Building sustainable credit unions

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Abstract: *We review how changes in the form of regulation since the passage of the Credit Union Act, 1979, have affected the activity of Scottish credit unions, and predict how proposals for a new, prudential approach to regulation will affect the sector. We compare the approach of the regulators with that of other public authorities, arguing that these still tend to treat credit unions as being primarily concerned with widening financial inclusion. We argue that the strength of the credit union sector lies in its ability to provide financial intermediation services more efficiently than other institutions. Public policy should therefore recognise that credit unions' ability to extend financial inclusion is largely a by-product of their meeting members' needs. The policy framework for credit union development might usefully be aligned current proposals for prudential regulation, encouraging credit unions to engage in product and service innovation, and to extend their collaborative working.*

1. Introduction

As providers of affordable financial services, often targeted at relatively low-income groups, credit unions tend to be of interest to public authorities in two ways. Firstly, to ensure their stability, they typically operate under substantial regulatory constraints. In addition, given their ability to operate at very small scale, and in environments where other financial intermediaries struggle to see opportunities for profits, public authorities often support credit union development in order to address problems of financial inclusion. In this paper, we review how these types of public intervention have affected credit union development in Great Britain,[1] although we concentrate on the effects of public support on credit unions in Scotland, where the devolved government has had the freedom to develop its own forms of support.

We argue that in the last 20 years, there has been substantial movement towards prudential regulation of credit unions, and that this has offered credit unions opportunities to expand the range of services that they offer their members, while enhancing the sustainability of those credit unions which are willing to engage in service innovation, such as increasing the utilisation of web-based and mobile technologies. We contrast the understanding of credit unions as businesses, which is implicit in the regulatory framework, with the emphasis on achieving financial inclusion, which we argue still risks placing too great an emphasis on the achievement of outcomes that are necessarily ancillary to the primary objectives of trading profitably and achieving sustainable growth. Edmonds, 2015, catalogues the balance of public activity across regulation and promotion of credit union.

[1] We exclude any discussion of credit union activity in Northern Ireland because its credit unions have faced a very different regulatory framework.

2. The legislative and regulatory environment

Credit unions are member-owned cooperatives. The first credit unions in Great Britain were formed in the 1970s, and authorised in terms of the Industrial and Provident Societies Act 1965. The subsequent Credit Union Act, 1979, was intended to address concerns that the legislative framework needed to recognise the distinctive nature of credit unions as small-scale financial co-operatives. Section 1 (3) of the Act identifies the objects of a credit union:

a) the promotion of thrift among the members of the society by the accumulation of their savings;
b) the creation of sources of credit for the benefit of the members of the society at a fair and reasonable rate of interest;
c) the use and control of the members' savings for their mutual benefit; and
d) the training and education of the members in the wise use of money and in the management of their financial affairs.

The requirement that credit unions should provide financial education is perhaps particularly distinctive.

It is often asserted (e.g. McKillop & Wilson, 2014) that credit unions are the purest form of co-operative because they are restricted to providing services to members, among whom there must already be some form of association or common bond. The Act defined permissible common bonds in terms of residence within a locality, employment by a specified set of organisations, or by membership of a trade, or through some other form of association, such as membership of a church or a trade union.

The Act confirmed the Registrar of Friendly Societies as the primary regulator of credit union activities. It placed minimal barriers on the entry of credit unions, but restricted opportunities for profitable activity, since the 1% maximum monthly charging rate on loans was often less than the cost of funds for established financial institutions during the 1980s, when there was relatively high inflation, and interbank rates only rarely fell below 10% p.a.[2] Donnelly & Haggett, 1997, argue that the regulator sought to manage the risk of credit union failure implicit in the legislation by insisting upon newly formed (community) credit unions operating within very tightly drawn common bonds. Taken together, the legislation and the regulatory framework effectively restricted the space within which credit unions could operate to the acceptance of small-scale sight deposits and consumer loans, secured by the pledge of members' share deposits. Credit unions were isolated from other parts of the financial system, and the wave of financial service regulation in the 1980s largely passed them by.

