Can credit unions bridge the gap in lending to SMEs?

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Small firms continue to experience difficulty accessing adequate finance from formal external sources, notwithstanding many and varied institutional and policy initiatives introduced to address this seemingly perennial problem. Underpinning research indicates that information asymmetry is the principal reason for the finance gap, particularly for young firms. The aim of legislation introduced in the UK in 2012 is to utilise the credit union sector to increase the amount of new lending to SMEs. The rationale for this legislative change arises because credit unions typically operate within a defined geographic region, they can compile detailed local knowledge of small businesses and are therefore uniquely placed to minimise information asymmetries thereby reducing the funding gap for small firms. Despite this perceived advantage, credit unions have been reluctant to take advantage of this legislative and lending by credit unions to SMEs has been negligent to date. We investigate the reasons for this lack of engagement in SME lending by interviewing the chief executives of five credit unions in Scotland. Our findings reveal that the CEOs of the credit unions are reluctant to lend to SMEs at present, as they are uncomfortable with the level of risk associated with lending to a sector of which they have little experience or expertise. Furthermore, credit unions will need to offer attractive interest rates to compete with high street banks and an increasing number of microcredit providers. Policy makers need to better understand the structure and function of credit unions before assigning a greater role in SME lending. It is too early to say whether credit unions can play a significant role in SME lending, and our evidence suggests that structural issues must first be resolved before they become an established presence in the SME lending ecosystem.

Keywords: credit unions; SMEs; finance gap; information asymmetry

Introduction

The existence of a finance gap, first identified in the Macmillian Report (1931), purports that a 'gap' exists between what small and medium sized enterprises (SMEs) would like to borrow and what lenders are willing to lend at market interest rates. Perennial debates have surrounded the existence, size, the nature of the finance gap and the necessary policy measures required to alleviate its impact. At a theoretical level the explanation for this gap has centred on the issue of asymmetric information. Asymmetric information arises from the differing views of the lender and borrower regarding the nature of risk involved in advancing finance, which in turn leads to adverse selection and moral hazard (Berger and Udell 1998; Nofsinger and Wang 2011; Denis 2004). It is postulated that '…liabilities of smallness and newness…' (Jones and Jayawarna 2010, p.127) impose particularly severe restrictions in access to investment finance for firms in the SME sector. Whether government intervention in SME finance markets '…is justified or necessary, governments persist with [supply side] programmes such as the Merlin agreement in the UK (HCBIS committee, 2011), and the Small Jobs Act 2010 in the US' (Mac an Bhaird, 2013, 106).

A recent government intervention to improve access to finance for SMEs in the UK is the 2012 legislative change permitting credit unions to lend to corporations. The rationale behind this legislative change is that credit unions are seen by government as repositories of local knowledge (DWP 2011), and therefore better able to make informed lending decisions to SMEs and uniquely placed to help close the finance gap. Early indications are that this intervention is not having the desired effect, as very few additional loans have been advanced to SMEs from credit unions. We investigate potential reasons for the initial lack of success of this policy from the viewpoint of the credit union sector. We interview chief executive officers of five credit unions in

Scotland to ascertain their views on the low level of lending to SMEs, reasons for the apparent unwillingness of credit unions to embrace an expanded role, and structural changes necessary to increase the supply of credit to small firms. The primary research question addressed is 'Why have credit unions not increased their lending to SMEs as envisaged by the 2012 legislative change (LRO 2011)?".

In the following section, we contextualise our study in relation to previous research by outlining our theoretical perspective. We then describe a number of features of the credit union sector in the UK, before describing our sample institutions. We present our findings, along with a discussion of what credit union CEOs perceive as the barriers to the expansion in lending to SMEs and what can be done to facilitate it. We conclude by providing a number of suggestions for future research.

Literature Review

The most important source of external finance for small firms is bank debt (Beck, Demirguc-Kunt, Maksimovic, 2008), although small firms are frequently constrained in their access to adequate debt to resource their ventures (North, Baldock, and Ekanem 2010). This has significant adverse consequences, both for individual firms and the macroeconomy, and particularly for new firms seeking to grow (Beck and Demirguc-Kunt 2006). The principal obstacle to an efficient debt market for small firms is information asymmetry between financial instiutions and SMEs. Detailed financing information on small firms is not publicly available, and as the market for this data is limited, it is costly to obtain (Baas and Schrooten, 2006). Lack of detailed financing data on SMEs is particularly acute for micro-enterprises (Lean and Tucker 2000), which comprise 92% of small firms in the UK. Additionally, information asymmetry is

particularly acute for new ventures (Hall et al. 2000; Schmid 2001), and in enterprises where assets are knowledge based and exclusively associated with the entrepreneur (Hsu 2004).

