Policy Paper

Loan Interest Rate Cap

Credit Union Advisory Committee

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Contents

1. BACKGROUND

This paper considers the interest rate ceiling on credit union loans. As recommended by the Credit Union Advisory Committee (CUAC) in its 2016 Report, in reviewing the interest rate ceiling, account will be taken of international experience and of CUAC's Credit Union Survey 2017 which provides views from individual credit unions.

In this paper CUAC presents reasons for and against the interest rate ceiling. Some international evidence on the interest rate ceiling for credit unions in other jurisdictions (US and UK) is detailed. A profile of a credit union in Great Britain is presented (London Mutual Credit Union). In Great Britain the interest rate ceiling was raised from 1 percent per month to 2 percent in 2005 and then from 2 percent to 3 percent in 2014. In Northern Ireland the interest rate ceiling remains at 1 percent per month. An overview is then presented of how credit unions in the Republic of Ireland (ROI) perceive the interest rate ceiling with these views obtained from CUAC's Credit Union Survey 2017. The discussion concludes with summary comments and a recommendation for change to the interest rate ceiling.

Rationale for and against the Loan Interest Rate Ceiling

Interest rate ceilings can be justified as protecting borrowers by offering access to credit at fair and reasonable interest rates. Access to credit at fair and reasonable rates is one of the primary objectives of a credit union. Those against the use of interest rate ceilings (or ceilings set at relatively low levels) believe they reduce product diversification and competition between institutions. In addition, interest rate ceilings may result in institutions choosing not to lend to some higher risk borrowers, many of whom will have limited access to alternative sources of credit (Miller, 2013; Maimbo and Gallegos, 2014).

2. INTERNATIONAL EVIDENCE

US Credit Unions

In the US the Federal Credit Union Act established a 15 percent per annum interest rate ceiling. The law, however, gives the National Credit Union Administration (NCUA) Board the ability to raise this ceiling level to 18 percent for 18-month periods. Since May 1987, the NCUA has consistently chosen to set the interest rate ceiling at 18 percent per annum at which level it stands today. The argument put forward for keeping the interest rate ceiling at 18 percent is to allow federal credit unions to continue serving borrowers with low credit scores and provide these borrowers with much needed access to short-term credit (Goddard et al., 2016).

Additionally, in the US, Credit Union Payday Alternative Loans (PAL loans) are not covered by the 18 percent per annum ceiling. Rather, they are capped at 28 percent per annum.

Great Britain

The interest rate ceiling for credit unions in Great Britain was raised from 1 percent per month to 2 percent per month in 2005 and then to 3 percent per month from April 2014. The rationale for the most recent increase was explained in a feasibility study commissioned by the Department for Work and Pensions (2012; 2012a). The study concluded that credit unions in Great Britain were unable to break even on small short-term loans. This caused a lack of stability in the sector and damaged the long-term future of credit unions. The feasibility study claimed that allowing the interest rate ceiling to increase would enable credit unions to become more stable over the long term. This in turn would mean that low-income consumers would have greater access to reliable and affordable credit, without having to resort to more expensive means, such as home credit or payday lenders, or worse, illegal lenders. The study also emphasised that with a 1 percent increase in the monthly rate of interest (from 2 to 3 percent), credit union loans would still be substantially cheaper than the alternatives for consumers with no mainstream options.

It should also be noted that the increase in the interest rate ceiling to 3 percent per month in the UK is permissive. That is, it does not require credit unions to increase the interest rate they charge but simply permits them to do so if they judge that the benefits outweigh the costs.

Northern Ireland Credit Unions

In recent years, legislation for credit unions in Northern Ireland has played catch up with legislation in Great Britain. The Credit Unions and Co-operative and Community Benefit Societies Act (2016) updates the Credit Unions (Northern Ireland) Order 1985 ('the 1985 Order') which governs the operations of credit unions. The primary aim of the 2016 Act is to promote the continued growth and ongoing sustainability of the sector and give credit unions in Northern Ireland greater operational flexibility, while seeking to ensure that this flexibility does not put at risk the prudential running of these entities.

