.9 Credit unions involved in a change programme will need to demonstrate at an early stage a greater capability and willingness to change. We would also recommend that strict criteria are applied to ensure that only suitable credit unions, which have already demonstrated sufficient progress, are selected to participate in a program of behavioural, process and systems change.

2.10 The evidence of the feasibility study suggests that it would be possible to deliver the desired growth and modernisation strategy, and to achieve something close to sustainability within 7 to 10 years, from this year, with a suitable funding package. Further detailed work on business and systems design will be required to understand whether it may be possible to achieve these changes within the current spending review period, or whether it may be less risky to plan on the basis of some work running into SR14 (2014 – 2018). If it is decided to deliver the project beyond the SR10 (2010 – 2014) period we would expect the costs in SR10 to amount to about 80% of the total, with the balance of about 20% being spent in the first two years of SR14.

2.11 The estimate for delivery will include £13 million already committed for financial subsidy to credit unions in the current year (11/12); up to 25% of potential costs for future systems design and product implementation. The balance of resource that could be available would be needed to support business change; re-engineering and reorganisation, and a marketing campaign to increase consumer awareness.

2.12 To quantify the impact of the changes recommended in this report we commissioned Experian to develop a financial model for the study which uses cautious estimates for achievable business growth and financial sector estimates[1] for losses from loan delinquency that reflect current and forecast adverse market conditions. The financial models are provided at Annex A of this report.

2.13 Annex A, figure 5a shows that if credit unions, operating within the economic restrictions that currently apply to them, successfully make all the changes we recommend they could get close to achieving sustainability within 7 to 10 years from this year, but this does not guarantee they would ever become fully sustainable.

2.14 To achieve the sustainable change you require within 5 to 7 years you may wish to consider looking seriously at the economic issues they face. For example: credit unions are the only financial institutions in the UK to which a legislative cap on interest rates applies. This report demonstrates that the current rate (2% per calendar month (pcm) on the receding balance of loans) does not allow even the most cost effective to break even on smaller loans at present. The point was raised by several credit unions during consultation.

2.15 Annex A, figures 5b and 5c show that if credit unions change as we advise they should, and legislation were changed to allow them to charge up to 3.0% pcm on loans from April 2014, they could become sustainable within 5 to 7 years, and have a much greater chance of maintaining sustainability in the long term.

2.16 But we would like to be clear that, in our view, any move to amend legislation to allow a higher, more representative rate of interest to be charged should only be considered as part of a package that included credit unions making the business and cultural changes we consider to be essential.

2.17 When the current rate was increased from 1% pcm to 2% pcm there were strong arguments for and against the change within the sector. However, as financial markets have become more volatile and are likely to remain so for the foreseeable future, the costs of loan delinquency and of capital for on-lending are increasing, and credit unions are working to become more efficient, you may wish to consider whether now is an appropriate time to make the case for increasing the rate. We understand that the Credit Union Act 1979 contains a power that enables Government to change the rate figure using secondary legislation if there was general agreement that change is desirable.

[1] Advice was taken from Barclay’s Bank plc on current and future market conditions.

3 Background - The Problems to be solved – financial exclusion and lack of access to affordable credit

3.1 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 them ‘paying a poverty premium’. About 7 million people on the lowest incomes are affected by the problem.

3.2 There is a gap in the market for provision of affordable credit and other suitable financial services to people on low incomes. The principal reason for this is that lending small sums to low income (sub prime) consumers is expensive, and carries a higher risk of default and eventual write off. The banks do not, therefore, tend to serve this sector of the market, seeing reputational risk from the high interest rates required to make adequate returns on capital.

4 Responding to the Gap

4.1 For more than a century the credit gap in the sub prime market has been filled by home credit, mail order catalogue and more recently ‘rent to buy’ companies. These organisations charge high interest rates or premium prices, sometimes including product insurance. They operate lawfully within the terms of credit licenses from the Office of Fair Trading and other financial regulation, but place a heavy burden on the low income consumers they serve.

4.2 Credit unions have been helping to address this gap in the credit market, particularly so since 2006, but their operating costs are relatively high and they are not financially sustainable at present. They rely on grant income from DWP and other external funders, such as local authorities and social landlords, but these sources of funding are likely to come under even greater pressure in the future.

4.3 Independent evaluation of the DWP Credit Union Growth Fund showed that credit unions have been doing a good job in helping to keep low income consumers out of debt since 2006. By March 2012 [updated] those contracted to DWP had made over 650,000 loans to people on low incomes, saving individual borrowers an average of about £401 each year compared to the cost of borrowing from a range of other lenders (Personal Finance Research Centre 2010). This equates to a total saving of about £250 million over the period.

4.4 The principal gap in the market concerns lack of access to affordable credit, but credit unions are an important source of access to other financial products. If they can change by reducing their costs and developing the capability and capacity to provide a fuller range of financial products and services, they could be well placed to serve many more lower income consumers. The list of products and services required includes differentiated credit products, bank accounts, accounts featuring a ‘jam jar’ type budgeting and bill payments service, and cash savings deposit accounts.

4.5 The interest that credit unions may charge on loans is capped by legislation at 2% per month on the receding balance of the loan - the equivalent of 26.8% APR. They are the only institutions in the UK to which an interest rate cap applies and we recommend that you give further consideration to increasing this cap as part of a range of support measures.

5 Other Options

5.1 The banks and building societies have made progress in recent years in making basic bank accounts available, opening nearly 4 million since 2003. However, they remain wary about entering the lower end, small sum, high risk credit market and there is no evidence of an appetite to do so.

5.2 It is fairly clear from evidence gained during this study that up to 1.4 million people who do not currently own or operate a bank account would prefer to use a trusted local provider if that were possible.

5.3 We understand that Post Office Ltd may be looking at options for working with credit unions and for developing own brand banking products. They are enthusiastic about the prospect of working with credit unions but may have a different focus in terms of target customers for their own business.

5.4 Given the expense associated with delivering suitable products, Government should consider providing financial support to not-for-profit credit unions. Where they are providing a ‘service of general economic interest’ to meet a recognised gap in the market, this should not fall foul of EU state aid rules.

5.5 We commissioned Experian to assess the gap in the consumer market and the capacity of credit unions to deliver the services they require. The research demonstrates that by investing in credit unions we can create a more cost effective and accessible affordable credit service that will save a range of consumers money, and provide value for money for a Government investment. The value of such an investment would need to be tested and proven by a well managed project.

6 Feasibility Study Research

6.1 Experian was commissioned to look at the market for credit union services; they conducted interviews with 4,523 consumers, and stakeholder consultations with 92 credit unions to inform this study. These elements of research had at their core the wish to broaden financial inclusion by providing suitable financial services to a million more people.

6.2 Experian was also commissioned to look at the business models and financial accounts of a sample of credit unions thought to be potentially suitable to work with Government on a change programme in the future. Experian has developed financial models to indicate what the effects of the required cost reductions, expansion and automation may be on these credit unions over the next 10 years.

