

Building better credit unions

There is growing agreement that credit unions have an important role in the provision of affordable credit and Government across the UK is keen to see the sector develop. This study, by Peter Goth, Donal McKillop and Charles Ferguson, seeks to identify patterns of credit union development; quantify the performance of credit unions; and isolate those factors that make for success. They found:

- The credit union sector has experienced solid growth in recent years. Currently there are 779 credit unions with 814,538 members and £900 million in assets.
- Across the UK, only one in a hundred of the adult population belongs to a credit union; in Northern Ireland, the figure is one in four.
- There is a question mark over the long-term survival of at least half of credit unions in Great Britain. In Northern Ireland, the number affected is small. The relative success of credit unions in Northern Ireland is partly due to them being inspired 'by the community for all the community'.
- In Great Britain, some credit unions have focused too much on low-income communities, creating the perception of credit unions as the 'poor man's bank'; this has hindered development of the movement as whole.
- Larger credit unions have scale efficiency advantages over smaller credit unions. This has encouraged many to extend their common bond to increase both their membership and asset size.
- Mergers have been a feature of credit unions in Great Britain. However, merging with a weak or failing credit union can weaken a strong 'acquiring' credit union in the short term.
- Between 2002 and 2004, 54 new credit unions were established in Great Britain. Many have experienced rapid membership expansion and received significant support from their local authorities.
- Credit unions are founded on the principle of self-help. Outside funding dilutes this principle and runs the risk of creating a 'dependency culture' within credit unions.
- Credit unions with both a skilled and motivated manager/management team and board of directors are the best performers.
- Many credit union boards do not meet the World Council of Credit Unions job prerequisites. Areas of failure are knowledge of risk management, familiarity with asset liability management, familiarity with marketing concepts and ability to understand financial statements.



Background

Credit unions are not-for-profit, co-operative financial institutions. Traditionally, they have been seen as serving the financial services needs of disadvantaged communities and individuals. Government across the UK is keen to develop credit unions.

In Great Britain, there is a growing acknowledgement by Government that, as 'third sector' lenders, credit unions have an important role to play in providing affordable credit and the Government has endeavoured to develop a framework to broaden the appeal of credit unions. In Northern Ireland credit unions operate under a separate legislative framework. Although the movement in Northern Ireland is much more successful than elsewhere in the UK, consultation has taken place on a series of proposals for the modernisation of Northern Ireland policy on credit unions.

Against the backdrop of this evolving framework, this study provides a financial profile of all UK credit unions. In addition, through case studies, the researchers examine the establishment of new 'fast growth' credit unions and the extensive merger activity among existing credit unions and identify why some credit unions perform better than others.

The sector as a whole

In the UK, the credit union sector has experienced solid growth in recent years. Today there are 779 credit unions with 814,538 members and assets of £900 million. Across the UK, only one in a hundred of the adult population belongs to a credit union; in Northern Ireland, the figure is one in four.

The research ranked credit unions from 'weak performing' through to 'strong performing'. This analysis emphasised a degree of weakness in the UK credit union movement, particularly those in England and Wales and in Scotland. There is a question mark over the long-term survival of at least half the credit unions in Great Britain. While some credit unions in Northern Ireland are also structurally weak, this is less pronounced than in Great Britain.

The success of credit unions in Northern Ireland is in part due to them being organisations inspired by 'the community for the community'. In addition, from the outset credit unions have recognised that long-term viability requires that they attract a cross-section of people from local communities, not just those who are socially or financially excluded. In Great Britain, some credit unions have focused overly on low-income communities, creating the perception of credit unions as 'the poor man's bank'. This has hindered both the development of individual credit unions and of the movement as a whole in Great Britain.

New 'fast growth' credit unions

A recent feature of the British credit union movement has been the establishment of new 'fast growth' credit unions. The research looked at two such credit unions, both in England. Both were strongly supported by their local authorities. This has enabled them to have good quality offices and a team of paid employees from the outset. This 'hot house' approach contrasts with the more traditional/ethical approach to establishing and developing credit unions, focused on volunteers and evolutionary in nature.

These new credit unions were concerned with providing a service to those who might otherwise face financial exclusion; some of their funding depended on providing this service. In the longer term, however, they need to attract a cross-section of members from their local communities if they are to be sustainable and not dependent upon grants and subsidies. Credit unions are founded on the principle of self-help: in the long term, outside funding can weaken and dilute this principle. Outside funding may also encourage a credit union to take decisions that might not be undertaken under normal growth conditions and that at a later stage may be detrimental to stable development. An example of this is grants being used to finance state-of-the-art capital equipment without recognition that such investment brings with it ongoing running and maintenance costs.

Mergers

Since 2001, credit union amalgamations have gathered pace in Great Britain. The research looked at five mergers, involving two to eight organisations. In most of the case studies, as is currently the norm, one organisation was dominant and the merger was essentially a transfer of engagements into that credit union.