In the run up to the introduction of the 2016 Act, the Department of Enterprise Trade and Investment consulted on 19 proposed legislative updates.[1] At the end of the consultation a number of the proposed amendments were abandoned primarily due to lobbying by the sector. The suggested amendments that were abandoned included a proposal to facilitate the easier dissolution of a credit union, a proposal

[1] The consultation process occurred between 11 June 2013 and 6 September 2013 and received 37 responses. During the consultation period, 3 public consultation events were held.

to abolish the 8 percent per annum limit on dividends and the proposal to increase the 1 percent per month interest rate ceiling (French et al., forthcoming).

Therefore, the 1 percent per month interest rate ceiling on interest rates for credit unions in Northern Ireland remains despite the fact that it is now 3 percent per month in the rest of the UK.

3. VIGNETTE: LONDON MUTUAL CREDIT UNION[2]

We present in Table 1 a vignette of London Mutual Credit Union which has availed of the increase in the loan interest rate ceiling in Great Britain to offer a variety of loan products across the interest rate spectrum. London Mutual Credit Union was established in 1982 and now has a common bond designated as live and work. Although small in terms of asset size (£21 million) but not in terms of members (23,679) it has a relatively sophisticated transactional account service, and an impressive range of savings and loan products. It also makes good use of ICT in the delivery of services to members.

[2] This overview of London Mutual Credit Union is drawn from French et al. (forthcoming)

Table 1: London Mutual Credit Union

History

London Mutual Credit Union common bond includes those who live in Southwark, Lambeth-Westminster, and Camden. It was established in 1982 to serve employees of Southwark. Since then it has expanded through mergers with six local credit unions. It is now one of the largest live-or-work credit unions in London. It is a member of the trade body ABCUL.

Key Statistics

At the end of 2015 it had 23,679 members, assets of £21,218,111, loans to members of £12,390,715 (loan to asset ratio 58%), total income of £2,987,245, a pre-tax surplus of £363,472 a total dividend payment of £51,691 and no interest rebate.

Support from Grant Income

London Mutual Credit Union for the year ended 30th September 2015 released income of £70,367 from Grants & Donations held for specific projects. This equated to 2.36% of total income. For the previous year, £116,948 was released which equated to 4.54% of total income for the year end 2014.

Technology

London Mutual Credit Union provides members with mobile banking apps. The apps provide capability to view balances, transfer money between credit union accounts, request payments to be sent to external bank accounts, request statements to be posted or emailed and enable loan applications to be made. London Mutual Credit Union also has an online banking platform. Many of the capabilities of the online banking platform are similar to that available through the banking apps.

Current Account

London Mutual Credit Union offer a current account. Members can have their wages, benefits, or pension deposited directly into their account. The current account also offers access to money through the Link ATM network. Bills can be paid through the current account. A Visa card is also available through the account. The credit union also offers a current account specially designed for teenagers to help young members to learn how to manage their finances from an early age and achieve financial independence.

Loan Products

Premier Loans are available up to £7,500 loans payable up to 5 years at 13.68% APR.

Saver Loans secured against savings in a Membership Account are subject to a 4.5% APR which can be payable over 10 years.

*Gold Loan*s from £5,000 to £7,499 at 6.9% APR, for 6 to 60 months. These are available to those with an excellent credit record, a take home salary income of at least £1,500 per month, with the person a tenant or a home owner.

Platinum Plus Loans from £7,500 to £15,000 at 5.9% APR, for 12 to 60 months. These are available to those with a take home salary income of at least £1,500 per month, with the person a home owner.

Payday Loans are also available. The typical amount borrowed is £400 for a 30-day period. The interest rate charged is 42.6% APR.

Plus Loans are for those who do not have a good credit file or are unemployed. Loans are typically for 18 months (APR of 35.1%). Up to £1,200 can be borrowed. Usually when one third of the loan is repaid a top up loan is available.

Savings

Membership Account where the return is the dividend rate paid by the credit union which varies depending on profits.

Junior Savings where the return is also the dividend rate paid by the credit union which varies depending on profits.

Cash ISA which offers an interest rate of 0.75% EAR[3]

Holiday Savings and *Christmas Savings* accounts are also available.

