Research and Library Services

Northern Ireland Assembly

Research Paper 118/08 **November 2008**

FINANCIAL INCLUSION, CREDIT UNIONS & HM TREASURY LATEST PROPOSALS FOR CREDIT UNION REFORM

This paper provides an outline of the HM Treasury Financial Inclusion Strategy as it applies to credit unions and an overview of the HM Treasury's latest position on credit union reform, drawn from the consultation document 'Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain'.

SUMMARY OF KEY POINTS

This paper provides an outline of the HM Treasury Financial Inclusion Strategy as it applies to credit unions, as well as an update on the strategy's progress.

The second part of the paper presents an overview of the HM Treasury's latest proposals for credit union reform drawn from the consultation document 'Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain'.

The paper acts as a compliment to already existing research into possible credit union reform in Northern Ireland.

FINANCIAL INCLUSION STRATEGY

The Financial Inclusion Strategy sets out steps for *ensuring everyone has access to appropriate financial services*, in three areas:

- day-to-day money management;
- planning for the future and coping with financial pressure; and
- the effective treatment of financial distress

Maximising the role credit unions play in the above is seen to depend *upon extending their coverage and capacity, and providing greater access to the affordable credit they supply.*

The document outlines steps to achieve this expansion; the steps fall into two broad areas of action – the dissemination of growth funding and a review of mutuals legislation.

Growth fund allocation has been recommended in three areas: supporting third sector lender growth in areas lacking affordable credit; expanding credit unions' transactional banking capabilities; and investment in the skills of third sector lender staff.

To date the fund has contributed over £40m to third sector lenders, supporting 46,500 individual loans totalling £20.4m. However, some gaps in the strategy's progress have been identified, namely:

- a total of 81 local authority areas (in England, Scotland and Wales) with a high demand for, but little supply of third sector lending (equivalent to 25 "red alert" areas and 56 "amber" areas);
- an estimated nationwide demand for affordable credit from excluded persons totalling £1.2bn per annum.

As such, further targets have been set for the period 2008-2011:

- an extension coverage to 25 "red alert" areas:
- an increase of capacity to double Growth Fund levels;
- £60 million per annum to be lent to 150,000 financially excluded clients per year by 2011; and

- a widening of the opportunities for commercial financing, to support credit union and Community Development Finance Institution lending to the financially excluded.

The financial inclusion strategy recommended **legislative review** in the following areas:

- the "common bond" restrictions that define the geographical areas in which credit unions can operate;
- whether to allow credit unions to accept corporate deposits; and
- the impact of allowing credit unions to create subsidiaries on reducing risk and facilitating product innovation.

To date, the consultation process on this review has led to the publication of a further HM treasury consultation – proposals for a legislative reform order for credit unions and industrial & provident societies in Great Britain. The closing date for responses to this document was 15 October 2008

PROPOSALS FOR A LEGISLATIVE REFORM ORDER FOR CREDIT UNIONS AND INDUSTRIAL & PROVIDENT SOCIETIES IN GREAT BRITAIN

The Treasury's proposals are intended to modernise and liberalise the credit union movement in Great Britain.

The Treasury argues that current legislation is not applicable to the running of *modern* organisations. The same legislation places restrictions on the operations of credit unions, which inhibit their operational effectiveness, the provision and flexibility of services to members, as well as their ability to deal with other corporate bodies.

To reduce the legislative burden eight proposals in relation to credit unions have been put forward:

- **Proposal B1: Replace the "common bond" requirement for credit unions with a "field of membership" test.** Amendment of the legislation to replace the common bond will, it is believed, lessen financial costs and administrative inconvenience, as well as removing obstacles to efficiency, productivity, and profitability.

- **Proposal B2: Reform the requirements relating to membership qualifications and rename them "common bonds".** The amendments under this proposal will remove the limits enforced upon membership qualifications, which are deemed to be detrimental to productivity, innovation, mergers, and efficient administration.

