

# 94

Financial Services Authority

## Credit unions: consumer compensation and consumer complaints

May 2001



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 20 July 2001.

Comments may be sent by electronic submission using the form on the FSA's website (at [www.fsa.gov.uk/pubs/cp/cp94\\_response.html](http://www.fsa.gov.uk/pubs/cp/cp94_response.html)).

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**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.**

# 1 Introduction and summary

## Introduction

- 1.1 In November 1999 the Government announced that credit unions would be brought within the scope of the Financial Services and Markets Act (FSMA). This means that the FSA will be responsible for regulating credit unions along with all other financial services firms.<sup>1</sup>
- 1.2 At the moment, credit unions are registered by the Registry of Friendly Societies, which has a limited number of regulatory powers. For example, credit unions are required by the Credit Unions Act 1979 to make an annual return to the Registry containing specified information. The Registry has statutory power to order a credit union to stop doing new business and, in certain circumstances, it can cancel a credit union's registration or bring a petition for its winding up.
- 1.3 These powers are of limited scope and do not provide the basis for a fully developed system of regulation. The FSA is developing a new regime of regulation and supervision for credit unions to replace the existing one, and our proposals for this are set out in *CP77: The Regulation of Credit Unions* (December 2000).
- 1.4 The FSA is committed to developing a practical system of regulation for credit unions that meets the FSA's statutory objectives under the FSMA and takes account of the special characteristics of the sector. Our aim is to provide credit union members with appropriate levels of protection through a regulatory regime which is proportionate and which reflects the sector's needs.
- 1.5 The FSA is consulting fully with interested parties in order to develop a regime which is effective, proportionate and affordable. Our intention is to get the new regulatory regime for credit unions up and running on 1 July 2002.

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1 It is not intended to bring credit unions in Northern Ireland within the scope of the FSMA. They will continue to be regulated by the Northern Ireland Registry of Friendly Societies under the Credit Unions (Northern Ireland) Order 1985.

- 1.6 We consider that membership of the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS) will be a significant benefit for credit unions and their members. The proposal for a credit union Share Protection Scheme has been under discussion for many years. This reflects the importance the credit union movement itself attaches to the principle of investor protection. Under our proposals, when credit unions come under the full scope of the FSA in July 2002, members of credit unions would, for the first time, have access to a compensation scheme and an ombudsman service.
- 1.7 The importance of this cannot be underestimated, both in terms of ensuring that members of credit unions have the same levels of consumer protection as depositors with banks and building societies, but also in terms of the development of the sector. In short, we consider that proper consumer protection will make credit unions more attractive to potential members, particularly those who primarily wish to save. This is likely to have a significant impact on the growth and expansion of the sector.

## Outline of the paper

- 1.8 The structure and scope of both the FOS and the FSCS have already been determined. The purpose of this consultation paper is to invite views on the particular arrangements for how credit unions will fit in to each scheme.
- 1.9 Chapter 2 considers the protection of credit union members if their credit union fails. It sets out our proposals on bringing credit unions within the FSCS.
- 1.10 Chapter 3 deals with how credit unions should handle members' complaints. We propose to introduce a set of binding complaints handling rules. Chapter 4 proposes that, if a member is not satisfied with the credit union's response to their complaint, the member may ask the FOS to adjudicate.
- 1.11 Although we are still not in a position to provide exact details of the proposed fees structure, Chapter 5 sets out our objectives in relation to the regulatory costs that will be faced by credit unions, including the cost of participating in the FSCS and the FOS.
- 1.12 We have tried, wherever possible, to ensure that this consultation paper is written in simple, straightforward language. However, sometimes it has been necessary to use terms which are not traditionally associated with credit unions in order to ensure consistency with FSA policy and publications as a whole.
- 1.13 For example, FSA regulates a number of different types of financial organisations. For shorthand purposes the FSA has decided to use one single

term to refer to all the different organisations it regulates – ‘firms’ – whilst continuing to recognise the special characteristics of the organisations in each particular sector, including credit unions. Similarly it is useful to be able to use one single term to refer to the people who have a financial relationship with the firms we regulate – ‘customers’. This does not undermine that fact that, in the case of credit unions, customers are, first and foremost, members.

### Cost-benefit analysis

- 1.14 Cost-benefit analysis involves preparing an estimate of the costs that will be associated with the proposed new policy, and an analysis of the expected benefits. The aim is provide a clear statement of these matters so that people can see as far as possible that the incremental costs imposed by the new policy are justified by the benefits it is expected to deliver.
- 1.15 The FSA is required by the FSMA to publish a cost-benefit analysis whenever it publishes draft rules which it proposes to make. Although this consultation paper does not set out the draft text of proposed rules, we think it is useful nonetheless to discuss the costs and benefits associated with the policy proposals it contains, and this discussion is in Chapter 6.

## Summary of main proposals

### Financial Services Compensation Scheme

- Credit unions should be included in the FSCS at the same time that they are brought within the FSMA.
- Credit unions should be required to contribute to the base costs of the scheme on the same basis as other participants, that is, in proportion to regulatory fees.
- Credit unions should participate in the deposit-takers’ contribution group with banks and building societies.
- The first £2,000 of a member’s shares in a credit union should have 100% protection.
- The next £33,000 of a member’s shares in a credit union should have 90% protection.
- Credit union deposits with banks and building societies should continue to be protected.
- Directors and managers of credit unions should not be excluded from protection under the scheme.

## Complaints handling rules

- Credit unions will be required to comply with a set of complaints handling rules. These will be designed to ensure that credit unions have appropriate and effective procedures for dealing with members' complaints.

## Financial Ombudsman Service

- Credit unions will be subject to the jurisdiction of the Financial Ombudsman Service when they are brought within the Financial Services and Markets Act.
- Credit unions should participate in a separate credit union contribution group.
- This consultation paper invites respondents to decide between two options for how the credit unions contribution group will be funded:

### Option A

- Credit unions should contribute to the general levy of the scheme on a similar basis to other deposit-takers.
- Minimum levy payers should be exempt from any case-related charges.

