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*democrati*

*community*

Credit Unions in Canada  
Design Principles  
for Greater Co-operation

Murray Fulton  
Brett Fairbairn  
Dionne Pohler

SEPTEMBER 2017

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UNIVERSITY OF  
SASKATCHEWAN



Centre for the  
Study of Co-operatives

## Credit Unions in Canada

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Design Principles for Greater Co-operation

Murray Fulton  
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## Centre for the Study of Co-operatives

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- to develop and offer university courses that provide an understanding of co-operative theory, principles, developments, structures, and legislation
- to undertake original research into co-operatives
- to publish co-operative research, both that of Centre staff and of other researchers

Our publications are designed to disseminate and encourage the discussion of research conducted at, or under the auspices of, the Centre for the Study of Co-operatives. The views expressed constitute the opinions of the authors, to whom any comments or queries should be addressed.

## Executive Summary

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**I**N ATTEMPTING TO CREATE NEW NATIONAL organizations, Canadian credit unions face a trade-off between efficiency and autonomy.

The consolidation of the credit union system is ultimately a problem of governance. Unless a governance structure is found that fosters shared norms and values in addition to economic benefits, it is unlikely that credit unions as a system will be able to overcome free-riding behaviour, foster trust and legitimacy, and adapt and respond to a rapidly changing and uncertain environment. All these challenges must be met if the credit union system is to achieve the efficiencies required to operate in Canada's highly competitive financial industry.

This paper identifies six design principles (next page) that can contribute to the good governance of a new national organization. These principles have proven valuable in achieving co-operation in a range of other settings, two examples of which are discussed in the text below.

Table 1: Implementing the Design Principles in the Credit Union System

Design Principle	Implementation
Clear boundary rules for membership	<ul style="list-style-type: none"> <li>• Develop strict guidelines on who can access the services of the consolidated organization</li> <li>• No requirement that everyone has to be a member</li> </ul>
Allocation of benefits and decision-making rights in proportion to each member's contribution to the central organization's success	<ul style="list-style-type: none"> <li>• Establish definition of a member's contribution to the central organization's success</li> <li>• Use this definition to allocate voting rights and benefits</li> </ul>
Rapid access to low-cost arenas to resolve conflict	<ul style="list-style-type: none"> <li>• Use the central organization's leaders (managers and board directors) to resolve conflict by mediating disputes, providing recommendations for compromise, and/or arbitrating between member organizations</li> </ul>
Participation in making and modifying the rules	<ul style="list-style-type: none"> <li>• Establish a forum where members can make and modify the rules that are then applied by the central organization</li> </ul>
Member organizations' selection of their own monitors	<ul style="list-style-type: none"> <li>• Ensure the members of this forum are selected by the membership in conjunction with the decision rules developed under the second design principle</li> <li>• Use the information that members obtain as users of the services to provide insight into the activities of the central</li> </ul>
Multiple layers of organized governance activities	<ul style="list-style-type: none"> <li>• Use the design principles at all layers of the system and in all activities undertaken</li> </ul>

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## Introduction

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**T**HE CREDIT UNION SYSTEM IN CANADA is at a crossroads. The following quote from Central 1's October 2016 report "If not now, when?" illustrates the challenges nicely:

Canada's Credit Union system is approaching a tipping point. As the small player in the national financial services sector, Credit Unions are being consistently outpaced by the scale and marketing strength of the major banks. Our competitors are larger and motivated exclusively by profit.

The Credit Union system is struggling to keep up with the digital offerings of banks and of new financial technology entrants. Many of our systems are outdated and lack coherence. We have an ageing membership base, and we lag behind the banks in selling secondary services to our members. We lack the capacity for data analytics that would help us understand and more effectively meet our customers' needs. We face a complex and ever-changing regulatory environment. Further, the story of the cooperative sector is largely unknown to younger generations, even though they tend to be closely aligned with cooperative values and are actively looking for connection to their communities and for ways to make a difference.

The second tier network has also fallen behind the times. The structure of provincial or regional centrals is a relic of the pre-digital era, and is too expensive to maintain over the long term. While there will always be provincial government issues and local economic conditions to address, most of the needs of Credit Unions are substantially similar across the country. A fragmented system is structurally incapable of

providing or implementing the technological innovations that Credit Unions need to compete effectively with banks, and does not have the transaction volume to make its services affordable to Credit Unions (Central 1 2016, 6).

To date, the first-tier, or local, credit unions have responded to these developments through mergers and consolidation, which has resulted in an increasing bifurcation of the system into large and small credit unions. Credit unions have also developed a range of marketing and branding strategies — some are opting to adopt a low-cost delivery strategy and to compete directly with the chartered banks, while others are attempting to differentiate themselves by positioning their organizations as values based, with a particular focus on the local economy.