- **Proposal B3: Reform the restrictions on non-qualifying members of credit unions.** This proposal will remove the 10 percent limit on the number of non-qualifying members, allowing credit unions to set their own limits in this area, improving productivity and profitability.

- **Proposal B4: Allow credit unions to admit bodies corporate, unincorporated associations or partnerships to membership.** Amending the legislation in this area will bring economic and social benefits to corporate/unincorporated bodies, credit unions and their members. The current legislation also negatively affects the profitability of the credit union and the long-term stability of its balance sheet. This proposal will also introduce interest bearing shares, to be issued to corporate bodies only.

- **Proposal B5: Allow credit unions to offer interest on deposits, provided certain requirements are met**. A credit union’s inability to offer interest on deposits limits their ability to attract members. This is deemed to constitute an obstacle to productivity and profitability.

- **Proposal B6: Abolish the 8 per cent per annum limit on dividends.** This proposal is designed to bring parity with banks and building societies.

- **Proposal B7: Repeal the “attachment” requirement, which restricts withdrawal of shares.** As above, this proposal is designed to bring parity with banks and building societies.

- **Proposal B8: Allow credit unions to charge the market rate for providing ancillary services to their members.** Again, this proposal is designed to bring parity with banks and building societies.

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1 INTRODUCTION

What follows is an overview of the UK government's ongoing process of credit union modernisation. It provides an overview of the parts of 2007 financial inclusion strategy relevant to credit unions and a progress update. The second part of the document focuses on the recently published *"Proposals for a legislative reform order for credit unions and industrial & provident societies in Great Britain"* using the document to present an account of the Treasury's current position on credit union reform.

2 FINANCIAL INCLUSION STRATEGY

The HM Treasury's 2007 document *Financial inclusion the way forward* defines the concept of financial inclusion as *ensuring everyone has access to appropriate financial services*, to the extent that they are able to:[1]

- manage their money on a day-to-day basis;
- plan for the future and cope with financial pressure;
- deal effectively with financial distress.

The document puts forward the argument that promotion of financial inclusion, via these three goals, will lead to *significantly improved life outcomes.* It is worthwhile to examine the three factors in more detail, before the role of third sector lenders in providing these goals is defined.

Effective day-to-day money management – central to this goal is increasing access to *transactional bank accounts* and instilling, within individuals, *the confidence to make full use of them.* The report notes that people who do not have bank accounts pay more for goods and services, and for accessing their money. It also stresses the centrality of transactional banking to the paying of utility bills, the cashing of cheques (for free) and the payment of wages.[2]

Planning for the future and coping with financial pressure – the report suggests access to affordable credit, savings and insurance products are key factors in determining an individual's ability to cope with financial pressure. All three are deemed to provide a financial buffer and to allow individuals to better cope with the pressure of expected or unexpected increases in outgoings. The report states that those without access to such products are more likely to be '*forced into using high-cost sources of lending… including home credit ("doorstep lending") or, worse, illegal loan sharks who use fear and intimidation to extort huge sums of money from their victims'.* As a result of these recognitions the following target was set: ***affordable credit, savings accounts and simple insurance products should be available to all who need them.***[3]

Dealing with financial difficulty and distress – financial difficulty and distress are defined as *'long-term sickness, unemployment or family breakdown'* leading to *over-indebtedness.* To aid those facing such problems the Treasury promotes the assistance of a *qualified money adviser* and the *provision of free face-to-face and telephone money advice.* Beyond advice, access to financial services (the already mentioned trio of credit, savings and insurance) is again held up as a *buffer against financial distress*.[4]

The Role of Third Sector lenders – at the time of its publication, the financial inclusion strategy noted a number of key developments in the promotion of *affordable third-sector lending,* including:

- a bespoke *light-touch regulatory framework for credit unions under the Financial Services Authority;* and
- the Department for Work and Pensions £36m *Growth Fund* (extended by a further £6m following the fund's early success) .

The strategy also outlines the *next steps for financial inclusion*. The steps applicable to credit unions were concerned with extending their coverage and capacity, and providing greater access to the affordable credit they supply. These steps are divided into two broad areas: the dissemination of the additional of growth funding; and a review of mutuals legislation.