### Option B

- Credit unions to be given the alternative of participating in the scheme on a 'pooled' basis, whereby they would not contribute to the general levy or pay case fees on a similar basis to other firms, but would pay a proportionate share of the total annual cost of handling all complaints made against credit unions.

## Fees

- Small credit unions are expected to pay no more than £200 in fees each year, including the cost of participation in the FSCS and the FOS. (We have not yet defined what we mean by 'small', but it could be around the £500,000 mark.)
- The largest credit unions will be expected to pay regulatory fees comparable to those paid by banks and building societies of a similar size.
- There is expected to be a reduced application fee of £500 for new credit unions that wish to become authorised subject to Version 1 requirements.
- New credit unions wishing to become authorised subject to Version 2 requirements should pay the minimum application fee applicable to other FSA regulated firms, currently expected to be around £2,000.

# 2 Credit unions and the Financial Services Compensation Scheme

- 2.1 Since 1979, bank customers have had a significant degree of protection against the risk that the institution where they keep their money might fail. Similar protection has been provided for building society customers since 1987. The banks' Deposit Protection Scheme and the Building Societies Investor Protection Scheme pay the customers of a failed bank or building society 90% of the money they had deposited with the bank or building society, up to a maximum of £18,000.
- 2.2 When the FSMA comes into effect later this year, these compensation schemes, together with other existing schemes for investment business and insurance, will be replaced by a single Financial Services Compensation Scheme set up by the FSA – the FSCS. The general proposals for the new compensation scheme were set out in *CP58: Financial Services Compensation Scheme Draft Rules* published by the FSA in July 2000 and *CP86: Financial Services Compensation Scheme Draft Funding Rules* published by the FSA in March 2001.
- 2.3 The possibility of a credit union Share Protection Scheme has been the subject of discussion for many years. These discussions would seem to indicate that the credit union movement is strongly in favour of some form of compensation scheme. In this chapter we explain why we consider that credit unions should be included in the FSCS, and we set out our proposals for doing this.

## The proposed compensation scheme

- 2.4 The compensation scheme will contain three sub-schemes which will be self-contained. There will be a deposit sub-scheme, an insurance sub-scheme and a sub-scheme for all other business authorised by the FSA.
- 2.5 Each sub-scheme can be further divided into contribution groups. For example, in the insurance sub-scheme, there is likely to be a general insurance

contribution group and a long-term insurance contribution group. It is proposed that banks, building societies, and credit unions should form a single contribution group – the deposit takers sub-scheme.

- 2.6 Because their main regulated activity involves collecting money through members' share accounts, credit unions will be classed as deposit-takers for the purposes of regulation.
- 2.7 How the contribution groups are organised is important for the question of costs. All firms in the compensation scheme will have to contribute to its base running costs. However, the costs of compensating consumers of a failed firm will be shared only by the firms in the contribution group of which that firm was a member. So, for example, if a deposit-taking firm goes out of business, causing loss to its depositors, the cost of compensating its customers will be spread among all the other firms in the deposit-takers contribution group. Firms in other groups will not be expected to contribute.

#### Claims under the scheme

- 2.8 The purpose of the scheme is to provide some degree of protection for the customers of a financial services firm that fails. A customer will be eligible for compensation if the scheme manager decides that the firm in question is unable or unlikely to be able to meet claims against it. This decision will usually be triggered by a specified event – for example the appointment of a liquidator, the passing of a resolution for a creditors' winding up, or a declaration that the firm is in default.
- 2.9 Compensation will be available to meet claims connected with activities that fall within the definition of 'scheme business'. For credit unions, the relevant scheme business is deposit-taking, and the regulated activity is accepting deposits.<sup>2</sup>
- 2.10 The amount of compensation that claimants can get will be subject to limits. These are discussed at paragraphs 2.24 – 2.26 below.
- 2.11 Subject to these limits, customers will be fully compensated by the scheme, even if the firm or its liquidator might in due course have been able to pay some of what they are owed. For example if a member has £1,000 in a credit union which fails, the member will be entitled to receive the full £1,000 in compensation from the scheme. Even if the credit union might eventually have been able to pay some or all of the £1,000, the scheme would pay the full amount initially and recover the costs if there was likely to be a delay. The purpose of this is to avoid consumers having a long wait for their money.

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2 For the purposes of this paper the word 'deposits' includes credit union members' shareholdings.

When this happens, the compensation scheme will become entitled to the money that the insolvent firm would otherwise have paid to the customer. The payment of compensation is conditional on the claimant assigning their rights to the FSCS.

## Credit unions and the compensation scheme

- 2.12 One of the FSA's four statutory objectives under the FSMA is the protection of consumers. In developing policy and rules to meet the statutory objectives, the FSA is required to have regard to the principles of good regulation. The FSCS contributes to the achievement of two of the four statutory objectives: maintaining confidence in the financial system and securing an appropriate degree of protection for consumers.
- 2.13 The FSA has stated previously that the FSCS should be largely directed towards those customers who are least able to stand financial loss. We consider, therefore, that to ensure credit union members have an appropriate degree of protection, their share accounts must be covered by a compensation scheme.
- 2.14 The proposals we make below are intended to bring credit unions within the FSCS on an affordable basis.

### Base costs

- 2.15 The 'base costs' of the FSCS are its basic day-to-day running costs. These do not include the costs of dealing with, and paying, claims for compensation (these are called the 'specific costs' and are discussed below). The intention is that these costs should be shared by all participating firms under the scheme and that the costs should be distributed to all firms, including credit unions, in proportion to FSA regulatory fees.
- 2.16 *CP86: Financial Services Compensation Scheme Draft Rules* proposes that the FSCS should be able to set a de minimis amount in respect of the base cost levy (although as yet we do not know what the de minimis amount is likely to be). Where a firm's share of the levy is calculated as being below that figure, the FSCS would have discretion not to charge that firm. This proposal has been designed specifically to assist small firms such as credit unions.

### Specific costs

- 2.17 Specific costs are the claims-related costs of the scheme (i.e. all the expenses involved in paying compensation to customers of firms that have failed). These will include not only the actual compensation, but also the expenses involved in verifying and processing customers' claims. As mentioned above,

the general proposal is that these costs should be shared amongst the firms in the same contribution group as the firm that has failed.