This changed with the recognition of credit unions as a third class of deposit taker, alongside banks and building societies, in terms of Part IV of the Financial Services and Markets Act, 2000. Regulatory oversight of credit unions became the responsibility of the newly created Financial Services Authority, and credit unions were admitted to the Financial Services Compensation Scheme. Commentators noted that the regulator immediately relied on prudential regulation (McKillop & Wilson, 2003), with a substantial liberalisation of credit union activities[3] and a clearly signalled intention to encourage the formation of fewer, but financially sustainable credit unions. Since 2002, the number of GB credit unions has fallen from 730 to approximately 360 (Bank of England, 2015), although in Scotland, the number of credit unions has only fallen from 116 to 104.

Subsequent steps towards the liberalisation of credit union regulation include increasing the maximum rate of interest that credit unions might charge: from 1% to 2% per month in 2006; and then from 2% to 3% in 2013. In addition, the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 broadened the definition of the common bond, creating for the first time corporate membership; allowed credit unions to issue new financial instruments, notably deferred shares, which

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[2] It was only in May, 1992 that the Bank Rate finally dropped below 10% per annum on a consistent basis; and a persistent period of low inflation began shortly after that. This now means that credit unions struggle to compete with larger, better capitalised businesses in offering competitive loan rates. (Bank of England, 2016)

[3] For example, through the creation of 'Version B' credit unions, which were permitted to grant larger loans over a longer period, so long as they could demonstrate adherence to more complex risk management procedures than other, 'Version A,' credit unions.

have much the same role as transferable capital in other cooperatives, or the equity of a private company; and also permitted credit unions to issue interest bearing shares and cash ISAs.

The shift towards prudential regulation is continuing, with Prudential Regulation Authority,[4] 2016a, implementing a new version of the CREDS rulebook. These rules, first issued in draft form in PRA, 2015, increase the minimum capital: assets ratio for all but the smallest credit unions, and require credit unions wishing to broaden the range of services offered to their members to demonstrate that they have sufficient resilience to absorb substantial financial shocks. The robust response from credit unions to the draft proposals was best captured in ABCUL, 2015. Arguing that restricting credit union members' maximum shareholding to the deposit insurance limit of the Financial Services Compensation Scheme would be a strong indication that the regulators considered credit unions to unable to manage their business effectively, ABCUL also argued that the prudential standards proposed were effectively the PEARLS ratios developed by the World Council of Credit Unions (Richardson, 2001) and were intended as guidance to credit union boards in providing effective governance and leadership. ABCUL therefore argued that by converting these normative statements supporting effective prudential management into minimum standards that should apply across the sector, the draft proposal, if implemented, would constrict development of the sector without increasing its stability. The effectiveness of this sustained, and broadly coordinated, activity, can be seen in PRA 2016b, in which the regulator provides a brief rationale for removing almost all of the provisions which ABCUL, through consultation with its members, found objectionable.

The overall effect has been a shift towards permissive regulation, and so may be considered beneficial to credit unions. The new rules nonetheless present substantial, immediate challenges to credit unions, for as well as specifying additional prudential requirements, they also impose a framework of responsibilities for the board of directors of each credit union, requiring directors to provide much more

[4] Hereafter PRA.

active governance, especially through strategic planning and the monitoring and assessment of risk. In many ways, these rules treat credit unions as being large enough to need to meet standards of member protection that are broadly similar to those that the regulator imposes on other financial intermediaries. PRA, 2016a, is therefore likely to be another substantial step in the development of GB credit unions, even if, as with earlier steps, it leads to further consolidation within the sector.

