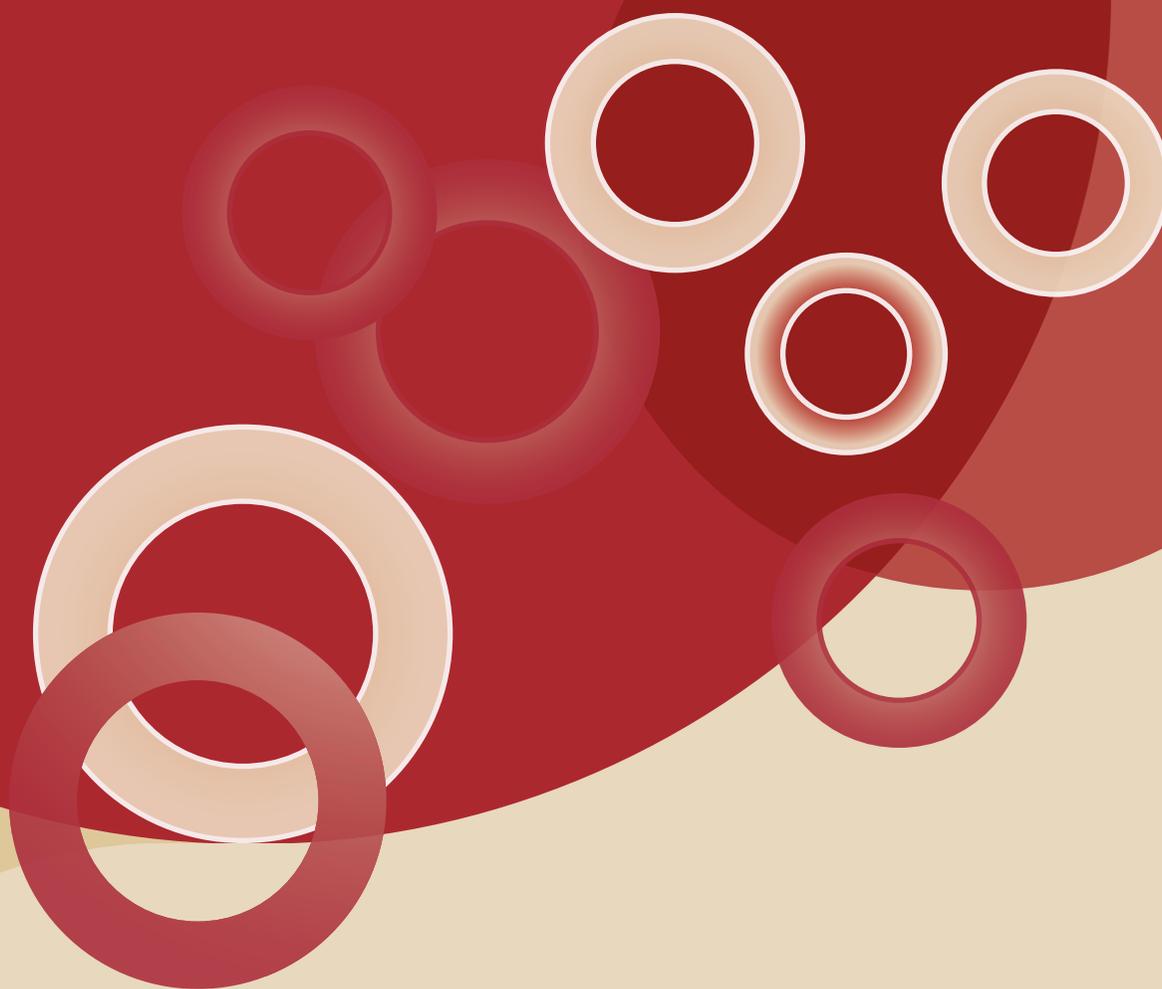
