Financing the Future: Achieving Sustainable Growth in Credit Unions

Main objectives and context

The programme aimed to bring together a broad range of credit union stakeholders to develop pathways for robust, sustainable growth of Scottish credit unions. It drew on the academic knowledge base and the expertise of credit union professionals and other stakeholders from Britain and overseas, distilling these insights into proposals for richer engagement between credit unions and outside bodies.

In very broad terms, credit unions in Scotland are very small (even the largest has assets that are similar to those of smallest building societies or banks). Every credit union has a clearly specified membership qualification, or common bond, which is usually community based (there are seven employment-based common bonds among 103 credit unions in Scotland). Credit unions are predominant in what might be classed as social lending, where advances are made to members who would fail the credit scoring criteria employed by more conventional financial intermediaries, often at subsidised interest rates. Alternatives to credit unions in this area, such as CDFIs, which cannot take deposits, have had marginal impact. In consequence, credit unions have been seen by policy makers as an important route for increased financial inclusion. Credit unions offer a very narrow range of products, compared with the range offered within other credit unions systems: and, partly as a result, one academic expert described the space in which credit unions operate as being 'small, and in danger of becoming smaller.' While, in principle, credit unions should be able to exploit being more nimble than other, more conventional lenders, their small scale may mean that they lack the resources needed to exploit opportunities.

It is easy to identify structural weaknesses across the sector. All are volunteer-led, and they tend to be quite strongly risk averse, and slow to innovate. Meaningful cooperation among credit unions is limited, and engagement with external stakeholders is often weak. Partly as a result, the Department of Work and Pensions-funded Credit Union Expansion Project (for Great Britain) has been predicated on the assumption that a final round of external recapitalisation is necessary for credit unions to reach the scale where their operations are fully sustainable. At the same time, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) are strengthening the regulation of credit unions: these reforms will very likely increase the need for credit unions to have access to sources of external capital funding, and enhanced governance relationships

The programme was designed to make a substantial contribution to Scottish credit unions' efforts to address these limitations, concentrating on three areas:

(1) The development of insights into improved credit union governance, so that they might remain accountable to their members and the communities in which they are based, while providing high quality financial services
(2) The identification of how credit unions might add value to the membership experience, especially through their statutory obligation to provide some form of financial education to members
(3) Identification of the ways in which small scale, lack of access to capital, and limited ability to diversify risk, all combine to constrict growth; and new models of cooperation among credit unions.

Insights resulting from the programme

The starting point has to be the claim: "We need to think about the space in which credit unions operate – because I would argue it's actually quite small, and getting smaller." (Sharon Collard, Professor of Personal Finance Capability at the Open University, at the stakeholder consultation, Edinburgh, 27th August, 2015) Our programme has identified many substantial challenges that credit unions face in reversing this situation, and has identified elements of a strategy that might permit this.

We began the programme by inviting Mark Lyonette, the Chief Executive of the Association of British Credit Unions (ABCUL) to reflect on the challenges that he believed 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 on Scottish credit unions (to March 2015) confirm both that credit union assets have passed £500m, but also that advances to members now account for 52.2% of all assets. 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 are now very thin.

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 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. He concluded that in Scotland, the main reason for credit union failure is likely to be a failure to adapt.

We believe that it is necessary for credit union board to address these weaknesses. Paul Jones (Liverpool John Moores University), reported on recent work on credit union governance, which has confirmed that many boards continue to seek to manage the credit union directly. This may reflects the board's origins as the management committee of a much smaller organisation. Boards lacking the capacity to delegate are unable to provide independent scrutiny of decision making. The research suggests that for boards to switch between these modes, they need to develop and maintain a strategic plan, with governance largely taking the form monitoring the achievement of financial and other operating targets.

Complementing the account of how boards might provide effective oversight, Kenny MacLeod (Scotwest Credit Union) reviewed the operation of Scotwest's risk management policy. He argued that risk management should flow 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. An important part of this management process is that risk can only be managed where it is recognised, 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.

Another perspective on effective governance came from the work of John Forker (University of Sussex; with Ann-Marie Ward (University of Ulster)) on the capacity of credit unions in Northern Ireland to manage loan delinquency. They have found that credit unions which used PEARLS financial management data significantly out-performed those credit unions that did not: effective scrutiny relies on information. In addition, they found that the composition of the board was important. 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.

