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21st century co-operative
Rewrite the rules of collaboration

This report discusses the Canadian credit union system, which, unless otherwise specified, refers to credit unions, Centrals and system strategic partners affiliated with the Credit Union Central of Canada. Caisses populaires, including Caisses Desjardins du Quebec, are specifically excluded from this analysis.

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The credit union system is about to change – again

The Canadian credit union system is entering a period of fundamental realignment that will redefine how credit unions function and interrelate - both with players inside and outside the system. All aspects of the system are undergoing a 21st century update, from how credit unions interact with their members, to the products and services they offer and how they source back office shared services.

These changes are being brought on by a combination of external factors - including increased competition from the Big five banks, customer preferences and regulatory requirements, as well as internal factors, such as aging technology and a quest for scale via mergers and acquisitions (M&A) or organic member growth.

At its core, this fourth wave of evolution is rewriting the formal and informal rules for credit union collaboration that have defined the Canadian co-operative marketplace for much of the past 80 years, resulting in a bifurcation of the system into a small group of larger credit unions and a shrinking but still sizeable set of niche players. As the system bifurcates, credit unions will need to solve the inherent conflict that will arise between the two primary categories of co-operatives: large organizations with the scale and desire to act independently, and a community of niche players who will increasingly need to rely on collaboration and co-operation to survive. Those credit unions caught in the middle will need to decide which of the two models best suits their members' needs, particularly in light of new federal charter rules, the consolidation of Centrals and the changing role of system strategic partners[1].

No matter which path they take, credit unions that fail to update their business models, and rely instead on current infrastructures and tools, will struggle to succeed in this new era of collaboration. Fortunately, there is still time to prepare for this transition. Those credit unions, Centrals and system strategic partners that act now to improve operations, manage their risks, strengthen governance and develop growth and/or M&A strategies will be well-positioned to provide their members with differentiated services and true value throughout the 21st century.

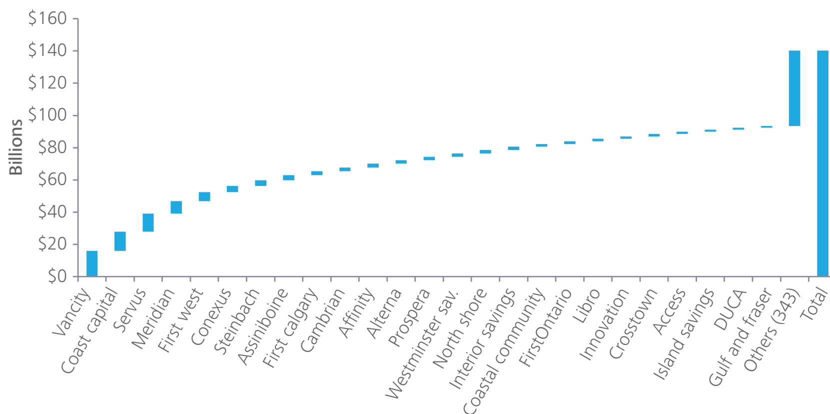
In 1966, there were over 3,200 credit unions in Canada. In 2012, there are less than 370.

Collaboration still matters

As credit unions contemplate these changes, it's worth considering whether the sixth principle of the co-operative movement[2] – "co-operation among co-operatives" – remains relevant. A number of Canadian credit unions have chosen to forego collaborative shared services to develop in-house capabilities or source from the open market. Similarly, certain credit unions are becoming increasingly reluctant to fund common activities if there is a perception that they will be subsidizing their peers.

In recent years, credit unions have become more willing to engage with non-system suppliers for everything from core banking systems to bonding insurance. As the at-scale credit unions (those with >$5B in assets and 150,000 members) continue to get larger, these trends are likely to expand, with credit unions increasingly acting unilaterally or forming smaller "coalitions of the willing" rather than rallying under a national-level or Central-level shared program. To succeed into the future, it will be critical to temper these unilateral moves with a renewed spirit of co-operation.

Cumulative assets by credit union[3]



Big is still small

The first reason for ensuring strategic co-operation is scale. While there is a significant disparity in size between the largest and smallest credit unions, even the largest credit unions are dwarfed by the largest financial institutions in the country. While the top three credit unions each have over $10B in assets, the Big five banks range from $350-$750B. Even the more directly comparable peers are significantly larger than any individual credit union[4]. Strategic sourcing and back office consolidation offers a much higher potential for savings when credit unions act as a common $139B asset block[5].