The Market for Credit unions

6.3 Experian advise that a potential consumer market of at least 7 million working age adults exists for the services credit unions could deliver:

- 1.4 million have no transactional bank account
- 1.3 million of the 1.4 million are likely to be DWP customers (UC data)
- 4 million incur regular bank charges
- 0.85 million incur financially crippling levels of bank charges because they need help to manage their money better

- more than 2 million use home credit each year, and up to 7 million on lower incomes use a matrix of home credit, mail order catalogues, store cards, and rent-to-buy from retailers

6.4 Credit unions are helping some of these people now but at high operating costs. A consumer survey commissioned by this study showed that, of 4,500 low income consumers contacted, more than 60% wanted the type of local, trusted service that credit unions provide. The challenge is, however, that only 13% are currently aware of the services credit unions provide.

6.5 In 2006 credit unions had 554,000 members. By February [updated] this year this had grown to 953,000 members, serving about 4% of the lower income population. Expanding to serve 2 million members requires them to serve no more than 8% of the same group.

6.6 Experian has separated the consumer market for credit unions into two categories used by them for research and modelling purposes:

- Tier II consumers - those with incomes in the 11% to 40% bracket, generally with household income below £30K, 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

6.7 Experian reports that credit unions offer the most competitive interest rates on personal loans of up to about £2,000 in the UK market. The position extends to loans up to £3,000 where credit unions can afford to reduce the interest rate charged to 1% per month on the receding balance.

Consumer Research

The challenge to credit union expansion is not one of demand:

6.8 Current met demand for those on the lowest incomes (Tier III) is significant at: total outstanding borrowing (excl. mortgages) of £7.3bn and total savings of £7.6bn.

6.9 For Tier II consumers the current met demand is even higher at £18bn and £23bn respectively

6.10 There is also a significant level of un-met demand, with a potential need for services that better cater for the needs of lower income groups, where around 50% of the target group have had difficulty keeping up with their bills and credit commitments.

6.11 There is evidence that people in both Tiers would be able and willing to save between £5 and £20 per week if they had access to a trusted local provider. The ability to deposit savings in cash would be helpful to some of this group.

The challenge to expansion is one of credit union awareness

6.12 Consumers told us in research what financial services they want and none of their requirements are beyond the capacity of credit unions working as described in this report:

6.12.1 Bank accounts that include:

- A bill payments service: e.g. direct debits and standing orders
- Access to a savings account, and
- Other facilities, such as “jam jar” accounts, provided they are priced at affordable levels

6.12.2 Savings facilities with:

- Interest or dividend payments on deposits, and
- Local accessibility of services, especially for lower tier consumers

6.12.3 Borrowing facilities to include:

- Competitive interest rates
- Access to affordable credit, especially for lower tier consumers, and
- Accessibility of a (relatively) local service

6.12.4 Accessibility and trustworthiness:

- Local access to services, including in cash for a minority, through a trusted provider, and
- On-line and mobile access (of target consumers 74% use online for other services and 16% already use mobile financial services)

6.13 The research shows that low interest rates on loans provided by local, trusted mutual service providers, rather than corporate plc’s, are what 60% of low income consumers say they are looking for, but at present only 13% have heard of credit unions and only 8% think they can help them, but on learning a little more about credit unions, up to 60% thought they may be able to help them.

6.14 This demonstrates how far from the mainstream financial services sector many credit unions are still considered to be by consumers. However, if this image and awareness gap can be addressed lower income consumers are likely to see credit unions as trusted providers, especially if they are able to offer the specific products and services required at an affordable price. Trust and local accessibility are likely to be enhanced if credit unions are able to work in collaboration with the Post Office in future.

6.15 To achieve this level of consumer recognition credit unions will need a more strongly recognised image (brand) and the ability to market the right products and services effectively. A key element of any expansion programme will, therefore, need to be publicising the services provided by credit unions to the targeted consumer market, to encourage them to join up.

Credit Union Research

Growth record and future appetite for change

6.16 Independent evaluation of the Growth Fund in 2010 demonstrated that, between 2006 and 2009, lenders had increased considerably in size, including in terms of their personal lending books.

6.17 Since 2006, these credit unions have increased their membership from an average of about 3,000 to 7,000. They have also increased the number of loans they make each year to low income consumers (from 50,000 in 2006/07 to 150,000 - worth £70 million - in 2010/11), with a forecast of 190,000 loans this year (worth about £90 million). In addition, these credit unions also make about 150,000 loans each year to consumers on slightly higher incomes.

6.18 Growth Fund evaluation also reported that 80% said their organisation had improved its working practices as a result of the Growth Fund and now operated in a more business-like way. And this was supported by Experian research which demonstrated that the credit unions consulted are keen to grow but have been cautious about losing their local identity; with more than 50% of those consulted saying they felt the image of the movement as a ‘poor man’s bank’ was holding them back.

6.19 Diminishing funding, particularly from DWP, was also a concern for over 40% and lack of other resources was a concern for over 20%.

6.20 More than 20%, when initially consulted, felt that processes were too slow and ineffective, and that they lacked appropriate technical solutions. However, the proportion that now recognise these as real challenges they want to address has grown to more than 80%; this has been as a result of post consultation workshops, where they had a better opportunity to understand the solutions available, and became more confident about how they can change their businesses and embrace technological change.

6.21 Only one of the 92 organisations consulted was totally set against change and technological development.

6.22 The credit unions initial resistance to change was for concepts new to the movement. For example, some credit unions are deposit rich whilst others have insufficient capital to lend. There is clear scope for the movement to develop a wholesale finance operation to manage commercial borrowing between organisations and negotiate with the Big Society Bank. However, many consulted had fears that such a development was beyond their reach and could impact on their traditional ethos of independence. During the feasibility study those fears have been addressed and the movement has begun to grasp the opportunity to lead on developing its own financial wholesaler, thus taking quite a significant step forward.

6.23 Nearly 75% felt that the Legislative Reform Order that is to be brought into force from January 2012 will support expansion and help with sustainability, enabling them to take on corporate members, begin to introduce interest payments on deposits and grow through mergers and partnerships.

6.24 Many also felt that Government could assist in a number of ways other than funding, the most popular being to help raise awareness (60%) and to facilitate links to other partners such as the Post Office (40%).

Financial sustainability

6.25 Evaluation of the Growth Fund and Experian research both demonstrate that the current credit union model is not financially sustainable. Both identified that cost structures are high, that interest on loans is significantly lower than charged by other sub prime lenders, and that the gap between cost and income needs to be bridged.

6.26 The credit unions examined as part of this feasibility study have grown considerably through Government subsidy and they have generally managed repayment delinquency well, but the current model remains sub-optimal and significant change to business models, customer profiles, and infrastructure support are required if they are to become more financially sustainable.

6.27 During consultation 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 on loans.

7 Financial Modelling and Sensitivity Analysis

7.1 Financial models were constructed to test the effects of modernisation and expansion on a sample group of credit unions selected. The models were populated with business and financial data from the accounts of those credit unions, and this was supplemented with detailed process and transaction costs acquired during field work. The models were subjected to some sensitivity testing.

7.2 Three scenarios were examined in detail. The first looked at the effects of ‘doing nothing’. The second looked at what impact the proposed modernisation and expansion program might have on the selected core of relatively ambitious credit unions. The third looked at what impact an increase to interest rates on loans might have in addition to the proposed modernisation and expansion programme.

The ‘do nothing’ scenario

7.3 In recent years DWP has ceased to fund 55 credit unions for poor performance, of these 25 have closed or been forced to merge to avoid closure.