- 2.18 The FSCS will be run on a pay-as-you-go basis. However, apart from this and the payment of base cost charges, firms will not in general be expected to make ongoing payments. Rather, they will pay in the money necessary to compensate consumers if and when a firm in the same contribution group fails.
- 2.19 If compensation has to be paid to the customers of a deposit-taking firm, the other firms in the deposit-takers' contribution group will be required to contribute to meeting those claims in proportion to the size of their protected deposit base.<sup>3</sup> So, for example, if £100,000 had to be paid out in compensation and Firm A had 1% of the total amount of protected deposits held by all of the firms in the contribution group, it would have to contribute £1,000. Since credit unions' share of protected deposits is low, their contribution to compensation payments would, likewise, be low.

#### The deposit-takers contribution group

- 2.20 An important question is how credit unions should be included in the FSCS. The scheme works on the principle that firms undertaking similar business should be responsible for meeting the cost of claims associated with that type of business. As described in paragraph 2.6 above, credit unions' main regulated activity will be classed as deposit-taking, hence they would fall into the deposit-takers' contribution group for the purposes of the FSCS. In other words, credit unions would have to contribute to compensating the customers of banks and building societies as well as members of credit unions. Similarly, banks and building societies would be required to contribute to compensating credit union members if their credit union collapses.
- 2.21 We consider that credit unions should be included in the general deposit-takers contribution group. It would provide better protection for their members without imposing disproportionate costs on the sector. At the same time, it ensures similarity of treatment for all deposit-takers.

#### The 'rolling cap'

- 2.22 The most that any firm in the deposit takers sub-scheme would have to contribute to pay for depositors' compensation would be 0.3% of its protected deposits (or protected share deposits in the case of credit unions). This cap would be 'rolling' – that is, it wouldn't be just a ceiling on contributions made during a set period, but would limit the total payments

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<sup>3</sup> A 'protected deposit' refers to the entire amount of any account where all or part of the account would be protected if the firm in question became insolvent. For the purposes of this consultation paper we shall refer to 'protected deposit base' when talking about banks and building societies and 'protected share deposits' when talking about credit unions.

that a firm could be required to make over any length of time. In other words, it would be a firm's payments added together over the long run that will count towards the cap, not contributions in just a one year period.<sup>4</sup>

### Start-up costs

- 2.23 The start-up costs of the FSCS were funded initially by the FSA and lately by an FSCS line of credit. These costs will be recovered from all participant firms by means of an additional levy over a period of three years from the first full financial year of operation. Again, the levy will be raised in proportion to regulatory fees, and therefore is not likely to be significant for credit unions

### Compensation levels

- 2.24 Under the FSCS there will be limits on the amounts of compensation claimants can obtain from the scheme. For claims concerning deposits, there will be limits on the percentage of their money that customers can recover and on the maximum total amount that they can recover.
- 2.25 The deposit-takers sub-scheme of the FSCS will pay 100% compensation for the first £2,000 of a customer's deposits. The Scheme will pay 90% of the next £33,000 of a claim (i.e. 90% of any amount greater than £2,000 up to £35,000). In other words, if a credit union member had £35,000 in shares, the maximum amount of compensation payable under the FSCS would be £31,700.
- 2.26 Although in the larger credits unions it may possible for individual members to save more than this amount, this would be exceptional. Indeed, at the present time, the largest individual share holding in a credit union is considerably less than £35,000. Given the amounts of money normally held in credit union share accounts, and taking into account the need to retain appropriate levels of customer responsibility, we consider that £35,000 represents a comfortable upper limit for compensation for credit union members, in common with depositors with banks and building societies.

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4 The calculation of what percentage of its protected deposit base a firm has already paid in contributions will be based on the size of that base *at the time the call for a levy is made*. For example, suppose that as a result of the failure of Firm B, Firm A is required to make a contribution of 0.02% of its protected deposit base in 2001. If during the period of time before another firm in the contribution group fails, Firm A's protected deposit base doubles in size, then for the purposes of this next contribution it would be deemed to have already contributed 0.01% of its protected deposit base. This is to ensure that as a sector grows in size, so too does the amount of money available to meet any claims by consumers.

## Eligible persons

### Will credit unions' own deposits be excluded from protection?

- 2.27 Both individuals and companies will be eligible to bring claims under the FSCS. However it is proposed that certain types of firm (i.e. large mutual associations, large companies, credit institutions) should be excluded from protection. This would mean, for example, that money which one bank holds with another bank would not be protected if the second bank fails. Under the existing Deposit Protection Scheme and Building Societies Investor Protection Scheme such claims are excluded. However, deposits held by credit unions with banks and building societies are protected.
- 2.28 We propose that credit unions' deposits with other firms should continue to be protected. Credit unions will also be able to bring claims for compensation in connection with insurance policies and investments with financial services firms that fail.

### Deposits by directors etc.

- 2.29 The FSCS proposes to exclude directors, managers and their close relatives from the right to claim compensation. The rationale for this is that directors and managers of firms are required to have appropriate levels of skill and competence. As a result, they can reasonably be held to bear at least some of the responsibility if the firm of which they are an officer fails. They can be expected to be in a position to make informed decisions about whether or not it is wise to keep their money with the firm in question, so should not need deposit protection.
- 2.30 We consider that, given the voluntary nature of credit unions, it would not be appropriate to exclude from protection under the scheme those individuals who participate in the management of a credit union on a voluntary, unpaid basis. We also think that excluding directors from the scheme might act as a deterrent to members of credit unions to wishing to volunteer to become directors.
- 2.31 Directors of credit unions may not have the same opportunities as directors of other financial institutions to deposit their money elsewhere. Lack of access to mainstream financial services is, after all, what attracts many people to credit unions. Therefore, to exclude directors' savings from protection might, effectively, exclude them from any form of investor protection.
- 2.32 We also propose that paid managers' savings should be protected. Because of the co-operative and democratic nature of credit unions, most managers do not have the discretion to influence how the credit union is run. Rather, they are paid to implement decisions made by the volunteer Board. We consider

that under these circumstances it would be unreasonable to exclude paid managers.