At present, all credit union directors are volunteers. In the absence of research into the experience of Scottish credit unions in managing the shift from being volunteer-managed to being volunteer-led, 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 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.

Developing such niche services might help to promote a more distinctive credit union identity, and also be a first step in the diversification of services discussed above. An important niche might be associated with credit unions' statutory responsibility to provide 'financial education.' Andrew Downin (Filene Research Institute) reviewed the use of gamification by credit unions in the USA to add value for to credit union membership. By using game play, setting out an environment with rules, challenges, feedback loops, and rewards, to address non-game problems, credit unions can 'nudge' members' dispositions toward behaviours that they want to acquire, strengthening the relationship between the credit union and the member, and increasing credit union income. Gamification has emerged from advances in behavioural science, and Ivo Vlaev (University of Warwick) demonstrated how simple, low-tech interventions can have substantial effects on financial competence. We believe that it is important to consider a unified credit union campaign in this area.

Our stakeholder consultation explored two ways of extending services. Lindsay Melvin (Chartered Institute of Payroll Professionals) described the programme that his organisation has developed to create standards for the operation of payroll deduction schemes. Our discussion of possible extensions emphasised the importance of including resources for promoting financial capability within these. Promoting financial capability was also important to the arguments presented by Niall Alexander (Consultant), which examined the capacity of credit unions to engage in lending to people who might otherwise face financial exclusion. Here, our conclusions are rather more tentative. It is not clear that credit unions are the best vehicle for social lending. There are many challenges in achieving the scale necessary to realise cost efficiencies while maintaining the personal interactions, which are the basis of credit unions' information advantages over other lenders.

Main outcomes and (expected) impact

We have had several opportunities to use findings to provide advice and guidance to participants.

ABCUL launches its Scottish Credit Union Charter at its annual conference on 2nd October. The charter consists of five policy interventions, to which it is expected that Scottish political parties will subscribe in the run-up to the Scottish Parliament elections next year. Priority will be given to seeking support for the extension of employer sponsorship of credit unions by making payroll deduction arrangements a standard workplace benefit. The conference includes a workshop presenting programme outcomes. This will be followed by a presentation at the International Credit Union Day reception, hosted by the Cross-Party Parliamentary Group on Credit Unions at the Scottish Parliament on 8th October. While simply being an opportunity for brief comments, MSPs have already made contact, seeking a briefing about the outcomes.

The Church of Scotland has invited us to draft its response to the PRA's proposals for revised credit union regulation. The Church has a particular interest in credit unions, as one of the sponsors of the Churches Mutual Credit Union, and a more general interest, through the commitment of its General Assembly in 2012 to support the expansion of cooperative and mutual financial services.

There have been many discussions within credit unions relating to the outcomes of the workshops. For example, several workshop participants have visited Scotwest Credit Union to understand better how it operates its risk management policy. This is an indication that our intention of running workshops so that they blended professional and academic expertise has helped to strengthen professional networks.

Lastly, we anticipate being in a position to edit a special issue of the *Journal of Financial Services Marketing*, with the call for papers being circulated in October, and aiming for publication in the last quarter of 2016.

Key recommendations for end user / policy communities

In 2016, it is likely that there will be substantial changes to credit union regulation, both through the adoption of the FCA and PRA proposals for a new senior manager regime for all financial services institutions, and the revision of the PRA's Source Book for Credit Unions. These are likely to focus attention on the matters emerging from workshops, specifically:

- Reviewing governance arrangements to ensure separation of board and management responsibilities
- Implementing timely collation and distribution of management information as part of the monitoring of strategic plan implementation.
- Strengthening relationships with external stakeholders, such as employers, trade unions, housing associations, local authorities and money advisers to enhance service distribution channels.
- Increasing cooperation among credit unions as part of a strategy for widening the space in which credit unions operate.

Planned follow up activities

At present, the follow-up activities that we have planned are based around presentations of findings and putting together the papers for a special issue of the *Journal of Financial Services Marketing*. We are considering other possibilities, including a further session with the CIPP to identify more precisely how credit unions might add member value through workplace partnerships; and also, partly responding to the direction of regulatory change, work on how credit unions might cooperate with each other and with external stakeholders to manage risk more effectively, and to raise external capital. We also believe that it will be important to extend the existing work on governance, bringing analysis of process with a deeper understanding of the motivation of volunteers and the development of a stronger sectoral identity.