Exploring Cooperative Management

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Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs, the Institute examines issues vital to the future of credit unions.

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

Traditionally, the Filene Research Institute focuses on long-term research questions that can take months or years to research and publish. Occasionally Filene also publishes Research or Innovation briefs. These briefs allow Filene to present important, time-sensitive, notorious, and unbiased topics to the credit union system. Oftentimes these briefs present an opportunity to distribute original research or innovation findings from Filene researchers or Fellows. We hope the “brief” format meets your need to obtain actionable and objective information in a timely manner.
For their focus on serving their credit union members and supporting the cooperative spirit, Filene would like to thank CO-OP Financial Services for their support of the Filene Research Institute.
What do Finnish and Italian grocers, a defunct Fortune 100 agriculture services firm, and credit unions have in common? They are all cooperatives. The grocers are noteworthy for growing market share in a cutthroat retail market, Farmland Industries (the erstwhile Fortune 100 example) didn’t manage its phenomenal growth well, and credit unions—well, credit unions can learn a lot from these and the other cooperative examples in this report.

As North American credit unions navigate the ongoing shift from instrumental lenders that wrote loans when nobody else would to competitive firms that have to win business in a market saturated with financial options, the cooperative basis can be either a drag or a competitive advantage. This brief illuminates both sides of that picture.

What Is the Research About?

Credit unions are cooperatives, of course, but what does that mean in practice? On the one hand, a credit union looks a lot like any business in that it needs revenue to exceed expenses, members must be well cared for, and employees must be paid. But in very interesting ways, a cooperative is not the kind of business that most of the business world understands. Its equity is dispersed and often inaccessible to its member-owners, creating value is not as simple as maximizing profits, and value itself is often measured (rightly or wrongly) in noneconomic terms.

This brief is a foray into these interesting differences, an attempt to spark conversation among boards and managers about the ways that a credit union should mirror traditional businesses and the ways that it needs to think differently and deeply about the differences. The treatment here is not comprehensive; instead, it is probing in its exploration of the possible themes. Use it as an idea document, and if you’re intrigued, follow the source notes for more.

What Are the Credit Union Implications?

A review of the cooperative banking literature produced some clear categories:

- **Changing need for cooperative finance**—Most North American credit unions were originally organized around a group that was poorly served by existing providers. But today most North Americans now have access to an overabundance of financial services.
• **Defining a cooperative mandate**—The oversupply of financial services in many communities means that credit unions must justify their existence as a cooperative in a competitive market. We address several possibilities for accomplishing this.

• **Risk aversion**—Cooperative financial institutions are, on average, more risk averse than their competitors, leading to different, market-steadying behaviors.

• **Reasons for growth and profitability**—The traditional cooperative model has not always prioritized growth as a goal in itself, but without minimum levels of growth, profitability, and capital accumulation, the credit union business model is unsustainable.

• **Returning value to members**—Boards and management have a fiduciary duty to return value to members. That value, not limited to money, may be returned in various ways, but its form should be well defined and closely monitored.

• **Member engagement**—Ensuring that members’ needs stay front and center is a key aspect of good cooperative leadership. To discover and address those needs in large and growing credit unions, leaders must use or, if necessary, create engagement and communication channels.

The report also addresses the challenges that credit unions, as cooperatives, face in a competitive environment: serving stakeholders instead of shareholders, appropriate management incentives, member engagement, limited market opportunities, and, most fundamentally, the ownership of capital. But the report doesn’t just dwell on challenges; it finishes with a handful of interesting cooperative ideas and a section dedicated to the ways a credit union should operate differently from its noncooperative competitors.

Credit unions are not grocers, agricultural service firms, or even European mutuals, but the shared cooperative basis of each helps us think about what being a cooperative should mean. In practice.
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Ben has served as director of the Institute’s CU Tomorrow project, and previously as editor of The CEO Report and chairman of the National Directors’ Convention. Ben has been cited in the Wall Street Journal, American Banker, the Credit Union Times, and the Credit Union Journal. He holds a master’s degree from Northwestern University and a BA from Brigham Young University.
Introduction

This cooperative management brief has two goals: to clarify the management challenges facing credit unions as cooperatives, and to suggest ways that credit union leaders can use the cooperative structure to enhance the value they offer to members. We recognize from the outset that many practices at credit unions are not, and should not be, different from those at commercial banks. Instead, we seek to highlight those practices and considerations that can or should be different, with the goal of helping you add value to your members’ lives.

We use the term “cooperative financial institution” as a broad category that comprises credit unions and mutually owned banks, because much of the thinking about cooperative finance concerns both. Even though credit unions and cooperative banks differ in size, regulatory schemes, and structure across jurisdictions, they face very similar challenges in maximizing their value to their member-owners. Some of the most rigorous thinking about cooperative value comes from Europe, where large cooperative banks thrive alongside investor-owned banks, with the difference being that the former focus on returning value to their member-patrons instead of outside shareholders.

Some of the points in this report seem obvious, perhaps barely worth noting, but others may be controversial. When taken together, they outline the variables a modern financial services cooperative should consider if it hopes to stay true to the demands of its accumulated capital within its cooperative charter, all the while operating in a competitive marketplace. We attempt to keep governance and management issues separate, but they occasionally overlap because cooperative-oriented governance will define and monitor appropriate goals for credit union managers.

The brief is divided into eight sections, each of which illuminates a unique aspect or challenge of the cooperative model:

• **Changing need for cooperative finance**—Most North American credit unions were originally organized around a group, such as people united in a workplace, in a town, on a military base, or in a congregation, that was poorly served by existing providers. Some communities are still poorly served, but most North Americans now have access to an overabundance of financial services.

• **Defining a cooperative mandate**—The oversupply of financial services in many communities means that credit unions must justify their existence as a cooperative in a competitive market. We address several possibilities for accomplishing this.
• **Risk aversion**—Cooperative financial institutions are, on average, more risk averse than their competitors, leading to different, market-steadying behaviors.

• **Challenges**—We focus on some of the obvious and some of the less well-known challenges faced by flourishing cooperatives.

• **Reasons for growth and profitability**—The traditional cooperative model has not always prioritized growth as a goal in itself, but without minimum levels of growth, profitability, and capital accumulation, the credit union business model is unsustainable.

• **Returning value to members**—As part of a member-owned firm, boards and management have a fiduciary duty to return value to members. That value may be returned in various ways, but its form should be well defined and closely monitored.

• **Member engagement**—Ensuring that members’ needs stay front and center is a key aspect of good cooperative leadership. To discover and address those needs in large and growing credit unions, leaders must use or, if necessary, create engagement and communication channels.

• **Different management practices**—Thought leaders are surprisingly frugal with their advice about how cooperative leaders should manage differently from peers at investor-owned firms. Still, some clear examples emerge.

• **Interesting cooperative ideas**—We finish with a little fun. These ideas may seem quirky or compelling, difficult or obvious, but they represent interesting possibilities about the future of cooperative finance.

### Changing Need for Cooperative Finance

*Make no little plans. They have not the power to stir men’s souls.*

—Howard Cowden, founder and former president of Farmland Industries

Let’s start not with credit unions but with Farmland Industries, which at one point was the 78th largest company on the Fortune 100 list. Founded in 1929 as an agricultural cooperative, Farmland eventually grew to offer a huge range of services: agricultural supply, fertilizer, shipping, and marketing. Along the way, it maintained its cooperative structure, evolving into a federation owned by nearly 2,000 member cooperatives.