These changes are also affecting the second tier of the credit union system — the network of centrals and system partners across Canada that provide services to the first-tier credit unions. Over the last ten years, there have been a number of restructurings, including the formation of Central 1 (the central for credit unions in British Columbia and Ontario) and the transformation of Credit Union Central of Canada into the Canadian Credit Union Association (CCUA), a national trade organization. As Central 1 notes in its report, there is a recognition that the second tier will continue to change. The key question is whether the centrals will continue the process of piece-meal reorganization that has been underway, or whether the current system will be replaced by a new consolidated organizational structure.

Second-tier organizations such as Central 1 and SaskCentral believe that a new consolidated organizational structure is required to provide the greatest cost savings and to strengthen the decision-making process at the second-tier level. In its report, Central 1 indicated that the process to achieve this goal would take the following form:

1. Ongoing implementation of CCUA
2. Consolidation of the centrals' payment functions into a PayCo, an interprovincial operation that consolidates payment and technology functions

3. Examination of co-ordination and merger opportunities among willing centrals
4. Efforts to bring about an economic scale, integrated wealth management platform
5. Replacement of the centrals with a single national financial institution

Since the release of its report in October 2016, a great deal of effort has gone into the creation of a PayCo as a credit-union-owned organization. Unfortunately, the parties have not been able to agree on the structure of this organization, and the process is in danger of breaking down. This lack of agreement is critically important, since it signals the difficulty the credit unions and centrals are having in reaching a consensus on how to undertake consolidation.

The purpose of this paper is to provide some thoughts on the consolidation process — a consolidation that most credit unions and centrals believe is required and yet one for which agreement remains elusive.

## Conceptualizing the Problem

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The challenges facing the credit union system as it attempts to consolidate are based on two interrelated concerns. The first is that consolidation involves a trade-off between efficiency and autonomy. The second is that it involves the introduction of a different governance structure. For each of these challenges, the views of different organizations and individuals in the system are likely to differ. We will examine each of these issues in turn.

### *The Efficiency-Autonomy Trade-Off*

Figure 1 (page 4) illustrates the trade-off between efficiency and the exercised autonomy of a financial organization. The chartered banks allow their branches to exercise little autonomy — managers must, for

most issues, follow practices set out by head office. In exchange for this centralization and uniformity, the chartered banks are able to achieve high levels of efficiency — they have better efficiency ratios than credit unions (57 versus 75), and they have a much higher ratio of assets to branches (\$625 million per branch versus \$80 million per branch on average) (Deloitte n.d.).

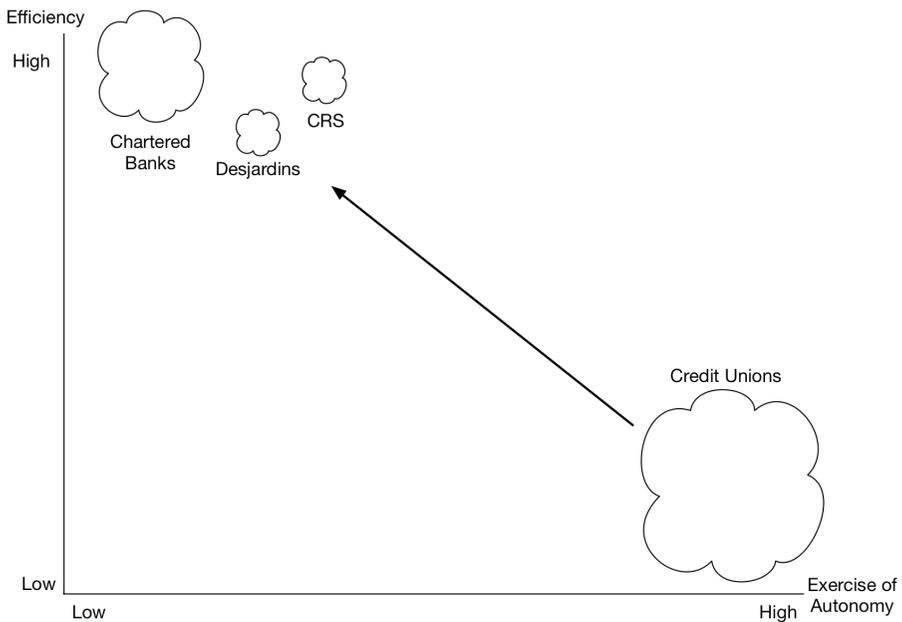


Figure 1: The Credit Union Dilemma: The Efficiency-Autonomy Trade-Off

In contrast, the credit unions operate independently of each other, which allows each credit union to exercise a fair degree of autonomy, albeit at the expense of lower efficiency. Figure 1 also shows an estimate of the location of the Desjardins Group and the Co-operative Retailing System (CRS), the organization of local retail co-ops and their wholesaler, Federated Co-operatives Limited (FCL). It is important to note that the horizontal axis shows the degree to which local autonomy is

exercised, but it does not show legal autonomy. A local retail in the CRS, for instance, has a great deal of legal autonomy, but when it becomes part of the CRS, it chooses not to exercise its legal ability to operate independently.

