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THE FINANCIAL SERVICES INDUSTRY - EMERGING TRENDS IN THE CREDIT UNION SECTOR

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THE FINANCIAL SERVICES INDUSTRY

EMERGING TRENDS IN THE OECS CREDIT UNION SECTOR

By

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THE FINANCIAL SERVICES INDUSTRY - EMERGING TRENDS IN THE CREDIT UNION SECTOR

ABSTRACT

Financial institutions have undergone significant changes in the last decades. Changes in technology, distribution systems, mergers and acquisition activity, cross-selling and competition have contributed to the developments in the financial services industry. The boundary of depositories is becoming more and more blurred, as institutions respond to increasing demands for financial services.

The credit union sector in the OECS countries mushroomed in the 1970's and 1980's with the increasing demand for credit by the working-class people who had little or no access to the credit facilities of the commercial banking system. This was further facilitated by the widespread establishment of occupational-type credit unions for the purpose of savings mobilisation.

Credit unions are challenging small banks and thrift institutions for retail banking business, becoming increasingly involved in mortgage lending, and in the last few years, have become a significant financier of micro and small enterprises. They offer long term home improvement loans, chequing accounts through special clearing-house facilities with other commercial banks, utility bill-paying services and Automated Teller Machines.

Given the difficulty in differentiating between credit unions and commercial banks when it comes to servicing the banking needs of retail customers, regulatory agencies are concerned with respect to the financial health of credit unions. Insofar as these developments could have implications for the soundness of the financial system as a whole, there is a need to assess the policy mix which could be adopted to ensure the financial soundness of credit unions.

This paper discusses the role of credit unions in the financial services industry in the OECS countries, analyses the nature of trade in financial services in the credit unions and the way in which trade in financial services takes place, and examines the implications of these developments for the maintenance of financial stability.

The paper is structured as follows: Recent developments in the financial service industry are discussed in the Introduction. Section II gives an overview of the OECS financial system. Section III analyses the growth of credit unions. Section IV discusses financial innovations in the credit union sector. Section V, the Conclusion, considers the implications for policy formulation.

INTRODUCTION

The international financial services industry has been experiencing a dramatic transformation. Technological innovations combined with regulatory constraints on depositories have contributed to the entrance of a large number of non-depository institutions into markets that have traditionally been the domain of the commercial banks and thrift institutions. Financial supermarkets are offering an array of financial services to customers that are designed to meet the needs of consumers.

Like the rest of the Caribbean, the blurring of the boundaries of financial institutions is already evident in the OECS countries.[1] Commercial banks act as agents for insurance companies and both institutions share common ownership. In the next few years, we are likely to witness a deepening of regional expansion of Caribbean banks; a widening of diversification; and an increase in the use of technology. Recent developments in product innovation in the credit union sector reflect the changes that are taking place in sub-regional market, as well as changes that are taking place in the regional and international credit union movement. Credit union activity in the ECCB Area is being influenced by developments in the international credit union movement in the United States, where credit unions, which include in their membership more than one-fourth of the American households, offer share drafts (which are in fact, cheques), credit cards, certificates of deposit, mortgages, home improvement loans. Some credit unions have marketed their own national credit cards which compete with Visa and Master Card.

Since the 1970's, credit unions in the OECS markets have been competing with small banks and other thrift institutions for retail banking business. Credit unions are able to provide some services on more favourable terms. They offer business and mortgage loans, credit cards, utility-bill paying services, Automated Teller Machines, among other services.

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[1] *The member countries of the Organization of Eastern Caribbean States (OECS) are Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines. This financial space is usually referred to as the ECCB Area since this jurisdiction encompasses all the countries that are signatories to the Eastern Caribbean Central Bank (ECCB) Agreement.*

The growth of credit unions in the OECS was facilitated by a combination of external and internal forces. The organisation, structure and operations of credit unions are due to the influence of such exogenous factors as the recommendations of the Moyne Commission (with respect to the development of cooperatives), the spread of the Rochdale principles of cooperatives in the Caribbean, and the crisis in global capitalism in the 1970's. The development of the sector movement was also aided by endogenous factors such as the established culture of cooperation in the Windward Islands, the welfare ministry of the Catholic church where it was the established church and developments in the labour market in the 1970's.

The credit union was the ideal institution for the mobilisation of small savings and for making small loans to the labouring population which could not access credit from the commercial banking system. The existing practice of labour-sharing, joint ownership and communal ownership in several of the rural economies harmonised perfectly with the principles of pooling of resources and distribution to deficit units.

