Evolving Role and Challenges Confronting National (Apex) Credit Union Organizations

A presentation at the Asian Credit Union Forum
21-23 September 2006
Galadari Hotel, Colombo City,
Sri Lanka

By: Robby Tulus[1]

Introduction

In September 2002, I presented a paper entitled ***"The Role of Credit Union Federations in positioning credit unions in the changing landscape in the 21st Century"*** at the ACCU Forum held in Bangkok. I made an assertion at that time that the impressive growth of credit unions has made this sector an essential part of the financial system in many local communities in Asia. But the changing financial landscape in the 21st Century has brought about increasing competitive pressures to primary credit unions. While primary credit unions are resilient and could withstand these pressures thus far, in the end they will suffer if institutional strengthening and systems redress to fit the financial market are not happening at a pace that will create sufficient advantages over their competitors.

I was happy to respond to the request of my good friend and colleague Ranjith Hettiarachchi[2] when he asked me in Colombo recently if I could elaborate further the above topic by pinpointing the more recent challenges confronting national (apex credit union) organizations and how they could evolve their roles in meeting these challenges. It follows from what was described in 2002 as a challenge for credit unions to "think out of the box" and to leave their respective comfort zones, and move forward towards overcoming problems of governance and capture untapped and underserved markets to increase their share. Federations must add value to these credit unions by working with regulators to improve sensible regulations to increase greater access to these markets.

[1] Research Fellow, BCICS (British Columbia Institute for Co-operative Studies), University of Victoria (Canada), and former Regional Director of ICA (International Co-operative Alliance) for Asia and the Pacific.

[2] CEO, Asian Confederation of Credit Unions

My current paper intends to address the dichotomy inherent in credit unions in meeting their challenge to grow as member-based institutions in the financial market, and the regulatory framework needed to support such growth.

Movement-wide challenges for growth and development.

Credit unions in this region have expanded in their range of financial services with a business infrastructure that is able to compete with the rest of the financial sector. ACCU must be praised for having led its members over the years in fostering acceptable prudential and governance standards.

Credit unions in the region has thus evolved a new paradigm in creating and augmenting new products and services more akin to commercial banks and in some ways more refined than many MFIs, yet faithful to its mission to develop the (enterprising) poor and their local communities.

With the constant growth of credit unions in so many countries in Asia, the credit union leadership is being challenged to play a support role to, and also be motivated by, the mutual efforts to create a sound and safe national financial architecture in their respective countries. Credit unions are strategic contributors to help strengthen the financial sector in local communities, thereby augmenting capital markets through the enhancement and protection of credit union brand, risk management mechanism, and technological application throughout the movement.

Credit unions cannot exist in isolation from the development of financial markets in their respective countries. Competition has not been stagnant as new entries such as unregistered village and community-based financial institutions are on the rise in many developing countries on account of the availability of micro lending through MFIs. The consumer credit market in urban areas is also highly competitive, with intermediation margins getting thinner as only a small segment of the markets being served by so many formal and informal institutions (including credit unions) at the same time.

If we take the Indonesian case, Credit unions are at the forefront as member-based and member-driven financial co-operatives compared to other co-operative sectors. Credit unions have developed clear standards, having their own credit union brand, and have begun developing risk management mechanisms. As well, there has been increased technological application to gradually reach nation-wide movement coverage.

However, outreach of credit unions is largely concentrated on the upper end of the co-operative and microfinance market, and in fact credit unions are competing fiercely for this narrow base, while the multitude of lower income households remains under-served.

A recent study has shown that even the BRI Unit Desa network that is highly regarded as a paragon among MFIs is really much more effective in mobilizing savings than providing micro-credit in the rural areas, with the network's depositors far outnumbering its micro-borrowers. This is symptomatic in many markets in other developing countries in Asia as well.

In fact, this reality is seen as siphoning rural savings into the center and likely adding more to the already highly skewed urban-rural wealth disparity of income distribution. The BRI network, for example, is reported to currently serve about 3 million micro-borrowers -- compared to around 500,000 credit union micro-borrowers.

This comes up to only a little over 700 micro-borrowers per BRI Unit Desa that is conceivably equal to one primary credit union, yet still concentrated on a narrow base. Credit unions, having a better ratio and equilibrium between their savings and loan portfolios, have great opportunities in their outreach to the larger market segment.