Since the goal of consolidation is to lower costs and increase efficiencies, the trade-off between efficiency and autonomy means that this can only be done if the credit unions give up some autonomy. In other words, the consolidation process requires a movement in Figure 1 from the bottom right-hand corner to somewhere closer to the top left-hand corner.

As can be seen with the case of PayCo, getting credit unions to agree to this move is difficult, and there are a variety of reasons why this is the case. The board and management (and maybe even the members) of what are currently relatively autonomous organizations may be reluctant to give up the power and authority they possess. Loss aversion theory, in fact, suggests that people are reluctant to give up the autonomy associated with the status quo unless doing so offers large and obvious benefits.

Even when greater efficiency appears to offer substantial advantages, these benefits are not certain and may not occur for some time; both of these factors diminish the benefits in any benefit-cost analysis. Board members and management may also not trust the accuracy of the cost estimates, since large-scale transformations are often more expensive than budgeted — a further reason to believe the benefit-cost ratio may be overstated. There may also be straightforward disagreement about the premise. Given their experience and the culture and environment within which they operate, some leaders may not believe that consolidation is even necessary.

In short, the move from the lower right to the upper left corner will only proceed if there is widespread agreement on the following three critical points:

- that the credit union system is truly at a crossroads and in need of a major transformation
- that a gain in efficiency is more highly valued than the loss in autonomy
- that the benefits and costs have been properly measured and are likely to materialize as forecasted

Given the complexity of these requirements, it is no wonder that the credit union system has had trouble reaching agreement on how to proceed.

### *The Governance Problem*

Governance has emerged over the last decade or two as the most important feature of what makes organizations work (Bevir 2012). For the analysis in this paper, governance is defined as *the set of formal and informal arrangements by which power is allocated and exercised in any system with interdependent actors*. Governance is thus the set of formal (e.g., voting rules, board selection rules, etc.) and informal (e.g., norms, etc.) arrangements that structure decision making in an organization. As Figure 2 illustrates, the formal arrangements are captured by organizational structure, while the informal arrangements are captured by organizational culture. Governance determines which stakeholder groups define and shape the organization's values, norms, strategy, and incentives, and whose (and thus, which) information is privileged. In a nutshell, governance determines who gets to decide what. Different governance arrangements give different stakeholders more or less power to make decisions, highlight who is accountable to whom, and determine which stakeholders have a voice in the decision-making process (Institute on Governance 2017).

A good governance arrangement allows an organization to operate successfully and to meet its various goals. For credit unions, good governance allows both the individual credit unions and the supporting system to remain financially viable and strong, and to provide a set of

services to members that are deemed valuable. To meet these objectives, the formal and informal arrangements must address three challenges:

1. managing strategic interdependencies (the relationship between the board and management, between service suppliers and individual credit unions, and among the credit unions)
2. establishing and maintaining legitimacy among internal and external stakeholders
3. adapting and responding to changing and uncertain environments (Pohler, Fairbairn, and Fulton 2017)

Figure 2 shows these outcomes as a consequence of the governance system.

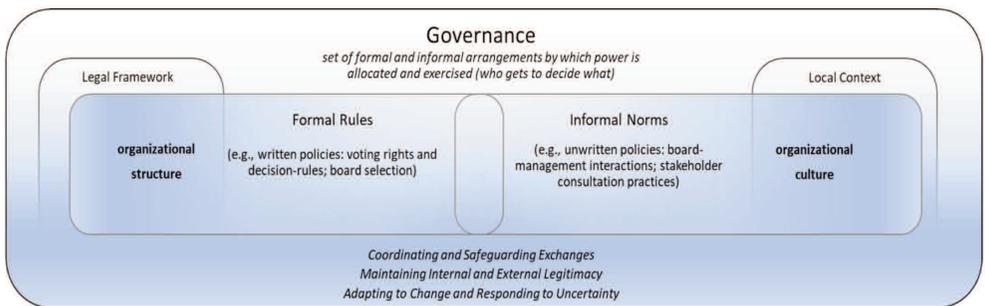


Figure 2: Governance Model (Pohler, Fairbairn, and Fulton 2017)

The consolidation of the credit union system described in the previous section is ultimately a problem of governance — i.e., the move from the lower right to the upper left corner of Figure 1 involves giving up power and influence, captured in the diagram as autonomy. People are reluctant to give up power and authority for a variety of reasons. They may believe their views matter and result in better decisions; they may feel that their own or their group’s interests will be disadvantaged if they do not have a say in the decision making; and/or they may simply have a desire for power. Regardless of the reasons, what people are concerned about is the classic governance problem — namely, who gets to decide what.