Another striking comparison with the chartered banks is in the degree of concentration. While the top six banks in Canada control 83% of total bank assets, the largest six credit unions control slightly more than one-third of system assets. No single credit union owns more than 11% of the total asset base and, while some are regionally significant, none hold a dominant position in the system. In such a market there are clearly advantages to working together.

Failure is not an option

The second key reason for effective co-operation is the need to avoid the failure of individual credit unions. Any failure, large or small, will reflect poorly on the entire co-operative movement. While the system has successfully ensured the orderly wind-down of credit unions (generally via acquisition) any material failures would carry significant reputational risk for all players. Furthermore, the failure of any particular credit union could remove some portion of members from the system. Since membership is growing at a slower rate than the Canadian population, it is critical to retain all existing members. Finally, if a credit union plans to grow through M&A, it needs access to a pool of viable organizations with which to merge. As a result, it is still in the best interests of credit unions and their members to ensure that the overall system remains sustainable.

How did we get here?

The first three waves of the credit union movement

To understand where the credit union system is headed, it is instructive to review the formative drivers that led the system to develop as it has over the last hundred years. For this analysis, it can be helpful to group the system's evolution to date into three distinct waves:

- **Wave 1: Establishment**, from the 1900s to 1940s, in which credit unions were founded in small communities across the country and issued loans to a largely rural membership base
- **Wave 2: Infrastructure building**, from the 1940s to 1980s, where membership and total assets increased dramatically and credit unions began offering a wider range of financial products through the support of Centrals and system strategic partners
- **Wave 3: Consolidation**, from the 1980s to 2000s, where credit unions merged and combined to achieve the advantages of scale for controlling costs and driving growth

Wave 1 (1900s to 1940s)

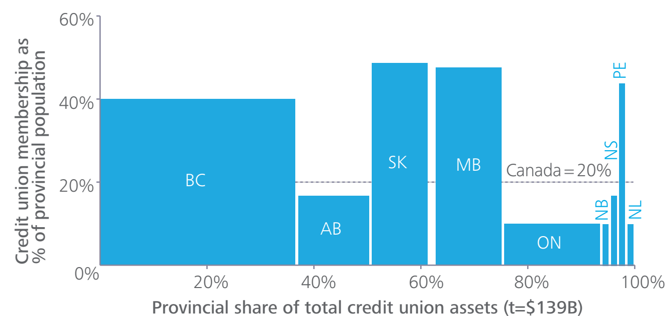
Establishment

In the first four decades of the 20th century, credit unions were established across the country, in large cities, small towns and particularly in rural/agricultural locations. Drawing on the success of caisses populaires in Quebec, credit unions first spread to Ontario, starting with the Ottawa Civil Service Savings and Loan Society (now Alterna Savings) in 1908[6]. After several decades of steady growth, credit unions rapidly spread across the Maritimes, Prairies and BC throughout the 1930s and 1940s.

The defining feature of collaboration during the establishment wave was co-operation between individuals. Credit unions were formed around a "common bond", such as a shared industry (Reserve Mines Credit Union, NS – 1932[7]), religion (Jewish Colonization Association, SK – 1910[8]) or geography (Blackville Credit Union, NB – 1936[9]). In almost all cases, the credit unions were formed to overcome the difficulty/impossibility of acquiring credit through conventional banking channels, particularly during the Great Depression. Credit unions were generally small (dozens or hundreds of members) and offered a limited range of products.

Prior to the 1930s, any co-operation between credit unions was informal and unstructured. There were no shared services, no system strategic partners and no Centrals. Risk sharing was not an option and activities were strictly limited by the available capital. However, as the 1930s progressed and the number of credit unions exploded, it became clear that this was not a sustainable structure.

Regional variances in credit union influence[10]
Membership penetration of population vs. share of system assets, by province (2011)



Wave 2 (1940s to 1980s)

Infrastructure building

The 1940s to 1950s saw an explosion in both the number of credit unions and the infrastructure to support the new organizations. Centrals were established across the country, provincial governments passed co-operative financial association acts, provincial deposit insurance facilities were established and system strategic partners emerged to take on increasingly-complex products and service delivery channels.

Credit union membership rose dramatically, from an average of approximately 100/credit union in 1940 to almost 2,500/credit union in 1980[11]. Urban, industrial (e.g., employees of Dofasco Credit Union[12]) and public sector co-operatives began to overtake rural credit unions in relative size and scope.