- 2.33 However, we consider it an important principle that directors or managers who deliberately set out to take advantage of their position should not be compensated if their actions have resulted in a call on the FSCS. We therefore propose to exclude from protection individuals whose deliberate behaviour has contributed to the failure of a credit union, either through fraud or gross negligence.

#### Payment of levies

- 2.34 The FSA is expected to act as collecting agent for the FSCS. In respect of the base costs levy, credit unions will have the option of paying the full amount on receipt of the invoice, or the levy may be made payable by direct debit.
- 2.35 All firms will be required to pay any levy for which they are liable within one month of its falling due. The FSA proposes that the FSCS should be able to charge an additional administrative fee in respect of any overdue payments.
- Q1: Do you agree that credit unions should be included in the deposit-takers contribution group?
- Q2: Do you agree with the proposal that the deposits of directors and managers, and their close relatives, should be protected?
- Q3: Do you agree that credit unions' deposits with other firms should be protected?

# 3 Complaints handling rules

- 3.1 This chapter sets out our proposals on the complaints handling procedures for credit unions when they are brought within the new regulatory regime. As mentioned above, under the FSMA one of the FSA's statutory objectives is the protection of consumers. We consider that the proper and effective handling of consumers' complaints forms an important part of this objective.
- 3.2 The issue of consumer complaints needs to be dealt with at two levels. First, at the level of the firm, it is important that there are appropriate procedures to ensure that complaints are taken seriously and dealt with professionally and speedily. Responsibility for attempting to resolve complaints must rest in the first place with the credit union. That is what this chapter is about. Second, it is important that consumers can take their complaint to some external person if the firm fails to deal with the matter to their satisfaction. The involvement of credit unions in the Financial Ombudsman Service (FOS) is dealt with in the next chapter.

## The FSA's complaint procedure rules

- 3.3 The FSMA gives the FSA the power to make rules that require authorised firms to establish appropriate procedures for resolving complaints. We propose to provide a short set of complaints procedure rules specifically for credit unions, tailored to meet the needs of credit unions and their members, and we will publish these draft rules for consultation later this year as part of the draft Credit Unions Specialist Sourcebook
- 3.4 Credit union members will not be permitted to make a complaint to the FOS without first having exhausted the credit union's own internal complaints handling process.

## The meaning of 'complaint'

- 3.5 Those complaints which a firm must deal with under the complaint handling rules are any expression of dissatisfaction about any financial services activity provided or withheld by the firm. Complaints may be oral or written. This definition is wider than the definition of the complaints that can be taken to the FOS. (As explained below, only complaints involving allegations of financial loss, material inconvenience or distress can be considered by the Ombudsman.) We consider it important that a credit union deals properly with any reasonable complaints made by its members about its services, whatever the precise subject matter of the complaint.

## The general requirement

- 3.6 The FSA proposes to make a simple over-arching rule, requiring all authorised firms, including credit unions, to have in place appropriate and effective procedures for dealing with complaints.<sup>5</sup>
- 3.7 These procedures will have to be written down. A small number of specific rules will also be necessary to set out what the FSA sees as the minimum standards for an appropriate complaints procedure.

## Access

- 3.8 We propose to require credit unions to draw their new members' attention to the availability of the credit union's complaints procedures (including the credit union's membership of the FOS). We also intend to require that credit unions make their complaints procedure available quickly if requested, and as soon as they receive a complaint which cannot be resolved on the spot.
- 3.9 The general FSA requirement also stipulates that firms must publicise 'at the point of sale' the availability of their complaints procedures. We propose that credit unions should make details of their complaints procedure available to members at the credit union's registered office and at collection points.

## Handling

- 3.10 We propose to require that:
- credit union collectors and staff are made aware of the complaints procedure and that the credit union takes steps to ensure that they act in accordance with it;

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5 The proposed general rules state that compliance with British Standard 8600 'Complaints Management Systems – Guide to Design and Implementation' will be taken as tending to demonstrate compliance with the FSA's complaints handling requirements. Rather than using this general document as a guide for credit unions, we will produce a set of model procedures specifically designed for credit unions.

- appropriate management controls are maintained to ensure fair and consistent handling of complaints, and identification and remedying of problems;
- complaints are investigated quickly – wherever possible by a member of staff, or a member of the committee of management, not involved in the matter complained of; and
- that responses to complaints should adequately address the subject matter of the complaint and offer redress where appropriate.

### Time limits

- 3.11 We propose to require that complaints which cannot be resolved on the spot (i.e. by close of business the following day) should be acknowledged quickly in writing. If unresolved, credit unions will have a total of eight weeks from receipt of the complaint to produce a final response to the complaint. After this, if the complaint remains unresolved and it is a complaint which falls within the jurisdiction of the FOS, the complainant will have the right to refer it to them. The credit union must inform complainants of their right to refer their complaint to the FOS at the end of the eight week period, or sooner if they are not satisfied with the credit union's response.
- 3.12 We propose that there should be limits on the length of time that may elapse before a complainant makes a complaint to the FOS. We propose that, unless the Ombudsman considers that there are exceptional circumstances, complainants will be required to bring their complaints to the FOS within six months of the date when they received a final response from the credit union.
- 3.13 More generally, and in line with the general FSA proposals, we propose that there should be a maximum of six years between the time the event complained of occurred and the referring of a complaint to the FOS, or three years from when the complainant knows (or ought to have known) about the problem.

### Outcome

- 3.14 Where a credit union decides that a complaint is valid, we propose that it should offer the complainant an apology and, where appropriate, a suitable level of redress. If redress is accepted, the credit union should make that redress promptly. Where a credit union decides that a complaint is not valid, it must give reasons for reaching that decision.

### Keeping records

- 3.15 We propose to require credit unions to make adequate records of complaints and to keep them for a minimum of three years from the date of their final response to the complaint. These records should contain such matters as the

details of the complaint, any correspondence with the complainant, and any redress offered. This requirement only applies to complaints that fall within the scope of the FOS – that is, those which allege financial loss, material inconvenience or material distress (see paragraphs 4.5 – 4.7 below). These records will then be available to the FOS if necessary and for monitoring by the FSA.

