BC Credit Union Futures – Trends & Choices

Introduction

This discussion paper is an attempt to provoke some critical thought and discussion about the future of the BC credit union system and movement. With proposed changes to governance in the second tier credit union organization, and potential revisions to the governing legislation, the moment presents an opportunity for all involved to choose just what kind of future we want for our consumer co-operatives.

At this time BC credit unions claim to have @25% market share of the retail banking and loan business in the province, and a similar presence in small business markets. In addition, they have significant positions in insurance sales, mutual fund sales and wealth management markets. By these measures, credit unions are viewed as quite successful. However, the self-congratulatory perspective may obscure trends and realities that are a little deeper.

Movement

Credit unions were created in BC as a response to social inequities and economic needs; largely to provide basic financial services to ordinary people. The social movement generated a vision of co-operatively owned self-help enterprises. The movement perspective proposed goals that were more attuned to the economic issues facing working people: providing loans at a fair price (in response to loan sharks), providing reasonable savings options (challenging the oligopoly of banks and trusts) and, later, providing mortgage loans to assist in home ownership.

These were the key issues of BC credit unions' first few decades. Notably, the credit unions brought about many changes in the financial services landscape and changed the lives of many working people. This was the real measure of their success. The success was not to be assessed by size and market 'share' of the institutions but by the welfare of the ordinary working people they sought to assist.

So, on this basis can the credit unions of BC congratulate themselves? Maybe, maybe not:

- Usurious loan sharking is now again prominent with the expanding presence of pay day lenders, pawn shops and cheque cashing shops. Many credit unions adopt policies that do not provide small loans and/or may insist on borrower qualifications that are unduly restrictive.
- Savings options are now open to almost everyone. Guaranteed deposits, mutual funds, mortgage investments, and other similar savings vehicles now give ordinary working people an array of options that are far safer and fairer than once existed.
- Residential mortgage loans are now a 'commodity' that are available to virtually anyone with stable employment. The only caveat may be that real estate prices are high, potentially pricing some out of the marketplace.

As some of the pressing social issues have receded, credit unions have evolved. Small business lending has become more important, and to a lesser degree insurance sales, real estate development, mutual fund sales, etc. But these have almost always framed as 'business' expansion opportunities rather than responses to social needs. The growth of credit unions over the last thirty years has shifted dramatically from 'movement' based projects focused upon the needs of target populations ("members") to 'system' based projects driven by growth imperatives of the business.

Additionally, the original credit union legislation provided a framework for communities to organize themselves and provide financial services (in the same way co-ops were created to provide food, housing, transportation and other things). Credit unions were 'community organizations' that provided financial services. Over time the legislation governing credit unions has changed and made it harder and harder to form a new credit union. Since the current legislation was brought into force, in 1989, no new credit unions have been authorized to do business.

Interests

In business literature the 'owner-agent' problem is well developed. In short, it asserts that those engaged to 'manage' an enterprise will have interests that are not the same as those of the owner(s). It may be said that in a consumer co-operative the member-owners have a set of interests, directors have their own self-interests, and executive managers, similarly, have their own self-interests.

Changes introduced over time will favour one interested party over another. Within the BC credit union community these distinctions are routinely obscured or evaded.

I would argue that over time the position of member-owners has been substantially eroded and their interests not always well served. In part, this has arisen as a result of a 'reframing' of member-owners as consumers, and the adoption of 'dollar votes' being more important that democratic participation. Certainly, member attendance at AGMs, voting in elections, and involvement in consideration of special resolutions are all very modest and trending down. At the same time, proposals arise to further restrict member debates at meetings, nominations, initiatives related to recalls, requisitions for meetings, and the proposal of resolutions.

The differing interests are most stark when the distribution of economic benefits is to be determined. Insiders, directors and executive managers, now largely determine what will be 'distributed' to members through dividends and rebates; with proposals ratified routinely at the AGM. Notably, even what is nominally 'available' for distribution is set by insider decisions before and at year-end when the financial statements are prepared. And, comparatively, the member-owners have a relatively limited opportunity to consider the overall compensation, perks and other benefits allocated to the other parties.

Notably, the apathy of member-owners is also likely advantageous to the other parties. Without the scrutiny of member-owners the directors and executive managers have broader discretion. So there is a perverse incentive to not encourage active member participation in co-operative governance. One can see how the interests of certain parties may contribute to long-term trends within the BC credit union community.

Consolidation

The most significant trend in the last few decades has been consolidation and rationalization of BC credit unions. While BC credit unions have maintained a good market share overall, the number of credit union has dropped by 50% in the last 30 years, and there is a high concentration of assets in a small number credit unions – two credit unions comprise over 50% of total BC credit union assets.