[3] EAR is Effective Annual Rate. This takes account of the interest rate and how often interest is charged. It does not include any other fees or charges

4. Survey of Credit Unions in the Republic of Ireland (ROI)

A survey of ROI credits unions was undertaken by CUAC between April and May 2017. A total of 117 credit unions completed the survey. This represents a completion rate of approximately 42 percent. The survey was completed by 10 industrial credit unions and 107 community credit unions. The asset size of the credit unions completing the survey was as follows: 23, < €20m; 33, €20m - €40m; 19, €40m - €60m; 9, €60m - €100m; and 33, > €100m.

In Table 2 we profile responses to four questions. The first question (Question a) which was answered by all credit unions was '*Do you believe the interest rate ceiling should be changed?*'. From Table 2 it can be seen that 47 (40%) indicated that it should be changed, 63 (54%) indicated that it should not be changed and 7 (6%) didn't have an opinion. It is also clear that there is a dichotomy in responses between credit unions in the three smaller asset categories (< €20m; €20m - €40m; and €40m - €60m) relative to those in the two larger asset categories (€60m - €100m; and > €100m). A majority of credit unions in each of the three smaller asset categories did not believe the interest rate ceiling should be changed. In contrast, a majority of credit unions in the two larger asset categories suggested that the interest rate ceiling should be changed.

Credit unions were asked the follow-on question (Question b) *'Do you believe the interest rate ceiling is restricting your business growth potential?'* In this instance 115 credit unions provided an answer and of that number 84 (73%) believed that the ceiling did not restrict business growth potential (see Table 2). It can also be seen that for each of the asset size categories a majority of credit unions stated that the interest rate ceiling did not restrict business growth potential.

Two other questions are profiled in Table 2 (Question c) '*Do you believe the interest rate ceiling should be fully removed?*' and (Question d) '*Do you believe the interest rate ceiling should remain but the current level be increased?'* The expectation was that respondents who answered yes to (Question a) '*Do you believe the interest rate ceiling should be changed?'* would opt to answer yes to either (Question c) or (Question d) but not both. It appears that in a small number of cases this did not happen. Accepting there are a small number of inconsistencies, it appears from Table 2 that approximately 47% of those who believe the interest ceiling should be changed want it fully removed while 53% want the interest rate ceiling to be set at a higher level.[4]

Table 3 presents information for those who stated that the ceiling should be altered, that is, answered yes to Question (d). A total of 22 respondents suggested an alternative interest rate ceiling. A ceiling of

[4] The percentage figures are obtained by adding the number who answered yes to (Question c) and (Question d) and then calculating the relative percentages.

between 16% and 20% was most commonly chosen (7 respondents), while 5 respondents chose 12-15% with a further 5 opting for 21-25%.

Respondents were asked to list, where relevant, additional products/services that their credit union would wish to offer if the interest rate ceiling was removed/increased. A number of respondents provided examples of more than one product/service. The products which would be offered are detailed in Table 4. Three products were highlighted relatively frequently. These were higher risk loans to compete with money lenders, overdraft facilities and credit cards. In each instance the risk profile of these loan products are such that a majority of providers elsewhere in the marketplace charge rates above the 1 percent interest rate ceiling.[5]

Those that believed the interest rate ceiling should be changed were asked what would be the appropriate time framework for such a change to occur. This information is detailed in Table 5 and reveals that 47 (77%) considered that the change should occur in less than two years.

The survey also sought to illicit views about why the interest rate ceiling should or should not be changed. Those that wished for change tended to highlight three main points. Firstly, there was a view that credit unions are at a competitive disadvantage as the interest rate ceiling does not adequately compensate for increased risks on certain small scale higher risk loans. Secondly, if the interest rate ceiling was removed it would permit credit unions to address both excessive moneylending activities in credit union communities and new borrowers with unproven track records. Thirdly, some respondents suggested that there is no place for an interest rate ceiling in a modern financial setting and why should it apply to one financial institution and not another.