Growth Fund – the financial inclusion strategy outlined the following destinations for the growth fund: [5]

- supporting new lenders in parts of the country where supply of third sector affordable credit is insufficient;
- supporting the emergence of new banking providers, through financial support for credit unions investing in transactional banking capability; and
- increasing investment in the skills of third sector lender staff and volunteers through a capacity-building programme.

Progress – the latest update (2008) from the Third Sector Credit Working Group of the Financial Inclusion Taskforce provides a progress report on Growth Fund dissemination and future plans. With regard to the Growth Fund's progress the report notes:[6]

- a government investment of over £40m in third sector lenders through the fund;
- growth fund support of 46,500 loans, totalling £20.4m since July 2006;
- 80% of loans were to low income customers in areas of high financial exclusion; and
- over two-thirds of lenders hitting targets for on-lending[7] and managing delinquency.

The report notes certain gaps in strategy's progress, namely:[8]

- a total of 81 local authority areas (in England, Scotland and Wales) with a high demand for, but, little supply of third sector lending (equivalent to 25 "red alert" areas and 56 "amber" areas);
- an estimated nationwide demand for affordable credit from excluded persons totalling £1,2bn per annum.

The working group's long-term vision is one of sustainable coverage in the estimated 200 local authority areas with an above average demand for affordable credit. To achieve this aim the working group have calculated that individual lenders will require a loan book of at least £2m per annum (equivalent to 5,000 loans a year), necessitating a minimum total capacity of £400m per annum (equivalent of 1,000,000 loans per year). The working group state that achieving these goals will take approximately ten-years. In the short-to-medium term, the working group has set the following targets, for the period 2008-2011:[9]

- extend coverage to the 25 "red alert" areas:
- increase capacity to double Growth Fund levels;
- £60 million per annum to be lent to 150,000 financially excluded clients per year by 2011; and
- widen the opportunities for commercial financing, to support credit union and Community Development Finance Institution lending to the financially excluded.

Review of Legislation – the financial inclusion document recommended review of third sector lending legislation in the following areas:[10]

- the "common bond" restrictions that define the geographical areas in which credit unions can operate;
- whether to allow credit unions to accept corporate deposits; and
- the impact of allowing credit unions to create subsidiaries on reducing risk and facilitating product innovation.

Progress – June 2007 saw the instigation of a consultation process, with the publication of the document "Review of the GB cooperative and credit union legislation: a consultation".[11] The consultation sought stakeholder input on the issues and led, ultimately, to the publication of the "HM treasury consultation – proposals for a legislative reform order for credit unions and industrial & provident societies in Great Britain".[12] A detailed overview of this latter document follows.

3 HM TREASURY CONSULTATION – PROPOSALS FOR A LEGISLATIVE REFORM ORDER FOR CREDIT UNIONS AND INDUSTRIAL & PROVIDENT SOCIETIES IN GREAT BRITAIN

Published July 23, 2008, the latest HM Treasury consultation on credit unions sets out to reform existing legislation, which is deemed detrimental to a credit union's *"ability to serve their members and to help in the delivery of government programmes such as financial inclusion"*.[13]

The Treasury argues that current legislation is not applicable to the running of *modern* organisations. The same legislation places restrictions on the operations of credit unions, which inhibit their operational effectiveness, the provision and flexibility of the services offered to their members, as well as their ability to deal with other corporate bodies.[14]

The proposed reforms are intended to remove administrative burdens on credit unions, allowing them, with the consent of their members, to change their rules including those defining who may become a member and on what terms. The intention is to open up membership to a wider range of individuals and groups. The changes should also allow credit unions to offer a wider range of products to members, including interest bearing shares.[15]

3.1 PROPOSALS

The eight proposals suggested by the Treasury are as follows:[16]

- **Proposal B1:** Replace the "common bond" requirement for credit unions with a "field of membership" test.