3. The social policy environment

Over the last 20 years, governments – both of the UK and within the constituent nations – have actively supported credit union development. (McKillop *et al*, 2007, Chambers & Ryder, 2008) The initial work on using credit unions to extend financial inclusion was undertaken by Policy Action Team 14 (HM Treasury, 1999). This recommended the promotion of credit unions, through the creation of a Growth Fund, administered by the Department of Work and Pensions, of £35m (HM Treasury, 2004). The currently active Credit Union Expansion Project (Oppenheimer, 2012), was designed to provide a further, but final, tranche of public funding so that the sector would achieve sustainability within a decade.

In general, there has been widespread academic support for this approach. Research into the barriers to financial inclusion has frequently identified credit unions as having the capacity to offer a range of simple savings and loan products to people who might not easily use other financial intermediaries (e.g. Collard *et al*, 2001, Brown *et al*, 2003, Collard, 2007). It is claimed that credit unions have the capacity to use the existing social ties within the common bond to reduce the costs of monitoring, and also, implicitly, to increase the costs of default to a member. In effect, credit unions are supposed to have many of the same operating advantages as micro-finance institutions (Armendariz de Aghion & Morduch, 2005), and so can outperform conventional banks by identifying relatively low-risk borrowers, who are either screened out, or subjected to credit rationing, by banks.

Successive interventions have received support from a particular interpretation of the ‘new model,’ of credit union development (Richardson, 2000; Jones, 2002), which emerged from work undertaken by the World Council of Credit Unions in Guatemala. This approach stresses the importance of consolidation with the sector, professionalisation, improved governance and an emphasis on service development in order for credit unions to attain a sustainable growth path. While the ‘new model’ is silent about the sources of the capital funding needed to finance the sectoral development implicit in it, given that public funding has been the only reliable source of external funds available to credit unions, it was at least tempting for credit unions to accommodate the arguments that they should promote financial inclusion to ensure access to public support. Jones, 2006, 2008, argues that the restructuring, growth and increased sustainability of the British credit union sector achieved through the use of public funding has led to a substantial increase in financial inclusion.

There are two distinct criticisms of this approach. The most obvious one is that any provision of funding to credit unions in order to support financial inclusion risks leaving credit unions in the position of being seen as the poor man’s bank (Ryder, 2002, McKillop & Wilson, 2003, McKillop *et al*, 2007, Chambers & Ryder, 2008). A more subtle critique reflects a long-standing division within the credit union sector between the Association of British Credit Unions (ABCUL) and the Scottish League of Credit Unions (SLCU). As Sinclair, 2014, notes, the formation of SLCU in 1994 reflected concern among some community credit unions that credit unions should only be accountable to their own membership, so that every credit union should develop its service offering in response to the needs of members, rather than as a response to pressure from external stakeholders.

The debate is rather inconclusive, with the positions taken being based largely upon theoretical arguments. There do not appear to have been any robust outcome evaluations of government programmes. For example, while it is certainly true that credit unions participating in the Growth Programme attracted new members, who then borrowed from these credit unions, the independent evaluation (Collard *et al*, 2010) concentrates on the impact of growth fund activities on credit union members. While the review did consider the impact on credit unions' operating procedures, and discusses their ability to engage actively with other stakeholders, it does not provide any systematic examination of the extent to which the Fund added to the profitability of participating credit unions; and there has certainly been no attempt to demonstrate that the provision of payments for activity is a particularly efficient way of improving the performance of credit unions.[5]

In this context, it is understandable that the feasibility study for the ongoing DWP-funded Credit Union Expansion Project (Oppenheimer 2012) simply points to the outcomes for the previous Growth Fund project in general terms. CUEP is sponsoring the development of new information systems for credit unions, and, once again through the provision of cash incentives to credit unions to encourage membership growth, it attempts to provide credit unions with sufficient capital to achieve 'sustainability,' finally ending the need for public support. Again, following Sinclair, 2014, we note that the feasibility study models the effect of the expansion project by assuming that members will be drawn exclusively from the lowest two quintiles of the income distribution, and so risk imposing a particular conception of credit union activity on the sector.