A related concern for providers of finance to small firms is that of agency costs, which are potentially higher when information asymmetries are greater (Hand et al 1982). Debt contracts can be conceived as a principal-agent relationship (Jensen and Meckling 1976), whereby the financial institution is the principal, and the firm owner is the agent, managing the principal's capital. Because of the "…possibility that the agent will not always conduct business in a way that is consistent with the best interest of the principals…" (Jensen and Meckling, 1976: 308), this relationship can result in agency costs for financial institutions. Additionally, there is a perceived unequal payoff structure in debt contracts, whereby a financial institution receives an interest payment if an investment project succeeds, whereas it bears the total loan loss if the investment project fails. Financial institutions employ a number of techniques in order to counteract information asymmetries and insure against potential losses in the event of loan default. These lending techniques may be classified as 'soft' (relationship lending), or 'hard' (asset-based lending, financial statement lending, and small business credit scoring lending) (Baas and Schrooten 2006). The former technique becomes more widely used over time, as firms become established and develop a trading and credit history (Voordeckers and Steijvers, 2006).

The past four decades have witnessed significant structural changes in the banking sector due to bank failures and consolidation through mergers and acquisitions (Wheelock 2011). This has been accompanied by a change in the means of service provision, resulting in reduced importance in bank branches as services are increasingly offered over the internet, by telephone or ATM (Heffernan 2006). A significant

reduction in the number of branches and increased centralisation of services (Adams 2012) has resulted in a reduction in the effectiveness of relationship lending, which is more acutely experienced by micro firms. This combination of industry changes and macroeconomic effects suggests that financial deepening in support of economic growth is still something that needs to be nurtured (Gregorio and Guidotti 1995; Acemoglu and Zilibotti 1997; King and Levine 1993). A further consequence of the recent financial crisis is that lending through traditional banking channels is reduced (SAFE, 2009-2014), due in part to an increase in non-income bearing activity (Fecht, Nyborg and Rochall 2011). As banks are the primary source of external finance for SMEs, this has adverse consequences for investment by the sector.

From a supply perspective, the numbers of potential sources of funding have increased. The traditional banking format has been supplemented by the arrival of new so-called challenger banks. While still small in comparison, new banks such as Aldermore (£1.8bn SME lending) and Handelsbanken (£8.8 billion loaned to UK firms) are beginning to have an impact (Barty and Ricketts 2014; British Banking Association 2014). Other institutions that made a cross-sector journey include retailers such as Tesco and Virgin, who have recently established a banking arm to their portfolio. In addition, at the micro and social enterprise level, there are government backed organisations such as Community Development Finance Association (CDFA), whose member institutions had a loan portfolio of £76m in 2011, comprising approximately 5,600 loans (Henry and Craig 2013). However, CDFA, unlike credit unions, is not a deposit taker and thus a vital link that affects the decision making criteria for credit unions is lost. While such community lending is encouraging, it remains a very small amount compared with the overall total of £112bn loaned by banks to SMEs between Q1 2013 and Q1 2014 (British Banking Association 2014). The total level of

community-based financing available to small businesses is relatively small at around £130m (Henry and Craig 2013). Banks remain the primary source of external finance for SMEs, with the largest five banking groups holding approximately 90% of the SME banking market share (BIS 2013).

Efforts to support SME lending are found in a variety of government initiatives designed to boost lending and thereby boost economic growth. These efforts include: the Business Growth Fund, the Enterprise Finance Guarantee, the Funding for Lending Scheme and Project Merlin. Despite such interventions, market failures remain (BIS 2012)[2], particularly on the supply side where issues of asymmetry of information remain a key problem (Henry and Craig 2013). In terms of identifying and measuring the finance gap, the Breedon Report (2012, 3) predicts that by the end of 2016 '…the finance gap could be in the range of £84bn to £191bn…'. For smaller firms in particular, the estimated finance gap is between £26bn and £59bn (Breedon 2012, 16). From a community lending perspective, CDFA estimates the demand for SME lending to be around £1.3bn, including around 103,000 'potential' borrowers (Henry and Craig 2013). But the data reveal a more complex picture.