In most of the case studies, the primary drivers for mergers were the existence of weak credit unions and the desire to create a financially viable credit union within which members' funds are safe. Beyond this, a variety of other factors influenced merger activity. For example, the trend for wider common bonds, to embrace a wider membership mix, was important. Larger credit unions have scale efficiency advantages over smaller credit unions; this has encouraged many to extend their common bond.

In most cases, mergers were 'reactive' and essentially 'mopping up' exercises, dealing with the problems encountered by small community credit unions. In some cases, the merger adversely affected the performance of the acquiring credit union, but only in the shorter term. Other short-term problems included diluting the acquiring credit union's focus on its own members, increasing the level of arrears and reducing dividend payments. In many cases, the co-operative spirit was paramount in driving through such mergers, particularly when failure would have led to the loss of funds by members. (This motivation has been weakened somewhat by the introduction of the Financial Services Compensation Scheme. This protects members' funds in the event of credit union failure.)

Why do some credit unions perform better than others?

Case studies of 15 credit unions investigated the factors behind performance differences. Seven were strong performers, four were average-to-good and four were marginal. The fifteen cases were geographically spread; five in Scotland, four in England and Wales and six in Northern Ireland.

Isolating the factors behind performance differences is not without problems, as credit unions use different business models. In the UK, discussion about appropriate business models tends to centre upon the relative virtues of the 'new' model versus the 'ethical/traditional' model. However, this debate may be more about theoretical mindsets than hard realities. For a credit union to be effective, irrespective of its label, it must satisfy conditions such as serving the financial needs of a varied membership base, offering a good return on members' funds, providing appropriate products, operating efficiently, demonstrating financial discipline and being subject to appropriate governance structures.

The better performing credit unions attached importance to having good quality, centrally located premises. However, this does not imply that a poorly performing credit union can be transformed through refurbishing existing or acquiring new premises. Rather, there appears to be an appropriate point in a credit union's growth cycle when such activities will give a further pronounced impetus to membership and asset growth.

Credit unions with a skilled and motivated manager, management team and board of directors significantly outperformed others. Where a board was not functioning to its full capacity, this created greater problems for smaller credit unions as many did not have resources to appoint paid employees.

It was also evident that many credit union board members did not meet the 'job prerequisites' established by the World Council of Credit Unions in 2002. Areas of failure for both weak and strong credit unions were 'knowledge of risk management and effective management', 'familiarity with asset liability management' and 'familiarity with marketing concepts'. More worryingly, many boards had a sizeable number of directors with no 'ability to read and interpret financial statements'. Creating better functioning boards is, however, not a simple task: many of the credit unions studied found it difficult to attract members to serve on the board in the first place.

Policy recommendations

On the basis of these findings the researchers make the following policy recommendations for individual credit unions, trade associations and government across the UK. The aim is to assist the credit union movement in the ongoing debate about the development of strong, sustainable, self help credit unions that can positively contribute to the financial well-being of their members. The recommendations include:

- Placing greater emphasis on credit union development based upon a cross-section of the population, including affluent sections of society; this offers a more viable long-term model than concentrating only on financially excluded people.
- Encouraging the current trend towards widening of common bonds, especially where this facilitates greater diversification of credit union membership.
- Greater use of credit scoring for loan purposes, given that direct knowledge of members will be diluted and bad debt might otherwise increase.
- Recognising that it is not in the interests of the credit union movement as a whole to expect strong credit unions to merge with weaker ones if this in turn weakens the stronger body.
- Greater investment in the training and development of volunteers serving on credit union boards, given their critical role.

- More research into the role of volunteers, their use by credit unions, the changing demand for volunteers (as affected, for instance, by the growth of professionalism in credit unions), the supply of volunteers and the continuing evolution of volunteering policy and practice in different parts of the UK.
- Targeting grants to credit unions to particular areas of need (e.g. financial exclusion) rather than funding core business activities or as a substitute for self reliance upon sufficient revenue generated by credit unions themselves. Relying upon grants to fund the core business of credit unions leads to a dependency culture that ultimately is not conducive to sustainable development.
- Greater attention to the potential for ‘shared services provision’ by UK credit unions, particularly in relation to IT. A scoping study supported by all the trade associations would be beneficial.
- Benchmarking of credit union performance by either government or the trade associations for all credit unions (using a selected subset of metrics from the PEARLS system), with associated training.
- Allowing access to individual credit union data. This was previously in the public domain but, because of legislative change introduced by the Financial Services and Markets Act 2000, credit union financial data submitted under the regulatory regime of the FSA is legally confidential. This presents a barrier to independent scrutiny of the sector.

About the project

The research was undertaken by Peter Goth and Donal McKillop of Queen’s University Belfast and Charles Ferguson of Volunteer Development Scotland. A performance assessment of the credit union movement was undertaken based upon financial data specific to each credit union. This enabled the relative performance of credit unions to be considered for the UK as a whole and separately for Northern Ireland, Scotland and England and Wales. Case studies involved interviewing senior representatives, including the chairperson, treasurer and manager.

For further information

The full report, **Building better credit unions** by Peter Goth, Donal McKillop and Charles Ferguson, is published for the Foundation by The Policy Press (ISBN 1 978 86134 829 6, price £9.95).

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