Tension clearly exists across the regulatory and the policy environments in which credit unions operate. We have argued that this reflects differences in understanding about the nature and purpose of credit union activity, but we also consider that there has been a lack of communication between credit union regulators and government units providing financial support. Liberalisation of credit unions has given them the freedom to raise external capital through the development of partnerships with external partners: churches and housing associations might be the most obvious example. Without being

[5] In this respect, we think that the most relevant analysis is to be found in Forker & Ward, 2012, 2015, which argues that profitability and sustainability derive from the types of behaviours that Collard *et al*, 2010, have identified within credit unions participating in the growth fund. But this analysis does not allow us to avoid the question of whether credit unions that adopt these behaviours also tend to be those which are amenable to participation in development programmes.

prescriptive at all, we can envisage a situation in which local authorities work with other organisations to set up and endow local credit union trusts, inviting credit unions to include the local trust within their common bonds. Trusts could then participate in the issue of deferred shares, and provide an effective voice for credit union governance.

Such a system, allowing credit unions to redefine their relationships with strategic stakeholders, might obviate the need for capitalisation through vehicles such as CUEP, in which revenue support is intended to facilitate capitalisation through retained profits. We do not suggest that this precludes further government initiatives, but it seems to provide a much more direct route for government agencies, and other advocates of credit unions operating in the space designed to increase financial inclusion, to provide support in a form that is consistent with the freedoms conferred by the more liberal regulatory regime.

4. Four strategic issues facing Scottish credit unions

The last review of the capacity of Scottish credit unions (McKillop & Wilson, 2008), suggested that Scottish credit unions were still at a relatively early stage of their developmental process, and identified four problems facing the sector: fragmentation and the small scale of Scottish credit unions; high operating costs, partly as a result of the failure to develop shared services; lack of human as well as physical capital; and limited opportunities for development in the context of competitive markets for personal finance. In framing our own work, we have paid less attention to the challenges and opportunities facing the sector as a whole, concentrating instead on those challenges that we believe credit unions can best address by themselves.

Exploiting the common bond. Credit unions can only admit, and provide services to, members, among whom there is some form of prior association, or common bond. In terms of the typology of credit union systems set out in Ferguson & McKillop, 2000, relaxation of the common bond is an attribute of mature credit union systems. Such a common bond implies that credit unions might consider their members to be linked through a network in which weak ties are predominant, with the purpose of the common bond being to hold the credit union accountable to the community within which it operates, rather than to facilitate screening of members' activities.

The Legislative Reform Order, 2011, removed many restrictions on the common bond. We draw particular attention to the new class of corporate member, which allows businesses wishing to enter payroll deduction agreements, organisations which might support credit union development, and other credit unions, to be admitted as members of a credit union. This change also opens up the possibility of credit unions engaging in lending to corporate bodies, including organisations whose social objectives might be considered congruent with the purposes of the credit union in terms of the Act. We are aware of only one credit union which is currently considering using these freedoms to engage in corporate lending, although there has been some discussion of the possibility of providing structured finance to local housing associations. More immediately, we consider that corporate membership is a route through which formal relationships with stakeholders might more easily be mediated, with these corporate members having shareholdings, and participating in corporate governance.

Purpose: Not for profit, but for service. As cooperatives, credit unions are often described as 'not-for-profit' institutions (e.g. Brown *et al*., 2003, McKillop & Wilson, 2014). Nonetheless, credit unions need to generate sufficient surpluses from operations to remain financially sustainable. We are willing to concede that, lacking external shareholders, credit unions may not need to meet quarterly performance targets in the same way as public companies; and even that, given the dispersion of ownership rights across their membership, their directors may face less scrutiny than their counterparts in other businesses. This might suggest that credit unions are under less pressure to be profitable than other businesses, and that they will struggle to expand in a competitive market.