7.4 This scenario assumes that credit unions would entrench and recast their business to absorb the impact of an increasing funding gap. An increase in loan interest rate alone to 3% from April 2013 does not generate sufficient additional income to balance the books, in fact the trading losses continue to increase year on year from £11.1 million to £18.9 million in March 2021. Membership could reduce by 40%, loans to poorer Tier lll customers would fall by about £14 million each year, and a proportion of credit unions would be likely to close - leaving large areas of the country with no coverage.

The ‘modernisation and expansion’ scenario

7.5 The Growth Fund has demonstrated there is a group of credit unions that are ambitious to grow. This scenario is based on delivering a project with a sizeable group that can demonstrate they are ready and able to change.

7.6 To modernise and expand credit unions will need to:

- Start taking immediate steps towards sustainability by working towards achieving cost reductions of approx 40% - the study shows this level to be possible
- Automate loan decision-making to improve speed of decisions, further reduce operating costs, and reduce the cost 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 building campaign to maximise customer awareness of the services that credit unions offer
- Work with landlords and other community businesses to increase membership and generate additional income
- Work with the Post Office to increase accessibility and membership.

7.7 The model shows that if selected credit unions achieve the levels of performance and cost reductions that we believe possible they could:

- Increase membership from 354,600 now to 1,720,700 by 2021
- Increase loan numbers from 138,500 now to 650,300 by 2021
- Increase loan value from £89,900,00 now to £443,600,000 by 2021
- Increase deposits from £113,900,000 now to £453,100,000 by 2021
- Increase trading deficit of -£11,500,000 to £6,300,000 by 200/21

7.8 To achieve these results they would need to:

- Reduce unit process costs by 40% by 2014/15
- Increase Tier ll members, loan values and savings by up to 20% pa
- Increase Tier lll member loans and savings by up to 15% pa
- Increase total membership by 1 million within 7 years

Estimated project costs from financial modelling

7.9 The financial models in the report are based on real credit unions, and forecast expansion data. The costs to achieve the objectives using this model are estimated at £51 million over the SR10 period, including a contribution from credit unions as shown below. Other models would be likely to result in different costs and you would wish to consider different models in proposals on their merits. It is possible that delays could cause the project to run into SR14, but we do not anticipate any major additional costs for DWP or credit unions if that were to happen.

7.10 Estimated costs in the table below from April 2015 - March 2021 for ongoing lease, maintenance and further modernisation would be born by the credit unions as part of their ongoing business. DWP funding would cease in 2014/15, unless there were delays and funding within the £51 million estimate ran on beyond SR10 and there was scope after that period to continue funding the project.

Project cost (£ millions)

	SR10		**2015 - 2021**	
	DWP	C U Sector	DWP	C U Sector
IT support implementation	9.0	3.0	0.0	1.0
IT support maintenance	0.0	1.0	0.0	6.0
National Image & Marketing	3.0	0.0	0.0	3.0
Change in Credit Unions	23.6	0.0	0.0	0.0
Project Costs	2.4	0.0	0.0	0.0
2011/12 costs	13.0	0.0	0.0	0.0
Total	51.0	4.0	0.0	10.0

The impact of other factors on the credit union sector

7.11 Assuming that the sector can make the necessary changes to modernise and expand their business, they will need to compete in the market place for deposits and investment. This will mean that they need to declare interest or dividend rates for savings. If a rate of 1.5% is paid on savings the movement becomes more or less sustainable by 2020/21.

7.12 We recognise that as we have only modelled loan income within the model, it is possible there will be other services that credit unions offer that could make surplus/losses and this will impact on the overall figure: for e.g. RSLs subsidising jam jar accounts for their tenants to ensure payment of rent when welfare reforms are introduced could create a net surplus for credit unions.

Credit Union interest rates

7.13 Credit unions are currently limited to a 2% per month interest rate cap (26.8% APR). They are serving some of the hardest and most expensive to serve people and struggle to be sustainable. Maintaining this interest rate means that even after process improvements and infrastructure change credit unions will not be able to generate sufficient income to cover the cost of making small sum, low income loans.

7.14 We have recommended that you consider increasing the interest rate cap for credit unions. For business modelling purposes we have assumed that an interest rate change can be achieved by April 2014 and that increased charges would only be applied to lower value loans i.e. < £1,000. The table below demonstrates how an increase in loan interest rates has an immediate impact with the sector beginning to operate from a surplus position after 2015/16.

Impact of increasing interest rates on loans from 15/16

Income & Expenditure	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Interest on low value loans (%)	2	2	2	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Surplus/Loss on trading activity	**-11.5**	**-9.3**	**-10.2**	**-6**	**-3.5**	**-0.2**	**1.1**	**2.9**	**4.8**	**6.3**
Interest on low value loans (%)	2	2	2	3	3	3	3	3	3	3
Surplus/Loss on trading activity	**-11.5**	**-9.3**	**-6.2**	**-3.3**	**0.2**	**4.3**	**6.4**	**8.9**	**11.5**	**13.8**

7.15 Interest/dividend rates on savings are in the model at 1.5%, but the majority of credit unions currently pay nothing. If it were necessary to increase this to 2.5% to remain competitive and attract capital then there would be a commensurate increase in losses.

7.16 Any increase to the loan interest charged affects the customer. The table below demonstrates the additional charges a customer would pay for a low value loan if it was decided that increasing the rate were appropriate.

Total interest charged on low value loan

Loan repaid over 12 months	**Interest rate charged pcm**		
	2%	2.5%	3%
£400	54.01	67.94	82.19
£600	81.01	101.91	123.29

7.17 The table at paragraph 7.16 shows interest charged on a £400 loan to be £82.19 using a rate of 3% pcm over 52 weeks, which would still compare very favourably to the interest charge of over £300 on a similar loan from a leading home credit lender.

7.18 In 2014/15 the financial model demonstrates that the total cost of loan processing and credit control is £11.9 million. Charging 2.5% or 3% pcm would generate £13.2 million or £16 million, respectively, in interest repayments over the same period.

7.19 To achieve a better balance between sector sustainability and additional costs for low income people we are recommending that you consider whether credit unions could be allowed to charge a maximum interest rate of up to 3% pcm. The change to legislation could be permissive so that individual credit unions could decide what rate it would be appropriate to charge in the circumstances that prevailed, and it would enable the sector to achieve financial stability and end its dependence upon grant funding.

Sensitivity testing of the model

7.20 All models are based on a series of assumptions. It is important to understand the impact of under achievement against these assumptions.

7.21 Testing the model by flexing the expected change downwards in key variables by 10% shows where the key strains are likely to be – and thus the most important areas to set Key Performance Indicators to manage outcomes. These tests were applied to models based on the current 2% pcm interest rate, not the potential 3% rate.

7.22 Missing cost reduction targets by 10% sees the trading loss of £1.2m in 2020/21 increase to £6.3m, making it very difficult for credit unions to become sustainable in the long term. This is a particular issue in the latter years when the number of members and loans are significantly higher than the current rate.

7.23 Missing customer growth targets by 10% will mean that there would be around 100,000 less members by 2020/21. If the reduction in growth were split evenly between Tier II and III customers this could have the effect of turning the small forecast trading deficit in 2020/21 into a small surplus, because the number of loss making Tier III loans would be reduced.