The paradox is that the amount of cash held by SMEs in current and deposit accounts has grown, even through the recent financial crisis. Cash held by SMEs grew by 9 per cent between Q1 2013 and Q1 2014 to stand at £138bn, meaning that there is a net cash surplus overall for the sector. This is partly explained by a relative lack of demand for business lending by SMEs, which has fallen for the past three years from an average of fifty-one per cent of businesses requiring credit, to thirty-three percent in 2013 (SME Finance Monitor 2013). For small non-employing businesses, the figure

[2] BIS (2012) SME Access to External Finance, BIS Economics Paper, No 16

currently stands at just twenty-six per cent (SME Finance Monitor 2013). In addition, approval rates for SME loans remains high with smaller businesses achieving successful application rates of seventy-nine per cent for loans and seventy-seven per cent for overdrafts (British Banking Association 2014). Approvals for medium sized businesses are even higher at ninety-one per cent and ninety-three per cent respectively (British Banking Association 2014). While this reflects an element of self-denial on behalf of SMEs which decline to apply due to a poor finance and/or track record, the numbers are still impressive and suggest that the finance gap, while existing, may not be as severe as heretofore suggested. Only two per cent of SMEs recorded an insufficient track record as a reason for a loan refusal and twenty per cent cited insufficient security as the reason (BIS 2012).

A role for credit unions?

While the credit union movement celebrates its fiftieth year, Birchall (2013) argues that the antecedents of credit unions (what he calls cooperative banking) has a history which can be traced back to 1798 with the establishment of a cooperative bank on the Solway Firth in the South West of Scotland. Like its forerunners each credit union operates on a mutual governance structure. Mutualism is established in individual unions by the 'member-customers' owning the union having the right to elect senior officers to ensure stewardship of the union (McKillop, Ward, and Wilson 2011). Thrift and self-help within specific communities are encouraged through what is known as 'the common bond'. The 'common bond' refers to the relationship that exists between members. Members have to live within a certain specific area or have something else in common such as an occupation or an association such as a religious grouping, the idea being that this would "…strengthen the security of the union with members connected by more than financial ties…" (Wright 2013, 5). Saving and borrowing is restricted to members,

who are prescribed by the terms of the common bond, and institutions are regulated by the Financial Services Authority.

In theory, the mutual structure and spatial aspect attached to the credit union structure would suggest that these small, locally based institutions are well placed to correct some of the market failure identified earlier by providing loans to small firms. The principal advantage small lending institutions have in providing credit to SMEs is in alleviating information asymmetries, thereby reducing the potential for moral hazard and adverse selection (Nofsinger and Wang 2011; Denis 2004). The latter is reduced through more effective use of 'soft' information, as small institutions are better suited to relationship-based lending than large institutions, whose structures require hard information to flow to a centralised decision making centre (Ely and Robinson 2009). Community based credit unions have access to local knowledge which gives them a much better understanding of the risk profile of their customers (Birchall 2013). This type of knowledge is particularly valuable when lending to small firms which are without access to collateral, including tangible assets and receivables (Canales and Nada 2012). Access to more complete information should result in reduced risk for the lending institution. Securing loan finance from a local institution based on soft information also reduces the risk for the small firm owner, as she does not have to provide personal assets as collateral. Risk is therefore ameliorated for both parties.

Additionally, firms lacking collateral are often compelled to access expensive sources of finance such as credit cards, bank overdrafts and trade credit (DeYoung, Hunter and Udell 2004). Substituting these sources with short term loans is cheaper, more sustainable and facilitates more long term planning. Moral hazard should also be reduced, as firm owners are more likely not to engage in risky behaviour to the detriment of the locally based principal and repay the loan. Furthermore, firm owners

are also less likely to endanger the survival of the community owned bank for social and community reasons (Baas and Schrooten 2006; DWP 2011). The logic of community-based lending is therefore compelling.

Structure of the credit union sector

The credit union sector in the UK is complex involving 380 unions ranging from small savings clubs to multi-million pound enterprises employing many staff (credit unions range by size of assets from £130 million to £20,000 (Bank of England, 2013). Six trade associations cover this sector and each has its own perspective. While government tends to view credit unions as homogeneous and designed to address the needs of the financially excluded, this is not the case. Many credit unions specifically avoid the financially excluded and focus on profit-making for the benefit of their members. Increased competition from new entrants to the small-loan market has led to consolidation within the sector, which has seen some credit unions cease trading and others merge as they seek the scale of operation and skill base necessary to compete in a rapidly changing environment. Table 1 shows that while the number of credit unions operating in the UK has significantly decreased over the past five years, membership has doubled indicating a demand for such services. Interestingly, profits in real terms have remained flat. Credit unions are reliant on members' funds and income derives solely from interest on loans or from deposits in the bank. No non-income activity is allowed, which is a major distinction from banks. The key metric is the loan to asset ratio which ideally should be around 80 per cent, but low demand from the retail sector means that this ratio is normally much less. Ideally corporate borrowing would enable credit unions to achieve this figure, although credit unions have not succeeded in engaging significantly with the business sector.