We use “was” because the company went bankrupt in 2002, done in by something as common as a liquidity squeeze when a large loan came due. In its heyday, Farmland “struggled to reconcile
growth with populism by being ‘the Giant with the personal touch’ [that] grew large while seeming to stay small to the membership.”¹ Farmland’s story is not, however, an indictment of growth, which all firms—including cooperatives—must seek. Instead, Farmland’s story, like that of other agricultural cooperatives, holds parallels for credit unions. Both face pressures to grow in scale and sophistication while remaining true in their obligations to members and members’ accumulated capital.

Like credit unions, Farmland grew out of Great Depression roots to fill a niche in purchasing and marketing for small farmers that the market couldn’t meet, at prices that the farmers could afford. As the early success and growth passed, though, it became apparent that while American farmers supported collective marketing in principle, in practice they were not strongly loyal to cooperatives.² Agricultural cooperatives were judged according to a survival-of-the-fittest criterion that today’s credit unions will recognize: The cooperative had to compete in the market for farmers’ products, just like any other buyer. As the farmers’ needs for the access that cooperatives could provide passed, cooperatives increasingly had to justify their existence in purely economic terms. “When the farmers no longer needed the collective action of a cooperative, the cooperative that was a child of prior collective action turned its sights to ‘efficiency, homogeneity, standardization, being the low cost provider.’”³ The resulting companies, like Farmland Industries, could still flourish, but their reason for being a cooperative, as opposed to an investor-owned firm, slowly shrunk away.

The example is instructive. Today, financial services cooperatives, of which credit unions are one kind, generate nearly $400 billion (B) in revenue and $100B in profit and employ more than 1 million people in the United States.⁴ They operate in a business environment that reflects two competing ideas (rarely articulated) about the purpose of a cooperative:

1. **Instrumental**: This is the populist, original concept of cooperatives as a “competitive yardstick,” restoring competition and battling monopolies. Here, cooperatives emerge to keep other firms honest.

2. **Market-oriented**: In this view, cooperatives are purely economic, preferably large-scale organizations that maximize bargaining and economic power. By virtue of their structure and mandate to
return profits to member-owners, cooperatives can undercut the prices charged by competitors.

The first purpose, to battle monopolies and market inequalities, has changed. Rather than joining a credit union to combat an access problem, today’s consumers join for other reasons, ranging from price and convenience to social well-being.

Member contributions may initiate a cooperative, but the role of the contributions becomes limited once the co-op starts making profits—a threshold most credit unions passed decades ago. Because the member’s share is measured on a cash basis, progress is not determined by capital appreciation but by the value of the services available for cost of the share. In other words, the value of credit unions, to whose capital members have no ongoing claim, is the value of use, not the value of ownership. Because today the cost to “buy in” is negligible and driven largely by regulation, credit unions need to present a unique value proposition and make that proposition as clear to their member-owners as their competitors already do to their outside shareholders.

This need to redefine credit unions’ unique value has led HEC (Montreal) Professor and Filene Research Fellow Daniel Côté to write: “In mature cooperative sectors, cooperative values and principles are no longer important for reasons related to the emergence of cooperatives but more for reasons linked to competition dynamics and the need to meet the requirements of the ‘king’ customer.”

In the drive to satisfy a consumer, credit unions differ little from investor-owned firms. Côté continues: “Whenever there is a choice to make about a generic strategy (price or added value), cooperatives can exercise their freedom of choice just like capitalist enterprises.” Still, Côté notes that, more often than not, many more credit unions choose to add value in ways other than pure pricing.

So while the original causes of credit union proliferation—lack of access to financial services, anticonsumer behavior by other providers—may be mostly gone, credit unions’ reasons for being have not disappeared. By joining depositors and borrowers together as shareholders, credit unions provide economic well-being, offering competitive services and superior prices, not to mention a moral constraint as an alternative to opportunistic competitors.
Defining a Cooperative Mandate

A useful distinction between investor-owned firms (IOFs) and cooperatives is that the former exist to maximize the net present value of the firm’s earnings, while cooperatives exist to maximize member satisfaction derived from the use of their services.\(^8\)

The value a shareholder expects from holding GE stock is fundamentally different from the value a credit union member expects from participating in the credit union. In the first case, the shareholder is satisfied as the shares appreciate and with the payout of a regular dividend, regardless of which business line at GE generates the profit. But the shareholder at a credit union is principally satisfied as a consumer, and then only if he or she receives tangible value from transacting with the credit union. Unlike the shareholder value produced by an IOF, which can be reinvested or divested, shareholder value at a credit union is not transferable, both legally and because it is fundamentally experiential.

IOFs may operate in virtually any segment where there is an opportunity to make money and satisfy shareholders’ expectations. On the contrary, cooperatives have historically been formed to counteract existing inequities or monopoly behavior. IOFs can change strategy freely, while cooperatives are obliged to serve members, even in the face of declining markets.

As one observer of agricultural-sector cooperatives puts it: “Unlike proprietary firms, which are essentially profit driven, cooperatives can represent multiple, sometimes conflicting social or economic objectives in a reflection of the varied characteristics and objectives that often comprise their membership.”\(^9\)

An IOF’s profit demands can be at odds with the interests of customers (although that makes for bad long-term strategy). But there should be no conflict between a consumer cooperative and its members; both are motivated by the best interests of members.

One interesting way to think about a cooperative is as a hybrid between a corporation and a foundation.\(^10\) This implies that, among other things, the cooperative concept is based on a stakeholder view...
in which directors guide managers to reconcile the needs of the different constituencies (savers and borrowers, long-time and newly joined members, etc.). A troublesome implication is that some stakeholders, specifically future members, are impossible to identify and to consult.

With their original purpose largely gone (except in underserved areas where they are very much needed), and given the challenge of consulting all stakeholders, credit unions—either in groups or individually—need to formulate a core purpose that is demonstrably different from that of commercial banks. Banking consultancy Oliver Wyman, in an examination of European cooperative banks, argues that formulating such a purpose benefits three groups:

- Credit unions themselves, as a means to set strategy.
- Current and potential members, as a demonstration of the value of cooperative financial institutions.
- Regulators and policymakers.

For example, the Co-operative Bank in the United Kingdom has as a core goal to be the UK’s most admired financial services business. Note in Figure 1 that the Co-operative Bank’s core goal is tracked with tangible metrics that measure the mission, monitor growth, and ensure the bank’s solvency all at the same time.

As consumers consider whether to do business with an IOF or with a cooperative, their practical needs may not determine the choice; most everyone has the same need of financial well-being, regardless of who provides it. But consumers also have a variety of wants. They want a good deal, or more convenience, or the satisfaction of doing business with an organization they admire, as in the case above. Cooperatives have an advantage in that, if they are well managed,

\[\text{Figure 1: Core Goal of the Co-operative Bank: To Be the UK’s Most Admired Financial Services Business}\]

<table>
<thead>
<tr>
<th>Financial—Focus on profitability and underlying financial strength</th>
<th>Customer—Addresses key relationships that sustain and grow the business</th>
<th>People—Measure of perceived employee and customer advocacy</th>
<th>Process—Focus on efficiency in delivering services to customers</th>
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<tbody>
<tr>
<td>Operating profit</td>
<td>Customer advocacy as measured by steadily rising customer feedback</td>
<td>Colleague (employee) engagement as measured by internal survey</td>
<td>Cost as measured by efficiency ratio (38.2%)</td>
</tr>
<tr>
<td>Liquidity above minimum levels</td>
<td>Primary accounts as measured by those who hold at least one standard account and credit that account with at least £800 per month</td>
<td></td>
<td>Compliance with board-approved risk appetite in four main categories: credit risk, market risk, liquidity risk, and operational risk</td>
</tr>
<tr>
<td>Surplus capital as measured by operating above a set amount</td>
<td>Products per primary account customer (2.59)</td>
<td></td>
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</tbody>
</table>

they can serve consumers’ wants more effectively because they can send their profits directly back to their shareholders in precisely the form (economic, convenience, social, etc.) that their members choose.