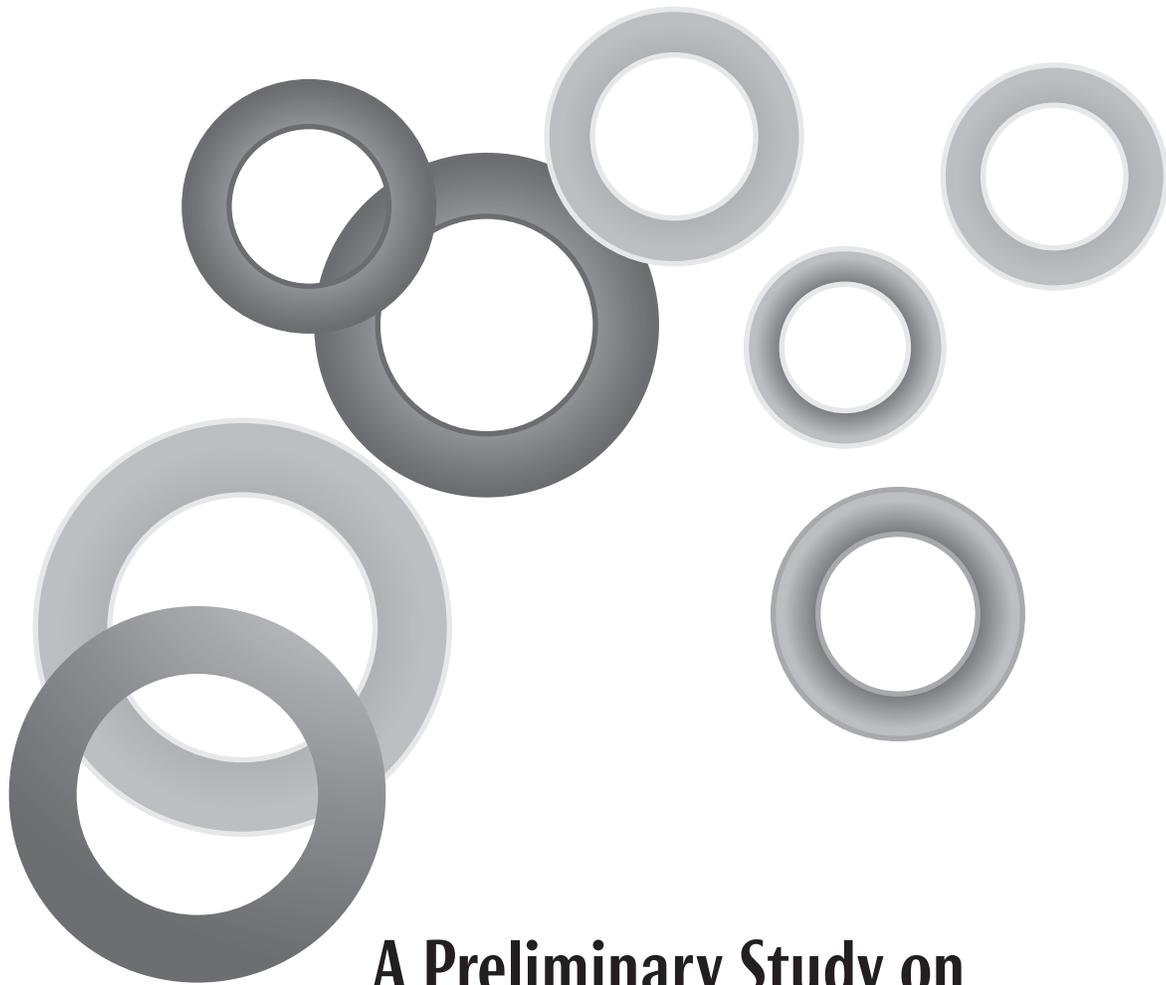