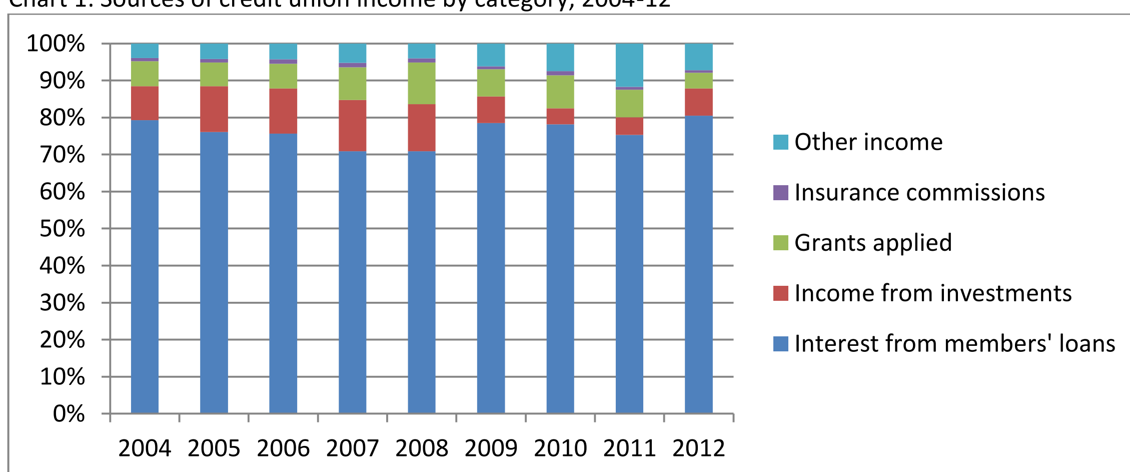
Table 1: United Kingdom credit union statistics 2004/12

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Number of credit unions	565	544	521	504	477	454	439	405	390
Total number of staff employed	473	482	561	680	776	775	925	991	1031
Total number of members	321,200	349,681	369,163	422,582	464,684	506,494	556,068	601,965	651,682
Profit (£,000) (Nominal data)	15,608	15,394	15,394	17,317	15,968	12,651	17,308	24,822	19,162
Total assets	231,993	249,468	270,506	299,543	324,543	372,969	418,191	487,747	538,930
Ave. loans as a % of total assets	75.30%	76.30%	75.20%	76.80%	77.20%	70%	69%	68%	65%

Source: Bank of England (2013).

Chart 1 indicates the reliance of credit unions on income from loans to members. Income from investments has fallen significantly, an unintended consequence of the recent monetary policy of quantitative easing which resulted in a reduction on the yield on government bonds. A declining loan to asset ratio means less income from a smaller loan book. Allied to reduced investment income, the credit union sector is facing serious issues surrounding income generation, which may result in many closures and some mergers (McKillop, Ward, and Wilson 2011). Therefore, within the overall sector some credit unions will thrive while others gradually fade away.

Chart 1: Sources of credit union income by category, 2004-12



Source: Bank of England (2013).

The UK government's recent call for evidence[3] into the future of credit unions is a recognition that they have reached a cross roads in terms of their current business model and that some radical thinking may be required if they are to survive another fifty years in their current form. However, changing the nature of credit unions and encouraging them to embrace opportunities emerging in the financial sector may prove to be challenging because of structural issues.

Credit unions are an important feature of the financial landscape playing a key role at the micro level in pooling small amounts of savings. A deep financial system improves efficiency in the allocation of saving resources by directing these to suitable individual entrepreneurs. Diamond (2007) emphasises the role banks, and by extension credit unions, have in creating liquidity by transforming illiquid claims (bank assets) into liquid claims (demand deposits). However, in the UK credit unions appear not to play a full part in the financial system in that while they are proficient at the former (they are cash rich), they are not involved in the latter. Credit unions have the opportunity now to play a fuller part in the financial system and to support local economic growth.