The essence of cooperative banking is simple: Members, who are savers and borrowers, use the cooperative to “recycle money from those who have it to those who need it, without anybody outside taking a profit and with interest rates set so that the system works in everyone’s interest.” The essence may be easy, but the practice is harder. That’s because profits are hard to come by, and in order to formulate a clear value proposition, credit union leaders need to know beforehand where the profits will go, preferably because those leaders know where the members want profits to go.

As outlined above, credit unions are cooperatives that are either instrumental, providing a service that wouldn’t otherwise be available in the market, or market-oriented, improving the market power of members by providing a more competitive market transaction than can be found among existing alternatives.

Under the market-oriented definition, a purely banklike credit union—one, for example, with strict, score-based underwriting, an unengaged membership, and loose or nonexistent social connections among members—may not be abandoning its cooperative roots if it still offers a superior market proposition to members through low costs and superior rates. If the credit union is growing, it is clearly providing a value proposition that some members find attractive. And regardless of whether that proposition is based on price, convenience, or needed products, the credit union can be filling its mandate even if its members are unengaged.

This conforms to the defining characteristic of a business organized on a cooperative basis: “that the interests of the capital investor are subordinate to those of the business user, or patron, and returns on capital are limited. . . . Member-patrons are the primary source of equity capital, and net earnings are allocated on the basis of patronage instead of investment.” As long as member-patrons receive tangible value based on their patronage, the cooperative is functioning well. That doesn’t necessarily mean that the cooperative will be inspiring or high performing, but simply that it is still a well-functioning cooperative.

Nevertheless, the bar for a cooperative mandate should be set higher. And in most credit unions it already is, because credit unions look out for members. Indeed, it’s precisely this kind of advocacy that
big banks are coming to see as necessary to earn more business from skeptical consumers. In its outlook on global retail banking, the Boston Consulting Group recently wrote:

But the truly perfect retail bank of the future will be more proactive. It will warn customers of potential overdraft scenarios. It will help them figure out whether they can afford to buy the car or house that they covet and suggest an appropriate level of savings based on their income. It will recommend moving to better tariffs or rates on its products—perhaps turning a very minor pricing issue into greater customer loyalty.14

Peter Duffy, managing director at Sandler O’Neill, an investment bank that advises bank and credit unions, endorses this approach as one differentiator that should come naturally to cooperatives. This approach leads credit unions to help members be prudent stewards of their own money, for example, by caring deeply and responding proactively to members with delinquent loans.

This is an approach that many credit unions already take. Aaron Sapiro, a pioneer in California’s early cooperative agriculture movement, once said: “If you raise something, you think of the locality. If you buy something, you think of the commodity.”15 Cooperatively oriented credit unions can conform to the “truly perfect” ideal much more easily, because they think about the locality—the members, the community, the people.

Many consumers notice the difference. A survey of Canadians showed that many already like how cooperatives play a local and, therefore, positive role. High proportions agree (strongly or somewhat) that cooperatives keep money in the local economy (70%), are an important part of their communities (69%), and create jobs that help support local communities (69%).16

Côté argues that the cooperative’s focus on people has a loyalty effect on both the organization and the members it serves. This is partly a function of the association already enjoyed by a credit union field of membership (either geographically based or group based), but that association is fortified by interactions between the membership and a healthy cooperative. We can think about four kinds of fortifying interactive practices:

- **Informational**: Meetings and ongoing disclosure of strategic issues, financial results, and competitive position ensure ongoing information sharing.
• **Training and education:** These ensure a degree of understanding around strategic issues and challenges, and the consequences of important decisions. Training also ensures that members have not just access to necessary information but the skills to act on that information.

• **Consultation:** The consultation process can occur on a permanent basis, through surveying and other feedback channels, and also as a function of special situations (e.g., periodic strategic planning, solving major conflicts).

• **Decision making:** This involves governance issues and is handled mainly by the board of directors, although it should be informed by the consultation outlined above.¹⁷

These practices are implicit in early-stage cooperatives, where they are necessary for the organization to form in the first place and then to operate. But later-stage cooperatives have to reinvent and reinforce such institutional behaviors in order to gain loyalty. Figure 2, modified from Côté, shows how emphasizing cooperative identity corresponds with factors that increase loyalty.

One further advantage credit unions have as cooperatives is a lower cost of capital because credit unions don’t need to remunerate their retained equity. Fonteyne argues that, in accounting terms, cooperative capital appears on the books as reserves, but it is more appropriately considered as an intergenerational endowment.¹⁸ This low cost of capital allows cooperatives to pursue objectives other than profit maximization, like offering lower prices to members or serving less profitable members and membership regions. But it also comes with several downside risks: The negligible cost of capital allows credit unions to dissipate capital through inefficient processes and technologies, through above-market remuneration for management and employees, by tolerating lower productivity per employee than peers, by allocating surpluses to parties other than members, or by maintaining higher levels of equity. All the more reason to formulate a core purpose that is tangible and traceable.

The paradigm of a firm as property that is owned and controlled through shares is imperfect in the case of credit unions because the putative owners have no access to the capital.¹⁹ Credit unions should embrace the difference by

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**Figure 2: Convergence of Loyalty and Cooperative Identity**

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<tr>
<th>Principle</th>
<th>Cooperative identity</th>
<th>Loyalty</th>
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<tbody>
<tr>
<td><strong>First order</strong></td>
<td>• Ethics and integrity&lt;br&gt; • Openness and access to information</td>
<td>• Ethics and integrity&lt;br&gt; • Mutual trust&lt;br&gt; • Openness and access to information</td>
</tr>
<tr>
<td><strong>Second order</strong></td>
<td>• Reason for being is improvement of members’ socioeconomic circumstances&lt;br&gt; • Owner-user&lt;br&gt; • Democratic power exercised by members&lt;br&gt; • Members’ economic participation</td>
<td>• Closeness to customer&lt;br&gt; • “Coaching” or feedback to enterprise&lt;br&gt; • True after-sale interest in customer</td>
</tr>
<tr>
<td><strong>Third order</strong></td>
<td>• Dual associative and business structure</td>
<td>• High value-added core business&lt;br&gt; • Focus on unexpected&lt;br&gt; • Anticipating future needs</td>
</tr>
</tbody>
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doubling down on the board’s commitment to honor the purpose of the invested capital and retained earnings.

For credit unions that do not invest time in identifying a core purpose, one final caution: “Adopting the prevailing organizational model of their [noncooperative] competitors would bring cooperatives within a short span of years to be essentially undifferentiated . . . save for some additional constraints to which capitalist firms are not subject.”