Whose interests are best served by consolidation? Director and executive compensation is directly correlated to the size of credit unions. The economic and status benefits to insiders would be one of the drivers of consolidation. Substantial severance arrangements have also accompanied several mergers. The economies of scale argument may well be valid, but credit unionists need to be clear about how the benefits are allocated and the trade-offs.

The growth of a few very large credit unions has created two distinct types of credit unions;

classic credit unions and 'near banks'. Examples might be Salmon Arm Credit Union and Coast Capital Savings. The old saw that "we are all credit unions" no longer makes sense. As corporate entities, the needs, aspirations and cultures have grown apart. The differences are apparent at the retail level, second tier level, and increasingly at the public policy level. Larger credit unions have increasingly 'gone their own way' over the last four decades; with banking systems, card services, and other initiatives, so that the co-operative network no longer has the strength and uniformity it once had.

Consolidation has resulted in a new risk, concentration risk. The failure of one of the larger credit unions would likely cripple the entire system. This is because the deposit insurance framework is based on a joint and several guarantee, so that all credit unions back the deposit insurance program. When the BC government arbitrarily increased the deposit guarantee from $100k to 'unlimited' in 2009, the consequence was that a major failure would drag down the entire credit union system 'for years'.

Concentration risk challenges the deposit insurance scheme and it should be more explicitly considered by the deposit insurer as the scheme is no longer is pooling 'similar risks'. The disparity in size may justify a concentration risk premium for larger credit unions, potentially a disincentive to further amalgamations. To the degree that larger credit unions have recognized the conundrum, they have proposed conversion to the Federal deposit insurance scheme, but this is not an easy path to walk.

Concentration risk has also challenged the regulatory authorities for similar reasons. Not only is the risk of a significant failure daunting, but the operational risks within the larger credit unions are increasingly complex and unlike those in classic credit unions. Assessing the effective management, intervening if necessary, and providing administrative decisions have become more challenging.

The evolution of the large credit unions has given rise to a paradoxical twist, the larger credit unions have benefited from legislation and government policy that was shaped for the smaller classic credit unions. And now, the government approach has reversed field and is pressing for more 'professional' management and governance practices. In effect, smaller classic credit unions are being pressured into conforming to the strictures of 'near banks'. This has most recently been visible with the publication of the FICOM Governance Guideline, proposals for the application of BASEL III, and changes to pooled liquidity management.

Another paradox is the regulator's bias to use mergers and amalgamations to solve some performance problems among credit unions. This regulatory bias at the institution level, promoting mergers, furthers consolidation and increases concentration risk, presenting new challenges at the system level.

Consolidation has had a most dramatic impact on the member-owner's role. The member-owner's vote has been diluted heavily and opportunities for members to become active volunteers have vanished. Voting schemes, elections, member initiatives, and debates have been 'modernized' over time in ways that further limit and discourage member democratic involvement. While social media (and the web) have empowered some member democratic action, there remains the fundamental weakness of a co-operative structure. Since no individual has a significant stake (equity investment/votes) in this kind of enterprise, effective governance relies on a number of ordinary members taking an active part. The erosion of this ordinary member-based governance has placed new pressures on third parties, most particularly, government (and regulatory authorities).

Lastly, consolidation has in part been driven by the evolution of consumer economics and the reduced role of community group identities (church, ethnic, trade, etc) which previously had given credit unions their 'common bonds' of membership. British Columbians no longer have the strong local affiliations, are more affluent, and are more and more urban.

Regulatory Burden

Another significant trend over the last three decades has been the added demands placed on banks and credit unions by government. Anti money laundering and anti terrorist projects have created new bureaucracies in government and effectively 'taxed' banks and credit unions to enforce the new laws. Privacy protection legislation has imposed other requirements. New regulatory constraints have been introduced in light of the events of 2008. And recently Canadian financial institutions were obliged to start reporting tax related information thru to the US Internal Revenue Service.

The oligopoly that is the Canadian banking establishment controls @80% of the financial services infrastructure of the country, and these large entities can be conveniently compelled to act as agents of the government, with any added costs simply passed on to consumers (a 'tax' effectively). Credit unions are obliged to keep up.

These added demands on credit unions introduce complexity and liabilities that effectively undermine the viability of independent classic credit unions. Second tier entities provide advice and support for many of these 'burdens', but the 'burdens' become substantial distractions from the core business for classic credit unions.