We argue instead that credit unions have the freedom to build relationships with members, deriving their profits from a high level of repeat business, and generating member value both from relatively modest interest spreads, and from the distribution of profit through dividends. Even if the return on assets for credit unions is modest compared with those of other financial intermediaries, the relatively robust performance of the credit union sector in the USA during the financial crisis (McKillop & Wilson, 2014, Smith & Woodbury, 2010) indicates the value, in that environment, of a motivation other than maximising short-run shareholder returns.

Rather than define credit unions as being 'not-for-profit,' it might be better to define them as being risk-averse, or loss-averse, (consciously) restricting the range of activities in which they engage in order to preserve members' capital. Alternatively, looking beyond the financial returns offered to members, we might argue that credit unions are effectively required by legislation to offer greater benefits to members than other institutions offer to their customers.

Establishing the service offering. With the liberalisation of the sector, credit unions have been able to offer a wider range of services, including acting as agents for payments providers (and so offering pre-paid debit cards and a product that is effectively a current account), interest-bearing deposit accounts and cash ISAs. Larger credit unions are able to offer house purchase loans and some credit unions are beginning to explore the challenges of lending to small businesses. We believe that credit unions introducing these services are often able identify unserved market opportunities within their common bond, so that they have not yet come into direct competition with existing financial intermediaries. In many ways, this contrasts with reports from credit unions that their members will frequently be promiscuous, using multiple providers of credit, including the high-cost sources whom external observers hope credit unions might drive out of the market (Macrory, 2013).

These products that credit unions offer are relatively easy to specify. There is also a much 'softer' service, much of which has never been systematically recorded, relating to the context in which credit unions effectively offer members advice and support. For example, we are unaware of any systematic study of the processes used by credit unions to reschedule loan agreements, even though we think that it is reasonable to argue that this may be an important and distinctive part of credit union activity. The important work of Forker & Ward, 2012, 2015, demonstrates that credit unions have effective procedures, ensuring that there is effective control of loan delinquency, and limiting impairment costs.

An even broader concern is that there does not seem to be any evidence relating to the extent or the effectiveness of credit unions as providers of "training and education of the members in the wise use of money and in the management of their financial affairs," even though this is a statutory responsibility in terms of Section 1 (3) (d) of the Act. Again, anecdotal evidence suggests that education is very important, if informal, element of credit union activity, and one that might best be understood through ethnographic study.

Capitalisation. As cooperatives, credit unions are limited in their ability to raise external finance, and in some ways the Credit Union Act, 1979, was defective. The LRO allows credit unions to issue deferred shares, which have essentially the same properties as the transferable capital of other cooperatives; or indeed the ordinary shares of a private company. To date, very few British credit unions have taken advantage of this new freedom, and we consider that this reluctance is in part explained by the development path of most credit unions, which have relied on retained profits, possibly augmented by grant income, to finance organic growth. This ongoing reluctance on the part of credit union boards to use external finance reflects both the skills and knowledge of directors and lack of clarity within the regulatory framework about how credit unions might use these powers. There is a need for further work to explore how to embed the use of external finance in credit union business planning, especially in the context of the changing regulatory framework. This should not simply be a review of procedures that might be utilised. The use of deferred shares as a source of finance might have a substantial effect on credit union governance. In the event of credit union liquidation, the holders of deferred shares are the residual creditors, and so they may legitimately expect to engage actively in matters of governance.