Risk Aversion

Cooperative financial institutions have a long history of risk aversion. Two primary reasons for this emerge from the research. First, because credit unions and other cooperatives do not usually have investors demanding outsized profits, they are less inclined to operate in risky sectors and with risky instruments. Second, cooperatives that operate as conscientious stewards of member capital may not wish to expose that capital to unnecessary losses. But risk, of course, exists on a scale, and low- or no-risk strategies cannot generate returns sufficient to keep the credit union growing.

A Filene review of US credit unions’ portfolio performance between 1986 and 2010 (Figure 3) shows that both charge-offs and delinquencies are much more subdued at credit unions than at commercial banks, largely because of credit unions’ allergy to risk. The same study shows that credit unions tended to buoy lending into recessions.

Figure 3: Charge-off Rates for Banks and Credit Unions

because their lower-risk profiles meant they weren’t pulling back as much to compensate for losses. These findings match what other studies with similar questions have found. The difference was apparent in the superior performance of mutual versus publicly traded savings and loans during the savings and loan crisis of the 1980s and 1990s, because investor-owned banks had tended to pursue more speculative investment policies. A 2008 German study comparing loan performance at traditional versus cooperative banks showed that cooperative banks tended to more highly specialize their lending and focused on lending in industries with lower loss rates.

Analysis by researchers at the International Monetary Fund shows that cooperative banks have z-scores (a measure of the variability of their earnings) that are significantly higher on average than those of commercial banks. This is not because of capitalization or profitability, which are, on average, weaker for cooperative banks than for commercial banks. The result comes from the fact that the cooperative banks’ standard deviation of returns is much lower. So, low average-return ratios at cooperative banks in normal years are compensated when they are able to extract some of the consumer surplus in weaker years.

Former Rabobank (Netherlands) chairman Bert Heemskerk argues that his cooperative bank weathered the Great Recession well because it was never under pressure to deliver huge returns on capital. Thus, it didn’t dabble in the high-risk, high-reward sectors that came in for huge losses during the financial crisis. Rabobank was part of the “dull but safe” trend lauded by The Economist at the nadir of the Great Recession, which saw cooperative banks increase their market share in Europe to one of every five consumers.

Because of credit unions’ capital rules for retained earnings, risk is often the last line of defense for credit unions facing losses and diminishing capital. But members themselves are rarely well served by undue risk or business lines designed to boost returns beyond steady and consistent growth. When risk is warranted, it should be aimed at the cooperative’s natural membership and take a form that actually returns value to that membership (e.g., credit risk) instead of improving yield from faceless investments.

Challenges

Whenever banking groups complain about built-in advantages to the credit union charter, the tongue-in-cheek retort is: “If credit unions have it so good, why don’t you switch charters?” To date, very few have.
This lack of charter switching is driven, in part, by different regulations in different jurisdictions (taxation, lending and membership constraints, etc.). But the real lack of enthusiasm is due to something more fundamental: Cooperatives’ reason for being has never been to maximize profit for a group of investors. And a group of investors is unlikely to give up control of (and profits from) a bank just for a tax break or a different examination structure. One useful distinction is between shareholder value banks and what Groeneveld calls “stakeholder value banks,” or, for our purposes, credit unions. The first maximize shareholder interests and the rate of return on equity capital. The second have a broader focus that includes “maximizing consumer surplus for owner-members.”

Nevertheless, the cooperative structure comes with challenges that are essentially baked in, some of which also evolve and harden as the credit union grows. This list is not exhaustive, but it does highlight the categories of challenges cooperatives face in remaining competitive and relevant.

**Management Incentives**

Because ownership of a cooperative is, by definition, diffuse and democratic, paid leadership cannot be compensated with equity. While there are no intrinsic limits on the amount of compensation able managers may earn, without the ability to reward leaders with equity positions, boards lack an effective form of compensation and incentive. Some argue that cooperatives do not attract or retain aggressive leaders, because those individuals don’t see as great a chance of accumulating personal wealth.

A related and broader issue is commonly called the principal-agent problem, and it is not unique to credit unions. It simply means that the legal owners of a firm (in this case, the members via the board of directors) hire an agent (in this case, a CEO) to carry on the day-to-day business. But the agent, with the firm’s operations and resources at his or her disposal, may be more interested in goals other than maximizing stakeholder value. These could include personal wealth accumulation, empire building, or simply doing enough not to get fired. A good board will minimize these concerns by tying a CEO’s employment and compensation to behavior that maximizes benefits to members, but a lazy or weak board runs the risk of rubber-stamping management decisions that don’t maximize member value.
Member Engagement

Members are the true owners of a cooperative, yet many modern credit unions struggle to engage with members in even the most minimal ways. Rather than voting in board elections, most members simply vote with their feet by joining or leaving the credit union as suits their needs. The danger is that, without consistent engagement with members, the credit union gradually drifts away from its charter and its membership. The strong counterargument, which we explore later, is that strong product use is engagement, and as long as existing members are using products and the credit union can attract new members with its value proposition, there is little need for constant collective action.

Even when members are engaged, however, financial democracy runs the same risks as regular democracy, where the majority’s decisions may threaten the organization. If the cooperative’s assembly fragments into factions, each with its own preferences, the cooperative risks tyranny by the majority—a scenario that would not arise in a capitalist firm, with its “one share, one vote” principle. The result is either decisional paralysis or the de facto transfer of control to managers. The former brings inefficiency, the latter, a detour away from cooperative identity.30

Static Membership Approach

There is an inherent danger that cooperatives will take a static view of membership, focusing on current members at the expense of new ones. As we have seen at US credit unions, such an approach can result in an aging membership profile, which can set the cooperative on a dangerous downward spiral. Countering this challenge requires a long-term view and recognition that past, present, and future members have a claim on the credit union’s capital and the efforts of its leaders.31

Credit unions are obliged to serve their existing members well, but serving them exclusively leads to the prospect of diminished membership growth, aging membership, and a product mix (savers versus borrowers) that cannot sustain the business model. This challenge is particularly acute for credit unions that serve small or dwindling fields of membership.

Zamagni argues that if the members’ assembly or the board of directors is composed of a majority of “old” people, close to or beyond retirement age, voting in favor of long-run investments becomes less likely, for obvious reasons.32 This is a theory-based argument for the importance of having younger board members who will, for example, prioritize strategic investments over superior deposit rates.
Interest Rate Risk
Cooperatives’ steady, risk-averse approach actually exacerbates some risks. Because they are more focused on traditional financial intermediation than other institutions, they have higher exposures to credit and interest rate risk, making them vulnerable to shocks in these areas. Without diverse revenue streams, they run the risk of a sustained mismatch between their loan income and the rates needed to attract and keep depositors.

Ownership of Capital
Ownership of capital is perhaps the thorniest challenge at cooperatives on two fronts. First, a credit union’s accrued capital comes from the efforts of past and current members, and even future members have a theoretical claim on the capital if the credit union expects to be sustainable. Second, even though the legal principles of control over the capital are straightforward, in practice, several parties—including the members, the board of directors, management, and regulators—have a claim on how best to use the credit union’s capital. And each party may have very different priorities.

Because cooperative financial institutions, with their restrictions on outside capital, tend to hold higher levels of reserve capital, it can be tempting for managers and boards to act opportunistically by demutualizing. In the event of demutualization or the need to distribute the accumulated capital, it is impossible to compensate past or future members. Even distributing capital equitably to existing members is a thorny challenge that must weigh the contributions of savers, borrowers, and all members.