The regulatory burden is also increased innocently with a host of requirements for new, and refined, registered products and investment products; TFSA, RDSP, RESP, LIRA, RRIF, mutual funds, derivatives, etc.. The niche tax savings instruments add complexity and introduce the need for more specialists. The extent to which second tier entities do provide advice and support is key to ensuring the competitive position of classic credit unions.

Overall, costs transferred to financial institutions by government are an economic burden (an erosion of productivity) but since these are not recorded as direct expenditures (or tax expenditures) by government they are quite attractive to government.

New Technology

New technologies are revolutionizing the 'banking' business. New service delivery channels and new payment systems have turned traditional branch-based banking upside down. And technology has introduced non-traditional service providers.

One of the outcomes is that few people in BC now can say that they cannot access basic banking services. Tele-banking, ATMs, online banking, and mobile apps have displaced bricks and mortar. With the exception of the most marginal, people in BC are well served.

However, changes in technology do force BC credit unions to keep pace, or lose ground. And BC credit unions lack a coordinated approach. A coordinated approach would promise the benefits of scale on the R&D and capital investment side, secondary service access (if needed), complementary marketing opportunities, and reduced duplication of efforts within BC credit unions. The costs, however, would be the loss of some independence and autonomy, a loss of some opportunities for innovation, and an erosion of market place differentiation (C.U. to C.U.).

The challenge to BC credit unions is to determine the number, size and scope of second tier entities (and suppliers) that will provide support to 'all credit unions' and ensure competitive offerings. Currently (to the best of my knowledge), BC credit unions do all use one clearer, one automated funds transfer system, one online/mobile banking platform

(MemberDirect), two ATM/POS networks, three different credit card suppliers, two merchant card services suppliers, several different banking systems, various tele-banking systems, and several different loans origination systems.

In contrast, the Desjardins system in Quebec has a homogeneous IT infrastructure and strategy, and it is now reported to have functional agreements in place with three mobile carriers related to imminent smart phone payment technology.

Public Interest

The broad public interest perspective is well represented in the OECD Principles of Corporate Governance (applicable to highly regulated and other industries). The primary public interest is in promoting transparent and efficient markets. And pursuant to the rule of law, good practice must include the clear articulation both of the industry specific public interests and the responsibilities/authorities of those acting in the public interest.

At present, there is not a clear understanding of the public interests as viewed by the BC Government, specifically regarding retail and small business financial services. The pending legislative review will provide an opportunity for the government perspective to be better outlined, consistent with basic Canadian administrative law.

Let's assume that government is interested in facilitating a healthy and efficient retail financial services market (and small business market). The first credit union legislation is widely viewed as the province's response to a "market failure" in the 1940's. The province enabled new service providers to enter the market – now termed 'creative disruption'.

It can be argued that we now do have competitive markets for retail savings, payments, loans and mortgages. Credit unions have played an important role in making these markets function well. However, government must assess whether the declining number of credit unions, the fewer firms competing for business, will disadvantage consumers.

It may also be argued that small business lending markets are growing less competitive (e.g. HSBC's recent exit), especially outside the lower mainland. Will the declining number of credit unions disadvantage BC entrepreneurs?

Market health is often also assessed by counting the new entrants. There have been no new credit unions in more than 25 years. A small number of new banks have entered the market in the last decade. However, many 'ghost' financial institutions have emerged – mostly unregulated and consequently placing consumers at risk (e.g. PayPal, Square, payday lenders, cheque cashers, prepaid cards, etc.). Effectively, the barriers to entry are exceptionally high for regulated FIs (i.e. the legislative requirements, the capital investment, and the other constraints introduced by existing players). Is it government policy to facilitate the entry of new players?

Credit union deposit insurance is provided through a government entity and the limits are set by government. The unlimited guarantee is problematic insofar as depositors have no incentive to critically assess the FI. One policy objective may be to protect small depositors. Another may be to ensure stability and prevent 'runs' by nervous depositors. What is the case for the unlimited guarantee? The public interest should be clearly stated and government's policy decisions, especially those that displace market mechanisms and market discipline, need to be rationalized.

The rush to 'harmonizing' regulation (e.g. Basel III) may also be misguided (Romano) and not in the public interest. Homogenizing risk profiles introduces systemic risks.

The public interest and regulator's interests are distinct, as the owner-agent problem presents itself in government too. Regulatory authorities have self interests that may not be fully consistent with the public's interests.

Authorities will seek to expand their powers, add resources, and otherwise act to enhance their status, reputation and compensation arrangements. Such interests may conflict with the broader goal of cultivating efficient markets. The authorities delegated to regulators by government, the oversight by government, and the appeal mechanisms, must be reasonable.