After less than one hundred years of establishment, credit unions bear very little resemblance to the socio-economic enterprise established to provide the working class with a place to deposit surplus funds and to borrow small sums when in need. These cooperative enterprises are owned by groups of individuals who share similar occupations, live in the same community, are members of the same fraternity or have some other common bond. In most cases, the common bond lowers the cost of collecting and investigating credit information which generally results in a reduction in loan losses.

This paper discusses the role of credit unions in the financial services industry in the OECS countries, analyses the nature of trade in financial services in the credit unions, and examines the implications of these developments for the maintenance of financial stability. The remaining portion of the paper is structured as follows: Section II gives a overview of the OECS financial system. Section III analyses the growth of credit unions and Section IV discusses financial innovations in the credit union sector. Section V, the Conclusion, considers the implications for policy formulation.

SECTION II

AN OVERVIEW OF THE OECS FINANCIAL SYSTEM

The financial system of the OECS includes forty-four (44) commercial banks, eighty (80) credit unions, sixty-seven (67) insurance companies, thirteen (13) finance companies, six (6) National Development Banks, eight (8) Social/National Security Schemes, seven (7) National Development Foundations, and four (4) building societies. A few savings banks and mortgage and finance houses supplement the services offered by the other financial institutions. (See Appendix I).

Commercial banks are the most important actor in the OECS markets with respect to savings mobilisation and credit creation. The National Developments Banks are also significant financiers of development projects. They finance educational, housing and agricultural projects, and extend credit to enterprises involved in productive activities.

National Development Foundations (NDFs) and National Development banks are the two major types of Development Finance Institutions (DFIs) operating in the OECS countries. The NDFs provide short to medium-term funds mainly to micro and small businesses. They package projects for micro and small entrepreneurs for funding by commercial banks, and may guarantee up to 80 per cent of the commercial bank loan where small enterprises lack the required collateral. Social Security Schemes, formerly National Provident Funds, are among the largest Non-Bank Financial institutions (NBFIs) in the OECS countries. They are capitalised by compulsory payroll deductions. These funds are used for claims payments, for meeting operations costs and for building reserves, and as is the case in most countries, some of the funds are utilised for development purposes. These schemes mobilise domestic savings which are used to provide a measure of security for the aged, and for financing investment. A sizeable portion of resources mobilised by the Schemes is apportioned to finance capital expenditure.

Mortgage institutions obtain funds from long-term bonds to offer loan term real estate loans and finance companies, extend loans to households, and differ from commercial banks in that they do not offer chequeing facilities. Insurance companies and credit unions are other important actors in the financial system. The insurance sector is the largest and most important component of the NBF sector. The market, which is basically an agency market, is dominated by agencies of regional and international companies. Insurance companies mobilise large amounts of savings and play an important role in domestic capital formation.

Like the insurance companies, credit unions are important NBFIs, competing with commercial banks offering retail banking services, and supplementing the financial services offered by other financial intermediaries. Apart from the financial institutions mentioned above, there are a number of non-formal and established depositories and welfare institutions providing a measure of security to persons in the lower income group.

Table 1.1

Total Assets of Financial Institutions, 1993-1995
(EC$M)

	1993	1994	1995	%93/95
Commercial Banks	4,122.7	5,590.7	6,232.7	51.2
Social Security Schemes	1,116.4	1,248.4	1,376.6	23.3
National Development Banks	322.6	349.3	301.9	-6.4
Credit Unions	269.9	315.2	378.5	40.2

Source: Statistics Unit, ECCB

Data for the period 1993-1995 were only available for the sub-sectors accounted for in Table 1.1. Changes in the stock of financial assets increased significantly in the three years under review. Except for the national development banks which registered a decrease between 1994 and 1995, the share of the financial institutions in the stock of financial assets held by NBFIs has been on the rise. Commercial banks, the most significant actor in the financial system, hold the largest share of the asset stock. Social Security Schemes, one of the most important sources of funds in the economy, account for a significant share of the total stock. Apart from insurance companies for which data are not available, credit unions enjoy the fastest growth rate in assets in the NBF sector.

Changes in the stock of financial assets of the financial institutions, and the relative contribution to the GDP (at market price) provide an indication of the level of financial activity as well as the sectoral contribution to economic activity. Odle (1972) uses the ratio of total financial assets (by institutions) to GDP to show the distribution of assets by institutions and to represent the degree of change in intermediation. The ratio also shows how the stock of financial is distributed by financial institutions. For the period 1993-1995, the rate of increase for commercial banks moved from 0.70 in 1993 to 1.1 in 1995. Except for the national development banks which recorded a marginal decline, all other institutions registered a small increase in the degree of financial intermediation.