A Preliminary Study on Credit Union Franchising

STEVEN C. MICHAEL
ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION,
UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN



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RESEARCH INSTITUTE



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Filene Research Institute

The **Filene Research Institute** is a 501(c)(3), nonprofit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. We support research efforts that will ultimately enhance the well-being of consumers and assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to communicate their findings and recommendations.

The Filene Research Institute is governed by an administrative board made up of the credit union industry's top leaders. Research topics and priorities are set by a select group of credit union CEOs called the Research Council. Additional research input is furnished by the Filene Research Fellows, a blue ribbon panel of academic and industry experts.

The name of the institute honors Edward A. Filene, the “father of the U.S. credit union movement.” Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Filene Research Institute has worked with over one hundred academic institutions and published over 150 research studies.

Please visit our Web site at www.filene.org to peruse our research library and learn more about the Filene Research Institute's past, present, and future.



Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene

Acknowledgments

Many thanks to Bob Hoel, George Hofheimer, and Vicki Joyal for educating me about credit unions, and helping throughout the project. We would like to thank the credit unions who participated and made this study possible. Remaining errors are my own.

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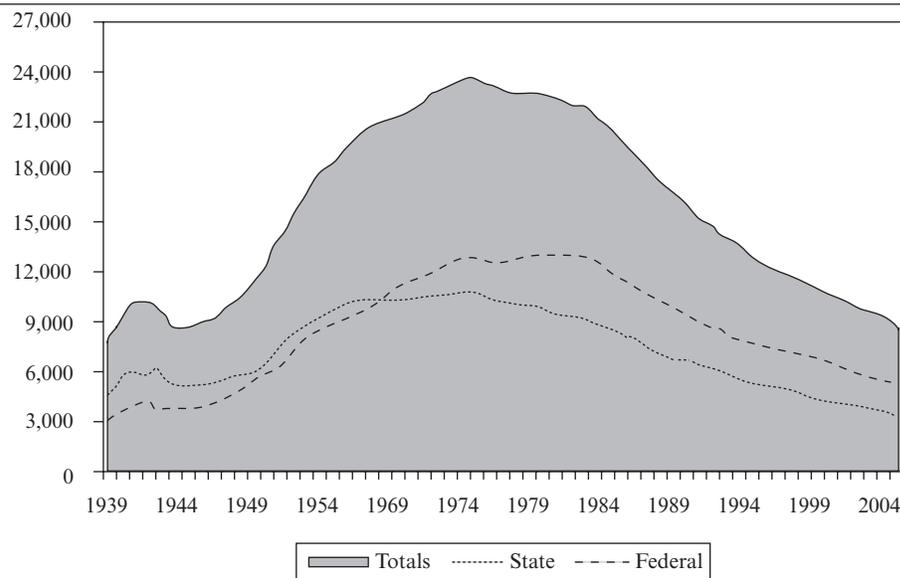
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Executive Summary and Commentary

By George A. Hofheimer, Chief Research Officer

U.S. credit unions have been consolidating at a steady pace since the mid-1970s. Recently, this pace of consolidation has become more pronounced, with an average of about 300 credit union mergers taking place per year—about one a day.

Figure 1: Number of U.S. Credit Unions, 1939–2004



What is driving this trend? The major issue seems to be the need for economies of scale. Consumers and regulators demand more from financial institutions, and it is difficult for smaller credit unions to offer the same level of service as larger institutions. Overwhelmingly, smaller credit unions are the victims of consolidation. Through the first nine months of 2006, the average merged credit union’s asset size was \$22 million, while the average asset size of surviving credit unions was \$81 million.¹

For many small credit unions, providing continued service to their membership in today’s business environment means finding a friendly merger partner. Mergers are not an altogether awful option for credit unions; as past Filene Research Institute studies have illustrated, credit union mergers are typically beneficial to consumers from a pricing and service perspective.²

¹ National Credit Union Administration (NCUA).

² Fried, Harold O., C. A. Knox Lovell, and Suthathip Yaisawarng. 1999. “How Credit Union Mergers Affect Service to Members.” Madison, WI: Filene Research Institute.

This research study, however, aims to provide a strategic option for small credit unions other than mergers: *franchising*. The idea germinated in the late 1990s when Filene researchers Bob Hoel and Bill Kelley examined the characteristics of thriving small credit unions.³ In the report Hoel and Kelley proposed a number of strategic recommendations for small credit unions to thrive in the future. One recommendation involved entering into a franchising system, whereby certain operations could be standardized for a large group of small credit unions. The concept invoked a vision of thousands of small credit unions collaborating on routine, back-office activities in order to gain economies of scale, concomitant with a renewed focus on high-gain activities involving impactful member contact.

