

Credit Union Governance

Unique Challenges

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Nexus, Number 41, Summer 1998

Member ownership and control is a hallmark of credit unions. Operating on the basis of one-member, one-vote, credit unions have always been socially-minded and democratic financial institutions. They are also traditionally savings-led. Yet these very strengths can easily be impediments to the effective governance that credit unions require to expand and compete in the financial market place. Brian Branch and Christopher Baker of the World Council of Credit Unions offer the following insights to the unique challenges that credit unions face in balancing the potentially competing aims of owner participation in decision-making and professional management.

In commercial institutions potential conflicts of interest between managers responsible for making decisions and owners who bear the consequences of these decisions are mitigated by Boards of Directors. Elected by the owners, Directors of the Board retain ultimate supervisory control over the management; to carry out this responsibility effectively, they should be qualified individuals skilled in various areas of decision-making and policy that they oversee. Credit unions are no different; their structure – the Annual Meeting, Board of Directors and Manager – offer the same mechanisms for separating decision-making and decision-monitoring and ensuring member control.

But credit unions are different on two fronts: (a) the Directors are elected by democratic vote; and (b) the owners are also the clients. Each of these distinguishing features of credit unions pose its own challenges.

The democratic election of the Board of Directors creates problems in credit unions due to (a) inaccurate representation of owners; (b) unqualified personnel in decision control; and (c) confusion of decision making versus decision-monitoring roles.

Because credit union directors are elected from the general membership on a one-person, one-vote basis, those elected do not necessarily own a major proportion of the invested savings or shares in the credit union. They may be a small percentage of the wealth of the entire member pool. If this is the case, they do not fully represent the owners as their decisions many affect them significantly less than the majority of credit union members. In the event of crisis or poor decisions, a credit union board member can have less at stake than a comparable bank or stock company director.

The democratic one-person, one-vote governance process has been maintained over the years to make credit unions responsive to their owners. Yet, this rule of governance is a problem when the individuals elected do not have the expertise to make sound judgements. The ability of directors to fulfil their role as a monitor or control depends upon their business acumen or management skills. Often this problem only emerges with the evolution and maturation of the credit union.

Often formed by local community leaders who are generally better educated than the rest of the citizens, credit unions begin among a small, sometimes closed group, and depend upon volunteers for operations, governance and member representation. The involvement of volunteers maintains low operating costs when the business volume is not large enough to afford professional staff. Where boards are dominated by non-professionals, directors can be very responsive to local social issues but fail to manage the financial business aspects that become increasingly complex as the institution grows.

With growth, credit unions generate sufficient income to hire specialised, professional staff to manage more sophisticated operations. Volunteer owner/representatives are less involved in operational matters and shift to decision-monitoring roles. As credit unions move to this level of professional operation, problems occur if volunteer board members engage in decision-making such as determining expenditures, directing department heads or making loan approval decisions rather than limit themselves to decision monitoring.

The second feature distinguishing credit unions from other financial institutions and creating a unique governance challenge is that the owners are the customers. That the owners can be savers and or borrowers poses a unique challenge for management. The institutional governance system must respond to two sets of owners/clients who have different and somewhat conflicting interests. For most financial institutions the owners, or principals, represented at the Board of Directors are primarily interested in the profitability of the institution. In credit unions, however, profitability is not the primary concern of all the owners.

It is the simultaneous presence of savers, who provide the funds, and the borrowers, who borrow the funds, which forms the basis for a self-sufficient or balanced financial intermediary. However, conflicts of interest are inherent in this balance. Borrowers want low loan rates, low transaction costs and lax discipline while savers demand high deposit rates and strong prudential disciplines. The savers have strong incentives to see the institutional viability strengthened by profitability and protected by financial discipline. Yet, the borrowers' short-term incentives favour conditions – lax discipline, low loan rates, easy access to loans – which adversely affect the financial stability of the credit union.

Management decisions may favour one group or the other, depending on the credit union's business/social mission, the nature of the membership, and the balance of borrowers and savers serving on the Board of Directors.

What are the possible responses to these unique challenges? First, the clear specification of *institutional rules*, which define the roles and responsibilities of the actors involved in the governance of the credit union can address the conflicts of interest between management, elected directors and members.

Second, credit unions need to counter the tendency of borrowers to dominate their governing Boards. *Regular and updated services* must attract more savers to join credit unions while *incentives* are needed to attract savers to serve on Boards. The presence of net savers on Boards will lead to more effective pressure upon the management and for prudent governance that will protect the interests of savers and help ensure the long-term sustainability of the credit union.

Finally, *external supervision* must serve as the ultimate check. Governance problems can still occur where structural rules are clearly specified and services are updated. Supervision not only establishes the rules for behaviour and responsibilities of actors but also monitors performance and enforces a prudent financial management framework, which protects the members and their savings.

Source

This article is an excerpt from a longer paper by the authors entitled: *Overcoming Governance Problems – What does it take?* To obtain a copy of the full paper, contact:

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Nexus is the quarterly magazine of Small Enterprise Education and Promotion Network (SEEP). They can be contacted C/o Pact, 777 United Nations Plaza, New York, NY10017, USA or e-mail: seepny@undp.org