SECTION III

GROWTH OF THE CREDIT UNION SECTOR

(a) Changes in Credit Unions' Stock of Financial Assets

In the last two decades, the credit union sector in the OECS countries has become a significant actor in the financial services industry.

Table 1.2

Growth in Credit Union Assets as Percentage of Nominal GDP, 1975-1995

Years	Assets (EC$M)	% Change	GDP (EC$M)	% Assets/GDP
1975	3.4	-	640.0*	0.5
1980	16.0	370.6	1207.0*	1.3
1985	57.1	256.9	2080.5	2.7
1990	179.7	214.7	3734.4	4.8
1995	378.5	110.6	4995.5	7.6

Source: Credit Union Quarterly Reports; Credit Union AGM Reports
* Figure estimated for Anguilla

Table 1.2 suggests that the stock of financial assets of credit unions increased phenomenally over the twenty years under review, the value of assets at the end of 1995 being more than one hundred times the value in 1975. This suggests that the last decades marked a period of rapid expansion in the sector. Although credit unions operated in the respective markets as far back as 1951, they assumed greater importance as financial intermediaries in the 1970's and 1980's when they became the only credit facility accessible to low-income earners who were denied access to the credit facilities of the commercial banks. During that period, loans, which constitute the core of the asset portfolio, expanded considerably.

The ratio of total assets to the GDP provides a useful indication of the relationship between financial intermediation and economic growth. The ratio of total assets to the GDP moved from 0.5 in 1975 to 7.6 in 1995, suggesting that credit union activity has become significant in the financial services industry, and that they have become an important contributor to economic growth.

The asset structure of the credit union sector reflects the changing posture of the sector. As at 31 December 1995, loans accounted for 79.0 per cent of the asset portfolio as against 54.8 per cent in 1975. The size of the loan portfolio is largely determined by movements in savings, demand for credit, the level of liquidity in the credit union system, and the loan servicing experience of the respective credit unions.

Gross investments, mainly term deposits and government securities, have been a significant portion of the asset base. The investment portfolio has been particularly significant in micro, small, medium-sized credit unions,[2] where growth rates have remained in double digits over the last three years (See Table 1.3). The value of fixed assets for the sector has also been on the increase, reflecting a noticeable growth trend in fixed assets in the small and medium-sized

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[2]*Credit Unions are classified according to asset size as measured in millions of Eastern Caribbean (EC) dollars. The categories are as follows:*

Micro:	*Up to $5m*	*Medium:*	*$16m to $50m*
Small:	*$6m to $15m*	*Large:*	*$51m and over*

credit unions, due mainly to investment in land and property and in computer software and hardware.

The growth in the credit union sector was attributable to a significant increase in the number of credit unions (from 63 to 80), the increased penetration of credit unions (membership increased from 20,646 to 133,492), the practice of systematic saving by the membership, the competitiveness of the credit unions' savings and loan products, the modernisation of a number of credit unions, increased marketing and the introduction of a variety of non-financial services.

(b) Changes in Credit Union Market Share

A credit union is firstly a depository and secondly a credit institution. The size of its loan portfolio is largely dependent upon the volume of savings mobilised, as loans are made from the share capital[3] which constitutes the core of the liabilities of the credit union. Credit union activity in the personal savings and private loans markets[4] has been particularly significant in the last twenty years. Savings grew from EC$1.9m in 1975 to EC$310.3m in 1995, and loans expanded from EC$1.8m to EC$299m in the same period (Table 1.4). This strongly suggests a significant increase in credit unions' market share in the personal savings and private loans markets.

Credit union activity in these two markets between 1985 and 1995 compared favourably with the commercial banks. While commercial banks' savings deposits and private loans grew by

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[3] *Shares and Deposits make up more than 80 per cent of the total liabilities of the credit union. Although a credit union may sell shares to its members at a par value fixed by the by-laws, the general practice has been to sell a share at a par value of five dollars.*

Shares are utilised for credit creation while savings deposits are used to meet transactional demands. Insofar as the share capital can be withdrawn at any time or with notice, it is not treated as a stock, but rather as a "call deposit". Hence in our financial evaluation, the term savings refers to total shares and saving deposits.

