

# Credit unions



## Changes affecting your credit union under the Legislative Reform Order

This factsheet is for you if:

- you are a credit union

Here, we summarise what credit unions considering taking advantage of the new provisions under this new legislation should take into account.

The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 (LRO), commencing on 8 January 2012, introduces some significant changes to the scope of activities that credit unions in Great Britain can carry out. (The LRO does not apply to credit unions in Northern Ireland.)

### Considerations for all credit unions

While the LRO allows credit unions to significantly widen the scope of their activities, there is no compulsion for them to do so. Provided they are compliant with the law and with FSA rules, credit unions can continue to operate with no changes after the LRO's implementation, with one exception – the need for member loan agreements to set out the extent to which shares will be attached.

**So, the section in this factsheet on attachment of shares applies to all credit unions in Great Britain, even if they do not want to take up any of the new provisions in the LRO.**

Before making any changes and beginning new activities following the implementation of the LRO, credit unions should ensure that they have amended their business plans and have in place an appropriately strengthened infrastructure of procedures and risk management controls. Credit unions should also consider whether increases in financial and human resources are necessary for them to carry out any new activities effectively.

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### Registering rules

Under Section 10 of the Industrial and Provident Societies Act 1965, no amendment of rules is valid until registered by the FSA. So a credit union must register amendments to its rules, appropriate to its revised activities, **before** it can begin to carry out the new activities provided for in the LRO.

The LRO sets out where rules **must** be changed to reflect a credit union's new activities. With other activities, a credit union should consider whether it is appropriate to change its rules.

#### How do we register the changes?

We have produced a separate [factsheet](#) on registering rule changes post-LRO.

Registering rule changes requires credit unions to submit a completed Mutual societies application form.

#### Statutory declarations

A statutory declaration is a legal document whereby a credit union confirms that any new common bond complies with the conditions specified by the LRO for this purpose.

A statutory declaration is required if a credit union is applying for a complete amendment of its rules, or a partial amendment of rules involving a common bond change. The statutory declaration forms part of the Mutual societies application form.

#### What will be deemed a suitable statutory declaration to submit to the FSA?

We will accept a statutory declaration which should be signed by three members and the secretary of the credit union. We will generally accept a statutory declaration if the wording of the credit union's membership rules directly follows the wording of a common bond from the Credit Unions Act 1979.

We will not be responsible for checking a membership rule before the credit union submits the formal application. It is the responsibility of the credit union to devise a compliant rule and decide whether to support it by a statutory declaration.

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### Attachment of shares – applicable to all credit unions

The LRO clarifies the position in relation to the attachment of shares so all credit unions, regardless of whether they are choosing to take up options under the LRO, should be aware of this.

#### What do we mean by attached shares?

Attached shares are shares which cannot be withdrawn because the credit union member has an outstanding loan in excess of his/her shareholding.

#### Are attached shares the same as secured loans?

No. The fact that shares are attached does not convert an unsecured loan into a secured loan. A loan may only be secured on shares if the member makes an application and has shares equal to or greater than the loan, and is not allowed to withdraw those shares in any circumstances.

#### Before the LRO

Before the LRO, attached shares could only be withdrawn at the discretion of the credit union by following an internal

policy. For example, a member with a loan of £1,000 and £1,500 in shares could freely withdraw £500, but the rest of the share amount could only be withdrawn at the discretion of the relevant committee, or in line with internal procedures.

#### What does the LRO require of all credit unions regarding attachment of shares?

Now the LRO is implemented, credit unions should clearly set out, in each new loan agreement, the extent to which shares will be attached. Credit unions are able to set out how this will be done in several ways, including specifying the monetary value or the proportion of shares to be attached, or by treating different shares accounts held by the member in different ways. The term in a loan agreement identifying which shares are unattached (withdrawable) and which are attached (non-withdrawable) for the duration of the loan may be varied in line with contract law.

The new requirement relating to the attachment of shares do not

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apply to any outstanding loans that may have been made to a member before the LRO legislation came into force ie before 8 January 2012.

### What should the loan agreement include?

- all loan agreements must include a term identifying which of the member's shares can be withdrawn and the amount that is attached;
- the loan agreement may break down the attached shares in different ways, including stating which accounts the funds are held in, or stating whether they are below a specific amount or proportion of the member's shareholding or outstanding balance; and
- the agreement should make clear the shares already held by the credit union and state the date of the agreement and the treatment of shares received after that date.

### What should credit unions do to make sure a robust policy is in place for dealing with attached shares?

- Credit unions will need to devise policies covering the terms appearing in loan agreements for unsecured loans, and the procedures that should be followed when considering whether to vary an agreement; and
- they will need systems capable of identifying at all times whether individual shares are either withdrawable or non-withdrawable, as this will feed into a number of other areas including the calculation of arrears provision requirements and the assessment of large exposures.

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## Common bond

### Membership

#### What are the member restrictions for a credit union's registered rules?

A credit union's registered rules must restrict membership to persons or corporates who fall within one or more of the following common bonds:

- following a particular occupation;
- being employed by a particular employer;
- residing or being employed in a particular locality;
- being a member of a bona fide organisation or being otherwise associated with other members of the society for a purpose other than that of forming a society to be registered as a credit union; and
- any other bond for the time being approved by the FSA.