The largest credit union in the UK, Glasgow Credit Union with assets around £130m, is insignificant when compared with traditional lenders but is a significant institution in the community financial development sector. The rationale for large banks is normally explained by the capture of economies of scale in areas of production, marketing, securitization and servicing of consumer loans. However, due to competition they tend to earn a low interest margin when bank products become financial

[3] https://www.gov.uk/government/consultations/british-credit-unions-at-50-call-for-evidence/call-for-evidence-british-credit-unions-at-50

commodities (relying on non-interest income for much of their profit). De Young, Hunter and Udell (2004) describe the benefit to small banks from operating in local markets and adding value by building relationships and lending to small idiosyncratic borrowers normally excluded from financial markets. However, changes within the credit union sector may put this 'local touch' under threat if they are coerced into lending beyond their traditional client base. Consolidation in the credit union sector in the UK appears to have followed a similar trend to that affecting US community banks, but for a different reason. Critchfield et al. (2004) found that the number of US community banks declined by almost fifty percent between 1985 and 2003, but those that remained were larger and more able to thrive. As table 1(above) shows, a similar picture emerges in the UK where the number of credit unions fell from 565 in 2004 to 390 in 2012 as many merged while others closed and total assets increased from £432m to £957m (Bank of England, 2013). The process of consolidation continues and raises fresh challenges to credit unions that remain: how can they fulfil the role that government expects from them under the recent change to their regulatory framework? Below we answer that question as we present evidence from five credit unions with respect to how recent legislation has impacted on them and their business model.

The rationale behind recent changes in the credit union regulatory framework is that they are now able to help close the financial gap through exploiting their local knowledge to reduce information asymmetries. The regulatory changes are a supply-side response to the finance gap and join other initiatives over the years. Past initiatives include the Bankers Industrial Development Company in the 1930s, ICFC in the 1960s, 3i in the 1990s and find their modern form in the new British Business Bank (2014) which includes all government support for small business under one agency. While the recently launched British Business Bank already lends to small businesses (e.g. loans of

£5k plus) credit unions in the two years since the regulatory changes have yet to engage in any significant corporate lending.

Methodology

Our approach involved identifying and interviewing five credit unions across the credit union spectrum: two of Britain's largest, two small members of the Association of British Credit Unions Limited (ABCUL), and one non-ABCUL member engaged in innovative financial activity. These credit unions were selected after discussion with ABCUL to reflect the diversity of credit unions (all are located in Scotland). One, an occupational credit union with 10,500 members conducts business throughout Scotland and the North of England; another has around 35,500 members but is geographically based; another has 3,500 members and is not seeking to embrace change; another one of around 7,000 members which is 'fearful of the changes' taking hold in the market; while the last credit union (5,000 members) takes a permissive approach to lending, designing innovative products to serve the financially excluded and compete against payday lenders. Three credit unions have version 1 status, and the remainder version 2. The primary difference is that version 2 credit unions can offer larger loans for longer periods, but have to maintain a capital assets ratio of 8% or greater. Whilst version 1 status prescribes minimum member and asset size requirements, version 2 has no such requirements and can offer variable dividends on different term savings accounts (ABCUL, 2002).

We adopt a qualitative methodology to investigate approaches to lending and to access the narrative of local stories. All interviews took place on credit union premises and were recorded and transcribed. The interviews included a mix of closed and semi-structured questions, and lasted from a minimum of one hour and a maximum two

hours. Table 2 summarises the key features of the credit unions interviewed.

Table 2: Summary of key features of credit unions interviewed

Credit union	Number of members	Assets (£m)	Staff	Loan ratio (%)	% of members borrowing	Status
CU 1	3,700	6	6	60	46	Version 1
CU 2	7,000	9.5	10	65	45	Version 1
CU 3	5,000	10	9	65	66	Version 1
CU 4	10,500	12	10	70	50	Version 2
CU 5	35,500	130	15	78	n/a	Version 2

In each case we interviewed the chief executive and focused on the impact of the 2012 legislation on their current business lending strategy.

Since 2012 credit unions can seek approval from the regulator to engage in business lending and lending to housing associations. However, the conditions attached to such corporate members are heavily restrictive. In general, corporate members can only make up a maximum of ten per cent of a credit union's total membership and are restricted to a maximum of twenty-five per cent of the shares in the credit union and be limited to a maximum of ten per cent of the loan book. To date there has been reluctance on the part of credit unions to take up this opportunity, and there is only one example (Bristol) where a small amount of such lending has taken place. Credit unions currently appear reluctant to engage with the business sector, and therefore are not conduits to stimulate the local economy through increased credit provision to the small firm sector.

Findings

Two common features are apparent in all five organisations: firstly, a very conservative approach to corporate governance, and secondly, the nature of their business model. All

interviewees were acutely aware of their responsibility to local members. Unlike banks, credit unions rely solely on members for funds and also for their revenue stream (interest-income). Regulation restricts them developing non-interest income streams such as those carried out by banks, making them highly dependent on their retail product portfolio. As interviewee 5 stated: "…where we place deposits is extremely restricted…" Banks are currently being curtailed in their non-income activities and this will impact on their growth prospects. However, they will still have greater freedom for manoeuvre than credit unions.