7.24 The full detail of the financial models is presented at **Annex A**.

8 The Case for investment

8.1 Whilst we advise that it will be difficult to achieve the objectives you wish to the timescale in the ToR, we think that without increasing the interest rate cap it could be possible for up to 60 selected credit unions to provide the services you wish to a million more low income consumers and for them to at least come close to balancing income and expenditure within 7 to 10 years.

8.2 We also advise that there is an opportunity for these credit unions to develop additional income streams which could, potentially, enable them to further bridge the gap between income and expenditure within 7 to 10 years, but again we stress that can be no guarantee that they will achieve long term sustainability with this model.

8.3 In return for the investment modelled it could be possible to achieve the following results over the full ten year period of the financial model:

8.3.1 There could be potential interest repayment savings of £0.9 billion compared to high interest payments for low income consumers

8.3.2 There could be a full range of suitable financial services available to a million more people on low incomes from providers that research indicates they would be willing to sign up with

8.3.3 These financial services could be available to benefit claimants and although the number of Universal Credit claimants who may use the services may not be great, those who do will be amongst those with the greatest need

8.3.4 You will have provided the selected, potential maximum of 60 credit unions with the opportunity to get close to financial sustainability

8.3.5 You will have provided the opportunity for other, less well developed credit unions to move to the financial systems and infrastructure they will need to move to at some point in the future if they are to grow. It will not be possible to insist that credit unions outside the project change as you wish but you could have left a valuable legacy that enables others to move forward when they are ready to do so.

8.4 At this stage it could be possible to complete the project by the end of SR10 and leave the credit unions to carry on expanding their business and bridging the, by then, much reduced revenue gap by providing additional services to landlords, etc, to increase their income. However, if there were delays to the project we think that some of the work of the project could spill over into SR14. In this case we think the most likely breakdown of costs would be to spend about 80% of the cost in SR10 and the balance of 20% in the first two years of SR14.

8.5 The model does not anticipate that government will fully subsidise the gap between income and expenditure for the credit unions in the financial model. This is, in part, because we think they should be asked to find ways of bridging some of the gap themselves, which could be by working to increase earned income from business partners, increasing their productivity and issuing more loans than forecast, or if necessary using small sums from their reserves rather than continue to rely on grant funding.

8.6 Our assumption is that, without an increase to the interest rate, by 2020/21 they should be able to increase income to the point where they can get close to bridging the gap, and we think it important they be set this challenge irrespective of a decision on interest rates.

8.7 There is significant risk in this approach. Market conditions are volatile and difficult to predict; the financial model is only a model, and the real appetite of credit unions is still to be proven. If the project were to go well these results would be possible, but if there were delay or under achievement it may not be possible to achieve financial sustainability. To mitigate these risks we would suggest that government manages the project on a staged basis, with next step investments only following prior success and achievement.

8.8 The proposition could also be de-risked by considering removing the current constraints on income earning capacity: i.e. allowing a small increase in the rate of interest that credit unions may charge.

8.9 If the proposed approach of supporting significant change and expansion were considered too high risk, it is nonetheless likely that government will need to provide some continued support for credit unions for a period of time, because after six years of substantial government funding they have come to rely on this support.

8.10 A complete withdrawal of government subsidy is likely to stifle capacity in this market.

8.11 This judgement is supported by the evidence from the 55 credit unions from which government support has been withdrawn. Of theses 25 have either closed their doors, or been forced to merge to avoid closure.

9 The way forward

9.1 If it is agreed that a project to continue the development and expansion of the services and financial sustainability of a selected group of credit unions could be a worthwhile investment, we would now like to advise on how a project should be taken forward.

Selecting credit unions that will perform and provide value for money

9.2 There are currently 80 Credit Unions and 10 Community Development Financial Institutions (CDFIs) contracted to deliver financial services. We think this is too many and unlikely to provide value for money in the future.

9.3 You should consider only supporting those credit unions and CDFIs that are 100% signed up to, and ready to make the changes we discuss in this report. To achieve this you will want to select the credit unions you work with in future very carefully. We have considered what a selection process might look like and include the following for illustrative purposes, rather than to specify what credit unions may do: i.e. to join a project credit unions should be able to prove they:

9.3.1 have re-engineered their business operating models and reduced their costs to acceptable levels as a result

9.3.2 have re-organised their business to make better use of resource saved through re-engineering: for example by moving resource to provide income earning services to RSLs on a fee charging basis or to making more loans

9.3.3 have plans to move to automated loan decision making systems to reduce their operating costs and to reduce loan delinquency

9.3.4 have appointed a professional, qualified director to their board to ensure board members understand the financial position of their organisation, and make decisions that will reduce expenditure and increase income from lending to improve financial stability

9.3.5 have plans to expand to serve a larger and more diverse geographical community (including tenants of RSLs that may have become corporate members of credit unions) with a wider range of products and services; this should include working with advisers in Jobcentre Plus offices and with DWP Work Programme providers

9.3.6 are ready and signed up to moving to the type of automated IT platforms required to deliver the fully featured accounts with web and digital access, ‘jam jar’ and automated lines-of-credit services required

9.3.7 are ready and signed up to pay fees to POL for service delivery across POL counters: growth forecasts in the business model from 2014/15 are partly dependent on new members being attracted to credit unions as a result of links with POL

9.3.8 are ready and signed up to promote a new professional image and to market their services to the mid income level consumers required to capitalise the forecast increase in lending that is required to work towards financial sustainability. It is the higher income from lending to a wider group of customers that will enable credit unions to improve their profit and loss and achieve sustainability.

9.4 Using these criteria we identified a sample of credit unions and conducted business modelling that informed the figures in this report. This sampling was conducted for illustrative purposes only, a full and final selection will be required to be held in accordance with UK Government procurement rules and EU State Aid rules.

9.5 Feasibility study research identified that many credit union sector processes were inefficient, often but not entirely due to systems limitations. To begin to address this, the project team implemented a programme of change and process improvement that will benefit the sector irrespective of the outcome of the feasibility study.

10 Managing highly focussed change and expansion

10.1 We advise that, in general, project resource should be committed on the evidence of agreed results rather than by paying for services in advance. Money should not be committed to new stages until there is clear evidence that each preceding stage has been fully and successfully completed.

10.2 By adopting and maintaining such a robust project discipline it should be possible to manage the risks associated with credit unions not delivering, to have early warning of any issues, and to restrict any financial loss to a minimum.

11 Recommendations

Having weighed up all of the factors and balances in the report we make the following recommendations:

11.1 The indicative model we have built could proceed with some chances of success for a total cost estimate of £51 million, of which £13 million is actually being spent in the current financial year and £38 million would be required for 2012 to 2015. There is some risk that delays could cause the project to run into 2015/16 but we do not think this need have major implications for the total estimate if the project is managed as we suggest.

11.2 The project should only proceed of the basis of the tight project management discipline we have outlined to maximise the chance of success and to minimise the risk of financial failure

11.3 Money should not be invested in expensive systems procurement until there is evidence of necessary change and commitment from the credit unions

11.4 Credit unions should be required to make a financial contribution to the actual cost of systems infrastructure change to demonstrate their commitment.