Additionally, as an organization grows, it tends to become a stakeholder in itself, as executives, directors, and employees take an acute interest in the continuance of the firm. Leaders that don’t acknowledge their fundamental role as stewards are more likely to make decisions (e.g., in mergers, strategic investments, or management compensation) that work against the interests of members.

Lack of Business Discipline
There is nothing automatic about the challenge of a lack of business discipline, because skilled directors and managers operate in many credit unions. Nevertheless, the structure of cooperatives, with ultimate authority in the hands of members who do not monitor performance (particularly operating efficiencies) as strenuously as equity
investors, means that managers may not practice the same levels of discipline as those at commercial banks. Widespread deposit insurance, while good for members, means that those same members have little incentive to monitor the health of the credit union or lobby for changes at unhealthy ones.

And, as discussed earlier, the lower cost of capital in a retained earnings model can lead to that capital being dissipated in a number of ways (through inefficiency, above-market remuneration for management, lower employee productivity, etc.).

Disclosure practices and requirements for cooperatives will not necessarily prevent this, as they are weaker than those in place for commercial banks. Even if there were adequate disclosure, other market pressures—like shareholder demands, interbank markets, and debt issuances, which can effectively discipline management behavior at other financial institutions—don’t really work in the case of cooperatives. Still more problematic: “Loyal and insured retail depositors are not likely to exert an effective market disciplining effect either at an early enough stage.”

Strategic Limitations
To repeat an earlier point, IOFs operate under the general mandate to do business in any area that offers the prospect of reasonable rates of return for their shareholders. Cooperatives, however, have fewer strategic options because of their duty to consider options that support the needs of their field of membership.

Reasons for Growth and Profitability
It is important to keep in mind that the stated objective of cooperative banks is to maximize their members’ consumer surplus, not profits. Theoretically, well-capitalized cooperatives don’t need to grow or to make any profits; if they simply recycle every dollar in as a dollar out to members, they are doing their job. But that theory matches poorly with the business reality that firms must grow in order to be sustainable in the long run.

In Filene’s Credit Union Strategic Growth and Budgeting, Higgins makes the compelling argument for growth as a cooperative mandate, not just a capitalist one. The biggest operating costs in credit unions—like payroll and facilities—are downward fixed (i.e., they often go up but rarely go down), so a credit union’s sole long-term path to sustainability is to maintain or grow revenue faster than expenses grow. Discipline and periodic cost cutting can help, but
revenue growth is the only thing that will allow a credit union to upgrade technologies, introduce new products, and maintain healthy capital levels as it grows.38

In a capital-centric industry like retail banking, growth is particularly important because capital needs to grow at least as quickly as assets in order for a credit union to remain financially stable. This is why measuring return on equity (ROE) is so important. ROE is net income divided by capital, so a higher number means a credit union is doing more with its available resources. ROE “can only improve with disciplined management of operational expenses, superior underwriting, and, most important, a focus on top-line revenue growth. None of these need come at the expense of the credit union’s members. To the contrary, done correctly, each aspect represents a deepening commitment to serve all members well.”39

Experts gathered for a credit union colloquium at Harvard University in 2010 agreed that credit unions needed to be more disciplined about pursuing profits in order to remain financially sustainable, and that the most urgent needs were to take a hard look at operating expenses, which have historically been higher at credit unions than at similarly sized banks.

If a cooperative prioritizes objectives besides profit maximization to the extent that the organization has very low profitability, “its balance sheet risks grow faster than its capital, leading to deteriorating solvency.”40

Experts gathered for a credit union colloquium at Harvard University in 2010 agreed that credit unions needed to be more disciplined about pursuing profits in order to remain financially sustainable, and that the most urgent needs were to take a hard look at operating expenses, which have historically been higher at credit unions than at similarly sized banks.41 Yet Peter Tufano, former Harvard professor and current dean of the Said Business School at Oxford University, was quick to point out that “cost reduction and operating efficiencies are a means to an end. The end is member satisfaction, member service, and all the kinds of things that the cooperative movement is designed to deliver.”42

Fortunately, in the battle for profits, cooperatives have a horizon advantage: more time. Because shareholders are not typically as demanding, a credit union can invest in long-term efficiency and even strategies that may not pay off for years.43 Nevertheless, the long-term view should not be used as an excuse to justify short-term stumbles.
Returning Value to Members

Recall the earlier distinction between cooperatives. Instrumental cooperatives spring up to fill a market vacuum. Therefore, their member value is in their mere ability to fulfill a transaction that wouldn’t otherwise take place on a member’s behalf. Market-oriented cooperatives are often the mature version of instrumental cooperatives, and they create value by providing a more beneficial transaction than could be found through other alternatives.

Cooperatives should have an edge in identifying and serving consumer needs because of their governance mechanisms. But as they migrate from instrumental to market-oriented they lose some of that built-in advantage and are also harder pressed to return value. Fonteyne, drawing on prior research, shows that, for consumers, cooperative ownership becomes less advantageous the more competitive a market is, and more advantageous the more uniform the membership is.44

Nevertheless, cooperatives bring an advantage to the task of building member value. They are freer to concentrate on building long-term efficiency and value, while investor-owned competitors, especially publicly traded ones, have to consider regular reporting pressures, like quarterly market disclosures, as well as pressure from investors to show immediate gains.

Low-income or community development credit unions in the United States still operate, in many cases, as instrumental cooperatives for communities that traditional financial services firms do not serve. But for most modern credit unions that compete for members with firms that also want to serve them, the market-oriented category is the prevailing model. Cooperatives must provide more value to members than their commercial competitors, or their mission as a cooperative is suspect. That value can take many forms:

- **Economic.** Economic value is the easiest to quantify and compare. If credit unions offer lower rates on loans and higher rates on deposits than their competitors, they are fulfilling their mandate. Lower average fees and free services count. And although the practice is more prevalent outside credit unions, many cooperatives turn to patronage dividends as a way to both manage capital and provide a windfall that differentiates them from competitors. Cooperatives also create economic value by acting as a check on other firms by offering services at their lowest economic cost.

- **Convenience.** Numerous sources find that convenience is at the top of the list of drivers for those choosing a new financial
institution. It’s easy to see how convenience drove the historical growth of credit unions, as workers, military service members, and other members found it easy to do business with the credit union that was set up in a venue members already patronized. A credit union that can provide convenience with a larger physical footprint (branches, ATMs, etc.) or a better electronic delivery system than competitors is maximizing convenience value.

• Service. While this is a valuable category, it is also a slippery one. In order to truly differentiate on service and meet the need of returning value to members, a credit union that latches onto service as its core value contributor to members is under the obligation to measure and show that its service is indeed a competitive differentiator.

• Advocacy. Closely related to service, advocacy entails doing what’s right for the member (e.g., policy exceptions, more transparent disclosures). Cooperatives generally do this in addition to pursuing other value paths. Advocacy can be measured in satisfaction and referral metrics, along with low levels of complaints and attrition. Consumer complaints, for example, are less frequent at European cooperative banks than at their for-profit competitors.

• Product. In most cases, credit union members use a traditional array of deposit accounts (e.g., savings, checking, CD), loan products (credit card, auto, mortgage), and investment products (IRAs, life insurance, brokerage services). But in cases where a credit union serves a field of membership with particular product needs, its cooperative value may be in offering products that are not available or economical from other providers. Examples include small-dollar personal loans or nontraditional underwriting for members with variable income.