- **Proposal B2:** Reform the requirements relating to membership qualifications and rename them "common bonds".
- **Proposal B3:** Reform the restrictions on non-qualifying members of credit unions.
- **Proposal B4:** Allow credit unions to admit bodies corporate, unincorporated associations or partnerships to membership.
- **Proposal B5:** Allow credit unions to offer interest on deposits, provided certain requirements are met.
- **Proposal B6:** Abolish the 8 per cent per annum limit on dividends.
- **Proposal B7:** Repeal the "attachment" requirement, which restricts withdrawal of shares.
- **Proposal B8:** Allow credit unions to charge the market rate for providing ancillary services to their members.

3.1A PROPOSAL B1: REPLACE THE "COMMON BOND" REQUIREMENT FOR CREDIT UNIONS WITH A "FIELD OF MEMBERSHIP" TEST.

Currently, membership is restricted on the basis of qualifications; as a consequence a "common bond" must exist between members. The Treasury argue that in contemporary society it is *increasingly difficult* to identify a common bond amongst people even if they live in the same area.[17]

As a result, the common bond is deemed to be a burden on the following grounds:[18]

- **Financial Cost:** current common bond arrangements cause the Financial Services Authority (FSA) to incur additional administrative costs, which are passed onto credit unions in the form of fees due to the FSA's full cost-recovery policy.

- **Administrative Inconvenience:** credit unions and those wishing to form a credit union encounter administrative inconvenience as they are required to demonstrate to the FSA that the current common bond test is satisfied.

- **Obstacle to Efficiency:** the current bond test is considered to negatively affect the FSA's efficiency as it is unclear in the current legislation how the FSA should apply the common bond test, or even what constitutes a "common bond".

- **Obstacle to Productivity:** current common bond rules are deemed to be detrimental to a credit union's ability to contribute to society's productivity as current restrictions may deter individuals or groups from forming credit unions or existing credit unions from merging. The knock-on effect is that credit unions may not maximise their contribution to local communities, particularly in the area of financial inclusion. Such restrictions are also deemed to prevent innovation (novel common bond types), competition, investment and enterprise.

- **Obstacle to Profitability:** as outlined above, common bond restrictions could prevent the merger of existing credit unions. This is considered an obstacle to profitability as it prevents credit unions from maximizing economies of scale.

The Treasury recommends the removal of the following statement from the Credit Union Act 1979: "*and that in consequence a common bond exists between members of the society"* (s1. [2] [b]). It is believed that such a move will *allow more* *combinations of membership qualifications, which could result in larger credit unions, which would be open to a larger section of the general public.*[19]

While the existing reference to common bond[20] is to be removed it will be replaced by a new "field of membership test", designed to keep the size of credit unions in check. Under this test the Authority (the FSA) will have to be satisfied that the field of potential members is appropriate to a credit union. In this sense:[21]

- A statutory declaration from three credit union members and its secretary stating that 100,000 members or less shall be considered by the Authority to be sufficient evidence of suitability;

- Where the field of potential members is greater than 100,000 but less than 1m, or 100,000 or less but no statutory declaration is given the credit union must demonstrate to the Authority that:

    - All members would be able to participate in the governance of the society;
    - The society would be able to service the needs of all members;
    - The field of potential members is less than 1m.

- Where the field of potential members exceeds 1m the credit union must demonstrate extraordinary circumstances to justify registration under the 1965 Act;

- The field of potential members shall be determined by reference to the proposed qualifications for admission to membership.

Whilst it is recognised that replacing the common bond with a new field of membership test will create new burdens, it is believed that the new burdens will be less than the existing burdens. A further disadvantage has been considered, namely "*reforms could result in larger and more diverse credit unions, which may lose some of their sense of identity and collective interest*". However, the Treasury is of the opinion that this disadvantage is outweighed by the perceived advantages.[22]

3.1B PROPOSAL B2: REFORM THE REQUIREMENTS RELATING TO MEMBERSHIP QUALIFICATIONS AND RENAME THE 'COMMON BONDS'