5. Insights from our programme

Our programme sought to enable credit unions in Scotland to understand more fully the challenges of sustaining growth. We have not tried to develop a comprehensive definition of business sustainability for credit unions, although in the context of our analysis of the interest of external stakeholders, we believe that widely differing definitions of sustainability might be drawn from the policy framework and the regulatory framework. The regulatory definition, based on robust financial management structures and systems, and adherence to capital adequacy and liquidity measures, seems likely to take priority, but we consider this to be a very static definition of sustainability, and perhaps does not give full consideration to the rapidly changing business environment facing credit unions. The policy approach defines sustainability much more in terms of achieving the minimum efficient scale necessary to embrace service improvements. Regulators are, of course, primarily concerned with the performance of individual credit unions, but policy makers are more interested in the capacity of the sector and its ability to deliver service improvements. It is partly for this reason that policy has consistently supported consolidation through credit unions transferring their engagements (effectively promoting the managed takeover of smaller credit unions by larger ones).

Like all other types of financial institution, credit unions have to be able to generate sufficient demand for their assets to remain liquid (Diamond & Dybvig, 1983, Allen & Gale, 2009), so that they avoid the problem of a 'run' on their assets. This suggests that it is more appropriate to rely on a dynamic definition of stability, since credit unions need to retain the confidence of investors not only that they are liquid now, but that that they will remain liquid in future. For example, at the start of our project, there was considerable interest in the possibility of credit unions developing products that might challenge pay-day lending; but by the end, a threat had emerged from the development of online and mobile platforms for payroll lending, which presents a substantial risk to credit unions in an area of key strength. Facing ‘fintech’ companies, which can raise capital from private equity companies, Scottish credit unions, often little more than small community-based community organisations, have to be very nimble to respond to the changing challenges and opportunities.

In specifying the activities of our programme, we analysed the strengths and weaknesses of credit unions’ organisational structures. Among the most significant weaknesses, we quickly identified the governance structures. The directors of a credit union are elected from among the members in general meeting, and are required to be volunteers. Following Jones, 2015, we argue that such a democratic form of governance presents substantial challenges, which have to be managed carefully. We also argue that it is potentially important for the legitimacy of credit unions as social organisations that they should retain these arrangements.

Expecting credit unions to be volunteer-managed, the Credit Union Act, 1979, prescribed a *board of management* to coordinate the activities of volunteers. Under the shift to prudential regulation over the last 15 years, the fiduciary duties of the board have been stated with increasing clarity. These include the ability to develop and monitor the credit union’s strategic plan, oversee risk control and monitoring, and hold senior managers to account.

We heard reports from larger credit unions, indicating that in discussion with the regulator, they are gradually adapting their rules to ensure that directors, upon election, are able to discharge fully these responsibilities. This might mean that the Board will appoint a nominations committee, which will scrutinise members’ nominations as potential directors, excluding those for whom there is insufficient evidence of capacity to engage actively in governance activities; or even that the nominations committee will seek to identify members, or even individuals willing to become members, who are willing to be nominated as directors, and will then be presented for approval at the AGM, much as would happen in other financial institutions.

Jones argues that it is very easy for a credit union board to continue in the pattern of a committee of management. This can disempower paid managerial staff, and lead to a situation where the board, rather than developing a strategic plan in conjunction with the management team, and then scrutinising its implementation on behalf of members, concerns itself with minor operational decisions, so that there is an absence of strategic leadership within the credit union. Of course, this does not prevent any credit union from meeting the static, prudential requirements of sustainability, but it will tend to restrict growth. It also seems likely to present substantial challenges in terms of dynamic sustainability, both in terms of the achievement of policy goals and in responding to changes in the operating environment.

Complementing the ongoing research into governance, through a presentation by Kenny MacLeod (Scotwest Credit Union), we reviewed the operation of a credit union risk management policy, in which risk management flows from credit union boards being aware of the risks inherent in all of their activities, and deciding on their willingness to bear risk in each area, allowing for risk management and risk mitigation activities to reduce the probability of loss occurring and the amount of loss. In this process, risk has to be recognised in order for it to be managed, and this emphasises the need for the board both to have a broad range of competencies, and also to be independent of management, so that it can fully represent the interests of members.