### **Reporting requirements**

- 3.16 The FSA will need feedback on the number and nature of complaints and the length of time taken to resolve them. We propose therefore to include a reporting requirement in the rules. Credit unions would be required to report to the FSA periodically on the number of complaints received, the length of time taken to resolve them, and the outcome. Again this would only apply to the narrower meaning of complaint. We envisage this reporting requirement being co-ordinated with credit unions' general obligations to make regulatory returns. There will also be a requirement that the credit union provides the FSA with the name of a contact person in the credit union who has responsibility for complaints.

### **Co-operation with the Financial Ombudsman Service**

- 3.17 Credit unions, like other authorised firms, will be required to co-operate fully with the FOS in its investigation of complaints. This will include producing documents on request, complying with specified time limits, attending any hearings that may be required, etc. Firms will also be required to comply promptly with any decisions made by the FOS or settlements agreed.

Q4: The FSA would welcome your views on the proposed complaints handling procedures described in Chapter 3.

# 4 Credit unions and the Financial Ombudsman Service

## The Financial Ombudsman Service (FOS)

- 4.1 Part XVI of the FSMA provides for the establishment of a financial services ombudsman scheme. The FSA's proposals for the FOS were set out in *Consultation Paper 49 (CP49), Complaints handling arrangements* published in May 2000, and finalised in the Policy Statement on CP49 published in December 2000. The draft rules relating to funding arrangements for the scheme were published in *Consultation Paper 74 (CP74), Funding the Financial Ombudsman Service*, published in November 2000. The final funding rules (*Policy Statement on CP74*) will be published later this year.
- 4.2 The purpose of the FOS is to provide a mechanism for resolving disputes which will be a simple, informal and accessible alternative to the courts. The service will be provided free of charge to complainants. The FOS will be available to customers of all FSA-authorized firms who are private individuals or small businesses (unless they are classified as 'intermediate customers' or 'market counterparties').
- 4.3 The FSA has consulted on the proposition that, once the FSMA comes into force, authorised firms will be required to be covered by the FOS. In the FSA's view there is no reason to exclude credit unions. Accordingly, credit unions should be included in the compulsory jurisdiction of the FOS when they are brought within the terms of the FSMA in mid 2002.
- 4.4 We consider that the principle that financial services consumers should have access to an independent scheme for the simple and informal resolution of complaints applies as much for credit union members as it does for other consumers. Such access is necessary to ensure an appropriate level of consumer protection.
- 4.5 The general proposal is that the FOS should cover complaints against authorised firms which concern 'regulated activities' (e.g. taking deposits) and any activities covered by existing financial ombudsman schemes (e.g.

lending<sup>6</sup>). From a credit union perspective this will include complaints about matters arising out of their savings and lending activities as well as their current and future ancillary activities – for example a complaint that a member is being charged more than the agreed amount of interest on a loan, or a complaint arising from insurance the credit union arranged for its members.

- 4.6 The decisions of the FOS will be based on what is ‘fair and reasonable’ in all the circumstances, rather than on strict legal liability. These decisions will be binding on firms if a complainant accepts them. There will be a maximum binding award of £100,000, although it should be emphasised that any award would be proportionate to the loss or material distress suffered by the complainant. Given this proportionality, and the fact that individual savings and loans accounts with credit unions are considerably less than £100,000, we can not envisage a situation where a credit union would be subject to the maximum award.
- 4.7 A central component of the proposed scheme is that complaints should not come to the FOS unless:
- the complainant has attempted to get the firm to deal with the matter; and
  - the firm has failed to have it resolved to his/her satisfaction within a reasonable time.

As we have seen in Chapter 3, all firms subject to the FOS must have complaints handling procedures that comply with FSA rules.

- 4.8 Once a complaint is made to the FOS it will be dealt with in up to three stages:
- Conciliation – FOS staff will see if there is any reasonable prospect of resolving the dispute by reaching a settlement acceptable to both sides. Based on the experience of existing schemes, we expect that the majority of complaints can be resolved speedily in this way;
  - otherwise FOS staff will investigate the complaint. They will have power to require information from the complainant and the firm. They will issue an initial decision setting out a recommended outcome and the reasons for it. If both complainant and firm accept the initial decision, the complaint is resolved.

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6 Although it is not proposed that a permission will be required for lending activities (other than in the case of mortgage lending), this is an activity about which complaints can be made under the existing Building Societies Ombudsman and the Banking Ombudsman Scheme. Accordingly, complaints about lending activities, including credit union lending activities, will be covered by the FOS.

- If either party does not accept the initial decision, one of the ombudsmen will review the case and issue a final decision. If the complainant accepts the decision, it will bind both parties.
- 4.9 The FOS will have a power of ‘early termination’ for complaints that it considers ‘frivolous or vexatious’ (in other words, deliberately mischievous). This means that the FOS will be able to dismiss such cases without considering their merits. Other complaints that the FOS can dismiss without considering the merits include those where there has been no financial loss, material distress or material inconvenience, and those where the complaint is about a firm’s legitimate exercise of its commercial judgement – for example, the refusal to grant a loan.
- 4.10 The FOS is intended to be an alternative to the Courts. Credit unions and their members will still have the opportunity to pursue complaints through the Courts (in accordance with the provisions of the Friendly Societies Act 1992) if they prefer, though not if the consumer wants to use the FOS and the Ombudsman is willing to investigate. However, FOS will not accept cases that are, or have been, subject to legal action. Conversely, if a complainant is not happy with the decision of the FOS they can reject the decision and pursue the matter through Courts if they wish. However, the Courts would not take on a case where the Ombudsman’s decision had been accepted by the complainant.