Each credit union has adopted a different strategy to deal with the various pressures facing the industry. Two of those interviewed are Version 2-type credit unions (two of only twelve in the UK) and achieving this status is viewed as a means by which the credit union could become more competitive on the high street and develop other income-bearing streams (e.g. engage in mortgage lending). Acquiring Version 2 status involves a major commitment on behalf of credit union management and may be viewed by some as a move away from the original ethos as seen by an expanded business model and the need to acquire further skills. Interviewee 2 noted that "…it was quite a struggle to convince the board…". Version 2 status requires a significantly higher capital-asset ratio, reflecting the higher risks entailed in such a change. It also involves a significant increase in costs through having a large amount of capital earning almost zero interest in a bank account. Interviewee 4 noted the pressure to effectively manage the credit unions surplus funds and having to monitor various market rates. Memories of failed Bank of Credit and Commerce International in 1991 and the recent Iceland crash are still fresh. Interviewee 5 noted how fortunate they were in "…having a very highly trained staff…", many of whom have backgrounds in the financial industry.

The remaining interviewees occupy a different landscape in many ways and

remain Version 1 credit unions, but facing similar pressures on their business model. Their room for manoeuvre is further restricted due to a series of legacy issues and resource constraints. Interviewee 1 noted "…having to let go three members of staff and place the remaining six on a four-day week…". This was directly a result of macroeconomic policies of interest rates which resulted "…in a drop of income of £68k…" from cash held in banks. This macroeconomic effect was noted by all interviewees and was used by Interviewee 5 to support the view that "government does not understand credit unions or their role". The same interviewee went on to say of government: "they are trying to fit credit unions into the answer to everything; and we are not. Business finance is very high risk". Here is the crux: credit unions are not homogeneous. Most have a legacy of community engagement and organic local growth.

Interviewee 2 noted the community development of the credit union and "when I first came it was run by volunteers". However, Interviewee 1 noted a decline in community feeling: "…very few of our members are here because of the commitment to the credit union i.e. the sharing of wealth. They're here to see what they can get for themselves these days. There has been a change. Part of it is the community". There is a rich pattern of diversity of environment and local experience, especially among the smaller credit unions. As Interviewee 5 noted, many of the community-based credit unions provide a valuable service to the community and are "excellent at what they do...and there is a need for them". Interviewee 3, while a Version 1 credit union, took a more economic-development view of the role of a credit union. "I think name in itself 'credit' doesn't properly describe what it is you do. Places in the UK have had growth but it's been different in different places like Glasgow. I wasn't really sure what a credit union was but through visits to other credit unions since 1991 you develop. We bought the place across the road [dis-used bank]. We probably loaned out about 35 – 40

million in the time we've been here, at least half of that if not more in your own local economy. The saving in a loan from a credit union instead of these finance companies is quite incredible. For us the next stage is [to address] pay day loans."

Interestingly, only Interviewee 3 would be prepared to lend to a new business "If there was a new start up and they were small and they can't get access we would try and help them". However, none of the other interviewees expressed an interest in SME lending. Interestingly, neither of the two largest (both Version 2 credit unions and with the funds to lend) saw SME lending as an avenue in the near future. Interviewee 4 noted that the subject "has not been on the radar" even though examples of public bodies such as councils being involved in such lending (Glasgow Council's lending to Tokyo's underground was seen as remarkable given the local need for such investment). However, the business case against SME lending was astutely put by Interviewee 5, "There is so much competition for business funding and so many different avenues that small businesses can go down; and the rates that we would have to charge for the risk element bearing in mind that credit unions money is the members money". Corporate governance concerns are the main impediment to credit unions' desire to engage in SME lending. As Interviewee 5 states: "…For the businesses that have strong business plans and backing then banks will step in there. We cannot compete on the rates that we would need to ensure a return for our members' dividend. It is very much a case that we have been granted the opportunity but tight parameters. We already fund sole traders and partnerships. But it is personal finance. It is not business finance but it is the individual's affordability around it. Business lend is a very different lend and I don't believe that the credit union world is ready for that. Why shift away from a model that we understand and are very good at delivering".