Further insights into the quality of credit union governance came through the contribution of John Forker and Anne-Marie Ward (Forker & Ward, 2012, 2015, Forker *et al*, 2013). This sequence of papers has examined the capacity of credit unions in Northern Ireland to manage loan delinquency, and has demonstrated that credit unions which used PEARLS financial management data significantly out-performed those credit unions that did not. PEARLS emerged from the same programmes, run by WoCCU, in which the ‘new model’ emerged. It seems reasonable to infer that credit unions which use

PEARLS are therefore more likely to embrace the WoCCU standards that underpin the 'new model,' than those which do not. Again, this is evidence associating adoption of these standards with the achievement of some form of sustainability.

All of these observations are entirely consistent with the argument that effective scrutiny of management relies on the board possessing relevant and timely information. Perhaps even more important, especially in terms of the desirability of democratic governance, with directors having legitimacy within their communities, this research has examined the importance of board composition for its effectiveness. Especially where credit unions are based in areas of deprivation, then where the board included a group of women, performance was better than if the board consisted solely, or almost entirely, of men. While it might be argued that managing default should be primarily an operational matter, and so reflects more the quality of credit union management, failure to control asset quality is perhaps the greatest risk for any financial institution, since it will rapidly lead to loss of liquidity, and challenge the survival of the business. It is therefore a matter of considerable strategic importance for credit unions.

Linking all of these insights is the observation that credit union directors are necessarily volunteers. In the absence of research into the experience of Scottish credit unions in managing the shift from volunteer to salaried management, Alasdair Rutherford (University of Stirling) drew lessons from research into volunteering in Scotland, while Ian Cunningham (University of Strathclyde) examined the effects of professionalisation of services within the provision of care services. Alasdair Rutherford suggested that credit unions have to understand the nature of volunteering since volunteers might perceive their activities in many different ways: as self-help, or as civil society participation, or as advocacy, or even as leisure. Credit unions should therefore think of volunteers understanding their activities in terms of social engagement, rather than simply in terms of a functional role. Ian Cunningham emphasised that the combination of salaried management and volunteer leadership in the context of a professionally delivered services might well lead to improved service delivery standards, but that this comes with the risk of loss of organisational identity and purpose. Developing niche services consistent with credit unions' mission, and building stronger relationships with other social organisations, might mitigate such risks. Such an approach highlights our suggestion that credit unions need to strengthen their efforts in membership development, so that they offer something more than financial benefits. In terms of our discussion of credit union sustainability, credit unions seem to need to create willingness among members to participate in decision making activities and governance, and the creation of an identity around member education seems likely to be important to achieving that.

The extent of consideration of governance arrangements emerged in our activities almost by accident, and we cast our net well beyond that. Our programme actually began with Mark Lyonette, the Chief Executive of the Association of British Credit Unions (ABCUL) reflecting on the challenges that Scottish credit unions might face. This presentation demonstrated how a long-term decline in the proportion of credit union assets taking the form of advances to members is putting downward pressure on returns on assets. Bank of England summary statistics (PRA 2016c) on Scottish credit unions (to September 2015) confirm both that credit union assets have passed £500m, but also that advances to members now account for 52.2% of all assets.[6] For Scottish credit unions, the Bank of England statistics indicate that total income is approximately 6% of assets, so that the margins on which credit unions operate, around 1.5% of assets after tax, but before distribution of dividends, are now very thin. In the context of maintaining sustainability, increasing these margins is a substantial, immediate challenge.