[4] *Credit union activity is largely restricted to the personal saving and private loan markets, as it transacts primarily with the households. Comparisons with commercial banks are therefore restricted to these markets.*

315.9% and 209.3% respectively, credit unions' savings and loans expanded by 588.9% and 486.3% in the same period. This suggests that credit unions compete with commercial banks offering retail banking services.

Table 1.4

Growth in Credit Union Market Share on the Personal Savings and Private Individual Markets, 1975-1995

Years	Savings(EC$M)	% Change	Loans (EC$M)	% Change
1975	1.9	-	1.8	-
1980	15.9	736.8	15.8	777.8
1985	44.8	181.8	51.3	224.7
1990	141.0	214.7	147.9	188.3
1995	310.3	120.1	299.0	102.2

Source: Credit Unions Quarterly; Credit Unions AGM Reports

Between 1975 and 1995, membership grew by 546.6 per cent, from 20,646 to 133,492. That is to say the number of persons who accessed credit union services in 1995 was more than six times that of 1975. The area penetration rate (the ratio of membership to population)[5] was 24.5 per cent as at December 31, 1995. In the last fourteen years, the sectoral penetration rate has moved from 7.7 per cent in 1981, to 15.8 per cent in 1989, and to 24.5 per cent in 1995, that is, a movement of 16.8 percentage points in 14 years. In Dominica where credit unions are concentrated, the penetration rate moved from 75.5 per cent to 78.2 per cent between 1994 and 1995.

A number of small, medium-sized and large credit unions have introduced a range of financial services, including time deposits, target savings and retirement accounts. Several rural community-based credit unions provide ancillary services on behalf of the suppliers at no extra

[5]*The ideal yardstick for measuring penetration rate in the credit union industry would be the ratio of membership to the working population, as only persons eighteen years old and over are permitted by the Cooperative Act (which regulates the operations of credit unions in most member countries) to access the services of the credit union. Consequent on the unavailability of labour market data, the total population is used as proxy.*

cost to members. These services include the payment of telephone and electricity bills. The commission earned provide additional income.

SECTION IV

FINANCIAL INNOVATION IN THE CREDIT UNION SECTOR

Credit union activity in the personal savings market largely reflected a significant increase in membership over the years, the practice of systematic saving by the membership, an increase in business and consumer confidence in the sector,[6] improvements in the quality of services offered by several credit unions and the introduction of new products in all classes of credit unions. Credit unions are becoming more competitive in their operation, and their credit policies are becoming more and more market-driven. As a result, there has been a noticeable shift from an overemphasis on consumer lending to productive and mortgage lending. The increasing demands for credit union services are being kindled by greater recognition among credit union members and other customers that it is more economical to access the services of the credit unions, and that they are an alternative to the commercial banks.

Credit administration is the responsibility of the Credit Committee which processes loan applications, counsels the borrowers, advises on security requirements, liquidity management and budgeting, disbursement of funds and the extension of credit services to the membership. In most cases, the lending policy allows for three layers of loan approval: a discretionary limit for managers, a lower limit for the Credit Committee, and a higher limit for the Board of Directors, which is the highest decision-making body.[7] Creditworthiness is determined on the

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[6]*The renewed confidence has been sustained by an ongoing process of reorganisation in some national markets, the implementation of a sub-regional cooperative project (initiated by the ECCB) geared at modernising credit unions and ensuring safety and soundness in the system, and a deliberate attempt by the credit union management to respond to the demands of the market.*

[7]*Members of the Board of Directors are elected at the Annual General Meeting. The OECS Harmonised Cooperative Societies Act which governs the credit unions stipulates that a director "shall be elected for a term of three years, but no person may serve as a director of a society for more than two*

basis of Capacity, Collateral and Character, in that order. The relative weight placed on collateral and character depends on the type of loan demanded, the value of the loans demanded, the share of the member's share deposit, and the borrower's credit history.

The credit unions offer five credit products: consumer loans, education loans, business loans, agricultural loans and mortgage loans; and only three types of deposit facility: savings accounts, target savings, term deposits and a range of savings and investment plans. The following is a list of the financial products and services offered by micro, small, medium-sized and large credit unions.

(1) Savings Accounts

Credit unions make available to their members a variety of savings accounts for everyday savings, special purpose savings and children's savings. Although interest rates are influenced by the market, the actual rates paid are decided at the Annual General Meeting (AGM). Moreover, because greater importance is placed on the share deposit, shareholders are more concerned with the dividend paid on shares.