Discussion

It became clear during our discussions with chief executives of credit unions that, beyond the industry, there is some confusion as to the purpose and role of credit unions. Government appears to want credit unions to play a major role in helping the financially disadvantaged (ABCUL 2011) and perceives the £38m Credit Union Expansion Project (CUEP) as a means for removing structural inefficiencies (e.g. reduce costs by sharing common platforms such as back office banking, human resources and marketing), while ignoring that many credit unions are not targeting the financially excluded. Instead, credit unions are run as profit making enterprises for the sole benefit of their members. For example, some credit unions require members to have a current account and thereby target those already financially active. These credit unions are in direct competition with banks and other financial service providers designing innovative and competitive products (e.g. accounts with draw-down facilities to compete with payday lenders). Other credit unions are successful savings clubs and provide valuable services to those currently financially excluded. These will be smaller, have fewer staff, relying on local knowledge for credit assessment, displaying limited financial skills at senior level and with no desire to expand beyond the current set up. Thus, the credit union market structure is more complex and subtle than the current stratification model suggests (i.e. the distinction between Version 1 and Version 2). This is reflected in the relatively large number of trade associations together with many who remain unaffiliated. A concern raised during interviews is that government does not fully appreciate the complexity and diversity of the credit union sector, perceiving credit unions as essentially a homogenous group with similar aims and objectives. One interviewee noted that the government "sees credit unions as the answer to everything, but they are not". The only common thread is their status as financial mutuals. It is for this reason that interviewees

expressed concern that CUEP need to explain is addressing issues that do not affect most credit unions and will have limited impact.

Of greater concern and of immediate impact is government's apparent lack of awareness of the credit union business model. While exhorting credit unions to do more, government action elsewhere has had an unintended but debilitating effect. Funding for lending has allowed banks to stabilise their balance sheets enabling them to remain competitive in markets, thereby displacing credit union activity in some retail markets. However, the impact of quantitative easing has devastated the balance sheets of many credit unions. Restricting investment of surplus funds to cash or government bonds has severely cut the income of all credit unions. For those with a limited loans portfolio the effect has been for cash to accumulate while employee numbers fall. Many credit unions have become cash rich but income poor. Some interviewees have seen their loan to asset ratio fall to around sixty per cent as the business slowly shrinks thereby encouraging thoughts of merger. The larger credit unions appear more able to innovate their way out of this trap, moving into areas directly competing with banks and building societies and achieving a ratio of around eighty per cent. The ideal ratio for a successful credit union business model which balances lending risk with attractive loan rates is around eighty-five per cent. To support this model one interviewee restricts large lump sum deposits to discourage opportunistic behaviour by those seeking to capitalise on the wider membership through benefit from higher deposit rates.

For a credit union to consider moving into the corporate lending market involves a serious realignment of the current business model and the trade-off between risk and reward. It is primarily a corporate governance issue; senior managers have to decide if they have the skills to manage the additional risk in a market that is currently served by a wide variety of sources and where loan rates are competitive. One interviewee noted

that their current business model had a loan default rate of one point five per cent. Radically altering such a successful business model to include corporate loans is viewed as very high risk and placing their members' funds in jeopardy. This is perhaps the emotional distinction between credit unions and banks; in all cases interviewees were acutely aware that they are custodians of their members' money. Credit unions are not allowed to borrow and therefore work within much narrower confines (proprietary trading by banks illustrates what may happen if the link between members and deposits is broken). Lending to sole traders and partnerships is undertaken but this is based on personal risk, rather than corporate risk.

One interviewee's credit union engaged in mortgage lending (one of only four that do so in the UK). Interestingly, here is where the credit union accepting more risk than banks and building societies by providing mortgages at ninety per cent loan to value. These products are targeted at the lower end of the housing market (£80,000) to assist those who would not normally have such access. This is an example of credit unions competing in a new market, knowing their client base and being successful. In essence, being close to their client base and dealing with issues such as moral hazard and asymmetry of information. However, while in theory the credit union could put such knowledge and expertise to use in the corporate market, there is no desire to do so. It is seen as moving too far from the current skills base.

It is unlikely that credit unions in the UK will soon be acting like their US and Canadian counterparts in terms of business lending and impact on the local economy. While the regulatory framework is in place to enable this to happen, and is being further supported by CUEP, the main constraint is the nature of the credit union business model. Within the current confines of a prohibition on borrowing, capped interest rates, and mutual status, the imperatives of corporate governance ensure that credit unions

will not, in the foreseeable future, embrace corporate lending.