An important explanation for this trend of declining loan advances as a share of assets was offered by Ralph Swoboda of Credit Union Financial Analytics. His thesis is that credit unions in Scotland continue to offer one particular service: unsecured consumer loans, often at a single rate of interest, and offered through distribution channels which are unattractive to younger members. His account of successful

[6] The December 2015 statistics indicate that with loans of £290m and assets of £540m, the loan: asset ratio has risen very slightly to 53.7%. This is the first occasion since the onset of the financial crisis in 2008 in which this key management ratio has shown even a modest increase.

credit union systems emphasised that it is possible for relatively small, community-focused credit unions to offer a full range of personal banking services at lower cost than banks, as demonstrated by McKillop & Wilson, 2014. He concluded that in Scotland, the main reason for credit union failure is likely to be a failure to adopt such an approach. In some ways, Swoboda's analysis goes well beyond the 'new model.' He argues that to complete the transition to maturity, Scottish credit unions will need to engage in sustained service innovation, finding new ways of serving members. They will have to abandon their reliance on the existing savings and loans offering, and develop a range of services that are attractive in the context of emerging financial technology solutions.

One relatively easy step in service diversification, which should complement other initiatives, is the extension of payroll deduction. We were particularly pleased to be able to engage Lindsay Melvin, Chief Executive of the Chartered Institute of Payroll Professionals, in a stakeholder consultation. The CIPP has identified employer sponsorship of credit unions through payroll deduction as a workplace benefit which has almost no cost to employers, and substantial benefits. Its policy paper (Thompson, nd) outlines the case for introducing this benefit, emphasising the lesson from behavioural science that the design of choice architecture, and particularly the presentation of the default outcome, can have substantial effects on the decisions that people make. Especially since payments to the credit union made by payroll deduction are deducted without the money ever reaching a bank account, it requires a conscious decision to cancel the payment, and so there are good reasons to expect payroll deduction to change participants' attitudes towards saving and the management of liquidity, and so their behaviour, in the medium term.

6. Conclusions and further work

Reviewing credit union activity in Scotland, McKillop & Wilson, 2008, concluded by asking whether or not there is actually a role for credit unions, given their relatively slow pace of development. In our own work, a very similar warning was sounded in a presentation by Sharon Collard: “We need to think about the space in which credit unions operate – because I would argue it’s actually quite small, and getting smaller,” although the presentation was actually a strong argument for credit unions not being fatalistic. The challenge for credit unions is to be nimble enough to achieve both the static, prudential form of sustainability demanded by the regulator, and the dynamic, market-responsive form required by technological advance and competition. We have suggested that public policy should consider new mechanisms for firm-focused innovations, rather than sectoral manipulation, arguing that there is no clear basis for the policy consensus combining the strategic orientation of credit union activity implicit in the ‘new model’ with the centralisation of public support seen project such as the Growth Fund and the Expansion Project. This conjunction of analysis and policy is expedient, and may actually be effective, but we do not consider that there have been adequate attempts to assess whether or not this is the case.

Our work with credit unions and stakeholders has led us to conclude that credit unions have work to do in giving people reasons to participate in a membership-based financial services organisation. Credit unions are aware that their members are promiscuous, obtaining financial services – even those where credit unions appear to have substantial cost advantages – from multiple sources. This appears to reflect a failure of credit unions, but we cannot say with confidence whether this is a matter of poor communication with members, or whether they are also failing to provide the exact service that their members want. While we concur with Ralph Swoboda that substantial service development will be required to address many of these concerns, we also believe that an attainable first step will be the development of payroll deduction services by the large body of community credit unions.

Such a service would have clear benefits to members, but there are also substantial benefits to credit unions, including a substantially higher degree of control over payments to the credit union, with members required to inform (and obtain the agreement of) the credit union to any changes. In addition, members in employment are likely to be able to save and borrow more, and this should be a form of saving and loan repayment likely to be attractive to younger members, who are likely both to borrow larger sums (relative to savings), and to borrow more frequently. More extensive use of payroll deduction is likely to reduce transactions costs, through a reduction in cash handling and transactions passing through bank accounts, as well as credit control and loan impairment costs. With the potential for higher income and lower costs, payroll deduction could have a substantial effect on credit union margins. For these reasons, and also consistent with our belief that there is a need for more effective firm-level development, we plan to work intensively with a few credit unions to understand better the challenges and opportunities associated with such a service innovation.

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