• Social. Defined broadly, social value accumulates when the credit union, as an agent of its members, reinforces social connections or community priorities. In some cases, this already occurs as a function (or at least a legacy) of the credit union’s activity in its field of membership. But in other cases, it must be revitalized, preferably with an appeal to members about what role they want the credit union to play. This could include an emphasis on “green” lending or credit union support of charities or causes closely tied to the membership.

In each of these cases, if members respond with little interest, then the credit union’s leaders must either present better options or eventually seek to differentiate purely on economic value. A conscientious leadership team should adopt metrics that demonstrate not only that the credit union is performing well in its chosen value proposition, but that it provides value by performing better than competitors or peers on that value.
When considering these different options, a natural tension should undergird cooperative leaders’ discussions about how to return value to members. Even though economic value and monetary benefits are straightforward ways to measure value, the cooperative structure is built on the principle that members’ needs can be satisfied directly through mutual benefits, and not always indirectly, as in redistribution of dividends or a share of profits.\(^5^1\)

In many cases, a cooperative can fulfill its mandate to provide economic value while also providing other value. An illuminating example, far from credit unions, appears in the case of the S Group, a Finnish cooperative grocer that competes head to head with Kesko, a publicly traded firm. The S Group has certainly been successful in ensuring economic value. It returned €263 million (3.4% of net sales) to customer owners in 2007, while Kesko was planning on returning €156 million (1.6% of net sales) in dividends to shareholders of its publicly traded stock. At the same time, according to those who have studied the S Group,\(^5^2\) the cooperative is pervaded by a sense of nationalism, and managers feel that the cooperative commands loyalty because it emphasizes community. Thus, value is returned in the form of both financial gain and inclusion. The group’s extensive membership rewards program (allowing members to, for example, earn a percentage of total purchases) exists alongside an acknowledgment of the need for competitive practices (the S Group has been aggressive in cutting down on complexity, for example, merging local stores in the 1970s and again in the mid 1980s from 183 to 35, putting the focus on regional rather than local cooperatives).

**Member Engagement**

One of the greatest challenges faced by cooperatives is maintaining an appropriate level of member engagement. Too little engagement leads to cooperatives in name only. Just as true democracy (one citizen, one vote) was more practical in Greek city-states than it is in modern nation-states, co-ops face large collective-action challenges. Many of the decisions a cooperative faces are technical and uninteresting to most members, so they are not inclined to be involved. Costs to switch financial institutions are low, so when complaints do arise, it is much easier to change institutions than it is to mobilize fellow members to demand changes.

Social engagement can also build loyalty. Through local, regional, and national initiatives, cooperative financial institutions position themselves as supporters of causes that resonate with their customer base.
The move to professionally managed cooperatives is both a cause and a consequence of members’ withdrawal. But without active participation from members, there is the risk that even the board, as the body that represents them, can lose track of the connection and become a rubber stamp for management instead of setting its agenda. If that happens, who will monitor the monitors?

The traditional model of formal democratic engagement does not, of course, have to govern the credit union’s engagement with members. Côté argues that loyalty is central to a “new cooperative paradigm.” Social engagement can also build loyalty. Through local, regional, and national initiatives, cooperative financial institutions position themselves as supporters of causes that resonate with their customer base. This “cooperative dividend” can be an important driver of loyalty and trust. But it should be an extension of the member base’s desires. Côté sees deepened product loyalty as an indicator of strong ties with members, and loyalty, in turn, driving growth. All firms strive for loyalty, but for cooperatives with restricted avenues for growth, it is crucial, becoming yet more important as firms struggle to distinguish themselves on the basis of economic value (products/services, quality, price) and brand name.

Even at Saint-Roche-de-l’Achigan Credit Union in Quebec, which commands enviable loyalty and on which Côté bases several of his cooperative studies, representation is less crucial than loyalty. The credit union’s general meeting attracts 300 out of 5,000 members. While this number is positive compared to turnouts at other credit unions, the executive director does not feel that the meeting is a key democratic exercise. Like many annual meetings, it is too passive and not sufficiently representative. Instead, the focus is on democratic decision making at the board level.

Consultancy Oliver Wyman suggests a similar approach, one that bypasses pure participation metrics in favor of tracking growth metrics with a cooperative angle. They suggest net membership growth as a simple but powerful indicator by which cooperative banks can measure engagement. After all, if the firm is consistently attracting more members, its value proposition must be strong. So its cooperative strength manifests in product usage, not necessarily through interaction or voting.

At the same time, new technology and social media are allowing a reapproach to the cohesion that characterized early cooperative efforts. Tools like sophisticated surveying and social media permit input by the membership without bogging members down with the challenges of collective action. Ratings and recommendation tools, like those used by Amazon.com or iTunes, can add up to a reapproach to member engagement that appeals to members. And the
promise of ratings tools is not limited to cooperative institutions. Large banks are realizing that in the wired economy the recommendations of others are both more powerful than much traditional marketing and easier to aggregate. Across the board, then, social media allow financial institutions to reap the benefits of candid, rapid feedback.

Different Management Practices

In many cases, running a cooperative business is no different from running a traditional business. Revenue should exceed expenses. The firm should seek to know and serve its customers. Managers should be held accountable for performance and growth. But in this section, we want to call attention to the aspects that do differ, because the literature suggests that properly managing these differences will allow strategic management of a cooperative that both reflects its core purpose and supports growth.

Some differences that the cooperative structure confers inevitably slow down the running of the organization. However, these same differences also provide other advantages not seen in traditional corporations. Key differences include:

- **Consensual decision making**: It might take longer to decide, but a cooperatively run organization can have more confidence that stakeholders will buy in.
- **Better communication**: Cooperative organizations are obliged to communicate more with internal and external stakeholders, which can lead to more employee and customer enthusiasm.
- **Long-range planning and experimentation**: Without the pressure of external shareholders or the need for quarterly growth, cooperatives can focus on long-term priorities while earning enough to meet short-term needs.
- **Openness to learning best practices**: Cooperatives’ internal structure tends to encourage cooperation outside, too. This facilitates sharing successful and failed management tactics with other credit unions.
- **Social dimension**: Cooperatives are effective at aiding emerging economies where the need for resources is real but outside investors might not earn attractive returns on their capital.56

Below, we explore some paradigms that have been developed, in theory and in practice, to successfully manage a cooperative’s difference. Each prioritizes one kind of management positioning that will serve the cooperative and its members.
Cost Leaders
A common role of a cooperative, whether a credit union, a retailer, or a purchasing cooperative, is to position itself as a cost leader compared with competitors. This is a valid pursuit for management because, all else being equal, cooperatives can afford to narrow margins more than profit-maximizing firms. But maintaining a low-cost position requires discipline, cost curiosity, and the habit of moving nonessential tasks to lower-cost providers. The Boston Consulting Group argues for an approach that is culturally foreign to many credit unions when it says that improving efficiency requires investigating numerous functions of financial institutions (especially repetitive, day-to-day activities, such as payroll), but also including nontraditional areas such as management support, for outsourcing. Among credit unions, where the historical tendency has been to manage from the inside, the prospect of pragmatic outsourcing might be daunting. Further, the same Boston Consulting Group report calls for all financial institutions, including cooperatives, to streamline processing via “straight-through processing” (STP) in order to create greater efficiency. A best-in-class goal is 90% of new-account openings and 70% of consumer unsecured originations processed with STP. If credit unions will compete with other financial institutions, they will have to shift their processes in a similar direction.