#### What are the membership qualifications for individuals?

The membership qualification must be specific: the particular occupation, employer or locality must be specifically identified.

The qualification may be based on more than one common bond on the list. For example, a credit union may admit people following a certain occupation and those who live or work in a certain area.

It should be clear from the membership qualification in a credit union's registered rules whether or not a person qualifies for membership, and this should be possible without having to exercise too much judgement or thought on the matter.

#### What are the membership qualifications for corporate members?

A credit union may only admit corporate members if the membership qualification in its registered rules provides specifically for this. There are three types of corporate member which the LRO permits:

- a body corporate;
- a partner acting for a partnership; and
- an officer or member of the governing body acting for an unincorporated association.

It is possible for a credit union to frame its membership qualification in a way that permits other credit unions to join.

It should be made clear in the credit union's registered rules how a corporate member can demonstrate that they have met the common bond.

We have published example wording for common bonds. This should be available from credit union trade associations and is in the application pack for new credit unions.

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## Locality

### What are the requirements for a locality-based common bond?

The following requirements exist if a credit union has a locality-based common bond:

- the number of potential members must not exceed 2 million; and

- the credit union must be able to demonstrate that it can service its members and allow them to participate in votes, serve on its committee(s), and have access to all its services.

These conditions apply in full if any one of the credit union's common bonds includes a locality qualification.

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## Corporate members

### Loans to corporate members

#### What kind of requirements are there for providing loans to corporate members?

The LRO requires that a credit union:

- may only make a loan to a corporate member if its registered rules provide explicitly for this;
- cannot make a loan to a corporate member that holds only deferred shares; and
- cannot make a loan to a corporate member if it causes the aggregate of the outstanding balances on loans to corporate members to exceed 10% of the aggregate of the outstanding balances on all loans to members.

### Shareholding for corporate members

#### Is there a limit to the amount of shares a corporate member can hold, either deferred or non-deferred?

There is no limit on the number of deferred shares that may be allotted, or held, by corporate members, but the number of non-deferred shares allotted to corporate members must not exceed 25% of the total of non-deferred shares held by all members. The shareholding limit is based on the number of shares allotted, not the amount paid on shares. The total of non-deferred shares allotted to all members is set by the most recent year-end balance sheet submitted to the FSA.

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## Deferred shares

### What are deferred shares?

This is a share that does not have any rights to the assets of a company (in this case a credit union) undergoing bankruptcy until all common and preferred shareholders are paid. Deferred shares are not withdrawable.

A credit union issuing deferred shares should have procedures, and issue documentation to their recipients, setting out the rights and obligations of both the credit union and the member.

### Who may be issued a deferred share?

A credit union may only issue deferred shares to a corporate or individual member.

### Do they carry a vote?

Deferred shares carry the right to vote but both the credit union and the recipient of the deferred share should bear in mind the 'one member one vote' system.

### Can deferred shares be used to borrow?

Members cannot borrow on the strength of their deferred shareholding.

### How can you include deferred shares towards your capital requirement?

If a member subscribes for deferred shares, the credit union must transfer an equivalent amount to its reserves.

### Are deferred shares transferable?

Deferred shares are transferable from one member to another.

### When can deferred shares be repaid?

Deferred shares can only be repaid in two cases. In case A all other creditors must have been paid first, including holders of subordinated debt. In case B we must consent to the repayment

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of the shares. This is to ensure that repayment only takes place when it is entirely in the interests of the credit union's members.

Deferred shares are not covered by the Financial Services Compensation Scheme (FSCS). So it is very important that share

issue documentation given to members about deferred shares prominently explains that deferred shares are not covered by the FSCS. This should be made abundantly clear to members considering purchasing them.

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## Interest bearing shares

### What are interest bearing shares?

Interest bearing shares give the member the right to a contractual rate of interest – regardless of the profits of a credit union – but no right to a dividend from profits.

### What conditions must be met before issuing interest bearing shares?

Before issuing interest bearing shares the credit union must check that its registered rules allow this and that the credit union has submitted annual audited accounts to the FSA showing that it holds reserves of at least the higher of £50,000 or 5% of total assets.

These minimum reserves are required by the LRO. It is important to note that reserves are not the same as regulatory capital and subordinated loans and provisions for bad debt will not count towards the reserves figure.

It is also very important, before issuing interest-bearing shares, that the credit union has secured its auditor's confirmation that:

- The credit union operates an accruals-based accounting system, which properly accrues expenditure and interest payable for the purpose of the credit union's interim, unaudited accounts, and management information;
- The credit union has a business plan that has been prepared with due care and reviewed and approved by the committee

of management, which demonstrates that the credit union will have adequate financial resources to:

- o meet its obligations to pay all interest due in respect of shares it has issued for the foreseeable future;
  - o maintain reserves equal to or greater than the amount specified in section 7A(1)(b) of the 1979 Act; and
  - o maintain any capital/assets ratio required by the rules set out in CREDS.
- The business plan:
    - o results from an appropriate process of development;
    - o is based on reasonable assumptions, including the level of bad and doubtful debt;
    - o includes the provisioning necessary to comply with the rules set out in CREDS;
    - o has been subject to a relevant sensitivity analysis; and
    - o incorporates safety margins that are sufficient to enable the credit union to maintain adequate financial resources in all reasonably foreseeable circumstances.
  - The credit union has in place a system that provides for monitoring performance against the business plan, and making changes to that plan to ensure that the credit union continues to meet the criteria.