## The funding of the FOS

- 4.11 The FOS will be funded by the firms that are covered by it.
- 4.12 For the first year of operation the FOS will fund 50% of its operating costs from the general levy (payable by all firms covered by the scheme) and 50% from case-related charges, by a combination of a general levy on all authorised firms and a case fee paid by firms in respect of each complaint against them handled by the FOS. However, the aim is to increase the ‘user pays’ element (i.e. the case-related charge) in the light of experience of the scheme.
- 4.13 The amount to be raised would be allocated between funding blocks in proportion to the workload that each funding block is expected to generate, and then within each funding block proportionately amongst individual firms.
- 4.14 The standard case fee will be calculated by dividing the amount to be raised from case fees by the number of chargeable cases the FOS expects to receive that year.
- 4.15 It is proposed that the standard case fee will be (initially at least) a flat rate charge for all members of the FOS. Case fees are expected to be collected monthly, in arrears.

- 4.16 We propose that, for general levy purposes, credit unions should be in their own separate industry funding block. The reasons for this are explained when considering the two options for how the costs could be levied on the credit union funding block, outlined below.

#### **Option A: the deposit-takers model**

- 4.17 Under this proposal, credit union would be charged on a similar basis to other deposit-takers (i.e. banks and building societies). There would be two types of payment – a general levy and a case-related charge.

##### General levy

- 4.18 All credit unions would be subject to a general levy. We propose that there should be a minimum levy, initially set at £50 (but subject to review in the light of the experience of the scheme) payable by all credit unions. Small credit unions (see paragraph 5.4) would pay no more than this. The remainder of the fees to be raised through the general levy would then be allocated amongst the remaining credit unions in proportion to their assets.
- 4.19 Until the FOS has sufficient experience of the number of cases credit unions are likely to generate, the Ombudsman will need to base its costs on an estimate of the number of complaints against credit unions he is likely to have to handle.
- 4.20 We expect that most of the amount to be raised by general levy will be met by the minimum fee. The amount that larger credit unions will be expected to pay in excess of the minimum fee is likely to represent only a small proportion of the total amount to be raised by the general levy.

##### Case related charge

- 4.21 We propose that credit unions paying only the minimum fee would be exempt from paying any additional case fees. All other credit unions would pay a case related charge for complaints against them handled by the Ombudsman. During the financial year 2002/03 the case related charge is expected to be between £330-£340.
- 4.22 Although similar to the funding arrangements for the deposit-takers contribution group, these proposals differ in two ways. Firstly, no other firms will potentially be exempt from a case related charge, regardless of their size. Secondly, the FOS will use number of accounts as a measure of size. All firms within a single contribution group must be levied on the same basis. It is therefore not possible to accommodate credit unions within the deposit-takers contribution group because of the special arrangements we are proposing.

## Option B: The pooling arrangement

- 4.23 The alternative option would be for credit unions to participate in the scheme on a 'pooled' basis.
- 4.24 Under the pooling arrangement, credit unions would pay a single levy based on the Scheme's actual experience over the previous year. The amount to be raised would relate directly to the actual cost of dealing with complaints about credit unions (i.e. the full unit cost of dealing with a complaint – currently estimated at £688 for the financial year 2002/03 – multiplied by the number of credit union complaints received). These costs would then be allocated proportionately between all credit unions in accordance with the number of accounts (i.e. members).<sup>7</sup> In other words, all charges would be raised by way of a general levy – there would be no case related charge.
- 4.25 Under option B it would still be necessary for smaller credit unions to pay a minimum fee. However, because no credit unions would be required to pay a case fee, larger credit unions should expect to pay a higher general levy under option B than under option A. On the other hand, the risk of incurring case fees would be eliminated.
- 4.26 At the moment it is very difficult to estimate the likely cost of option B to individual credit unions. If the total number of complaints received against credit unions is very low then it is potentially much cheaper than option A. However, as costs will fluctuate from year to year depending upon the number of complaints made against credit unions, it is not possible to provide assurances on costs as this would be entirely in the hands of the sector.
- 4.27 Therefore when considering the merits of option B, credit unions will, amongst other things, need to take a view on the level of cases the movement as a whole is likely to generate. They will also need to consider whether the advantage of not being subject to a case related charge outweighs the disadvantage of a potentially higher general levy for larger credit unions.

Q5: Do you think credit unions should meet the costs of funding their participation in the Financial Ombudsman Scheme through option A or option B?

## Start-up costs

- 4.28 It is intended that the start-up costs of the scheme should be distributed among participant firms in proportion to their annual levy over the first three

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<sup>7</sup> In order to borrow from a credit union an individual must be a member (i.e. have savings in the credit union). A borrower may not withdraw their savings whilst they are a net borrower. Because savings and loans are so inextricably linked, in the case of credit unions loans would not be categorised as separate accounts. In other words, the number of accounts will be the same as the number of members.

years of the scheme. Given the small amount of the annual levy that would be payable by credit unions on the above proposals, and the fact that start up costs would represent only a proportion of this, we do not consider that this is a significant factor.

# 5 Fees and charges

- 5.1 In *CP77 The Regulation of Credit Unions* we outlined the proposals for the new tariff structure for FSA regulatory fees. This current consultation paper outlines the proposals for meeting the costs of participation in the FSCS and the FOS.
- 5.2 Although we are working hard to ensure that regulatory costs are not unduly burdensome, we recognise that there is considerable unease among credit unions about the potential overall costs of the new regime.
- 5.3 The structure and level of fees payable for regulation by FSA, and the costs of participating in the compensation and complaints schemes, have not yet been determined for any of the firms the FSA will regulate. Until then we are not in a position to be able to provide credit unions with a definitive answer on how much it will all cost. However, it is possible at this stage to provide an indicator of what we are trying to achieve.
- 5.4 We hope that the total annual fees for small credit unions (i.e. the combined annual cost of regulation including membership of the FSCS and the FOS) will be no more than £200. We have not yet defined what we mean by small, but it could be around the £500,000 mark. For most credit unions, therefore, the costs would work out at no more than around £1 per member.
- 5.5 However, in respect of the FOS, if credit unions chose option B (i.e. the pooled arrangement) the charge might vary from year to year depending upon the number of complaints brought to the scheme. So it would not be possible to provide guarantees in respect of that share of the costs. And any levy in respect of a failed firm would be in addition to the FSCS share of the total.
- 5.6 Larger credit unions will be expected to pay more and, at the upper end of the spectrum, the largest credit unions will be expected to pay regulatory fees comparable to those paid by banks and building societies of a similar size.<sup>8</sup>

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<sup>8</sup> In the financial year 2001/2, the five smallest building societies will pay fees to the FSA averaging approximately £4,500 each, excluding fees to the Ombudsman and the Compensation Scheme.