### *A Way Forward*

There are clearly significant obstacles to consolidation in the Canadian credit union system, and although it is difficult to get agreement on the transformational process, it is not impossible. Other systems — such as the Co-operative Retailing System — have managed to make the move shown in Figure 1. Our research shows that successful transformations have involved good governance and that the development of good governance depends critically on following a set of design principles.

The next section outlines the governance issues that have to be addressed if an organization is to operate effectively — in this case, for a PayCo to generate sufficient benefits to encourage the credit unions to collaborate. The following section outlines the design principles for developing a suitable governance structure and provides some thoughts on how these principles might be applied to the credit union system. It also examines the circumstances in which they are most likely to be effective.

### Governance Issues for Co-operation

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As noted above, the potential credit union consolidation involves a group of independent organizations deciding how they will co-operate with each other. A great deal of work has been done to determine the conditions under which people will co-operate — i.e., give up some autonomy. A key challenge is the free-rider problem. Elinor Ostrom, awarded the Nobel Prize in Economics in 2009, carried out some of the most significant research in the area. Ostrom studied the manner in which independent users of a common pool resource, such as a grazing or fishing area, developed organizational structures to curtail free-riding behaviour. In the resources she studied, this behaviour took the form of overgrazing or overfishing — i.e., exploiting or overusing the resource to the point where it no longer provided any economic ben-

efit. To escape from this “tragedy of the commons,” the individuals involved had to learn to co-operate (Ostrom 2000).

There are many examples of common pool resources in credit unions. One is the credit union brand, which is built up by the “good” actions of credit unions, but can easily be tarnished by the failure, or problematic behaviour, of one or two organizations. Credit unions may free ride on the credit union brand by not focusing on members or by operating in a way that is contrary to the brand — e.g., functioning “just like a bank.” Another example is underinvesting in credit union trade associations and centrals, while capitalizing on the spillover benefits of lobbying paid for by the credit unions that do support them. Relying on deposit insurance protection that has been created over decades of investment while undertaking risky strategic activities is an additional case in point.

The inability of credit unions to adequately deal with the free-rider problems created by common pool resources is a key reason why the efficiency of the current system is relatively low. If they are to generate an efficiency benefit — a move from the bottom right to the top left corner of Figure 1 — credit unions will need to give up some autonomy.

While it is easy to argue that the establishment of a large, centralized organization will create efficiency gains, reducing free riding is difficult to realize in practice. Co-operation can generate a larger pie that can be split to benefit everyone, but co-operative arrangements almost always give at least one of the parties the chance to act opportunistically. In fact, as Ostrom (2000) points out, while creating a co-ordinating organization can address the original free-rider problems, another problem emerges around the manner in which the new organization operates. She refers to this as a second-level dilemma.

The second-level dilemma — the need to obtain co-operation among the participants and stakeholders in a new collaborative organization — is an example of a *strategic interdependency*, one of the three key governance challenges that has to be addressed in order for an organiza-

tion to operate successfully. There are a number of other strategic interdependencies:

- the co-ordination of activities between the first and second tiers
- the effectiveness of the relationship between the board and management of the organizations involved
- the rapport between the various organizations and their employees

One way to manage these various interdependencies is to build in economic incentives for co-operation. The maintenance of the brand can be greatly improved, for example, if a central organization provides a financial incentive to invest in new outlets with a common look and feel. This is exactly the policy that FCL practises with its local retail co-ops across western Canada.

However, while extrinsic incentives such as subsidies are important, they alone are typically unable to prevent free-riding behaviour. The main reason is that explicit incentives — e.g., a desire for more money — can crowd out intrinsic incentives, which often inspire people to undertake collective activities simply because they generate positive emotions and feelings of belonging. Extrinsic incentives reduce intrinsic motivation by shifting control to factors external to the decision maker, which results in a reduction in personal agency. Since intrinsic incentives are particularly good at addressing free-rider problems, any reduction in this form of motivation is likely to make free-riding behaviour more difficult to contain.

Organizations must establish *legitimacy and trust* — together, the second element in an effective governance structure — if intrinsic motivation is to be effective in addressing the free-rider problem. Part of the solution is to establish a set of formal and informal rules that will both generate the co-operative outcome and produce intrinsic benefits, thus making it more likely that people will adhere to the rules. Following the rules, however, only generates intrinsic benefits if they are perceived to be legitimate and fair, and if everyone else also adopts them. Without legitimacy and fairness, the rules will be questioned and there will be no

intrinsic incentive to abide by them. Trust is also important. To achieve and maintain co-operation, each participant has to have sufficient trust that the others will also co-operate. In summary, a good governance structure is an allocation of power and authority that builds legitimacy and trust, which in turn helps to sustain the intrinsic incentives required to deal with free-rider problems.