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## Dividends

The LRO removes the limit on the annual dividend rate payable on shares, unless the credit union is closing, in which case the dividend is limited to 8% (or whatever rate is specified by Treasury order). This is to prevent a credit union from circumventing the requirement that any surplus remaining on termination must be

transferred to another credit union or used for a charitable purpose.

Despite there no longer being a limit on dividend rates, credit

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unions should nevertheless ensure that any dividend awarded is prudent and commensurate with its financial position.

Moreover, if a credit union's registered rules state a maximum percentage dividend, this will continue to apply unless or until alternative rules are registered.

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## Fees for ancillary services

### What type of services can a credit union charge for?

The LRO permits credit unions to charge – more than an amount for cost recovery – for providing services which are ancillary to accepting a deposit or making a loan.

The following are examples of an ancillary service:

- making or receiving payment (via standing order or otherwise);
- issuing and administering the means of payment (via cheque books and debit cards);

- money transmission services; and
- giving advice on the above.

Members joining the credit union from now can be charged an appropriate fee for ancillary services, above the cost of providing it. Existing members (members as at the start date of the LRO – 8 January 2012) may only be charged the cost of providing the ancillary service.

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## Juvenile members

### What are Juvenile deposits?

Juvenile deposits are deposits from people who according to membership rules are too young to be full members.

Previously, only people over the age of 16 could be members of a credit union and only persons over 18 could be a member of the Committee or Board or hold any other formal office.

Since the LRO, people under 16 can become full members of a credit union and persons over 16 can become a member of the Committee or Board. However, this is subject to the credit

union's rules reflecting this – if the rules continue to state that no person under the age of 16 may become a member then the provisions in the LRO will not over-ride this.

### Can the credit union pay interest on juvenile deposits?

The credit union can pay interest on juvenile deposits but not a dividend.

### Can the credit union issue shares to juvenile depositors?

The credit union cannot issue shares to juvenile depositors nor do they have the right to vote.

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## Non-qualifying members

### What is a non-qualifying member?

A non-qualifying member is a member (either an individual or a corporate) who was eligible for membership when joining the credit union, but subsequently ceased to qualify, for example because they moved to a location not covered by the credit union's common bond.

### What restrictions are there surrounding non-qualifying members?

Previously, credit union legislation placed a 10% of total membership limit on the number of non-qualifying members. The LRO removes this restriction. However, if the

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credit union's rules state a maximum percentage on the number of non-qualifying members, this will continue to apply unless or until alternative rules are registered.

A credit union's registered rules can restrict the entitlement of non-qualifying members to its services and place a limit on the number of non-qualifying members permitted.

Where there are no restrictions in the credit union's registered rules, non-qualifying members retain full rights to all membership services and there will be no limit on the number of non-qualifying members permitted.

### Regulatory reporting

You may need to complete details of non-qualifying members

on the Supplementary Sheet for regulatory returns – please see the 'Notifications and Supplementary Sheets to Regulatory Returns' section below.

### What about corporate partners acting for a partnership?

Where the corporate member is a partner acting for a partnership, then they would also cease to qualify if they stopped being a partner in the partnership.

### What about officers and members of governing bodies?

Where the corporate member is an officer or member of the governing body acting for an unincorporated association, then the corporate member would cease to qualify if the officer or member ceased to hold office in the unincorporated association.

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## Notifications and supplementary sheets to regulatory returns

### Notification

When a credit union intends to begin certain of the new activities permitted by the LRO, it must notify us. It is important to be aware that this notification is separate to the registration of rules.

Failure to notify us could result in inaccurate regulatory reports being submitted to us.

Our **Notification Form** for credit unions helps you do this. If you choose to use the form, it should be completed and submitted to the FSA at the point the credit union actually begins conducting the activities (or just before it does so).

### Supplementary sheets to quarterly and annual returns

A credit union is required to submit a supplementary sheet along with its quarterly (Form CQ) and annual (Form CY) regulatory returns once it has begun the following new activities permitted by the LRO:

- admitting corporate members;

- issuing deferred shares; and
- issuing interest-bearing shares.

**See Annex D of Policy Statement 10/11**

### Proportion of non-qualifying members

If **any** credit union's rules – irrespective of whether they are undertaking the three activities listed above – stipulate a limit on the percentage of non-qualifying members, this should also be reported on the Supplementary Sheet **for the annual return (Form CY)**. This is not required for the quarterly return (Form CQ).

To be clear, a credit union that is not changing its rules as a result of the LRO would still need to complete and return a Supplementary Sheet with its Form CY if its rules include a limit on non-qualifying members.

We have produced a **separate factsheet** on this new regulatory reporting.

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