11.5 Relevant Government departments work together, and with the credit union sector to consider increasing the maximum rate of interest charged on loans to 3% pcm on the receding balance, whilst insisting that credit unions simultaneously demonstrate they have changed and reduced their operating costs to avoid placing an increased burden on low income consumers rather than taking responsibility for change themselves.

11.6 The credit union sector should press ahead with plans to develop its own financial wholesale operation so that it can speak to Big Society Capital and other funding organisations as one ‘organisation’ large enough for investors to be interested in. This will be an area for further discussion with the sector but is beyond the scope of this report.

Annex A - Financial Modelling and Sensitivity Analysis

1. Three principal scenarios for moving forward were examined in some detail. The first looked at the effects of doing nothing. The second looked at what impact a modernisation and expansion program might have on a suitable core group of relatively ambitious credit unions. The third looked at the potential for raising the cap on interest rates in conjunction with the modernisation and expansion program.

The Financial Model

2. The credit union movement is made up of over 400 organisations of various sizes and ambitions. It is therefore impractical to consider that any change programme could be implemented across all of them.

3. The Growth Fund has demonstrated there is a group of credit unions that are ambitious to grow. Therefore financial modelling is based on delivering a project with a sizeable group that can demonstrate they are ready and able to change.

4. Given the current diversity of credit unions, it was considered necessary to look at conducting the project in 2 stages:

- Stage 1, consisting of a select group of pathfinder credit unions: those most ready to adopt wholesale expansion and modernisation plans,
- Stage 2, consisting of a further select group of those who need to undertake some basic changes prior to becoming accepted on the scheme.

5. Stage 1 credit unions are likely to be ready to enter a full change programme from 2012, with Stage 2 following on up to a year behind. We have used this as the baseline for modelling the results for both scenarios.

6. In general, Stage 1 credit unions are larger, with a mixed client base, giving them a good business foundation to build upon. They tend to operate more commercial decision making processes than Stage 2, but their costs and delinquency are higher because their IT systems are not interactive and cannot ‘talk’ directly to the banks with whom many of their members currently transact their current account business.

7. Stage 2 credit unions are younger. They are typically able to operate good and cost effective processes and maintain a lower rate of delinquency because their members transact directly with the credit union, which is able to recover loan repayments at source. The main sustainability issues for Stage 2 are that they currently service too high a proportion of Tier III customers, and consequently have lower average loan sizes and incomes, and lower savings levels.

8. For Stage 1 and 2 we have assumed a starting point of £428 for a Tier III loan, the Growth Fund average, and £1000 for a Tier II loan.

Figure 1: Starting point for Stage 1 and 2 credit unions in the project

Starting point (model starts FY10/11)	Stage 1	Stage 2
Members		
Tier 3	87,791	124,836
Tier 2	65,094	45,720
Total	152,885	170,556
Loans numbers		
Tier 3	23,938	51,808
Tier 2	34,298	15,850
Total	58,236	67,658
Loan Values (£)		
Tier 3	10,245,513	22,173,837
Tier 2	34,297,676	15,850,454
Total	**44,543,189**	**38,024,291**
Savings value (£)		
Tier 3	6,584,303	9,362,681
Tier 2	52,856,405	37,124,846
Total	**59,440,708**	**46,487,527**
Other Assets (£)	6,224,856	5,017,637
Loans/Asset Ratio	0.68	0.74
Cost of Loan per loan (£)	106	102
Cost of Credit control per loan (£)	60	25

The 'do nothing' scenario

1. National credit union membership has grown at a rate of just under 10% a year between 2006 and 2010, excluding the effects of the Growth Fund. In the absence of any further outside intervention it is likely that the rate of growth could stabilise at around this rate and the underlying growth rates for savings and loans on this basis would be below membership growth rate, at about 7%.

2. Figure 2 illustrates the levels of reliance on increasingly hard to find grant income to balance its books to finance the level of underlying growth we expect to exist. Purely on the loan and membership activities we are looking at in the expansion plan, we might expect to see a funding need of nearly £182m by 20/21.

3. This reflects a much slower growth pattern of an average of 50,000 members or less each year, and would quite possibly mean that the imbalance between Tier II and Tier III customers would not be addressed for the newer Stage 2 credit unions.

Figure 2: Projected losses in 'Do Nothing' continued grant funding

	Mar11	Mar12	Mar13	Mar14	Mar15	Mar16	Mar17	Mar18	Mar19	Mar20
Surplus/Loss all activity (£ms)	-11.5	-13.9	-14.6	-15.5	-16.9	-18.4	-20.1	-21.9	-23.9	-26.0
Customers (000's)	354.6	388.7	426.2	467.2	512.2	561.5	615.6	674.9	739.9	811.1
Loan Values (£ms's)	89.9	99.7	110.5	122.4	134.0	145.0	157.0	169.9	183.9	199.1

4. In reality, given the current funding landscape, it is likely that many individual credit unions will face severe financial difficulty, and pressure from the Financial Services Authority to reduce their loss making business or close.

5. Figure 3 illustrates a scenario where membership and loans are forced to drop to a level that halves the funding gap in the next few years. The relationship between Tier lll and Tier ll customers has been maintained, though it is recognised that many credit unions may try to hold Tier ll members whilst losing Tier lll members.

6. In this scenario membership drops by 40 per cent, Tier lll loans values fall by £14m and if this reduction translated into a commensurate reduction in credit unions about 40% of the credit unions identified as participants of the project may close leaving large areas of the country with little or no coverage.

Figure 3: Projected losses in 'Do Nothing' reducing grant funding

	Mar11	Mar12	Mar13	Mar14	Mar15	Mar16	Mar17	Mar18	Mar19	Mar20
Surplus/Loss all activity (£ms)	-10.7	-9.0	-8.6	-6.6	-7.5	-6.0	-5.8	-5.7	-5.3	-5.2
Customer total (000's)	339.0	339.0	322.7	260.5	248.0	236.1	224.7	213.9	203.6	193.8
Loan Value total (£ms's)	86.6	87.1	84.0	70.9	68.1	65.4	62.8	60.3	57.9	55.6

Highly focussed change, modernisation and expansion model

7. The Growth Fund has demonstrated that there is a tranche of credit unions that are ambitious to grow and the model for this option is based on taking forward a change program with Stage 1 and Stage 2 credit unions.

8. This model demonstrates the effects of operational cost reductions, centralised loan decision making, organisational change, customer expansion, the

introduction of automated systems and improved financial products, working with the Post Office, and improving the image of credit unions.

Improved and common processes will provide immediate steps towards sustainability

9. It is apparent that there is room for significant improvement in the processes many credit unions use for on-boarding, handing out loans and credit control/bad debts, especially in Stage 1. This is recognised by credit unions.

10. Improved processes are most likely to be achieved through a programme of sharing best practice and mentoring through the change. This part of the project could be implemented immediately and should have an impact on member credit unions within months of implementation. It should be a requirement of joining the expansion and modernisation project that costs for on-boarding, loans and credit control fall to, and remain within certain key parameters. It is expected that there would be an immediate and sustained fall in process costs as a result. In the medium term we expect this measure alone to reduce process costs by around 40 per cent.

Economic conditions may hamper attempts to lower delinquency

11. Following the approach of most financial institutions, forecasts in the model for delinquency rates on unsecured personal lending have been increased for the next few years before dropping back to normal levels. This is mainly due to the impact of the protracted slowdown of the economy.