Currently, to register a credit union, the FSA must be satisfied the membership is restricted to persons who fill either one single combination of qualifications or a limited combination of qualifications. At present, the FSA must also be satisfied the existing common bond requirement is met.[23]

The Credit Union Act 1979, it in its present form, allows registration of credit unions meeting the qualification *"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"* (herein referred to as the *macro* qualification) along with one *other* qualification, i.e. following a particular qualification, residing in a particular location, working in a particular location etc.[24]

This particular configuration disallows certain combinations, namely: two *other* qualifications without the *macro* qualification; any qualification with an additional qualification approved by the FSA; more than two qualifications; and two specific qualifications under the same paragraph (residing in one of two particular locations for example).[25]

As with Proposal B1, the current legislation is deemed too restrictive, preventing further liberalisation of membership qualifications. It is also believed to be detrimental to productivity, innovation, mergers, and efficient administration.[26]

The Treasury proposes to replace references to "qualification for admission to membership" with a set of criteria to be referred to as a "common bond". Two possible "common bond" options have been proposed, these are:[27]

Option A: amendment of the 1979 Act to allow:

- Combinations of any two membership qualifications, including both the Macro and Other qualifications, and all possible configurations therein;

- Any combination of existing membership qualifications with any new criteria approved by the FSA;

- Combinations of any membership qualification with another qualification under the same provision (two specific locations of residence for example);

- Combinations of more than two qualifications (effectively easing the merger process).

Option B: amend the Act to allow a combination of any number of qualifications, from any category, without limitation.

3.1C PROPOSAL B3: REFORM RESTRICTIONS ON NON-QUALIFYING MEMBERS OF CREDIT UNIONS

The 1979 Act restricts the number of "non-qualifying" to 10 per cent of total membership, defining a non-qualifying member as one who ceases to fulfil the qualifications for membership. This, according to the Treasury, equates to an obstacle to productivity and profitability. The consultation proposes removal of the 10 per cent limit allowing credit unions to impose their own limits on non-qualifying members.[28]

3.1D PROPOSAL B4: ALLOW CREDIT UNIONS TO ADMIT CORPORATE, UNINCORPORATED ASSOCIATIONS OR PARTNERSHIPS TO MEMBERSHIP

The 1979 Act only permits individuals, who fulfil membership qualifications, to become members of credit unions. Preventing corporate bodies, partnerships and local community groups from joining credit unions acts as a bar to the economic and social benefits membership could bring to those bodies, credit unions themselves and their members. The current legislation also negatively affects the profitability of the credit union and the long-term stability of its balance sheet.[29]

To enable groups to join credit unions the following steps have been proposed;

- Repeal of prohibition on corporate membership in the Credit Union Act 1979;
- Allow unincorporated association and partnerships to become members of credit unions, if the rules so provide;

- Create a new class of deferred shares: bodies corporate will only be able to subscribe for deferred shares in a credit union.[30]

A statutory limit on the number of corporate members and the level of their deposits will be imposed. Therefore, the number of corporate members will not exceed 10 per cent of total membership, the number of shares allotted to them shall not exceed 25 per cent of the total and the aggregate of their loans will not exceed 10 per cent of the total.[31]

For unincorporated associations/partnerships to become members of a specific credit union it must be specified in that credit union's rules.[32]

Deferred shares will be introduced as a mechanism for bodies corporate to invest in a credit union, to give it support and strengthen its finances, without giving them excessive influences over the credit union by being able to withdraw their shares. Deferred shares will have the following characteristics:[33]

- They will only be issued to corporate members;
- They will be issued at a premium, or to be paid by premium;
- If issued at a premium, the premium must go into the credit union's reserves;
- Deferred shares will not be withdrawable, but will be transferable;
- The terms of issue must prohibit repayment of the principal paid on the shares to the shareholders unless;
    - The credit union is wound up or dissolved, or
    - The FSA has consented to repayment.
- Documents relating to the shares must bear a prominent statement that the shares are deferred shares and are not protected investments for the Financial Services Compensation Scheme.