Challenges in expanding credit provision to SMEs by credit unions

There are a number of additional considerations when considering the potential of credit unions in the UK to expand lending to the small firm sector. With just 4% market penetration (compared with 44% in USA, 47% in Canada and 75% in Ireland), the majority (75%) of credit unions in the UK are small (with assets of less than £0.5 million) (Henry and Craig 2013). The low asset base may be particularly problematic in this regard (for example, in the US credit unions with over $500m in assets issued almost 64% of credit union loans; those with less than $10m in assets issued 1% of business loans (Ely and Robinson 2009). Although inadequate at present, a member-contributed deposit base is the most appropriate for a sustainable small business lending 'book'. A related issue is that there may be capital adequacy concerns, as the capital base of credit unions is restricted to the deposits of members (although credit unions are not subject to Basel III capital adequacy requirements, recent experience indicates the deleterious effects of inadequate capital reserves, as five credit unions were liquidated in 2013, including South Warwickshire and Cornish Community Banking (Wright 2013). Credit unions may also lack the expertise and personnel with appropriate skills to develop and administer a business loan book. Additionally, credit unions do not have the IT systems required (OFT). There is also the perception that credit unions are the poor person's bank (McKillop, Ward, and Wilson 2011), and that credit unions are lenders of last resort and hence more risky businesses may end up attempting to secure funding from credit unions (Beck et al. 2011). Without the necessary expertise to access risk credit unions could end up with a high proportion of bad debt. However, more

active lending by credit unions to the small firm sector would result in reduced volatility in credit provision and a degree of credit smoothing, as small locally based lending institutions are generally not susceptible to extremes in access to finance to the extent of large banks, relying on local small savers rather than accessing wholesale money markets. Additionally, a system of small community based initiatives is a more sustainable financial system than one relying on ‘too big to fail’ banks (Henry and Craig 2013).

Conclusion

Recent legislative change in the UK provides credit unions with the opportunity to lend to the SME sector, increasing the financing options for small firms unable to access external finance. It is hoped that this initiative will result in financial deepening, and help alleviate the worst effects of the post financial crisis credit crunch. Through interviews with the CEOs of five credit unions, we investigated the potential of this expansion in microcredit. We have a number of interesting findings, which suggest that further modifications and structural reform are necessary before credit unions are in a position to lend to the small firm sector. Firstly, there is a major corporate governance issue with CEOs of credit unions being uncomfortable with the type and level of risk associated with expanding lending to a sector with which they have limited experience. They are therefore unwilling to countenance wide scale lending to SMEs, as they feel that as organisations they do not have the requisite skills to assess business-loan applications the risk attached to which may endanger the viability of the credit union.

Secondly, credit unions have seen their loan-to- deposit ratio decline over the last few years, falling below the necessary eighty per cent level which sustains the credit

union business model. Compounding this problem is over-reliance on interest income due to the negative impact of macroeconomic policies on investment income streams. Credit unions are in the unusual position of being cash rich but income poor; they have the cash to lend to small businesses but are constrained in lending by their corporate governance concerns. When compared with other countries in which credit unions form a significant part of SME lending, UK credit unions are reluctant to move forward in this area.

Thirdly, credit union CEOs are frustrated that policy makers do not understand their business model and how they are capitalised. This miscomprehension has led to unrealistic demands from government, along with a growing expectation that credit unions are the panacea to the provision of microcredit in the economy. Demands from policy makers that credit unions provide increased credit to the financially excluded have led to initiatives such as the CUEP, and there is a risk of 'mission overload'. Fourthly, there is an increase in the sources and amounts of microcredit available to small firms, particularly from the co-called community lenders. Credit unions seeking to expand lending in this crowded market will need to offer SMEs an incentive, as their loans typically carry a higher premium than traditional high street and community lenders. A related issue is that credit unions should not become perceived as a 'lender of last resort', accessed when all other funding options are exhausted. The negative effects of a higher loan failure rate associated with SME lending will only heighten the aforementioned fears of CEOs, compounding a reluctance to lend to small firms.

Finally, policy makers should be aware that whilst credit unions have the potential to extend financial deepening and help boost local economic growth, their impact will necessarily be minimal unless the higher associated risk attached to SME lending is mitigated. Credit union lending is concentrated in microfinance, and is

suitable for small loans to micro firms with a partnership/ sole trader business structure. They can address market deficiencies at this level, but are unlikely to alleviate credit access difficulties at the level of the SME.

Our results suggest that it is unlikely that the legislative change as presently constituted will make a significant difference to the amount of loans advanced by credit unions to the small firm sector in the UK. Future studies should examine the experience of SME lending by credit unions in other countries, particularly those in which it is extensive, such as the US. Of particular interest would be the nature of the corporate governance arrangements his would greatly assist policy makers in quantifying the viable level of lending, along with providing a greater understanding of the role of credit unions in the UK economy. Future studies should provide a detailed examination of the general profile of potential SME customers, as information pertaining to collateralise-able assets, accounts receivable, and so forth are key variables in assessing the riskiness of a small firm loan book. Finally, consideration should be given to the infrastructure of credit unions, particularly in closing skills and expertise gaps, as these may determine credit union effectiveness in closing the finance gap.

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