Member needs expanded beyond savings and loans to full service banking, including small business, mortgages, payroll processing, investments and insurance. To remain competitive, credit unions needed to offer these products in a cost-effective manner.

To achieve this goal, provincial Centrals provided liquidity, risk management and back office infrastructure, particularly to support the move to electronic record-keeping. System partners stepped in to provide new products and channels, such as insurance (Co-operators, 1945[13]) and trust services (Concentra, 1952[14]).

The defining characteristic of collaboration during this phase was the establishment of Centrals and system strategic partners to help manage the risk and complexity of offering a greater diversity of products to a relatively homogenous set of credit unions.

Wave 3 (1980s to 2000s)

Consolidation

By the 1980s, it became increasingly clear that changing consumer needs required a fresh approach to delivering services. Members were demanding a full-featured banking experience that was competitive with the big banks. Members expected a full range of channels, such as ATMs and internet/telephone banking, as well as features such as credit cards and access to point-of-sale debit purchases.

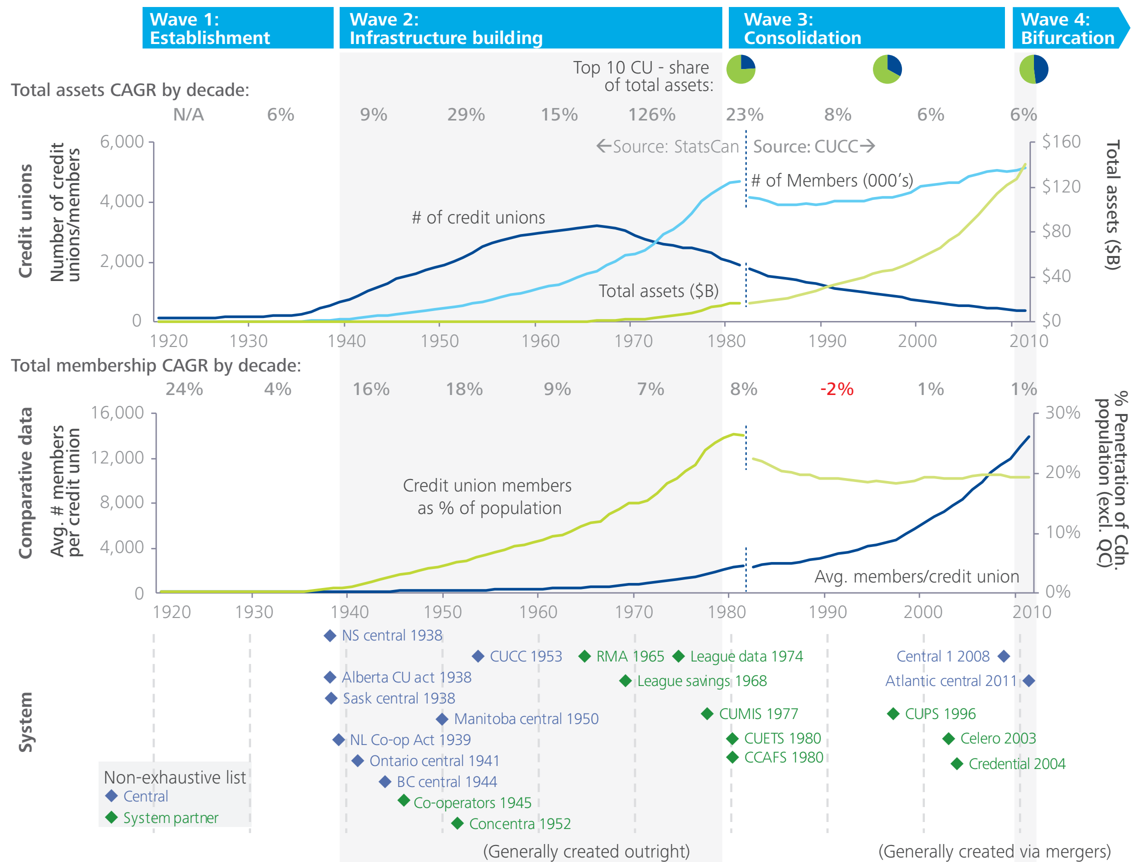
Meanwhile, credit union penetration of the population leveled off at approximately 20%. Faced with the need to deliver increasingly-complex products and services to a stable customer base, a number of credit unions turned to M&A activity to drive scale. The result was a continued drop in the number of credit unions (a trend that began in the late 1960s) and a dramatic rise in the average membership per institution (from almost 2,500/credit union in 1980 to 13,000/credit union in 2010, with the largest approaching half a million members). The distribution of assets and members also became more concentrated. The top ten credit unions doubled their share of total system assets – from 24% in 1980 to 48% in 2010.