Not many people took this strategic recommendation to heart. Credit unions *do* conduct a variety of collaborative activities across the country, including shared branching, data processing service bureaus, ATM networks, and debit card systems. But the industry still lacks a cohesive system that would allow for the large scale possible in a traditional franchise model.

To kick-start the industry's thinking about this concept, Filene Research Institute contacted a leading academic expert in franchising, Professor Steven Michael from the University of Illinois at Urbana-Champaign. Specifically, we were curious to know if a franchise model could be used to alleviate staff resources expended on routine, time-consuming functions performed by smaller credit unions. The following report is a summary of our preliminary research and Professor Michael's thoughts on the viability of a credit union franchising model. We intend to follow up this report with further discussions on the future development of credit union franchising models and the larger question of how credit unions can strategically respond to industry consolidation.

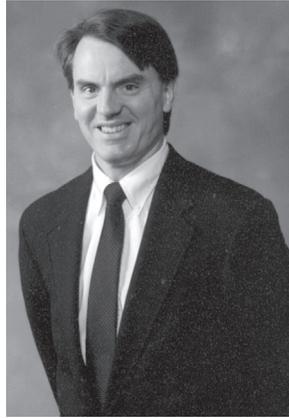
Briefly, our research team spoke to a handful of CEOs at smaller credit unions and did a time-utilization study to identify activities that might be candidates for a back-office franchising system. The activities identified as having the most potential were:

- Compliance and internal audit.
- Consumer lending/Marketing.
- Human resources.
- Accounting/Information technology (IT)/Security.
- Facilities management and planning.

³ Hoel, Robert F., and William A. Kelly, Jr. 1999. "Why Many Small Credit Unions Are Thriving." Madison, WI: Filene Research Institute.

Despite the identification of these activities, the viability of a credit union franchising system seems to be premature because of a lack of a unified credit union IT system. In other words, in order for a franchising system to work, credit unions would first need to consolidate the basic IT systems in play. Keep these considerations in mind as you read through this preliminary research project.

About the Author



Steven C. Michael, Ph.D., is currently the Schoen Faculty Fellow of Entrepreneurship and an Associate Professor in the College of Business at the University of Illinois at Urbana-Champaign. He received a Doctor of Philosophy degree in Business Economics from Harvard University in 1993, through a joint program between the Department of Economics at Harvard University and the Harvard Business School.

Dr. Michael is the author of over two dozen published research studies, and his work has appeared in the *Strategic Management Journal*, *Journal of Business Venturing*, *Journal of Management Studies*, *Journal of Economic Behavior and Organization*, *Journal of Management*, *Information Systems Research*, *Journal of Retailing*, and *Management International Review*, among other journals. His research has focused primarily on franchising, a strategic choice of organizational form for service entrepreneurs. He has also published in information systems strategy as well as entrepreneurial management. He serves on the editorial boards of the *Journal of Business Venturing* and the *Journal of Management*. In the classroom, Dr. Michael teaches courses in Entrepreneurship, Technology Management, and Business Strategy to undergraduates, graduates, and executives. He has won several teaching awards.

Prior to entering Harvard, Dr. Michael took a Master of Management with distinction in 1987 from the Kellogg School, Northwestern University, where he studied management policy and marketing. Before Kellogg, he worked as a development engineer with Bell Laboratories. He holds one United States patent for developing a method and equipment to price telephone calls. His bachelor's degree was earned at Rice University in Mathematical Sciences; in addition, he earned a Master's in Systems Engineering from the University of Virginia.

Chapter 1: Introduction

BACKGROUND ON FRANCHISING

Franchising can be summarized as a contractual arrangement where one party, the franchisor, owns a trademark and a production technology and licenses those two to a second party, the franchisee. The franchisee then combines local knowledge, effort, and financial capital with the trademark and the production technology to develop a business. For our purposes, technology here does not mean science-based knowledge, but simply “how we do what we do.” McDonald’s is the prototypical example of a franchise chain; their trademark is valued by consumers, and their production techniques (making hamburgers and complements in a small space) make them more productive in sales volume than most other restaurants.