The third element of an effective governance structure is *the ability to adapt and respond to changing and uncertain environments*. Good governance is easier to attain when the economic, political, and social environment in which credit unions operate is relatively stable, since people can rely on well-established practices and heuristics to guide decision making. In unstable, rapidly changing environments, relying on standard ways of doing things can often be highly detrimental. The Millennials offer a good example — a generation looking for different things from their parents and grandparents, focussing on digital services and a desire to make the world a better place. Attempts to market the same services to them as to their parents would likely be counterproductive. However, since the environment is uncertain (Millennials may change their perspective as they grow older), it is not clear what direction and practices organizations should pursue.

Governance plays a critical role in helping to determine the path an organization should take, since the allocation of power and authority have significant implications for which views are deemed important and hence for the decisions that are made. A good example is the structure of senior leadership teams within firms. For firms in high velocity environments, the centralization of power often leads to politicking within the organization wherein those without power withhold information, form coalitions behind the scenes, and attempt to control agendas. In the absence of co-operation and co-ordination, poorer performance is the likely result. In contrast, firms with a more equal distribution of power are often much more successful (Eisenhardt and Bourgeois 1988). In short, the unequal distribution of power leads to efforts to rebalance the situation. In the process, value is destroyed because the conflicting views

among senior leadership cannot coalesce to create a richer view of what the future might hold.

While good governance regimes address all three of the issues outlined above, it is not clear how they are actually achieved. In the next section, we sketch out the design principles associated with the development of good governance, paying particular attention to those linked to achieving co-operation.

### Design Principles for Co-operation

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While free-rider problems are common, some groups have found ways to minimize them in governing common pool resources. One of Ostrom's key insights was that the governance structures in these resource systems shared a number of common design principles:

1. establishment of clear boundary rules (i.e., who is in and out)
2. development of rules that consider local conditions, place restrictions on harvesting, and distribute benefits in proportion to required inputs
3. participant involvement in the creation and modification of the rules
4. participant selection of their own monitors
5. use of graduated sanctions
6. access to rapid, low-cost mechanisms for conflict resolution among users and between users and officials
7. governmental recognition of right to organize
8. multiple layers of governance in the presence of larger common pool resources (Ostrom 1990; 2000)

Of these eight design principles, all but two (graduated sanctions and government recognition) appear to be critical for establishing the efficacy and legitimacy of co-operative governance arrangements. A

recent study, in fact, argues that successful business federations such as the Co-operative Retailing System have used these design principles to structure the formal and informal arrangements for the allocation and exercise of power (Pohler, Fairbairn, and Fulton 2017).

The use of these principles reduces free-riding behaviour among member organizations in a number of ways. Clear membership rules result in a shared identity — a sense of being in the club — that facilitates norms of reciprocity, while the distribution of benefits in proportion to required inputs creates incentives that facilitate patronage and active involvement in governance. Participation in making and modifying the rules, access to low-cost arenas to resolve conflict, and member selection of their own overseers provide assurance that the monitoring of transgressions and the adjudication of conflict is done quickly, transparently, and on the basis of criteria that are acceptable and applicable to everyone.

In short, the design principles give members confidence that a certain type of fairness will prevail, one in which influence is allocated in proportion to perceived ranking within the system, and in which everyone is subject to the same rules. As Henrich (2015) argues, humans seem to have a predisposition to following rules, providing they are perceived to be fair. The design principles appear to offer a way to develop rules that people find acceptable.

There are limits, however, to the situations where these principles can be applied. For instance, if one member organization is significantly larger than the other member organizations, then the allocation of authority on a proportional basis effectively institutionalizes the concentration of power in a single member. In this case, it may be difficult to develop co-operative behaviour. Co-operation is most likely to occur when the individual organizations are not too diverse in their contribution to the success of the central enterprise.

## Implementing the Design Principles

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The design principles outlined above can be used to structure the formation of a PayCo, or indeed, any of the other service organizations envisioned in a reconfigured credit union system. Table 1 (page 15) outlines the six design principles relevant to the credit union system and summarizes the way in which each can be implemented. A fuller description of each principle and its implementation is provided below.

### *Clear Boundary Rules for Membership*

A review of successful business federations shows that while the rules around which organizations can become members may vary widely, and may differ on the requirements and barriers to entry, membership is clear once it is achieved. The result is that member organizations are able to define their relationship, expectations, and lines of accountability relative to the other organizations in the system. Clear boundary rules also create an organizational identity that fosters shared norms and reciprocity among group members (Ashforth and Mael 1989).

For the credit union system, it will be important to develop strict guidelines on who can access the services of the consolidated organization and who cannot. One of the implications of clear boundary rules is that there is no requirement that everyone has to be a member. Organizations should be able to elect to join the full system or remain outside. However, remaining outside needs to be just that — organizations that choose this route cannot expect to receive the services of those that elect to participate.