The provincial Centrals also embarked on a campaign of consolidation to achieve operational scale. The Ontario and British Columbia Centrals merged to form Central 1 in 2008, closely followed by the Atlantic Centrals in 2011. Credit Union Central of Canada (CUCC) delegated its operational responsibilities to Central 1 and focused on its role as the national trade association. Attempts to merge the three Prairie Centrals and Alberta into Central 1 were not successful, but could be re-launched in the future.[15]

System partners were also formed from joint ventures and consolidation, such as CUETS Financial in 1980[16] and CUPS Payment Services in 1996.[17] In contrast, the system has recently demonstrated a willingness to change system strategic partners, as evidenced by the sale of CUETS Financial to MBNA (now TD) in 2007[18], the joint venture of Ethical Funds and Desjardins in 2007[19] and the purchase of CUMIS by Central 1 and The Co-Operators in 2009.[20]

The defining characteristics during the third wave were the concentration of members and assets into a small number of very large credit unions, the concentration of shared services into a reduced population of Centrals and system strategic partners, and the rising willingness of participants to seek service delivery partners from outside the co-operative movement.

The four waves of credit union evolution



Sources: StatsCan 1900-1981 (all credit unions outside Quebec), CUCC 1982+ (all CUCC-affiliated credit unions), company websites, Deloitte analysis

Wave 1: Establishment 1900s to 1940s	**Wave 2: Infrastructure building** 1940s to 1980s	**Wave 3: Consolidation** 1980s to 2000s	**Wave 4: Bifurcation** 2010s +
Membership			
• "Common bond" membership, generally agricultural, small business, religious	• Increasing influence of ethnic-based and industry-based credit unions • Increasingly urban membership	• Increasingly urban • Increasingly sophisticated needs • Average age of member increasing	• Require competitive pricing and comprehensive services • Increased focus on social responsibility
Key characteristics			
• Dozens of members per credit union • Generally limited to basic savings and loan products	• Hundreds of members per credit union • Full range of financial services, including investments, insurance and small business	• Thousands of members per credit union • Channel proliferation, including ATMs, telephone and internet banking	• Hundreds of thousands of members per credit union • Competing against banks to offer differentiated member service
System support			
• No common structure	• Establishment of Centrals for liquidity, risk management and shared services • Establishment of system strategic partners for services and complex products	• Merging of Centrals to achieve scale • Increasing willingness of large credit unions to source outside the system	• Further consolidation of Centrals and system partners • Material shift to non-system partners for provision of shared services
External environment			
• World War I, Great Depression • Minimal government oversight/ regulation	• World War II, oil crisis, stagflation • Increased government regulation • Deposit insurance and other support	• Recession, credit crisis • Volatile interest rates • Entry of US competitors, increased competition from Schedule I Banks	• Banks targeting credit union customer base, value proposition • Dramatic increase in regulatory requirements (BASEL II/III, FATCA, AML)

The fourth wave

Bifurcation

The natural successor to the third wave of consolidation is the acceleration of the third wave trends, leading to the effective bifurcation of the credit union system into two groups of credit unions – a small number of relatively large credit unions and a shrinking group of niche players.

Centrals and system strategic partners will become much less critical for the large players, and absolutely vital for the niche players. Those credit unions caught in the middle will find their position increasingly untenable, and will need to either grow big or go niche.

It is not difficult to envision a scenario where, in the next decade, the top ten credit unions will grow to control more than 75% of the entire system's assets and one or two credit unions emerge with over $50B in assets. Growth will primarily be through mergers, further reducing the number of mid-sized credit unions.

Credit union Centrals are also expected to pursue their consolidation. Notwithstanding recent attempts by the Prairies and Central1/Alberta Central to merge, increased regulatory requirements, the introduction of federal co-operative charters and the need for economies of scale will likely result in further merging of the Centrals. The ultimate end-state for this process could be a single national Central, which would face significant implementation challenges but offer significant opportunities to leverage scale.