A franchise chain partitions functions into two broad sets divided between franchisee and franchisor. Partitioning functions, some to a local level and some to a national level, yields efficiencies. One valuable function of the franchisor might be centralizing brand-building efforts at a national or international level, allowing for economies of scale in advertising, for example. A second valuable function might be developing training or operational routines—how to service a muffler, for example. By centralizing this process, continuous improvement becomes possible, as the franchisor consolidates the experience of many franchisees.

Although generalization is difficult, the typical franchising model uses the franchisor for marketing functions, especially brand-building at the national level, as well as quality control. The franchisee provides local effort and operational supervision.

Of course, centralization comes at a cost: the loss of local service and local perception, the inability to customize a service, and the risk of loss of proprietary or strategic data.

ABOUT THE STUDY

The purpose of this preliminary study was to identify tasks performed at credit unions that would be candidates for franchising—specifically, tasks that would benefit from economies of scale and centralization.

During the spring and summer of 2006, a total of five in-depth interviews were conducted with CEOs of smaller credit unions. Four interviews were conducted over the telephone and one was conducted on-site. The term used in our interviews was *outsourcing*; the concept of franchising was not introduced during any part of the interview process.

The participating credit unions possessed the following characteristics:

- All were full-service financial institutions with multiple delivery channels, including online banking.
- A range of asset sizes was represented:
 - \$40M to \$60M 2
 - \$100M to \$150M 2
 - \$150M to \$200M 1
- All had multiple branches, ranging from a low of three to a high of eight, plus shared branches.
- The number of employees per million in assets ranged from a high of .60 to a low of .27. Four of the five credit unions had employee/assets ratios that were well above the norm for credit unions in their asset size category.
- All were “well capitalized” according to NCUA’s net worth classification system.

Chapter 2: Findings

CRITICAL PROJECTS AND STRATEGIC INITIATIVES

The first section of the interview focused on identifying the critical projects and types of strategic initiatives that smaller credit unions were undertaking. The interviewer assumed that if CEOs (and their direct reports) could spend less time on repetitive and routine tasks and functions, then staff resources would be redirected toward these critical projects and strategic initiatives.

Growth, and related objectives, surfaced as a critical strategic initiative during each of the five interviews. Whether it be attracting new members, building new facilities or opening shared service centers, increasing service penetration levels, or increasing deposits (and then loans), these smaller credit unions are struggling to grow. In addition to growth, smaller credit unions are undertaking core data processing system conversions, instilling sales and service cultures, searching for the optimal asset–liability management (ALM) mix and pricing, developing new loan and deposit products, and working to become more proactive with their planning. Critical projects and strategic initiatives tend to be led by CEOs and/or members of their executive management team.

WE'VE BEEN TALKING ABOUT THIS FOR YEARS⁴

Until now virtually all measures of success and planning have been for the individual credit union. Each CEO and board sees his or her organization as a ship on a financial services sea. Now the metaphor must shift—it is the flotilla in which the ship is participating that makes the individual ship powerful, and not vice versa.

Over time credit unions have had some success at cooperative, networked efforts. These activities have included credit card programs, various shared branching efforts, ATM cooperatives, and co-owned data processing efforts. In a number of situations today, credit unions would be unable to compete without these joint ventures. These situations are indeed helpful enough to provide a glimpse of what might be should the network become the business.

But these examples tend to be limited, not guiding strategy. Many credit unions have chosen not to participate in shared branching, first waiting to see if it will succeed. Few see the future of their credit union interlinked with other credit unions. Occasionally a threat, such as federal credit union charters faced with elimination of field of membership options, results in a collective effort. But once resolved, the combined campaign model is dissolved.

⁴ Originally published in May 2001 by Chip Filson, President, Callahan & Associates, Inc. Reprinted with permission.

As a result credit unions in most instances are being positioned, not doing the positioning, when it comes to defining the future of financial services. Credit unions are playing “catch-up” in diversifying to broader service models, deploying the power of the Internet and gaining more of our members’ financial activities.