### *Allocation of Benefits and Decision-Making Rights*

Allocating benefits in proportion to each member's contribution to the central organization's success is a common feature among co-operatives. Benefits are typically allocated on the basis of patronage, which

Table 1: Implementing the Design Principles in the Credit Union System

Design Principle	Implementation
Clear boundary rules for membership	<ul style="list-style-type: none"> <li>• Develop strict guidelines on who can access the services of the consolidated organization</li> <li>• No requirement that everyone has to be a member</li> </ul>
Allocation of benefits and decision-making rights in proportion to each member’s contribution to the central organization’s success	<ul style="list-style-type: none"> <li>• Establish definition of a member’s contribution to the central organization’s success</li> <li>• Use this definition to allocate voting rights and benefits</li> </ul>
Rapid access to low-cost arenas to resolve conflict	<ul style="list-style-type: none"> <li>• Use the central organization’s leaders (managers and board directors) to resolve conflict by mediating disputes, providing recommendations for compromise, and/or arbitrating between member organizations</li> </ul>
Participation in making and modifying the rules	<ul style="list-style-type: none"> <li>• Establish a forum where members can make and modify the rules that are then applied by the central organization</li> </ul>
Member organizations’ selection of their own monitors	<ul style="list-style-type: none"> <li>• Ensure the members of this forum are selected by the membership in conjunction with the decision rules developed under the second design principle</li> <li>• Use the information that members obtain as users of the services to provide insight into the activities of the central</li> </ul>
Multiple layers of organized governance activities	<ul style="list-style-type: none"> <li>• Use the design principles at all layers of the system and in all activities undertaken</li> </ul>

recognizes that each member’s business is critical for the co-operative’s success. The allocation of decision-making rights on the basis of one-member, one-vote — the most common rule in first tier co-ops and credit unions — is a recognition that organizational success depends on relatively equal say among members.

For second-tier organizations, both economic benefits and decision-making rights are often allocated on the basis of patronage/size. Some second-tier organizations do use one-member, one-vote for allocating decision making, while distributing economic returns on the basis of patronage, particularly when enterprises first form or are of roughly equivalent size.

It is important for the membership to define what is meant by “each member’s contribution to the central organization’s success.” While contribution certainly implies money, it can also take other forms, including the provision of key information and sound business and organizational advice. Thus, a fundamental aspect of this design principle is identifying the critical contributions and determining how to measure them. Once this is done, the definition can be used to allocate voting rights and benefits. As noted above, success in these two realms need not be based on the same thing, so it may be necessary to work through the process for both voting rights and benefits.

#### *Rapid Access to Low-Cost Arenas to Resolve Conflict*

A key objective for a PayCo or other central organization is how to best use its resources to achieve the goals of the system. With a diverse membership, however, there is likely to be conflict (e.g., Hansmann 1988). Some members, for example, may expect the central organization to provide high quality services, or an extensive range of services, while others might prefer service provision at the lowest possible price. The members are also located in different provinces, some in rural and some in urban areas, and will differ in terms of size, profitability, growth potential, and approach to financial service provision.

Resolving these conflicts requires a group that can mediate disputes, offer recommendations for compromise, and/or provide arbitration among member organizations. Officials of the central organization are the group best situated to do this, since they have the ability to see all the parts of the system and how they interact. Indeed, central organiza-

tions that fail to play a strong role in this regard are more likely to be unsuccessful (Fairbairn, Fulton, and Pohler 2015).

However, vesting the power and authority to resolve disputes in the central organization creates potential problems, particularly opportunism on the part of the central, whose officials may have their own goals, and rent seeking by the member organizations as they try direct decisions in their favour. Allowing the members to make and modify the rules that resolve disputes, and also to select their own monitors, will mitigate both problems. We examine these two design principles next.

### *Participation in Making and Modifying the Rules*

One way to ensure that the central organization deals fairly with conflict is to establish a forum where members can make and modify the rules that the central applies. In most second-tier co-operative arrangements, this forum is linked to the democratic process by which board members are selected, which keeps the board accountable to the members. This formal democratic structure typically needs to be augmented with regular meetings to keep members informed about activities and performance. Decisions about the rules and other matters are made during these meetings, which also allow the retailers to question the board and management on a regular basis, and to monitor the activities occurring throughout the system.

### *Member Organization Selection of Their Own Monitors*

Monitoring does not need to be carried out by everyone in an organization to be effective (Pohler, Fairbairn, and Fulton 2017). It can be highly successful if even only a small number of members are willing to engage in it (Ostrom 2000), providing it is done vigorously and relatively systematically. It is particularly important that this group be able to raise concerns if the activities of the central organization's officials have not been sanctioned, either formally or informally, by the membership.

Member organizations, of course, are also customers, which gives them an additional mechanism for obtaining information about the central's performance and activities. The dual role of owners/users helps to reduce the asymmetry of information between the members and the central regarding the actions of the central's board and managers (Hueth and Marcoul 2015).