Customer Champions
Of course, the other distinguishing feature of cooperative financial institutions is member ownership. For this reason, management strategy must ultimately serve the members. As discussed earlier, given the historical shift away from an instrumental reason for existing, cooperatives must establish a new core purpose. The member-owned feature of cooperatives, along with the current market of financial services in which the “customer is king,” has led some commentators to conclude that this purpose should be to act as “customer champions.” The question is, what does this mean to management? As we’ve seen, it can’t mean emphasizing the kind of direct democracy that was possible in credit unions of the past. Nor can it mean allowing a tyranny of the majority of members at the expense of a competitive market position. Instead, it should mean enmeshing practices that reflect the cooperative’s structure, especially member ownership, with practices that allow the cooperative to grow economically. For the consultancy Oliver Wyman, it means looking to two key indicators to measure success: (1) growth and (2) operating efficiency.

In this case, growth is measured in net membership growth, because that indicates success in providing value to existing members and the
power to attract new members to the value proposition. But care should be taken not to overemphasize loss leaders or accept undue dormant account behavior in the attempt to reach this goal.  

To avoid relying only on the depth of membership, then, two more detailed metrics can be considered as defining cooperative success: cost efficiency and income growth. The first implies an appropriate stewardship of member funds, which directly addresses the agency concern mentioned earlier that the cooperative benefit of cheap capital is being passed on to customers rather than dissipated by management. Figure 4, reproduced from Oliver Wyman, captures these two metrics.

As Oliver Wyman concludes, “Those that score poorly on both [dimensions] are not only failing their members, but also risk undermining the cooperative model by exposing it to the criticism of being insulated from owner and competitor pressure.”

Managing Loyalty
Modern consumers prize loyalty, particularly in the climate of distrust of financial institutions that has arisen since 2008. Luckily, loyalty happens to be an inherent advantage of cooperatives, given their emphasis on democratic participation, ethics, and transparency, and their associative practices (of information, education, consultation, and decision making). As discussed earlier, loyalty can also drive growth, leading to lower costs and higher revenues. Management thus has a mandate to ensure that loyalty toward the cooperative does not wane. This means addressing loyalty systematically. According to Côté, practices that generate and maintain loyalty fall under a number of main headings:

- Commitment and involvement of management to loyalty-oriented action and reinforcing behaviors
- Internal benchmarking
- Determination of customer needs
- Analysis of the competition’s capacities
- Ongoing measurement of customer satisfaction and loyalty
- Analysis of feedback
- Ongoing improvement

In his study of the Saint-Roche-de-l’Achigan Credit Union in Quebec, Côté further pinpointed areas where management was especially focused in order to actively foster loyalty:
• **Market:** The credit union conducts market studies and feedback. The stated intention is to serve everyone, even less profitable customers, using a “best offer from the outset” approach. All members are offered the same rates where the same conditions (amount, term, and risk) apply.

• **Human resources:** Employees work in a very open environment with flexibility in deciding on activities, methods, and related budgets.

• **Financial resources and risk:** With an aim to be conciliatory and more forgiving, the credit union uses “holistic risk assessment” and employees are empowered to make special arrangements with members with nonperforming loans.64

All firms, of course, should maintain loyalty-enhancing systems in these categories, but for credit unions these systems are particularly important. That is because limits on fields of membership and on viable strategic directions make maintaining current members essential for financial sustainability and for effective word-of-mouth growth. Duffy argues that measuring loyalty by depth of use and payment history is essential (e.g., measure the percentage of households that are current on all their credit versus competitors).

**Managing Capital for Member Benefit**

Strategic cooperative management must focus on utilizing capital well. One of the results of credit unions’ regulations and business model is a large capital base. As discussed earlier, this base can be thought of as an “intergenerational endowment” that stabilizes the organization. However, it can also do damage if managed incorrectly. For example, stagnant capital can actually stifle economic growth by diminishing aggregate savings and investment.65 Because members cannot make demands on reserves, the only entities in a position to demand that management maximize the value of the capital are regulators (who usually don’t do so, because they prefer high, stable capital levels) and boards of directors (who are not accustomed to thinking about the economic value or opportunity costs of retained earnings). So it is left to management to do something with the capital. Figure 5 provides a comprehensive list of options for this, as developed by the consultancy Oliver Wyman.

An added level of complexity in choosing from among these options is the unique nature of credit union governance and the role of the board of directors in setting strategy for the cooperative. To carry out good credit union management, then, requires optimal governance. In reference to European cooperative banks, Fonteyne produced a set of improvements that could contribute to such optimal governance.66 The proposals were made in reference to European banks, to which
many of the same principles apply. But the following improvements include only those that also relate to credit unions:

- Strengthen disclosure requirements.
- Develop measures to increase member involvement.
- Mechanisms that allow members to organize themselves and challenge management, especially in relation to questions regarding the future size of the institution.
- Increased minimum investment levels for members.
- Deliberate exposure to market mechanisms.
- Addition of independent and well-qualified board members.
- Specific prudential oversight.

Without appropriate governance, cooperative financial institutions face the real risk of bad management. When a co-op's business goals are not aligned with those of the members, apathy or cynicism results; members lose interest and cease to participate. Meanwhile,

### Figure 5: Options to Reduce the Capital Base

<table>
<thead>
<tr>
<th>Option</th>
<th>Method</th>
<th>Description</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disburse excess capital</td>
<td>Windfall dividends</td>
<td>Issue ad hoc payments to members</td>
<td>Relatively easy increase satisfaction</td>
<td>Rewards current members only</td>
</tr>
<tr>
<td></td>
<td>Charitable foundation</td>
<td>Diversify capital to charitable causes</td>
<td>Benefits for current/future generations</td>
<td>Endowments require special administration</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Positive impact on brand/values</td>
<td>Centralized giving may undermine local benefits</td>
</tr>
<tr>
<td>Utilize excess capital internally</td>
<td>Increase risk appetite</td>
<td>Invest in more capital-intensive business lines</td>
<td>Reach new customers, increased wallet share</td>
<td>Departure would require support from all stakeholders</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Increased risk may lead to better profits</td>
<td>New business lines may lead to poor decision making</td>
</tr>
<tr>
<td>Employ capital for expansion</td>
<td>Acquisitions or CUSO investments</td>
<td>Investigate investment opportunities in</td>
<td>Expand business to leverage scale</td>
<td>May result in empire building</td>
</tr>
<tr>
<td></td>
<td></td>
<td>complementary businesses</td>
<td>Support co-op movement elsewhere</td>
<td>May pay inflated prices due to lower return objectives</td>
</tr>
<tr>
<td>Reduce capital accumulation rate</td>
<td>Increase regular profit distribution</td>
<td>Increase profit payout to members via dividends</td>
<td>Opportunity to increase member participation,</td>
<td>May undermine cooperative model by emphasizing shareholder dynamic</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>widen membership</td>
<td>May raise member expectations that are difficult to sustain</td>
</tr>
<tr>
<td></td>
<td>Reduce profitability</td>
<td>Reduce capital growth by reducing profitability with lower margins</td>
<td>More economic value returned immediately to members</td>
<td>Regulators could view as risky</td>
</tr>
</tbody>
</table>

several bad scenarios can emerge with regard to the running of the cooperative, whereby managers:

- Pursue interests other than the general interest of members (e.g., by favoring a particular constituency, outside parties, or business subsidiaries like a credit union service organization [CUSO]).
- Seek their own interests, “empire building” by either retaining earnings unduly or expanding the business beyond ventures that add value to members.
- Appropriate or fail to prevent the appropriation of the inter-generational endowment through excess compensation or demutualization.67

Yet, numerous examples exist of organizations that have avoided these pitfalls and that successfully apply cooperative principles in their management practices. Finland’s S Group—discussed earlier in this brief, and which is closer to a Costco than to a credit union—is a good case study. On the one hand, the S Group emphasizes competitive pricing and a disciplined supply chain. On the other hand, it runs an extensive patronage reward system. So it takes advantage of both competitive market practices and the cooperative corporate structure. Group members receive a monthly statement showing recent and cumulative rewards they have earned based on usage. The company estimates that 66% of its 2007 sales were attributable to members earning rewards in this way. Members can also earn between 1% and 5% of their total purchases depending on their level of consumption. In terms of membership involvement, members’ duties are introduced and emphasized at account opening. Moreover, members’ “S-Card” rewards cards also function as voting cards, and the cooperative encourages voting with giveaways of a car and personal computers.

In an example out of Italy, the food cooperatives that operate under the “COOP” brand see their value as being cost savings for members. They have achieved this by changing store formats to make them more efficient and convenient, and by investing in their COOP-branded private label products. Additional emphasis is placed on loyalty services and financial products. These investments, and a core emphasis on efficiency, allow them to maintain prices that are 5% lower than most supermarkets and 2% to 3% lower than their closest competitors. They grew by an average 15% in the three years through 2006.68 More and more credit unions are taking a similar approach by tying explicit financial rewards, like excess dividends and interest rate discounts, to members’ use of the credit union. In addition to the standard benefits provided by superior rates, these credit unions incentivize deep membership engagement by paying out the most benefits to the most engaged members.
This brief offers some final notes on the unique task of managing cooperatives today. One area where an investment of time on the part of management will be returned with a host of benefits is through association with other cooperatives. Cooperation is a competitive advantage for credit unions, one that commercial banks simply won’t adopt. Forming networks allows credit unions to pursue cost advantages. Of the three types of systems within which a credit union can function—atomized systems, consensual networks, or strategic networks—the more closely integrated systems operate at lower costs.

Meanwhile, internally, it’s important to stress that cooperatives tend to have loyal employees who are close to customers. This, in turn, fosters the customer loyalty required in a “customer champion” model of governance. Though cooperative financial institutions lag in their ability to pay market prices for top talent, they should nonetheless seek ways to maintain this closeness.

Finally, it is accurate to argue, as does Fonteyne, that for many of the reasons stated above the success or failure of a cooperative depends on the people who run it. Many cooperatives are run by managers who genuinely want the best for their firm and their members, and such motives are rarely captured in theoretical models.69

Interesting Cooperative Ideas

Taking account of the impact of cooperative structure on decision making has to include some speculation. After all, cooperatives, including credit unions, began as an innovation. The literature provides hints as to future directions to follow to keep this innovative spirit alive.

Deterring Demutualization

As mentioned earlier, opportunistic demutualization is an ongoing risk for cooperatives. In some jurisdictions, however, the temptation to liquidate has been dramatically lessened. European policymakers differ from those in the United States in requiring that, upon dissolution, cooperative capital pass to either another cooperative or a charitable purpose, leaving fewer financial incentives to demutualize. Unlike in the United States, members have no claim on the net economic value of the firm.

Other potential approaches to the demutualization problem include imposing a windfall tax on members, distributing shares among members in proportion to their length of membership or volume of business, closing the cooperative to new membership in the run-up to demutualization, and donating the equivalent of the cooperative’s reserves to a charitable foundation.70
Positioned for Takeovers
This brief has described some of the drawbacks of cooperatives’ large capital base. It has also touched on the benefits of member ownership, particularly the freedom with regard to short- and long-term growth, where cooperatives are exempt from relentless quarterly reporting. Combining these two facets of the cooperative experience, it’s possible to envisage cooperatives outbidding commercial banks in takeover battles. If cooperatives see long-term value in a takeover, they are in a superior position to put their greater capital reserves to use in making that kind of acquisition—without the reporting requirements that would force them to show a benefit right away.

Preferential Treatment
Fonteyne argues that cooperatives have inherent advantages that allow them to call on and often receive preferential treatment in multiple realms. In Europe, not-for-profit status, large membership, close involvement in local communities, retail orientation, and links to broader movements all parallel advantages that credit unions, as co-ops, enjoy in the United States. Credit unions might see that preferential treatment as a benefit to be repaid by, for example, calculating the value of their tax exemption and using those funds in tangible ways that serve their field of membership or their broader community.

Annual Membership Fees
Given the emphasis in the literature on loyalty as a ticket to growth among cooperatives, and the traditionally strong connection between cooperatives and members, one possible route for stimulating active membership is to initiate an annual membership fee. This would prevent an overreliance on sheer numbers of members as the measure of success, given that few members with dormant accounts would be willing to pay annually to have no relationship whatsoever with the cooperative. At the same time, the fee would create an even stronger pact of trust between the cooperative and its active members, requiring the fee in exchange for the promise of better services than could be found elsewhere. In turn, this would encourage the cooperative to prove its value to members every year.

Bonding with Members
Some grocery cooperatives, which operate under different capital rules, have looked to raise growth capital while simultaneously strengthening bonds with existing members. They have done so by issuing interest-paying debt to fund growth. Obviously unconstrained by concerns about deposit insurance, these co-ops can offer fairly attractive rates for their members, while taking advantage of the “capital sitting in our members’ pockets . . . going unused.”
This innovation would require regulatory changes for credit unions, but in the case of the grocers, this capital has generally been used to expand market presence through new retail outlets. However, it is possible to imagine a credit union raising funds for an acquisition or to make strategic investments.

**Dividends**

As in the example of Finland’s S Group, there are cases when initiating either a windfall dividend payout to members or an ongoing loyalty dividend can be part of an overall strategy to become customer champions. Benefits include higher customer satisfaction and the all-important increased loyalty factor. But progressive managers realize that not all dividends have to be cash-based. For example, compensating members with specific services or community giving in the members’ names can be more valuable for certain groups.

**Conclusion**

This brief has outlined the changing need for cooperative finance and highlighted some of the challenges that face credit unions as they seek to grow while maintaining not just ties to their cooperative roots but a respect for the sources and appropriate uses of their accumulated capital.

On the bright side, a vocal and engaged segment of consumers is talking about the need for more human and more transparent financial services. Credit unions that take that challenge to heart by finding ways to double down on cooperative differentiators and simultaneously tell their story stand to win.

In the end, what’s most important for leaders and managers of cooperative financial institutions is to identify which benefits (economic, convenience, social, etc.) are most desired by existing and potential members. Once those plans are made, the hard work consists of pushing value all the way back out to the members.


3. Ibid., 68.


7. Ibid.


32. Zamagni, “Comparing Capitalistic and Cooperative Firms on the Ground of Humanistic Management.”


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Exploring Cooperative Management

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