Those that wanted no change in the interest rate ceiling also made a number of salient points. Firstly, the interest rate ceiling is simply not an issue for credit unions. Secondly, it is considered an integral part of the credit union ethos. Thirdly, credit unions are primarily for people of lower socio economic means and it would be more beneficial to have a more equitable regulatory regime than to lift any interest rate restrictions. Fourthly, the interest rate ceiling protects members from excessive charges.

[5] For example, a comparison of 13 credit card providers revealed rates to range from a low of 13.8% APR (AIB Click) to a high of 35.0% APR (Ulster Bank student MasterCard). Overdraft rates are also subject to significant variability. The PTSB 'Everyday Account' overdraft rate is 16.3% on authorised amounts and it is the highest of all the Irish banks, Bank of Ireland is the next highest rate at 15.9% followed by Ulster at 15.55%, National Irish Bank has the lowest overdraft rate of 11.43% although there is a fee to use that account. In ROI some 400,000 people are estimated to use money lenders which can legally charge interest rates up to 200% but which with charges can rise to 290%.

5. Concluding Comments

This overview noted that the interest rate ceiling in both the US and GB is set at a higher level than that in the ROI. The higher rate in these countries is in part due to the belief that interest rate ceilings (or ceilings set at relatively low levels) are considered to reduce product diversification and competition between institutions. In addition, it is contended that interest rate ceilings (or ceilings set at relatively low levels) may result in institutions choosing not to lend to some higher risk borrowers, many of whom have limited access to alternative sources of credit. The survey of ROI credit unions revealed that a majority did not want a change to the interest rate ceiling. The survey did however identify a dichotomy in the opinion of credit unions based on asset size. A majority of credit unions with assets of €60 million and above were supportive of a change to the interest rate ceiling.

CUAC's view is that credit unions should be permitted to charge an interest rate on loans greater than the present ceiling of 1 percent per month. CUAC believes that the loan interest rate ceiling should be raised to 2 percent per month. This change will provide credit unions with greater flexibility to risk price loan products and in so doing may create an opportunity for new product offerings. This recommendation to increase the loan interest rate ceiling does not mean that credit unions are required to raise their loan interest rates. Rather they can apply their own interest rate(s) within the parameters that are allowed.

To increase the interest rate ceiling on loans, legislative change to Section 38 1(a) of the Credit Union Act is required.

6. References

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Goddard, J., McKillop, D.G. and Wilson, J.O.S (2016), Regulatory Change and Capital Adjustment of US Credit Unions, Journal of Financial Services Research, August 2016, Volume 50, Issue 1, pp 29–55, http://link.springer.com/article/10.1007%2Fs10693-015-0217-y#rch

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Table 2

	(a) Do you believe the interest rate ceiling should be changed?				(b) Do you believe the interest rate ceiling is restricting your business growth potential?				(c) Do you believe the interest rate ceiling should be fully removed?				(d) Do you believe the interest rate ceiling should remain but the current level be increased?*			
Community	Yes	No	Don't Know	Total	Yes	No	Don't Know	Total	Yes	No	Don't Know	Total	Yes	No	Don't Know	Total
<€20m	0	20	2	22	2	18	1	21	1	19	1	21	1	17	3	21
€20m - €40m	12	15	3	30	10	20	0	30	5	22	3	30	7	20	3	30
€40m - €60m	7	11	1	19	3	16	0	19	3	15	1	19	6	12	1	19
€60m - €100m	8	0	1	9	3	5	1	9	4	4	1	9	4	4	1	9
>€100m	15	12	0	27	6	19	1	26	7	18	1	26	7	16	1	24
Total	42	58	7	107	24	78	3	105	20	78	7	105	25	69	9	103
Industrial																
<€20m	0	1	0	1	0	1	0	1	0	1	0	1	0	1	0	1
€20m - €40m	1	2	0	3	1	2	0	3	1	2	0	3	1	2	0	3
€40m - €60m	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
€60m - €100m	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
>€100m	4	2	0	6	3	3	0	6	4	2	0	6	2	4	0	6
Total	5	5	0	10	4	6	0	10	5	5	0	10	3	7	0	10
All Credit Unions																
<€20m	0	21	2	23	2	19	1	22	1	20	1	22	1	18	3	22
€20m - €40m	13	17	3	33	11	22	1	33	6	24	3	33	8	22	3	33
€40m - €60m	7	11	1	19	3	16	0	19	3	15	1	19	6	12	1	19
€60m - €100m	8	0	1	9	3	5	1	9	4	4	1	9	4	4	1	9
>€100m	19	14	0	33	9	22	1	32	11	20	1	32	9	20	1	30
Total	47	63	7	117	28	84	4	115	25	83	7	115	28	76	9	113