12. To a certain extent some credit union customers may be shielded from a number of these impacts, especially those already on benefits. However, this model is not just about lending to people on benefits and planned changes to ESA and the move to Universal Credit may have an impact.

Automated decisioning will improve speed and reduce bad debt

13. Many loan decisions that are currently made by credit unions could be automated. This will have an impact on the throughput they can handle, the speed of handling and a lowering of bad debt risk.

14. Systems can be calibrated to the risk that individual credit unions are willing to take, though to maximise benefits it is felt that being part of the project will require a minimum level of usage (starting at say 30 per cent of decisions and rising to 50 per cent during the course of the project).

15. It is likely that this strand of the project will have two impacts. Firstly it will reduce the operational costs of making loans and bad debt costs. Secondly, it will cause a small, but significant, rise in average loan size, as some of the smallest and most risky loans are refused.

Centralised systems and processing will offer customers what they are demanding – online banking, faster decision times

16. If credit unions are to offer products that meet the needs of customers and that compete in the market, there needs to be investment in systems that are capable of delivering them. On their own it is unlikely that a credit union could afford to invest in such a system, however, as a collective it potentially becomes a practical proposition.

17. There are many systems in the market and a full specification and tender process will need to be drawn up. However, we believe that a leased 'cloud' based system which can be built up in modules would be the most cost effective. The system itself is a major enabler, allowing new products and services to be rolled out to meet consumer demand and is a necessary requirement to fully achieving other objectives of the proposed project, such as facilitating a national marketing campaign and working with the Post Office. It is also a pre-requisite for offering jam-jar accounts.

18. The cost of such a system, or systems, will depend on the exact specification, with the phasing of the cost being subject to negotiation with the successful supplier. We have allowed a figure of £12m for the first 3 years of the system to be met by the project, followed by £3.3m in each subsequent year to be met by the credit union movement. These estimates are considered to contain a measure of contingency and it would be important to evaluate costs proposed by bidding organisations.

19. Funding support should only be made available for centralised systems and infrastructure support in conjunction with funding for credit unions, not ahead of funding for credit unions or on its own: for example organisations bidding to provide systems and infrastructure support could be required to provide evidence of the credit unions that have signed up to join their project and use their systems once implemented.

A national marketing campaign will maximise the benefits of new capabilities

20. One of the largest concerns for credit unions was their visibility in the market place and this was evidenced in the results of the survey. They felt that a new image and brand would be required if they are to attract the Tier II consumers needed to balance their deposit and loans portfolios. And they noted correctly that their competitors are prodigious marketers.

21. However, any national marketing strategy will need to wait until there is a coherent group of credit unions who offer similar services so that this set of standards can be effectively marketed. A significant campaign is capable of offering a large-scale uplift in membership, and it will be essential to ensure that there is sufficient capacity to deal with this. There will be only one chance to gain new members at scale; if people have a poor experience through lack of capacity they are likely to be lost for good. A scaleable back office infrastructure will, therefore, need to be in place prior to any such campaign.

22. It is envisaged that the campaign would be multi-channel, with an on-line option allowing direct sign up through the new back office system.

23. The costs of a large scale-marketing campaign of this nature would vary dependent on what media are used and the audience targeted. The business model has assumed an initial cost of £2m per annum after system implementation, falling to £0.5m over ten years, which is sufficient for a substantial ongoing campaign of this type and potentially affordable by the credit union movement.

Working with RSLs will boost financially excluded membership and income for credit unions

24. RSLs in many areas of the country work very closely with credit unions, with a number sitting on their boards. There is a natural affinity for the two organisations who serve a similar client base. With the upcoming changes to the way benefits will be paid many organisations are looking for methods that ensure they are paid by clients who are now receiving benefits directly and credit unions offer a route to do this. In particular, this is the case if they can create a common jam jar account. The RSLs will be able to drive significant rises in membership.

25. The cost of administering jam jar accounts is fairly high and almost certainly above a level which it is appropriate for someone on benefits to pay. It is proposed that RSLs would pay these costs as a quid pro quo for guaranteed rent. Early indications are that RSLs would be willing to pay an average of £5 for each monthly payment processed.

26. At this point we have been unable to model the positive financial effect of this potential new income stream in the financial model, but we note that if credit unions can play this market successfully the surplus from the income available to them could be sufficient to address the small ongoing annual financial deficit from 2016/17.

Other options can offer further improvements

27. The modernisation of credit unions also offers further opportunities for improvement.

- The Post Office offers an additional channel to market and access to different customers
- Encouraging payroll deduction through major employers will boost middle tier membership balancing loan sizes and boosting capital
- Centralising debt collection will gain economies of scale

28. Ultimately this should deliver an expanded and modernised credit union sector which could become sustainable by 2021

29. By combining the impacts of all of the strands of the project the overall impact for project member credit unions would be:

- Over 50 per cent reduction in process costs/process time
- Significant increases in Tier II members, loan values and savings
- Up to 50% per annum increases in Tier III member loans and savings

30. Applying these rates to the two Stages of credit unions would lead to an estimated start point for project member credit unions that would lead to an increase of 1 million members within 7 years.

31. Market penetration for the provision of loans will also significantly increase. Bottom tier loan values would see an increase of over 4 times in the same period

and over 6 times in the period of the model. This would give a large saving on interest charges to the financially excluded as they move away from high cost credit and the poverty premium.

Figure 4a: Combined impact on balance sheet variables (loans at 2% PCM)

Balance Sheet	Mar11	Mar12	Mar13	Mar14	Mar15	Mar16	Mar17	Mar18	Mar19	Mar20
Customers (000's)										
Tier 2	121.5	133.2	156.8	206.3	275.4	338.7	416.7	498.8	597.2	675.7
Tier 3	233.1	257.8	311.9	408.4	535.8	657.2	785.1	899.4	1004.2	1121.2
Total	**354.6**	**391.0**	**468.7**	**614.6**	**811.2**	**996.0**	**1201.7**	**1398.2**	**1601.4**	**1796.9**
Loan Numbers (000's)										
Tier 2	53.6	56.2	55.5	65.6	80.6	99.8	119.7	143.6	164.8	185.2
Tier 3	84.9	99.9	128.1	177.1	238.4	292.5	349.4	400.3	447.0	499.1
Total	**138.5**	**156.1**	**183.6**	**242.7**	**319.0**	**392.2**	**469.1**	**543.9**	**611.8**	**684.3**
Loan Values (£m's)										
Tier 2	53.6	57.3	63.5	79.3	101.8	126.0	151.1	181.3	208.1	233.8
Tier 3	36.3	43.6	57.0	80.3	108.1	132.7	158.5	181.6	202.8	226.4
Total	**89.9**	**100.9**	**120.5**	**159.6**	**209.9**	**258.7**	**309.6**	**362.9**	**410.9**	**460.2**
Savings Values (£m's)										
Tier 2	96.4	103.3	115.8	144.3	178.4	213.2	250.8	291.2	330.3	374.7
Tier 3	17.5	19.3	23.4	30.6	40.2	49.3	58.9	67.5	75.3	84.1
Total	**113.9**	**122.7**	**139.2**	**174.9**	**218.6**	**262.5**	**309.6**	**358.7**	**405.7**	**458.8**