(2) Special Savings Plans

Credit unions offer instruments for target savings. Members may open special accounts which have elements of terms deposits. Saving are made on a regular basis and the principal and interest are withdrawn at maturity. Some of these plans include Christmas Savings Plans, Back to School Savings Plans and Holiday Savings Plans. This provides needed cash flow and particularly where loan service history is good, it increases the revenue base of the institution.

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consecutive terms or an aggregate of six years."

(3) Term Deposits

The rates for Term Deposits are generally kept in line with the banking system. In some cases, interest rates may be negotiable for deposits over EC$25,000.00. Thus varying terms and competitive interest rates make credit union term deposits attractive investments.

(4) Chequeing Accounts

Credit unions are forbidden by the Eastern Caribbean Central Bank (ECCB) Uniform Banking Act to issue cheques, as this remains a facility exclusively for banks.[8] However, credit union members write millions of dollars in cheques annually on their savings accounts. In all cases, the cheques are drawn on a commercial bank which provides a clearing-house facility for the credit union.

(5) Consumer Loans

Secured consumer loans give credit union members access to finance for motor vehicles, medical services, holidays or any other purposes.

(6) Education Loans

This is a special facility for persons desiring tertiary education. Five per cent of the exposure is required to be share-covered. Interest is charged at 8 per cent and repayment begins after the completion of the course of study.

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[8]*According to article 2, sub-section (b) of the Banking Act, a " 'bank' means any financial institution whose operations include the acceptance of deposits subject to the transfer by the depositor by cheque." This seems a sensible restriction given the liquidity problem being experienced by most credit unions. A financial intermediary which offers its customers a cheque book facility should maintain a higher liquidity ratio and be linked through an on-line computer network. Moreover, the majority of the members who would open cheque book accounts would most likely be more affluent wage and salary earners.*

(7) Business Loans

Business loans are offered to members for investment in commercial agriculture, distribution, transport, tourism and tourism-related activities and micro and small manufacturing enterprises. Generally, credit unions lend exclusively to individual borrowers, as opposed to groups. Credit to businesses (distributive trades, transportation, tourism, and other business activities) and agricultural sectors has increased marginally over the years.

(8) Agricultural Loans

These are usually short term loans to finance seasonal operating expenses such as seeds, fertilisers, pesticides and so on. Loans are repaid after harvesting. Long term loans are required to finance livestock, equipment and land. Repayments are made from excess of sale proceeds over operating expenses.

(9) Mortgage Loans

All classes of credit unions make loans to members for the purpose of home construction, home repairs and renovation, and land purchase. The increasing size of the mortgage portfolio is worthy of note as this trend could have serious implications for the financial health of the credit union sector. Of the $299m in outstanding loans as at December 31, 1995, some $152.5m was distributed to the productive sectors of the economy and $146.5m to consumption. The largest share of the $152.5m apportioned to the productive sector went towards the development of housing and land, and mortgage loans accounted for 70.5 per cent of that volume.

(10) Retirement Fund

This product, referred to as the Golden Harvest Savings Plan in some credit unions, allows members to save for retirement. Some modification functions like an Endowment Policy. The lump sum may be harvested, for example, for the purpose of purchasing a house or at retirement.

(11) Insurance Services

Credit unions have a policy of insuring the savings of their members at no extra cost. Beneficiaries stand to gain up to twice the amount saved in the share deposit account and in the savings deposit account. Members' loans are also insured up to age 70. In the event of death the loan is automatically paid up or the insured portion is paid in full. The Life Saving (LS) and Loan Protection (LP) plans are important credit union products as they offer unique benefits to customers, since these products are only accessible to the savers and borrowers, thus making it difficult to be duplicated by other competitors. This product would give credit unions a slight advantage over money market funds if they are able to pay comparable rates.

What accounts for the range of products and services offered by credit unions? As noted previously, credit union activity in the OECS is influenced by developments in the regional and international credit union movements and developments in the sub-regional financial services industry. The international credit union movement offers a wide range of financial products including savings and chequeing accounts, term deposits, business and personal loans, mortgages, lines of credit, mutual funds and securities, credit cards and payment cards, and the largest ones provide access to ATMs. Through their credit unions, members can access advisory services in retirement planning, financial counselling and financial management. Developments in the regional economies have also forced credit unions in CARICOM countries to be innovative. Deregulation in Jamaica and currency depreciation in Trinidad have forced credit unions to be market-driven. Apart from the traditional retail banking products, credit unions provide Foreign Exchange Services, Blue Cross coverage, ATM services, Equity-Linked Savings Plans, Group Motor Vehicle Insurance, Travel Agency services, Small Business Training and Development, Tax Payer Assistance Services, Housing Development Services, and Discount and bargains at selected businesses.