If credit unions truly intend to compete with, not just imitate, the models of their competition, then some method must be found to realize the potential value of a linked credit union system. The reason is that the majority of financial services are likely to be provided by large national firms with wide ranging product and distribution options. No credit union will be “large” when viewed against the major players in this market.

(See Appendix 1 for full article.)

ONGOING, TIME-CONSUMING TASKS AND FUNCTIONS

The interview then moved away from exciting, high-energy projects to mundane tasks and functions. In preparation for this section of the interview, CEOs were asked ahead of time to prepare a list of the most time-consuming tasks or functions performed on an ongoing basis at their credit union, in descending order by total staff time spent. They were asked to exclude the front-line teller function from their lists.

During the interview, CEOs were asked to provide and comment on the list they had created (the unaided list), after which the interviewer probed on seven tasks and functions (the aided list) if they had not already been discussed. A complete list of the tasks and functions discussed during the exploratory interviews can be found in Appendix 2.

As with the critical projects and strategic initiatives, there was a substantial amount of overlap among CEOs’ unaided lists of routine tasks and functions. The two most frequently mentioned time-consuming tasks and functions (identified by four interviewees each) were (1) compliance testing and internal audit, and (2) various aspects of consumer lending. Ultimately, testing for compliance seems to be the most time-consuming compliance/internal audit task and therefore is most conducive to outsourcing, assuming a reasonable cost and security assurances. As for consumer lending, everything—from receiving applications to underwriting, loan documentation, and dispersal—appears to be a possible candidate for outsourcing. Potential barriers to overcome include affordability, consistency in applying underwriting criteria, ensuring the provision of high-quality member service, and loss of control over the process.

Aspects of human resources and accounting, each identified by three interviewees, comprise the second tier of most time-consuming tasks/functions. Human resource administration—including applicant screening, interviewing, background checks, compliance, and job description development—appears to be a potential candidate for outsourcing. Hiring and firing decisions, along with coaching and problem resolution, should remain in-house, but CEOs of smaller credit unions are willing to consider outsourcing the remaining human resources

functions if they haven't done so already. Some of the time-consuming tasks/functions related to accounting include bill payment, tracking, cataloging, and reconciliation; and seeking and securing approvals. Potential drawbacks of outsourcing this process include the fact that approvals would still need to be secured and errors might be more likely to occur.

There seem to be two distinct responsibilities within facilities management and planning, identified as a time-consuming, ongoing task/function by two interviewees. The first is negotiating and managing building maintenance contracts for services such as cleaning and snow removal. The second is a space management function, involving such responsibilities as overseeing building contracts and relocating staff while office upgrades are in progress. Potential drawbacks of outsourcing include cost and availability for this ongoing yet part-time function, as well as the need for confidentiality agreements with suppliers that work with competitors. Finally, problems could arise if a supplier did not fully understand the credit union's culture.

Time-consuming tasks/functions that were brought up unaided by two interviewees include:

- Marketing/Advertising, including creative design, writing, production and mailing assembly, and public relations.
- IT/Security, including data processing and security of hardware and software.
- Collections, including making calls, resolving problems, repossessions, and recommending charge-offs.
- Managing inventory of office supplies and forms, including submitting orders for customized forms and office supplies, receiving, and distributing and storing inventory.
- Opening new accounts.
- Card services, including ordering, processing, chargebacks, and disputes.
- ATM balancing and replenishing, which needs to be done in pairs.

Additionally, 13 time-consuming tasks/functions were mentioned by just a single interviewee. These can be found in Appendix 2 (items 15–27).

Finally, two tasks/functions—basic training and new product development (R&D)/innovation—never surfaced until mentioned by the interviewer. As it turns out, basic training (applicable to most or all employees) is frequently performed in-house, but some CEOs acknowledged that it would be effective to have an outside firm periodically provide training on global topics such as compliance, sales and service, and cash-handling, either on-site or via the Internet. On the other hand, innovation is rarely routine and is usually performed by the management team. Still, solutions providers can serve a valuable role once new products have been developed and approved and are ready for testing. A seemingly significant

drawback to outsourcing new product development/innovation is the fact that six to ten different core data processing systems are used by credit unions.