3.1E PROPOSAL B5: ALLOW CREDIT UNIONS TO OFFER INTEREST ON DEPOSITS PROVIDED CERTAIN REQUIREMENTS ARE MET

Currently credit unions cannot offer interest on members' deposits, limiting their ability to attract members. This is deemed to constitute an obstacle to productivity and profitability.[34]

To remove these burdens the insertion of a provision into the 1979 Act, to provide expressly that credit unions may offer interest on shares, is proposed, subject to the following safeguards[35]:

- The credit union will be required to hold reserves of £50,000, or 5 per cent of its total assets, whichever is higher. The FSA must receive an audited balance at the end of each year;

- The credit union must demonstrate that is has adequate systems of control in place to manage the greater risk of offering interest.

- Individual credit unions could continue to offer dividends on shares instead of interest, or they could offer a choice between dividend-bearing and interest-bearing shares. Interest-bearing shares, offering a dividend, will be prohibited.

3.1F PROPOSAL B6: ABOLISH THE 8 PER CENT PER ANNUM LIMIT ON DIVIDENDS

The 1979 Act prevents credit unions from paying a dividend in excess of 8 per cent per annum. This limits productivity as it prevents innovation and limits the range of savings products on offer. A proposal to repeal section 14(4) of the Credit Unions Act 1979 which sets the 8 per cent limit has been suggested as a remedy by the Treasury. This will effectively enable credit unions to offer savings products similar to banks and building societies who can offer an interest rate of over 8 per cent.[36]

3.1G PROPOSAL B7: REPEAL THE "ATTACHMENT" REQUIREMENT, WHICH RESTRICTS WITHDRAWAL OF SHARES

A member of a credit union currently requires the permission of the committee of the credit union to withdraw their shares. A member with a secured loan is prohibited from making a withdrawal. This prevents members with loans withdrawing shares in the way in which bank or building society members in similar circumstances can.[37]

To enable parity, section 7(5) of the 1979 Act will be amended to the effect that permission from the committee will not be required for such withdrawals.[38]

3.1H PROPOSAL B8: ALLOW CREDIT UNIONS TO CHARGE THE MARKET RATE FOR PROVIDING ANCILLARY SERVICES

Under the current legislation, credit unions may only charge on a cost-recovery basis for services which are ancillary to accepting a deposit or making a loan, such as issuing cheque books or transferring money. As with Proposal B7, rectifying this situation will bring about parity with banks and building societies, and remove a perceived obstacle to profitability. This will be brought into actuality by amending Section 9A of the 1979 Act which provides that a credit union may charge a fee "to cover a cost of" providing ancillary services. Such an amendment will allow credit unions to charge such a fee as it considers necessary, for providing ancillary services.[39]

3.1I IMPLEMENTATION

The closing date for responses to the consultation document was 15 October 2008. Subject to this response and parliamentary approval the necessary changes to the Credit Union Act (1979) are timetabled for October 2009. This date has been chosen to allow the FSA sufficient time to update the Credit Union Handbook.

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[1] HM Treasury – Financial inclusion the way forward, 2007 http://www.hm-treasury.gov.uk/d/financial_inclusion030407.pdf
[2] HM Treasury – Financial inclusion the way forward, 2007 http://www.hm-treasury.gov.uk/d/financial_inclusion030407.pdf
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[7] On-lending: an accounting term for re-lending
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[9] The Financial Inclusion Taskforce – Towards a step-change in third sector lending – Report of the third sector credit Working Group of the Financial Inclusion Taskforce, 2008 http://www.financialinclusion-taskforce.org.uk/PDFs/working_group_presentation.pdf
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[19] HM Treasury – Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain, 2008 http://www.hm-treasury.gov.uk/media/0/D/consult_lro230708.pdf
[20] The "Common Bond" is in actuality redefined by Proposal B2 (see below)
[21] HM Treasury – Proposals for a Legislative Reform Order for Credit Unions and Industrial & Provident Societies in Great Britain, 2008 http://www.hm-treasury.gov.uk/media/0/D/consult_lro230708.pdf
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