Like other financial institutions in the United States, Canada and Australia, most credit unions in the CARICOM and the OECS markets are full-service financial institutions that offer members a wide range of savings and investment options. However, the cost of accessing the services offered by credit unions in the OECS markets has remained relatively stable, as credit unions continue to lend at below market rates. The low cost of services is influenced by the relative stability of the Eastern Caribbean dollar, the relatively low rate of inflation, low expense ratios in several of the credit unions, and the credit union's business philosophy of maximising services and not profit. In most credit unions, the interest rate on all categories of loans is charged at 1% on the monthly reducing balance. Although the practice could have serious implications for several micro credit unions, the conventional wisdom among management is that unlike the case of Jamaica, where credit unions were forced to become market-driven, there is no rationale for any significant movement in price of services.

Credit unions have been transformed from non-formal socio-economic institutions to relative modern financial institutions mobilising funds across income groups and serving as sources of funds for a wide range of productive activities. An increasing penetration rate has resulted in the broadening of the common bond[9] in several credit unions, the broadening of the clientele base of several credit unions in the urban centres. Membership increased by more than 500 per cent between 1975 and 1995, and the number of persons accessing credit union services in 1995 was more than six times that of 1975. Moreover, the area penetration rate was 24.5 per cent as at December 31, 1995, from 7.7 per cent in 1981. In Dominica, which has the highest penetration rate in the world, about 80 per cent of the population access the services offered by the 19 credit unions. The Roseau Credit union, a $100m dollar asset credit union, was the first financial institution to introduce the ATM.

In addition, a number of small and medium-sized credit unions enjoy a community-wide and island-wide field of membership, thus allowing them to mobilise savings from a wide cross section of the society. Of the 80 registered credit unions, 59 are community-based. In several cases these community-based credit unions also enjoy a monopoly in the area of retail banking, being the only banking facilities easily accessible to the rural population. For example, three

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[9]Membership in the credit union involves sharing a common bond based on association, occupation or community. A member is a client and a shareholder enjoying the privilege of being elected to the Board of Directors and the Credit Committee and Supervisory Committee, and sharing in the distribution of profits. Ever member owns at least one share in the credit union and has an equal say in its overall direction.

credit unions provide the banking services for the south-western coast of St Lucia. This also explains why a number of credit unions offer a wide range of non-financial services.

With the broadening of their clientele base and an increasing demand for services, credit unions have become more competitive in the marketplace. Because the sub-regional market is relatively small, underdeveloped and not efficiently utilised, financial institutions adopt an aggressive posture in order to maintain and increase market share.

More importantly, credit activity has been largely influenced by the easier access to credit and the significantly lower price of credit. In addition, most associated charges are absorbed by the institutions, and comparable dividends are paid when surpluses are realised. This practice, however, makes some credit unions' operation very risky, as competition and increasing demand for loans drive them to take higher risk, financing ever more speculative ventures. This has led to a large volume of unserviceable debt, and unfortunately credit unions continue to depend on their balance sheets for most of their revenue despite the fact that they cannot find loan categories where they can generate both large volumes and high spreads.

SECTION IV

CONCLUSION AND POLICY ISSUES

Notwithstanding the growth trend which has been evident in the credit union sector since the 1970's, the financial health of several credit unions remains a cause for concern. Delinquency remains high in all classes of credit unions but is particularly critical among micro credit unions. At the end of December, 1995, Forty-one (41) of the 80 credit unions recorded double digit delinquency rates.[10] The global delinquency rate was 10.8 per cent, and the volume of delinquent loans was $32.2m. The area delinquency rate for commercial banks in the same

[10] *When the ratio of delinquent loans to loans outstanding is over 10 per cent, the credit union is considered to be in "trouble", between 5-10 per cent, the credit union is said to be on the "watch list", under 5 per cent, it is said to be not overly problematic. Under 3 per cent is described as "good".*

period was 11.4 per cent, and the volume of delinquent loans stood at \$468.1m. But given the fact that the balance sheets of commercial banks are much more diversified than those of credit unions, the deterioration in asset quality may have impacted more negatively on credit unions. The liquidity ratio, as measured by the ratio of loans outstanding to total savings, was 96.4 per cent compared with 81.6 per cent for the commercial banks. The global liquidity ratio of the credit unions as at 31 December was therefore 16.4 percentage points above the recommended ratio[11].