Figure 4b: Combined impact on balance sheet variables (increased APR)

Balance Sheet	Mar11	Mar12	Mar13	Mar14	Mar15	Mar16	Mar17	Mar18	Mar19	Mar20
Customers (000's)										
Tier 2	121.5	133.2	156.8	206.3	275.4	338.7	416.7	498.8	597.2	675.7
Tier 3	233.1	257.6	308.7	397.6	513.1	622.6	737.6	841.3	937.7	1045.0
Total	**354.6**	**390.8**	**465.5**	**603.9**	**788.5**	**961.4**	**1154.2**	**1340.2**	**1534.9**	**1720.7**
Loan Numbers (000's)										
Tier 2	53.6	56.2	55.5	65.6	80.6	99.8	119.7	143.6	164.8	185.2
Tier 3	84.9	99.8	126.8	172.4	228.2	277.0	328.3	374.4	417.3	465.1
Total	**138.5**	**156.0**	**182.3**	**238.0**	**308.9**	**376.8**	**447.9**	**518.0**	**582.2**	**650.3**
Loan Values (£m's)										
Tier 2	53.6	57.3	63.5	79.3	101.8	126.0	151.1	181.3	208.1	233.8
Tier 3	36.3	43.5	56.2	77.8	103.0	125.0	148.1	168.9	188.3	209.8
Total	**89.9**	**100.8**	**119.7**	**157.0**	**204.8**	**250.9**	**299.2**	**350.2**	**396.4**	**443.6**
Savings Values (£m's)										
Tier 2	96.4	103.3	115.8	144.3	178.4	213.2	250.8	291.2	330.3	374.7
Tier 3	17.5	19.3	23.2	29.8	38.5	46.7	55.3	63.1	70.3	78.4
Total	**113.9**	**122.6**	**139.0**	**174.1**	**216.9**	**259.9**	**306.1**	**354.3**	**400.7**	**453.1**

32. Figure 4a shows the forecast combined effect of the above factors on the business variables that drive the financial model. From the figure it is clear that 1 million more people will not be served by 2015/16 as in the ToR, but that this number can be achieved during 2017/18, and exceeded over time.

33. Our third approach of increasing the loan interest rate cap may have a negative effect on the number of Tier lll loan applications. Figure 4b demonstrates that even with a 10% reduction in Tier lll members and loan volumes, one million more people could be served by March 2018.

Figure 5a: Combined impact on income and expenditure variables (2% PCM)

Income & Expenditure		11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Income	Interest										
Loan Income (£M)											
	Tier 2 Interest	6.2	6.7	7.4	9.2	11.9	14.7	17.6	21.1	24.2	27.2
	Tier 3 Interest	4.9	5.9	7.7	10.8	14.6	17.9	21.3	24.4	27.3	30.5
	Total Interest	11.1	12.5	15.1	20.0	26.4	32.5	38.9	45.6	51.5	57.7
Total Income		**11.1**	**12.5**	**15.1**	**20.0**	**26.4**	**32.5**	**38.9**	**45.6**	**51.5**	**57.7**
Expenditure (£M)											
	New members	0.8	0.7	1.2	2.0	2.4	2.3	2.5	2.4	2.5	2.4
Loan Expenditure											
	Tier 2: Cost of processing	5.6	4.4	3.6	3.5	3.9	4.8	5.7	6.9	7.9	8.9
	Tier 2: Cost of CC in write off	2.6	2.1	1.5	1.4	1.5	1.8	2.2	2.6	3.0	3.4
	Total Tier 2	8.2	6.5	5.1	4.9	5.3	6.6	7.9	9.5	10.9	12.2
	Tier 3: Cost of processing	8.8	7.8	7.7	8.9	11.7	14.4	17.2	19.7	22.0	24.5
	Tier 3: Cost of CC inc write off	3.1	3.0	3.0	3.3	3.8	4.7	5.6	6.4	7.2	8.0
	Total Tier 3	11.9	10.8	10.8	12.2	15.5	19.1	22.8	26.1	29.1	32.5
Other Expenditure		0.0	2.1	6.1	7.1	7.1	5.4	5.4	5.4	4.9	4.9
Total Expenditure		**20.9**	**20.0**	**23.2**	**26.3**	**30.3**	**33.3**	**38.6**	**43.4**	**47.4**	**52.0**
Interest (@1.5%)		1.7	1.8	2.1	2.6	3.3	3.9	4.6	5.4	6.1	6.9
Surplus/ Loss on trading activity	All activity	**-11.5**	**-9.3**	**-10.2**	**-8.9**	**-7.2**	**-4.7**	**-4.3**	**-3.2**	**-1.9**	**-1.2**
	Tier 2 loan only	-2.0	0.2	2.3	4.3	6.5	8.1	9.7	11.6	13.4	15.0
	Tier 3 loan only	-7.0	-4.9	-3.1	-1.4	-1.0	-1.2	-1.4	-1.7	-1.8	-2.1
	Loans only	-9.0	-4.8	-0.8	2.9	5.5	6.9	8.3	10.0	11.5	12.9

Figure 5b: Combined impact on income and expenditure variables (2.5% PCM)

Income & Expenditure		11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Income	Interest										
Loan Income (£M)											
	Tier 2 Interest	6.2	6.7	7.4	9.2	11.9	14.7	17.6	21.1	24.2	27.2
	Tier 3 Interest	4.9	5.9	7.6	13.2	17.5	21.2	25.1	28.7	31.9	35.6
	Total Interest	11.1	12.5	15.0	22.4	29.3	35.9	42.7	49.8	56.2	62.8
Total Income		**11.1**	**12.5**	**15.0**	**22.4**	**29.3**	**35.9**	**42.7**	**49.8**	**56.2**	**62.8**
Expenditure (£M)											
	New members	0.8	0.7	1.2	1.9	2.3	2.1	2.4	2.3	2.4	2.3
Loan Expenditure											
	Tier 2: Cost of processing	5.6	4.4	3.6	3.5	3.9	4.8	5.7	6.9	7.9	8.9
	Tier 2: Cost of CC in write off	2.6	2.1	1.5	1.4	1.5	1.8	2.2	2.6	3.0	3.4
	Total Tier 2	8.2	6.5	5.1	4.9	5.3	6.6	7.9	9.5	10.9	12.2
	Tier 3: Cost of processing	8.8	7.8	7.7	8.7	11.2	13.6	16.1	18.4	20.5	22.9
	Tier 3: Cost of CC inc write off	3.1	3.0	3.0	3.2	3.6	4.4	5.3	6.0	6.7	7.5
	Total Tier 3	11.9	10.8	10.6	11.9	14.9	18.1	21.4	24.4	27.2	30.3
Other Expenditure		0.0	2.1	6.1	7.1	7.1	5.4	5.4	5.4	4.9	4.9
Total Expenditure		**20.9**	**20.0**	**23.0**	**25.8**	**29.5**	**32.1**	**37.0**	**41.5**	**45.3**	**49.7**
Interest (@1.5%)		1.71	1.84	2.08	2.61	3.25	3.90	4.59	5.31	6.01	6.80
Surplus/ Loss on trading activity	All activity	**-11.5**	**-9.3**	**-10.2**	**-6.0**	**-3.5**	**-0.2**	**1.1**	**2.9**	**4.8**	**6.3**
	Tier 2 loan only	-2.0	0.2	2.3	4.3	6.5	8.1	9.7	11.6	13.4	15.0
	Tier 3 loan only	-7.0	-5.0	-3.1	1.3	2.6	3.1	3.7	4.3	4.7	5.3
	Loans only	-9.0	-4.8	-0.8	5.6	9.1	11.2	13.4	15.9	18.1	20.3