### *Multiple Layers of Organized Governance Activities*

System performance is likely to be enhanced if these design principles can be used at every level and in all activities. The replication of these elements will create and sustain the expectation that members, whether at the local level or the central level, will have a say in running the system. The routine sharing of information and monitoring of activities will reduce free-rider problems, opportunism, and rent seeking.

This principle suggests that a strategy of separating the various centralized functions (e.g., PayCo, SettleCo, WealthCo, FinCo) — expressed in Central 1's "If not now, when?" report as the "Consolidate and Separate" option — is unlikely to be as successful as the "Consolidate and Integrate" option, which combines these functions. The reason is simple — centralization of functions requires building trust and legitimacy, and the more this is done within a common set of rules and players, the more likely it is to be successful.

## Discussion

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The argument presented above suggests that there is a way for credit unions to move from the bottom right to the top left of Figure 1. Experience to date, however, suggests that this will be difficult. Signs can be found not simply in PayCo's problems, but in the difficulties that Canadian credit unions have experienced over the years in trying to achieve co-operation that extends beyond provincial boundaries.

Different regulatory structures in each province have no doubt contributed to the challenges, but there are likely other contributing factors. Comparing the financial sector with the retail sector provides a useful example. Given the importance of local tastes and the day-to-day nature of shopping in the retail sector, and the obvious economies of scale in the financial sector, it might be expected that the retail side would exercise more local autonomy. Yet, as discussed earlier, the financial sector has exercised much greater local autonomy.

There are at least two possible reasons for this outcome. First, the ability of even relatively small credit unions to remain financially viable until ten to fifteen years ago will have reduced the pressure for them to give up local autonomy. In contrast, the smaller margins in the retail sector created a need for change much earlier. Second, until recently, the perceived specialized nature of local credit union managers' jobs provided them with greater power to operate independently.

Regardless of the reasons, the result is a set of independently minded credit unions and real challenges in getting them to move to a more consolidated system. Even when consolidation has occurred, it has been through mergers and acquisitions or because of regulatory requirements, which have made the remaining credit unions even more focused on independence and autonomy.

However, the economic, social, and political environment appears to have changed sufficiently to require some form of centralization. To date, the approach has been focused on economic solutions — the creation of a PayCo — and economic arguments — a PayCo will provide cost savings. While the economic incentives are necessary for centralization to occur, they are not sufficient. Organizations also need to develop trust in the process and in the legitimacy of a new governance structure.

As outlined above, a critical aspect of the design principles is to embed strong norms of trust, equity, and fairness into a particular set of voting and monitoring rules. Put another way, while the principles are intended to create an organization that will provide economic benefits,

they must also embody other values, since without them, the co-operation required to achieve the economic benefits will not develop.

Co-operatives have long subscribed to a set of values and principles, and they are much more than economic enterprises. Indeed, as the ICA statement on co-operative identity, values, and principles outlines, “A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise” (ICA 2017).

There is a strong sense that the ICA values and principles were devised with the free-rider and collective-action problems currently faced by credit unions in mind. Not surprisingly, the co-op principles appear to line up and support the design principles outlined above. It is important to note, however, that the co-op *principles* are not *values*; they are, rather, guidelines for putting particular values (e.g., self-help, self-responsibility, democracy, equality, equity, and solidarity) into practice. While these values are important in their own right, they also play a significant role in sustaining collective action.

The co-op principle that addresses membership illustrates one parallel between the two sets of principles. It states that co-ops are open to those willing and able to assume both the rights and responsibilities of membership, which means that people can be excluded. Co-ops do not provide service to members who do not contribute. This corresponds to the design principle around boundary conditions.

The co-op principle on member economic participation indicates that members should contribute equitably to, and democratically control, the capital of their co-operative. This echoes the design principle that calls for the allocation of benefits and decision-making rights in proportion to each member’s contribution to the central organization’s success. It should be noted, however, that the co-op principles do not require strict equality of voting; they state specifically that one-member, one-vote does not have to be practised in second-tier co-ops. Each sec-

ond-tier co-op can devise its own practices in keeping with the co-op values and its own circumstances. Most, for example, award more votes to organizations with larger memberships or to those who make greater commitments, which addresses the aspect of equitability. And the degree of inequality among members is kept within agreed-upon bounds.

It is interesting to note that autonomy is also a co-op principle. In this case, however, autonomy is viewed as independence from the providers of capital and from government. Seeing it in these terms suggests another reason why credit unions should consider centralising and co-ordinating their activities. It may offer an important way to defend their autonomy vis-a-vis banks and regulators.

The need to integrate norms that go beyond simply economic benefits poses a problem for the way decisions are currently made in the credit union system. For a variety of reasons, the people taking the lead in the consolidation process are the operating (e.g., CEOs and managers) rather than the elected officials. This is understandable since the threat they are responding to is largely economic, and if centralization does occur, many highly technical issues will arise that require extensive input from managers.