The tight liquidity position (particularly cash liquidity) of the credit union sector also reflects a tightening of liquidity in the financial system which has plagued financial institutions since the 1970's, and which continues to restrain economic activity in all the national markets. The high delinquency rate in many of the credit unions also accounts for the crippling effects of the liquidity problem being experienced in the sector. This is impacting negatively on the earning capacity of the credit unions. Earnings, as measured by the expense ratio, have been on the decline. The expense ratio, measured by the ratio of gross expenditure to total income was 61.1 per cent. The size of the global expense ratio results mainly from the high delinquency rate in the industry, as the large volume of delinquent loans depresses the growth of interest income which constitutes the major source of revenue of credit unions. Movements in earnings in several micro and small credit unions continue to be constrained by high expense ratios.

The financial problems of several credit unions are due mainly to poor credit practices, particularly in credit unions which are heavily dependent on volunteerism. Volunteers are generally not equipped with the relevant technical expertise, particularly in credit administration, to process the loans applications, counsel borrowers, and advise on security requirements, liquidity management and disbursement of funds. The absence of training programmes for borrowers demanding business and mortgage loans contributes to the problem of loan defaulting in the sector.

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[11] *Generally, the liquidity ratio, that is, the ratio of loans outstanding to total savings (shares and deposits) should not exceed 80 per cent.*

This leads us to the issue of future viability of the credit union sector. Given the fluctuating fortunes of the economies and the technological developments taking place in the financial system, is there a future for credit unions in the OECS countries? As a mobiliser of small savings, credit unions have thrived in periods of economic difficulty. In fact, the institutions mushroomed in during the crisis in global capitalism in the 1970's.

The credit union sector in the OECS is expected to maintain its buoyancy despite the slowdown in activity in Montserrat. Strong activity in the sector has resulted from a significant growth in membership and savings, a heightened confidence among credit union members, the implementation of several initiatives to modernise the sector, and the adoption of a more market-oriented approach by management. Credit unions benefit from a strong sense of member attachment in the institution, as the patrons perceive it as a fraternity.

Moreover, developments in the credit union sector have tended to follow a cyclical pattern. Periods of expansion have been accompanied by the introduction of new products and services, and an expansion of credit. Period of contraction have been marked by a decline in savings, a contraction in credit and the adoption of more rigid loan ceilings.

SOME POLICY ISSUES

As credit unions become more involved in retail banking, regulatory agencies would need to ensure safety and soundness. Another major concern of regulatory agencies would be to ensure that the financial institutions are endowed with the human resources to meet the challenges posed by the rapid changes taking place in the credit union sector. In small systems like the OECS, major failures in one sector could threaten the stability of the entire system. The following are some suggested policy considerations:

(1) Building Strategic Alliances and forming Mergers

What are the options open to credit unions? Firstly, they could remain traditional savings and loan institutions. Secondly they could offer full-service family banking services. Thirdly, two or more credit unions offering similar services or with a similar customer base could explore the possibility of merging. The first strategy is not financially sound, given the high cost of funds. While the credit union borrows at market rate, it lends at below market rate. The interest spread between what credit unions pay on loans from commercial banks and other lending agencies and what they charge for loans reduces credit union revenue. The second option is too costly for most credit unions. They lack the necessary capital, and technology (that is, the knowledge and skills) required to offer that range of services. Moreover, in most cases the individual market is too small to make such a venture profitable.

Credit unions could gain more advantage through the third option - building alliances. Micro, small and medium credit unions would have to take advantage of synergies arising from similarities among the services they offer, and among customer bases. From both a defensive and offensive posture, there is wisdom in credit unions taking advantage of building strategic alliances and entering into mergers. Particularly for the many micro and small credit unions in the OECS, there is a case for undertaking defensive mergers to protect the asset base, to diversify from unstable forms of cash flow, to improve the quality of management, to strengthen the capital base and to improve the quantity and quality of services. The pooling of resources would also allow credit unions to take advantage of the new electronic networks which are revolutionising the way financial services are delivered. This is important as most of them are not adequately capitalised and therefore are not able to afford the large capital costs of new technologies which could eventually reduce costs.

Mergers and sharing of common services are particularly crucial for credit unions, which are heavily dependent on untrained volunteers, and whose revenue base, in most cases, is too small to allow them to attract professional staff. However, its is does not seem feasible to combine credit union resources on a national scale in the short to medium term, given the inherent weaknesses, fragmentation and competition within the sector.