Figure 5c: Combined impact on income and expenditure variables (3% PCM)

Income & Expenditure		11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Income	Interest										
Loan Income (£M)											
	Tier 2 Interest	6.2	6.7	7.4	9.2	11.9	14.7	17.6	21.1	24.2	27.2
	Tier 3 Interest	4.9	5.9	7.6	16.0	21.1	25.7	30.4	34.7	38.7	43.1
	Total Interest	11.1	12.5	15.0	25.2	33.0	40.3	48.0	55.8	62.9	70.3
Total Income		**11.1**	**12.5**	**15.0**	**25.2**	**33.0**	**40.3**	**48.0**	**55.8**	**62.9**	**70.3**
Expenditure (£M)											
	New members	0.8	0.7	1.2	1.9	2.3	2.1	2.4	2.3	2.4	2.3
Loan Expenditure											
	Tier 2: Cost of processing	5.6	4.4	3.6	3.5	3.9	4.8	5.7	6.9	7.9	8.9
	Tier 2: Cost of CC in write off	2.6	2.1	1.5	1.4	1.5	1.8	2.2	2.6	3.0	3.4
	Total Tier 2	8.2	6.5	5.1	4.9	5.3	6.6	7.9	9.5	10.9	12.2
	Tier 3: Cost of processing	8.8	7.8	7.7	8.7	11.2	13.6	16.1	18.4	20.5	22.9
	Tier 3: Cost of CC inc write off	3.1	3.0	3.0	3.2	3.6	4.4	5.3	6.0	6.7	7.5
	Total Tier 3	11.9	10.8	10.6	11.9	14.9	18.1	21.4	24.4	27.2	30.3
Other Expenditure		0.0	2.1	6.1	7.1	7.1	5.4	5.4	5.4	4.9	4.9
Total Expenditure		**20.9**	**20.0**	**23.0**	**25.8**	**29.5**	**32.1**	**37.0**	**41.5**	**45.3**	**49.7**
Interest (@1.5%)		1.71	1.84	2.08	2.61	3.25	3.90	4.59	5.31	6.01	6.80
Surplus/ Loss on trading activity	**All activity**	**-11.5**	**-9.3**	**-10.2**	**-3.3**	**0.2**	**4.3**	**6.4**	**8.9**	**11.5**	**13.8**
	Tier 2 loan only	-2.0	0.2	2.3	4.3	6.5	8.1	9.7	11.6	13.4	15.0
	Tier 3 loan only	-7.0	-5.0	-3.1	4.1	6.3	7.6	9.0	10.3	11.5	12.8
	Loans only	-9.0	-4.8	-0.8	8.4	12.8	15.7	18.7	21.9	24.8	27.8

34. Figures 5 a, b and c demonstrate the effects of the forecast variables on the profit/loss of the Stage 1 and Stage 2 credit unions used to build the financial model.

35. Figure 5a shows the effects of not increasing the interest rate on loans. Whereas Figures 5b and 5c show the effects of increasing the rate to 2.5% pcm and 3% pcm, respectively.

36. Assuming that interest/dividends of 1.5% are paid on savings, the increases in the loan interest rate shown combined with process efficiencies and infrastructure change mean that the movement can become sustainable within 5 to 7 years from this year. Without an increase in the interest rate the model shows that the

sector could lose around £60m prior to that date; £40.1m falling within the period from this year to year 2014/15 when DWP funding is forecast to end. The model allows for a DWP contribution of £36.6m up to 2014/15, with £3m of the gap being the credit union contribution to the infrastructure and systems change element of the project, but it has to be remembered that these figures are the output from a model they are not actuals proposed in bids.

37. In addition to this modelling we are aware that credit unions could develop new income streams over the next 2 or 3 three years but, even assuming they could do this successfully, we cannot say with confidence they will be able to fully bridge the gap between income and expenditure whilst they are restricted to charging interest on loans at 2% pcm. So we recommend they be set the challenge of reducing their costs and developing new streams of income in conjunction with serious consideration being by Government to what an appropriate rate of interest on loans might be.

Annex B - Interest Rate Increase

Impact on Credit Union Sector

1. Credit unions are currently limited to 2% pcm interest rate cap. They are serving some of the hardest and most expensive to serve groups and are struggling to be sustainable. Many credit unions believe that the interest rate cap is a barrier.

2. The Credit Union Act 1979 contains a power that could enable Government to change the rate using secondary legislation if there was general agreement amongst MP's that change is desirable. However, for financial modelling purposes we assumed that full consultation would be necessary and modelled potential interest rate increases from April 2014.

3. The model demonstrates that interest rate change alone will not cause the credit union sector to become financially sustainable. Sustainability will only be achieved if the sector introduce process efficiencies, reduce costs and reorganise the business to improve customer acquisition and income generation strategies. The changes necessary to support these activities would continue throughout the legislative consultation period.

4. Figure 6 demonstrates that the impact of an increase in interest rate would be immediate and that whilst a smaller increase to 2.5% pcm could help credit unions involved with the project to work towards financial sustainability within the 4 years of the change, an increase to 3% pcm could help them, begin achieve this within 1 year.

Figure 6: Impact of increasing interest rates on loans 2014

Income & Expenditure	**11/12**	**12/13**	**13/14**	**14/15**	**15/16**	**16/17**	**17/18**	**18/19**	**19/20**	**20/21**
Interest on low value loans (%)	2	2	2	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Surplus/Loss on trading activity	**-11.5**	**-9.3**	**-10.2**	**-6**	**-3.5**	**-0.2**	**1.1**	**2.9**	**4.8**	**6.3**
Interest on low value loans (%)	2	2	2	3	3	3	3	3	3	3
Surplus/Loss on trading activity	**-11.5**	**-9.3**	**-10.2**	**-3.3**	**0.2**	**4.3**	**6.4**	**8.9**	**11.5**	**13.8**

5. To remain true to the credit union ethos, and remain competitive in the market place, the financial model assumes that higher value loans, e.g. >£1,000 will not be charged at the higher interest rate because a loan of £1000 repayable over 12 months at 2% pcm will earn about £135 in interest and generate surplus income for the credit union.

Impact on the customer

6. The table below demonstrates the additional charges a customer would have to pay for low value loans should you consider that the interest rate may rise to 2.5% pcm or 3% pcm.

Comparative interest charges on low value loans

Loan Term 12 months	**Interest % Charged PCM**		
	2%	2.5%	3.0%
£400	£54.01	£67.94	£82.19
£600	£81.01	£101.91	£123.29

7. Although the interest charged at 3% pcm on a £400 loan would increase from £54.01 per annum to £82.19 pa, this still compares very favourably to the interest of more than £300 that would be charged on a similar £400 loan from a leading home credit lender.

8. In hard cash terms, the cost to the consumer of increasing the rate to 3% pcm on a £400 loan would be just over £0.50 pence per week.