Table 3

INTEREST RATE CEILING	If you answered Yes to Q6(d) please state what the interest rate ceiling should increase to					
Proposed Rate	12% - 15%	16%-20%	21%-25%	26%-30%	30%+	Total
Community						
<€20m	1	0	0	0	0	1
€20m - €40m	2	2	2	0	0	6
€40m - €60m	1	1	1	1	1	5
€60m - €100m	0	1	1	0	0	2
>€100m	1	2	1	2	1	7
Total	5	6	5	3	2	21
Industrial						
<€20m	0	0	0	0	0	0
€20m - €40m	0	0	0	0	0	0
€40m - €60m	0	0	0	0	0	0
€60m - €100m	0	0	0	0	0	0
>€100m	0	1	0	0	0	1
Total	0	0	0	0	0	1
All Credit Unions						
<€20m	1	0	0	0	0	1
€20m - €40m	2	2	2	0	0	6
€40m - €60m	1	1	1	1	1	5
€60m - €100m	0	1	1	0	0	2
>€100m	1	3	1	2	1	8
Total	5	7	5	3	2	22

Table 4

	Social Lending /Micro Loans	Commercial / SME Loans	Overdraft Facilities	Revolving Credit Facility	Mortgages	Debit Cards	Debt Consolidatio n	Credit Cards	Higher Risk Loans*	Extra Insurance Products	Specialised Finance
Community											
<€20m	0	1	0	0	1	0	0	0	0	1	0
€20m - €4	2	0	1	0	1	0	2	1	4	0	0
€40m - €6	1	0	1	1	1	0	0	0	4	0	1
€60m - €1	1	0	2	0	1	0	0	1	0	0	0
>€100m	2	1	4	1	0	1	0	4	5	0	0
Total	6	2	8	2	4	1	2	6	13	1	1
Industrial											
<€20m	0	0	0	0	0	0	0	0	0	0	0
€20m - €4	0	0	0	0	0	0	0	0	0	0	0
€40m - €6	0	0	0	0	0	0	0	0	0	0	0
€60m - €1	0	0	0	0	0	0	0	0	0	0	0
>€100m	0	0	1	1	0	0	0	2	3	0	0
Total	0	0	1	1	0	0	0	2	3	0	0
All Credit Unions											
<€20m	0	1	0	0	1	0	0	0	0	1	0
€20m - €4	2	0	1	0	1	0	2	1	4	0	0
€40m - €6	1	0	1	1	1	0	0	0	4	0	1
€60m - €1	1	0	2	0	1	0	0	1	0	0	0
>€100m	2	1	5	2	0	1	0	6	3	0	0
Total	6	2	9	3	4	1	2	8	11	1	1

* Higher Risk Loans to compete with Moneylenders

NOTE: Some credit unions proposed more than one additional product/service, with some suggesting up to 4

Table 5

	Where you believe that changes should be made to the intert rate ceiling, what do you consider an appropriate timeframe in which to make those changes?			
	< 2 years	2-5 years	> 5 years	Total
Community				
<€20m	3	3	0	6
€20m - €40m	14	1	1	16
€40m - €60m	6	2	2	10
€60m - €100m	6	2	0	8
>€100m	13	2	0	15
Total	42	10	3	55
Industrial				
<€20m	0	0	0	0
€20m - €40m	0	0	0	0
€40m - €60m	0	0	0	0
€60m - €100m	0	0	0	0
>€100m	5	1	0	6
Total	5	1	0	6
All Credit Unions				
<€20m	3	3	0	6
€20m - €40m	14	1	1	16
€40m - €60m	6	2	2	10
€60m - €100m	6	2	0	8
>€100m	18	3	0	21
Total	47	11	3	61