In short, there is still so much room for credit unions to expand and deepen microfinance coverage in order to reach out to the larger segment of the real microfinance market, which are the low-income households that remain largely under-served despite the multitude of MFIs in rural areas.

Role and challenges confronting National Credit Union Apexes

In view of the highly competitive marketplace, national federations have the option to adopt a "financial systems development approach" that views the credit union market as an integral part of the overall financial market. Notwithstanding peculiarities that make credit unions identifiable from other segments of the market, they must also be subjected to the basic discipline and rigor required for the proper functioning of the broader financial market. This strongly suggests that the development of players in the microfinance market must be pursued not at the expense of the other segments of the financial market but as an important complement to them.

If credit unions are intent to penetrate and capture the microfinance market, the challenge for national credit union Apexes/Federation is essentially to heed two important supporting pillars of the institutional microfinance market.[3] One pillar is the **policy, legal, supervisory and regulatory framework.** This may comprise general policies that affect the market. For example, an interest rate policy that puts a cap on credit union loans will be a disincentive for MFIs to expand or will make credit union delivery unsustainable.

[3] Credit unions are hereby perceived as one of the players in the institutional microfinance market.

Likewise, the safety of depositors is an overarching concern for the financial market as it should also be for the microfinance and credit union sub-sector, since credit unions are active in deposit mobilization - both as a service to members as well as funding source for the credit union. Thus, it is crucial that the various components of the policy, legal, and regulatory framework are mutually consistent so that they can reinforce each other and strengthen the foundation for a vibrant microfinance sub-system, within the context of the overall financial market.

The other pillar is the **financial infrastructure**, which helps ensure that the market functions seamlessly. This includes the production and sharing of information that provides benefits among the key players in the market, and thus requires policy and operational support. Elements of the financial infrastructure include the standardization of accounting systems (e.g. chart of accounts) and performance standards, and their proper and timely processing through efficient and IT–enhanced management information systems (MIS). These not only strengthen the operational capacity and efficiency of the credit unions and other MFIs, but also ensure their transparency and allow better oversight over them.

Credit Unions, MFIs, apex institution-wholesalers, regulators, and oversight entities must have a common view of how the MFIs' performance will be gauged, and what an MFI audit and control system should contain. Likewise, the financial infrastructure should include effective capacity-building service providers that can facilitate information sharing, such as the adoption of microfinance best practices, which not only allows credit unions and other MFIs to viably deepen their outreach and expand their range of services but also helps them cope with inherent and peculiar risks in microfinance.

Widespread dissemination and appreciation of proven practices in the market will also allow policy, regulatory, and supervisory entities to make the needed adjustments to support the peculiarities of the credit union sub-sector. The credit union sub-sector is quite specific and not applicable to the other segments of the financial market (e.g., non-collateralized lending, use of social collateral, "door-step" off-premise banking, etc.).

In short, the financial environment is changing very rapidly these days, more so than at any period in our history on account of the proliferation of modern information technology. Credit union movements in Asia have continued to change with the times to meet its members' needs, to fend off competition from other financial service providers and to remain **relevant**. And the sustainability of the movement will require that credit unions get into increasingly riskier activities to survive and thrive. In these circumstances, formal, rigorous supervision will become more critical and more urgent.

REGULATORY framework and options for national Credit Union movements

Credit unions in many developing countries in Asia are still regulated under the Co-operative Societies ordinance and supervised by the government line departments in charge of co-operatives. As credit unions grow big, moral hazards become a risk to be reckoned with. Since credit unions in these countries are regulated under the Co-operative Societies Acts as the first option, these acts are not specifically customized to financial co-operatives alone; they also regulate other co-operative sectors, chief among them being the agricultural co-operative sector in the still overwhelmingly agrarian societies in Asia.

The question that arises, therefore, is: *"Are co-operative acts sufficient to regulate the growing needs of credit unions as it gradually moves to become an integral part of the financial market?"* Credit unions, when they have grown big in size and substance, require prudential supervision that is highly technical like any other formal financial institution. It will apparently be onerous for co-operative line departments to continue to keep up with supervising credit unions in such a situation.

The second option is to subject credit unions to prudential supervision by the banking superintendency. But again, credit unions are different from commercial banks because of their distinctiveness and proven practices, such as (a) democratic control by members, (b) only members can save and borrow, (c) members are owners and users, (d) ownership structure is based on share contributions, (e) surplus is returned to members. It is thus difficult to regulate credit unions under the banking act, because credit unions have internal protection mechanisms of savers and borrowers (= members), unlike banks whose superintendency must protect depositors (= public) who have no say in the banking policies and operations at all.