What's driving the change?

First, increased competition from the Big five banks will continue to put pressure on credit unions, especially as banks become more effective at delivering differentiated customer service to individuals and small businesses. Banks have also begun to compete against core co-operative values through initiatives such as corporate social responsibility, sustainable businesses and the environment. This trend has been in effect for some time and is expected to accelerate.

A second cause is increased regulatory requirements in the form of capital, liquidity, reporting and compliance. As credit unions struggle to demonstrate compliance with everything emerging from enterprise risk management and capital stress testing requirements, to FINTRAC[21] reporting and record keeping, to new Foreign Account Tax Compliance Act ("FATCA") requirements, a number of them will likely find that they lack the necessary scale to implement effective governance.

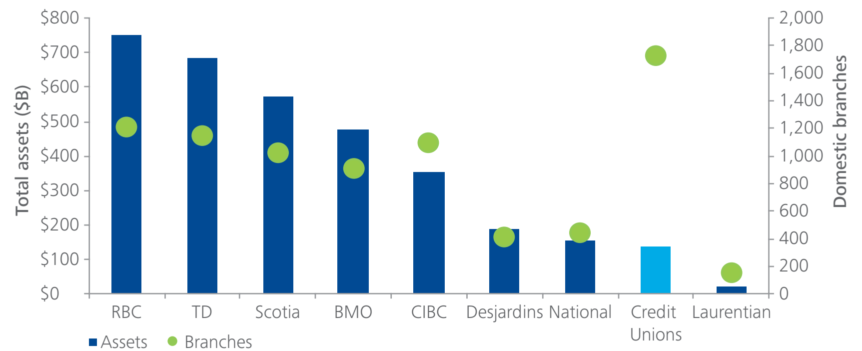
Third, technological changes will prove to be too difficult for some to manage. Mobile banking, contactless payments, core banking replacements and integrated cash management are just a few examples of table-stakes functionality that many credit unions will have difficulty implementing.

Finally, the introduction of federal co-operative banks will have far-reaching consequences for all aspects of the system, from the role of the Centrals to intra-system competition. Federal charters will accelerate the pace of credit union consolidation and place new regulatory burdens on federal participants.

The end of subsidization and the emergence of "coalitions of the willing"

The defining characteristic of collaboration for this emerging wave will be the end of consensus and the emergence of "coalitions of the willing". This evolution is already taking place. Credit unions have begun to source services from the open market, either directly or as part of purpose-built group purchasing syndicates. Very few services offered by the Centrals enjoy universal adoption by their member institutions. And, as competition heats up, at-scale credit unions will be increasingly reticent to pay into a shared system resource if they feel they are paying a disproportionate share of the total cost. The net impact of this collaborative tension will ripple across the entire credit union system.

Total assets vs. domestic branches (2011)[22]



Prepare for the 21st century co-operative system

The impact of these changes on the credit union system will be dramatic. The institutions, processes and formal/informal conventions that guided the system through the 20th century provide a solid foundation for change but are insufficient to support credit unions in this fourth wave of heightened competition and rising operational complexity. Attempting to manage the system using consensus models and institutions designed in the 1960s will result in reduced flexibility, reduced competitiveness and ultimately loss of market share.

However, these changes also present a unique opportunity for system participants to compete effectively, streamline their operations and target their member service efforts. Freed from the "one size fits all" model, Centrals and system strategic partners can focus on serving individual credit unions in a targeted manner.

Time to get big

As the at-scale credit unions continue to grow, they will increasingly focus on building internal capabilities, ultimately decreasing their reliance on Centrals and system strategic partners. This will position them to take advantage of their size to realize economies of scale and manage risk.

These credit unions need to continue their growth momentum. With limited opportunities for meaningful organic growth, this must come from mergers and acquisitions with other credit unions. Mid-tier credit unions ($750M-$5B in assets) are the natural source of partners, and the coming decade will see a number of these players absorbed into the larger organizations.

In addition to growth through M&A, some large credit unions may choose to offer products and services to other system participants via white labelling, back office service delivery and/or joint ventures. These "super credit unions" will complement, and in some cases overlap, the shared services provided by the Centrals, but without the obligation to provide services to all member credit unions.