- 5.7 For new applications, we are aiming to achieve an application fee for new credit unions subject to Version 1 requirements<sup>9</sup> of £500. This contrasts with the minimum fee of £2000 proposed for all other firms that the FSA will regulate. The FSA will need to consult on this proposal in due course as part of its main fees consultation.
- 5.8 For new credit unions wishing to start life as subject to Version 2 requirements<sup>9</sup> we consider that an application fee of £2,000 would be appropriate given the additional work this would involve for the FSA.

#### Post N2 / pre July 2002 costs

- 5.9 Presently the RFS uses a series of transaction-based fees to recover part of the costs of its activities. The remaining part of the costs is met by a subsidy from the government that will cease at N2.<sup>10</sup>
- 5.10 After N2, the cost of work we undertake in respect of firms which are not authorised under the FSMA will be allocated to a registrant only fee block. This will include credit unions, until such a time as they become authorised by the FSA (expected to be July 2002). The FSA will consult on the proposed registrant-only tariff in due course, but at this stage we do not expect that the fees for credit unions would be any greater than those they are likely to have to pay when they become authorised.

Q6: Do you have any comments on the fees and charges proposals?

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9 Details of the proposed Version 1 and Version 2 requirements are explained in *CP77: The Regulation of Credit Unions*.

10 At the present time N2 is expected to be no later than November 2001.

# 6 Costs and benefits

- 6.1 As explained in Chapter 1, the purpose of cost benefit analysis is to identify clearly the estimated costs of any proposals and analyse the benefits so that the two can be properly compared.
- 6.2 Detailed cost benefit analysis in respect of FSCS was published in *CP58: Financial Services Compensation Scheme Draft Rules* (July 2000), as was a detailed cost benefit analysis in respect of the FOS in *Consultation Paper 49 (CP49), Complaints handling arrangements* (May 2000). This chapter discusses the costs and benefits of bringing credit unions within the two schemes.
- 6.3 At this stage, the analysis contains only a general indication of the nature and scale of most of the costs involved, rather than numerical estimates. As such, it does not constitute a cost benefit analysis of the form required by the FSMA when the FSA consults on the draft text of proposed rules. We nevertheless believe that it is useful to publish the analysis here to inform the discussion of the policy options.
- 6.4 It is important to note that in carrying out cost benefit analysis the costs and benefits to a particular sector – for example the credit union sector – need to be balanced against costs and benefits to other sectors of the economy to assess the overall impact on the economy as a whole. For example, the fact that firms might have to pay consumers a certain amount of money under the proposed compensation scheme would be a cost to those firms. However, it would be balanced by an equal benefit to the consumers receiving the money. This means that for the purposes of cost benefit analysis, such payments are ‘neutral’ events. On the other hand, if firms would have to pay so much money under a proposed scheme that many of them would not be able to afford it and would go out of business, then that would clearly be a ‘cost’ to be taken into account.

## Credit unions and the Financial Services Compensation Scheme

### The costs

- 6.5 In light of the previous paragraphs, we can say that the main potential costs associated with our proposals for including credit unions in the FSCS are (a) the overall administrative costs of including credit unions in the scheme, (b) the risk of 'market distortions' arising from the reduction in consumer risk, and (c) the risk of undue impact on the credit union sector arising from their participation in the scheme.
- 6.6 **Administrative costs.** A feature of the credit union sector is that it consists of a relatively large number of firms (approx 680), many of which are very small. There will therefore be a need to collect base cost levies and claims-related contributions from a large number of firms. In many cases the amounts involved are likely to be very small, making their collection potentially problematic and disproportionately costly. We are considering ways of addressing this issue – for example the possibility of a de minimis fee.
- 6.7 A further type of administrative cost is that associated with processing the additional claims for compensation that may arise from credit union involvement. The average number of members per credit union is roughly 380. We have little reliable data on credit union failures. However the information we have does not lead us to expect there to be many failures in future. There are therefore unlikely to be a large number of additional claims.
- 6.8 **Market distortions.** Providing 100% compensation for the first £2,000 of a person's savings with a firm and 90% for the following £33,000 can be argued to carry risks of market distortion. Does this approach, for example, reduce too much the need for consumers to take responsibility for their choices about which firms to place their money with? Does it allow managers to operate on the basis that if things go wrong the resulting damage to consumers will be very limited?
- 6.9 These questions can of course be asked in relation to all firms and not just credit unions. The FSA considers that in general terms these arguments are not persuasive. Ordinary consumers can only be expected to be able to make material distinctions between regulated firms to a limited extent. Moreover, research carried out by the FSA suggests that consumers' general awareness of compensation arrangements is low. This research suggests that such arrangements are not a factor to which consumers attach much significance when they make savings and other financial decisions.
- 6.10 This issue is considered in detail in *CP58: Financial Services Compensation Scheme Draft Rules* (July 2000). The analysis in that paper concludes that

providing this level of consumer protection gives rise to no real risk of market distortion. We do not consider that there are any material differences in this regard between credit unions and deposit taking firms generally.

- 6.11 **Risk of undue impact on the credit union sector.** As mentioned above, the fact that under the scheme credit unions might have to make contributions towards compensating customers of failed firms and that banks and building societies might have to do the same for credit union members is, for cost benefit analysis purposes, a neutral event. This is because it is balanced by equal benefits to the customers who receive the money. Such payments would only be considered to give rise to a net cost if they threatened the viability of firms.
- 6.12 We have considered above some of the possible impacts on the credit union sector of credit unions being members of the general deposit takers' contribution group within the compensation scheme. Membership of the group is unlikely to give rise to significant costs to the credit union sector.