In such an environment the credit union national federation must discuss and advocate this credit union distinctiveness with the government or central bank regulators and supervisors to allow them to give credit unions special legal provisions. This seems to be the case with the Credit Union League of Thailand when it was given special legislative provisions by the Thai Government recently, notably by the Co-operative Promotion Department.

The primary option, naturally, is self-regulation. A special department in the national credit union Apex/Federation may be able to carry out such self-regulatory function as a delegated supervisor. The latter entails the need for an independent judgment and for that reason alone a special board must be created and composed of credible supervisory committee members of high standing chosen from member credit unions.

To be sustainable, however, self-regulation must remain vigilant and accompanied with enforceable legal actions against member credit unions violating the rules, and also disciplinary measures against those not abiding by the accepted prudential principles.

The ideal solution would be for Apex Institutions to convince policymakers and the lawmakers to furnish the credit union movement with a special and distinct Credit Union Act. Legislation meant for commercial banks is generally inappropriate for credit unions based on reasons mentioned earlier, because credit unions provide services exclusively to members who are depositors, borrowers and owners at the same time. To do so, however, credit unions must demonstrate that they now have adequate economies of scale and required standards to deserve special legislation.

To lend credibility to this regulatory approach there would need to be a process of intense dialogue between all the stakeholders – the Ministries of Finance, Labor, Co-operatives (and other relevant ministries), the credit union Apex Institution, and the Central Bank. Another role for the credit union Apex institution is to prepare its membership for such dialogue so they are involved in setting the stage towards the new regulatory environment. An empirical study rationalizing the need for a separate legislation would be a useful step to take.

Evolving Role of Credit Union Apex Institutions

A unique characteristic of a national Credit Union Apex is the fact that they could finance productive loans to member credit unions and consider financing opportunities for micro and medium enterprise lending of members designed to create successful projects. Providing such financing is not merely to reap financial returns but also to create economic and social development impact. It means reconciling the development objectives and sustainable lending policies.

With the exception of a few countries in Asia, credit union movements in developing countries have not penetrated the financial markets deep enough to compete in project lending alongside banks and large Microfinance competitors. There is a challenge to create greater impact by enlarging their institutional outreach. Market penetration of credit unions in Asia is well below 1percent as compared to 6.02 percent in the United States and 20.79 percent in Canada.

While a “financial systems development approach” is crucial to face stiffer competition in the financial markets, internal governance continues to be extremely essential[4].

[4] The issue of governance is being addressed in other sessions in this ACCU Forum (2006) as well.

More empirical work and case studies on the correlation of building prudential norms and the effectiveness of governance is therefore needed.

The challenge now is for apex institutions to extend and deepen credit union's institutional outreach. To do so, existing credit unions must inspire confidence and reliability within the immediate community where potential members subsist, known for their quality standards and profitability. Secondly, the national apex institution must consolidate the entire credit union network, in order that primaries as well as the whole movement can satisfy the acceptable standards of solvency, viability and service quality.

CONCLUSION

Credit unions are strategic contributors to help strengthen the financial sector in local communities, and if they do it well, they become key stakeholders to shape the financial architecture of their respective countries. But wittingly or unwittingly, credit unions are largely concentrated on a narrow base of the co-operative and microfinance market, and in fact competing fiercely for this overcrowded base.

In view of the highly competitive marketplace, national federations must adopt a "financial systems development approach" that views the credit union market as an integral part of the overall financial market.

To do so they must understand and heed two important supporting pillars: one pillar is the policy, legal, supervisory and regulatory framework, and the other pillar is the financial/business infrastructure, which helps ensure that the market functions seamlessly.

Apex institutions must begin to penetrate the under-served markets rather than competing in the crowded and narrowing market base. To gain comparative advantage, Apex institutions must lobby the government and legislators to give them special regulatory and legal basis, with a separate credit union act being the preferential option.

To gain such a comparative advantage, credit unions must continue to excel in governance and market penetration, and for their Apex to consolidate the entire network and movement to satisfy the acceptable standards of solvency, viability and service quality. This will inspire confidence not just among current members, but also among potential target members in under-served areas as they feel their money could be as safe and secure in a credit union as in other formal financial institutions.

Robby Tulus
August 2006