The at-scale credit unions can prepare for the fourth wave by:

- **Developing** an actionable strategic plan that creates differentiated value for members in a 'fourth wave' of system change
- **Developing** a growth strategy that includes specific M&A targets for expansion (e.g., new geographies, market segments), and a willingness to explore alternate delivery models (e.g., JVs, insourcing/outsourcing arrangements)
- **Developing** an enterprise strategy that considers whether it is appropriate to pursue a federal co-operative charter and/or eventual demutualization
- **Streamlining** internal operations so that growth can be accommodated without a corresponding increase in costs
- **Repositioning** enterprise risk and governance activities as strategic enablers rather than simply compliance requirements
- **Developing** a strategic sourcing strategy that considers the inter- and intra-system sourcing of shared services and assesses the impact of sourcing decisions on their respective Centrals and current service providers

Find your niche

Small credit unions (<$500M in assets) are unlikely to engage in M&A activities with the larger players. Some will participate in mergers of equals to gain stability, but in general they will find success through careful targeting of specific members and services. Their smaller size and scope will enable them to focus on strategic imperatives and move with increased speed and flexibility.

These credit unions can prepare for the fourth wave by:

- **Developing** an actionable strategic plan that enables them to target sustainable niche markets based on a uniquely defined value proposition
- **Developing** governance models that share the responsibility for monitoring with their respective Centrals
- **Advocating** for their respective Centrals to support technological innovation, especially for emerging channels and products
- **Developing** strategic sourcing strategies that focus on supporting their respective Centrals and/or engaging in group buying syndicates where appropriate

Caught in the middle

The mid-sized credit unions, need to decide where to compete. Without the scale required to "go it alone", these credit unions face tremendous pressure to either grow by acquiring smaller players or merge into a larger credit union. Complicating matters will be the size limitations of growing within a single province, particularly if you are already the largest credit union.

Mid-tier credit unions also need to determine how they choose to differentiate. Without the scale required to offer a truly full-featured alternative to the Big five banks, these credit unions need to be selective about where and how they will compete. The challenge of treading this line will make it difficult to remain a mid-tier player in the long run.

These credit unions need to:

- **Prepare** a comprehensive and executable strategic plan that takes into account current system realities
- **Develop** acquisition strategies, either as an acquirer or as an acquiree
- **Determine** which member/market niches they will target and strategically allocate capital to support these efforts
- **Have** the courage to try not to be all things to all people, and make conscious decisions to not offer non-competitive services

Race to the centre

Regional Centrals are in an exceptionally difficult position. In the bifurcated future, they will be required to offer increasingly complex shared services to the niche credit unions, while potentially losing the scale provided by large players who opt out of the collaborative model.

As credit unions grow in size, Centrals will need to deal with the asymmetry of one or two member credit unions contributing the vast majority of their assets. Further complicating issues will be the emergence of federal co-operative credit unions that will operate in multiple regional jurisdictions, and the emergence of large credit unions willing to offer outsourced products and services to smaller credit unions. If these trends continue, the only viable model may be a single national Central.

Centrals can prepare by:

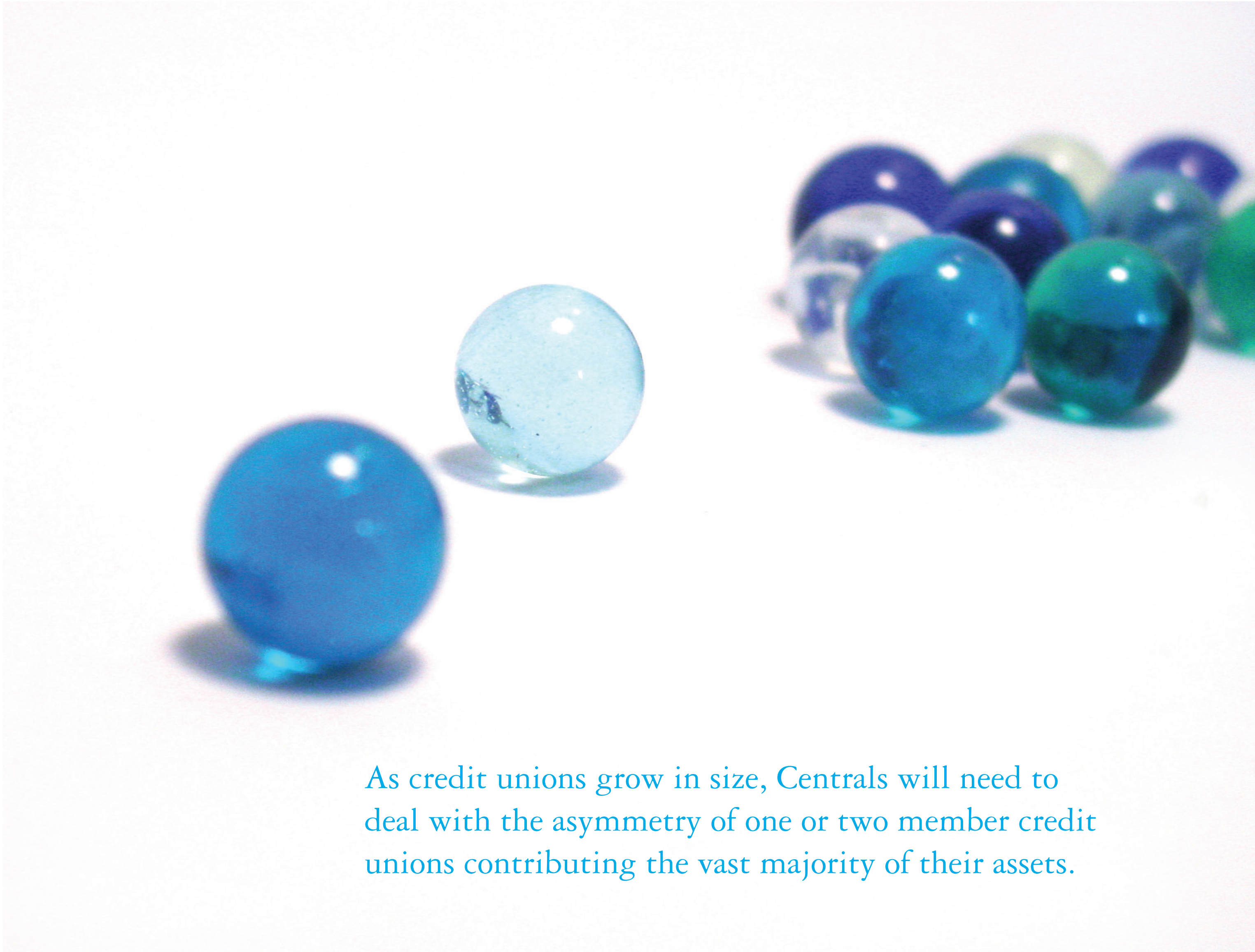
- **Developing** an actionable strategy that addresses two tiers of clients – smaller/niche credit unions and increasingly larger/complex credit unions
- **Renewing** efforts to consolidate to achieve scale and prepare for federal charters
- **Examining** strategic partnerships with system providers and external service providers to offer cost-effective services to member credit unions
- **Exploring** options for uploading governance and regulatory compliance from the credit unions to the Centrals
- **Developing** differentiated cost allocation models to allocate costs to those who use the services, making prices for shared services more competitive than those available on the external market and ensuring that some credit unions are not materially subsidizing their peers. Small credit unions may need to absorb higher operating costs as a result

Shared services

System partners will no longer be able to rely on goodwill to sell their products and services to credit unions and Centrals. These providers will need to compete on price and service to remain viable.

System partners can prepare by:

- **Developing** an executable strategic plan that caters to the changing two-tiered client landscape
- **Moving** from cost-plus or cost allocation models to true market-based pricing, so they can remain competitive against non-system competitors
- **Seeking** new revenue sources outside the credit union system
- **Exploring** partnerships and alternative delivery models with non-system players



As credit unions grow in size, Centrals will need to deal with the asymmetry of one or two member credit unions contributing the vast majority of their assets.

Embrace the new rules of collaboration

All credit unions, Centrals and system strategic partners must take steps now to streamline operations, manage their risks, improve governance and develop their growth strategies.Increased competition from external service providers will drive the system to become more efficient and ultimately more competitive. Mergers and acquisitions will provide new opportunities for larger players, while smaller credit unions will need to work with the system to obtain the support required to effectively target their own competitive niches.

The future bifurcated system will present credit unions, Centrals and system strategic partners with both considerable challenges and tantalizing opportunities. While the traditional consensus model for credit union decision-making and participation may no longer be viable, new frameworks based on market competitiveness and selective participation will emerge. Those participants who anticipate where the system is headed will be well-positioned for success in the new world of 21st century collaboration.

"We don't have time to wait for consensus."

Top ten credit union executive on the need to develop a unilateral channel strategy, April 2012

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