#### The benefits

- 6.13 As mentioned previously, consumer protection is one of the FSA's statutory objectives. We consider an essential component of consumer protection is securing an appropriate level of compensation if a firm fails. This is particularly the case for those consumers who are least able to sustain financial loss.
- 6.14 The impact of losing money on any consumer as a result of a firm's failure may be severe. But where this money represents a significant part or all of their savings it is likely to be particularly so. By extension, the benefits of protecting such consumers against losses are also particularly high.
- 6.15 As that the credit union sector has had a traditional commitment to confronting the problem of financial exclusion, it is likely to have a higher proportion of customers who fall into this category than other firms. This suggests that there are substantial benefits to be derived from including credit unions in the compensation scheme.
- 6.16 We consider that a healthy credit union sector is important to facilitate competition in the personal savings and loans market. Consumer confidence is an essential factor in ensuring the health of this sector. Credit unions' membership of the FSCS is, in our view, likely to lead to increased levels of consumer confidence.

#### The conclusion

- 6.17 It is our view, on the basis of the above, that the benefits of including credit unions in the FSCS considerably outweigh the estimated costs.

## Credit unions and the complaints handling rules

- 6.18 There are two types of cost likely to be incurred by credit unions when complying with the proposed new rules. First, the one-off costs of establishing the necessary procedures, and second, the ongoing costs of operating those procedures.

### One-off costs

- 6.19 Currently credit union model rules state that parties to a dispute within a credit union may, in accordance with section 83 of the Friendly Societies Act 1992, refer the matter to the County Court, or in Scotland to the Sheriff, for determination. We are not aware of many credit unions which have supplemented this provision with their own internal complaints handling procedures.
- 6.20 The aggregate costs involved, therefore, if each credit union had to develop its own individual set of complaints handling procedures would be likely to be relatively large.
- 6.21 We intend to devise a set of model procedures which credit unions can use to comply with the new rules (these will be included for consultation in the draft Credit Unions Specialist Sourcebook due to be published later this year). This would reduce to a minimum the cost to the sector of developing the new procedures.

### Ongoing costs of compliance

- 6.22 The ongoing costs of implementing the proposed new rules can be represented by the following formula:

$$\text{Number of complaints} \times \text{Number of staff/volunteer hours to deal with a complaint} \times \text{Cost per hour of person handling a complaint}^{11}$$

- 6.23 Assessing the likely costs of requiring credit unions to comply with the proposed complaints handling rules is difficult. We do not know how many complaints are currently made by members of credit unions. We therefore do not know to what extent having to comply with the proposed rules would give rise to additional costs on an ongoing basis.

### The benefits

- 6.24 In our view there are considerable benefits to be derived from requiring credit unions to comply with the proposed complaints handling rules. It is an important part of consumer protection that firms consider complaints quickly and properly.

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11 Where the person handling the complaint is not a paid employee, an estimate of the costs can be obtained by using the national minimum wage.

- 6.25 It is easy for consumers to feel they are powerless and unlikely to be heard by the firms they deal with. This can result from a perception that theirs is only one small voice and the firm will not bother to listen to them, a feeling that they do not understand the issues as well as the firm does, and concerns about appearing foolish. In the financial services context, where consumers have particularly important interests at stake, it is especially important that such reasons should not prevent consumers from voicing concerns and dissatisfaction.
- 6.26 Although it may be argued that the cooperative nature of credit unions makes it less likely that problems will arise, it remains the case that credit unions are financial businesses and that the interests of the credit union and of an individual member will often be different. It also remains the fact that members will often have significant financial interests at stake.
- 6.27 A further benefit of requiring credit unions to comply with complaints procedure rules is related to credit union participation in the FOS. If it is desirable for credit union members to have access to that service, then it is important that credit unions have proper complaints procedures in place which must be exhausted the FOS can consider a complaint. This process is necessary to avoid the danger of the FOS being abused by complainants and credit unions having to pay an unduly high levy.

#### The conclusion

- 6.28 Although we are not yet able to make a firm estimate of the costs involved in implementing these rules, it is our view that the benefits of these rules will be high and likely to outweigh the costs involved.

## Credit unions and the Financial Ombudsman Service

#### The costs

- 6.29 The costs of bringing credit unions within the FOS will essentially be the administrative costs of dealing with claims from the credit union sector.
- 6.30 Because credit unions have not been part of an ombudsman scheme up to now, it is difficult to assess the likely numbers of complaints from credit union members to the FOS. We think that, at least in the short term, the number is likely to be relatively low. This is because of the mutual co-operative nature of the credit union sector, the limited range of activities that credit unions can currently undertake, and the fact that the FOS can only hear complaints about services rather than membership issues.

- 6.31 The estimated full unit cost of handling a complaint for the financial year 2002/03 is £688. Supposing, however, that over a year there was as much as one complaint to the FOS for every 10 credit unions, this would give rise to a total cost for credit union participation of £46,784 (approximately 16 pence per credit union member).

#### The benefits

- 6.32 For the same reasons discussed above in relation to the benefits of applying the complaints handling rules to credit unions, we consider that there are significant benefits attached to giving credit union members the ability to take their complaints to the FOS. In particular, given the important financial interests that can be at stake for such consumers, and the likelihood that taking the matter to court will not usually be a realistic option, we believe it is very important that credit union members have access to a quick, cheap and informal mechanism for resolving disputes.
- 6.33 It could be argued that members of credit unions are disadvantaged presently by not having the same right of recourse as customers of other financial firms. By having access to the FOS, members of credit unions will have the same status as other consumers which, we consider, should enhance the reputation of credit unions.

#### The conclusion

- 6.34 In view of the relatively low costs likely to be attached to credit union inclusion in the FOS and the considerable benefits that flow from such membership, it is our view that the benefits of this proposal significantly outweigh the costs.

# 7 Summary of questions

- Q1: Do you agree that credit unions should be included in the deposit-takers contribution group?
- Q2: Do you agree with the proposal that the deposits of directors and managers, and their close relatives, should be protected?
- Q3: Do you agree that credit unions' deposits with other firms should be protected?
- Q4: The FSA would welcome your views on the proposed complaints handling procedures described in Chapter 3.
- Q5: Do you think credit unions should meet the costs of funding their participation in the Financial Ombudsman Scheme through option A or option B?
- Q6: Do you have any comments on the fees and charges proposals?