The operating officials thus face the challenge of promoting both the economics/efficiency and the values/norms dimensions of the process. It is difficult, though not impossible, to carry out this dual role. While they are naturally comfortable with the economics/efficiency aspect, this is frequently not the case for the values and norms, where they are often seen as having less credibility — even if they deeply espouse co-op principles and have a strong belief in the financial co-op model. If centralization is to be successful, elected officials may have to play a much larger role in the design process, but they will have to be prepared to give up some autonomy in order to achieve the efficiency that is required.

As shown in Figure 3 (an augmented version of Figure 1, page 23), credit unions need to find a way to move from the lower right to the upper left-hand corner. While there is clearly a trade-off between the

exercise of autonomy and efficiency, how this occurs need not be the straight line represented by Path A. Path B may better represent the way the change unfolds. If this is the case, credit unions have to give up autonomy before they can achieve the benefits of greater efficiency.

Following Path B, of course, is highly risky. While it might be possible to sell a move to a more centralized system, this move should come with some benefits — and the more immediate the benefits, the better. In fact, credit unions may have been moving along Path C — trying to gain initial efficiencies without having to give up autonomy. While taking Path C might be successful, organizations must be wary of this strategy. If it were possible to move at least partly along this path, why was it not done before, particularly since it offers the twin benefits of greater efficiency and little or no loss of autonomy? Since the gains in efficiency have not been forthcoming with the current level of autonomy, we conclude that Path C is not a viable option.

If Path B is the most likely route to a transformation of the credit union system, then the need for trust and legitimacy is particularly significant. This is because it will require all the players in the system to make a leap of faith, with a belief that it will eventually pay off. This belief is built on a foundation of trust — trust that the other players will not free ride, that they will not sabotage the process for their own benefit, and that they will remain committed for long enough that the process begins to pay dividends. In the highly volatile environment in which the credit unions currently find themselves, this foundation of trust is particularly difficult to build and sustain.

Yet, it is precisely this highly volatile environment that makes change necessary. The political, economic, and social changes outlined at the beginning of this paper highlight the need for credit unions to make significant alterations in their structure. But they need a process that will allow these changes to take place in a manner that is deemed fair to the participants.

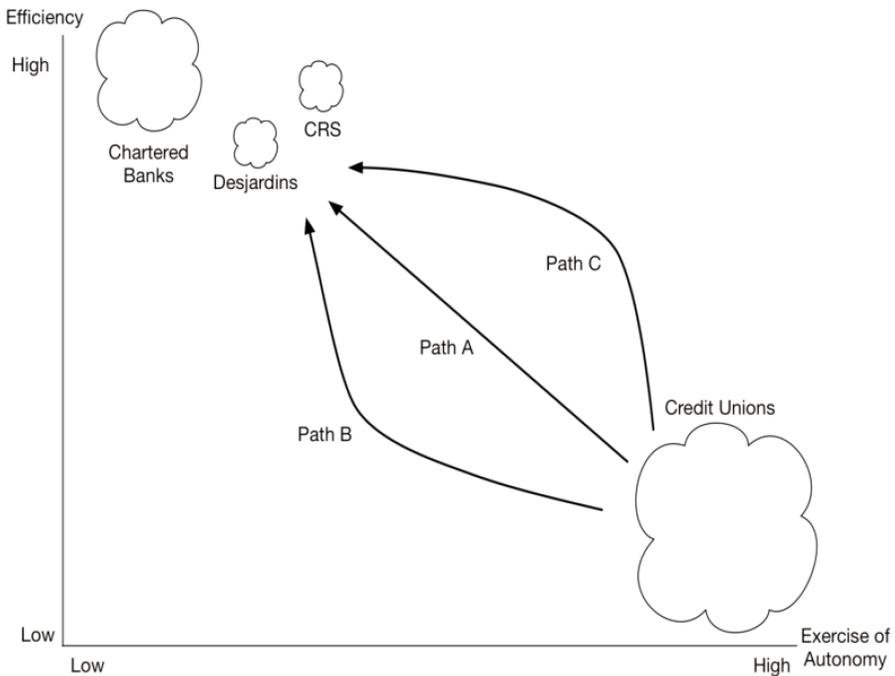


Figure 3: Efficiency-Autonomy Trade-Off Paths

Based on this analysis, our major recommendation is that credit unions should consider adopting a set of design principles that have proven themselves useful in achieving co-operation in a range of other settings. Successful examples include the creation of governance regimes for the management of natural resource commons and the development of organizational structures to govern large business federations. The design principles have a built-in process that embodies fairness, which in turn facilitates the development of trust. While the ultimate goal of transformation for the credit union system may be greater operating efficiencies, these cannot be achieved without first adopting the norms of trust and fairness that are required if they are to give up some of their autonomy. Credit unions may not have many other options if they wish to ensure the survival of the system.

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