Mergers could help to improve the capitalisation of weak credit unions, and allow them to take advantage of the facilities offered by the Eastern Caribbean Home Mortgage Bank. However, it is not prudent for micro and small credit unions to make long-term mortgage loans as that business involves too much risk. In any event, credit unions cannot continue to lend long and borrow short. There must be a matching of the assets and liabilities. Moreover, the application of a fixed interest rate on mortgage loans, may not allow the credit union to cover cost.

The regulatory authority would need to ensure that credit unions are adequately capitalised, and have sound credit and collection policies and competent management before they are allowed to participate in the ECHMB. This is particularly crucial as most credit unions have neither the expertise required for mortgage underwriting nor the liquidity required for mortgage lending. As we noted previously, their liquidity position demands that they maintain their assets as near to convertibility as possible.

(2) Find Area of Specialisation

Some micro and small credit unions must carve out a niche for themselves and develop expertise in that area. Inasmuch as several of these institutions have a reliable clientele among the lower and middle income strata in the marketplace, they are well placed to maintain their market share if they would take advantage of certain personal and specialised services. They could offer:

i. Small consumer loans;
ii. Education loans;
iii. Retirement Plans;
iv. Small and micro business loans;
v. Small agricultural loans and;
vi. Short-term construct loans.

There are sound institutional reasons for micro and small credit unions to offer a few products, as their introduction may require specialisation, which in the case of small institutions, may push up costs in some areas.

(3) Develop Human Capability

To survive in the competitive environment, the credit union would require an administration, and a management and staff which understand the advancements, emerging standards and practices, new techniques, new systems and new products and services in the financial services industry. Like other financial institutions, they will have to orchestrate a cultural shift which would align their organisation with their strategic thinking. Environmental auditing, risk management and cash flow analysis would have to become part of the new culture. Efforts should be directed towards helping credit unions to:

i. Focus on improving customer services and maintaining competitive advantage;

ii. Increase productivity and efficiency, and at the same time develop and maintain leaner, flexible organisational designs that minimise costs and maximise revenue;

iii. Create and market more innovative products to supply customer demands and;

TABLE 1.3
CREDIT UNION ACTIVITY BY CLASS OF CREDIT UNION 1993 – 1995
(all figures in thousands of Eastern Caribbean dollars)

	Number*	MEMBERSHIP @			SAVINGS			LOANS			ASSETS			RESERVES			INVESTMENTS		
	1995	Dec.93	Dec.95	95/93 %CHANGE	Dec.93	Dec.95	95/93 %CHANGE	Dec.93	Dec.95	95/93 %CHANGE	Dec.93	Dec.95	95/93 %CHANGE	Dec.93	Dec.95	95/93 %CHANGE	Dec.93	Dec.95	95/93 %CHANGE
MICRO	55	46,911	47,483	1.22	58,981	65,677	11.35	54,135	57,979	7.10	69,615	76,688	10.16	3,861	4,934	27.79	2,993	5,014	67.52
SMALL	12	26,288	42,246	60.70	60,670	84,398	39.11	55,741	71,249	27.82	72,741	102,676	41.15	7,262	9,915	36.53	5,360	14,054	162.20
MEDIUM	4	14,159	18,681	31.94	49,471	77,645	56.95	52,730	84,618	60.47	60,093	97,829	62.80	4,659	9,955	113.67	2,734	6,627	142.39
LARGE	1	23,508	25,082	6.70	64,267	82,618	28.55	61,813	85,157	37.77	79,565	101,326	27.35	5,228	5,698	8.99	8,566	7,488	−12.58
ECCB AREA	72	110,866	133,492	20.41	233,389	310,338	32.97	224,419	299,003	33.23	282,014	378,519	34.22	21,010	30,502	45.18	19,653	33,183	68.84

@ – Figures are actual
* – Number represents the number of credit unions by class
Source: Credit Union Quarterly Statistical reports

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APPENDIX I

Number of Financial Institutions in the OECS countries

	Number
Banking Institutions	
Commercial Banks	44
Off Shore Banks	63
Non-Banks Financial Intermediaries	
Credit Unions	80
Building Societies	4
Finance Companies	13
Insurance Companies	67
National Development Banks	6
National Development Foundations	7
Social/National Insurance Schemes	8
ECCB AREA	292

Source: Bank Supervision Department, ECCB