The combination of an unlimited guarantee and an increasingly interventionist regulatory authority (since 2008) has challenged the basic ownership and governance structures of credit unions. The province is now a unique partner with credit unions. Should the province consider a project similar to the Alberta Treasury Branches to address the concentration and governance risks?

Choices

At this time the choices are too modestly framed as; 'Professional directors or not?' 'Deposit insurance at $250k or $400k?' Or, 'What qualifies for capital under Basel III?'

Strategically, these are not the options. Looking 5-20 years out, what are we seeking to create? I outline four distinct strategic directions.

1. A few large credit unions

The natural consequence of current trends and pressures will see further consolidation and perhaps 6 large credit unions serving the province. This is the path that we are now on.

- The concentration risk increases as the insured pool gets smaller, potentially requiring greater interventions by the deposit insurer and regulator.
- The governance risks increase as the dilution of the role of member-owners is effected, government has to fill some of the void left behind (especially with an unlimited deposit guarantee)
- Technology strategies may or may not be collaborative.
- Marketplace competition is reduced simply due to a reduced number of actors.

2. A few large federal credit unions

The concentration risk can be mitigated by large credit unions migrating to Federal jurisdiction under the Bank Act where they would be small 'near banks', even if they merged with credit unions in other provinces.

- The concentration risks to the BC Government & other BC credit unions may be reduced, but BC also may lose jobs and government may lose potential partners in economic development.
- The commitment to lending locally is eroded. (In national entities, management will likely invest where the prospects are best.)
- The remaining provincial credit unions may or may not have a viable future.
- Member-owners' stakes and roles would be further diluted.
- Governance risks will be apparent and OSFI would champion bank practices (e.g. the increased role of professionals, 'independent directors')
- Depositors' nominal insurance coverage would be reduced.
- The Federal government would consolidate its position as 'bank' regulator, as advanced in a recent technical paper from the Department of Finance. BC would defer.

3. A network of integrated classic credit unions

Public policy decision-makers and credit union leadership could reverse the existing incentives to consolidate, and pursue a vision of an integrated group of 30+ medium size credit unions that conform to classic credit union ideals. Some large credit unions may actually be broken up. This is essentially the Quebec model.

- Concentration risk would be dealt with by better distributing the risks. But the BC government may need to provide emergency liquidity support assurances if the Bank of Canada does not do so through Central 1.
- Governance risk would be mitigated by restraining the size (and complexity) of individual credit unions sufficiently so that co-operative & democratic control practices would be adequate to the needs. CUIA/FIA Provisions could facilitate 'un-mergers'.
- Member-owner roles can be enhanced to strengthen the governance accountability and enhance the inherent pride of ownership.
- Second tier institutions would be used to coordinate technology development and share risks.
- Second tier institutions would collaborate closely with the regulator and deposit insurer to address vulnerabilities.
- Markets would retain more participants, be more 'competitive'.

4. A crown corporation

Credit unions could sell their businesses to a new BC Treasury Authority (like ATB) through which a commitment would be made to provide BC's own financial services alternative. The project would recognize the role of financial services as a utility and government's need to stabilize the market through direct participation.

- Concentration risk would simply be accepted under a new control structure, and the risks managed internally.
- Governance risks associated with co-operative ownership would not exist; accountability would be to the sole shareholder.
- Member-owners would be compensated for their equity stakes and continue simply as clients. Market mechanisms would be a primary source of consumer influence.
- Small business may be assured that they have a responsive BC lender.
- Second tier functions may be integrated into the crown corporation, or credit union based entities may provide services on a contract basis.
- Regulatory and deposit insurance schemes can be retrenched or retired.

Conclusion

If we can agree on where we want to go, it may be easier to address the control structure questions at Central 1 and legislative proposals. Over the last 40 years many decisions were taken, usually 'ad hoc', that have essentially created the incentives and the path to Option 1.

Classic credit unions have been marginalized. Interests, markets, and contrary incentives have eroded their positions. Two- tier legislation might reduce the pressures on some classic credit unions. Legislation can reduce unnecessary burdens and enhance competition. Classic credit unions will have to champion their interests.

Industry watchers may use the term 'member-centric' but too little attention is paid to the erosion of the role/rights of member-owners in effective democratic governance.

The combination of concentration risk and governance risk really confronts BC's large credit unions and government, in particular. Regulatory authorities increasingly see themselves as 'risk managers', the role that classically belongs with credit union executive teams and boards. The realities of governance and management of 'near-bank' credit unions challenge conventional ideas of co-operative ownership and traditional financial institution regulation.

Author: Ross Gentleman ross.gentleman@shaw.ca