BEST CANDIDATES FOR OUTSOURCING

With one exception, the CEOs of these smaller credit unions were readily able to identify between one and three routine but time-consuming tasks/functions that seem conducive to outsourcing. According to these CEOs, the best candidates for outsourcing include facilities management and planning, repossessions, human resources administration, collections, compliance testing/internal audit, and check imaging.

From an analyst's perspective, it appears that smaller credit unions would receive the most payoff by outsourcing compliance testing/internal audit and tasks surrounding consumer loans—applications, underwriting, document preparation, and disbursement. These functions require large amounts of staff time at smaller credit unions, so outsourcing them might free up the greatest amount of time for staff to spend on more complex and customized projects, functions, and initiatives. However, more research is needed to identify the step-by-step processes involved in completing these tasks and to determine the feasibility of outsourcing them.

IMPLICATIONS FOR FRANCHISING

As smaller credit unions struggle to grow and compete with larger financial institutions, business format franchising may prove to be a viable model for both credit unions and service industry entrepreneurs. By enabling credit union CEOs and their management teams to redirect staff resources away from time-consuming, largely repetitive functions, franchising could potentially serve as a catalyst for credit union growth and innovation. And the fact that credit union CEOs have historically been willing to share the secrets of their success with other credit union CEOs bodes well for entrepreneurs who are able to roll out a business concept that can reduce staff-intensive tasks, processes, and functions using franchisees.

Chapter 3: Conclusion

Currently, developing a franchising-like structure for small credit unions does not appear to be possible, primarily because of the different IT systems used by existing small credit unions and because of legal and organizational liabilities. This conclusion is amplified and defended below by focusing on the potential franchising areas for small credit unions.

COMPLIANCE AND INTERNAL AUDIT

In a typical franchise chain, the franchisor is responsible for quality control, including physical inspection. One can also envision a credit union franchisor assuring the quality of the credit union by centralizing the compliance and internal audit function. There are, however, at least two differences between credit unions and other franchises—say, restaurants. First, quality in a restaurant is primarily (but not exclusively) measured by examining output, while quality in a credit union—financial integrity—involves studying both product and process. It is easier for a mystery shopper to buy a hamburger and judge its quality than for an audit team to examine at length a credit union’s financial statements, supporting documents, and internal processes. (A specialist might reach a different conclusion, and it is surely worth asking how such a standardized process might be developed.) Also, such processes may be specific to each IT system, making standardization difficult.

A second consideration is that a franchisee answers to the franchisor (and the marketplace), while a credit union answers to multiple constituencies, including regulators and a board of directors. No CEO or credit union will want to be made vulnerable to legal liability or regulatory sanction based on another’s judgment; hence, centralizing this task may be risky. Such concerns were mentioned by respondents to the interview as well. For example, a violation of the privacy of member records could threaten a credit union’s existence.

GETTING THE STRATEGIC SEQUENCE RIGHT

Filene Research Institute recently released a publication entitled *How Blue is Your Ocean?: Value Innovation and Credit Union Strategy Development*, which analyzed growth opportunities for credit unions. This publication was based on the business bestseller *Blue Ocean Strategy* by W. Chan Kim and Renée Mauborgne (Harvard Business School Press, 2005). The authors argue that breakthrough business opportunities (blue oceans) exist for those firms courageous enough to engage in deliberate strategic moves, termed *value innovation*. One of the keystones to discovering these blue oceans of opportunity involves “getting the strategic sequence right.” The credit union franchising concept presented in this preliminary study is a prime example of the tenet of value innovation. Getting the strategic

sequence right, according to Kim and Mauborgne’s methodology, involves asking the following questions:

- 1. Is there exceptional buyer utility in your business idea?**
- 2. Is your price easily accessible to a mass of buyers?**
- 3. Can you attain your cost target to profit at your price?**
- 4. What are the adoption hurdles in actualizing your business idea?**

If at any point the answer to one of the first three question is no, you will need to reevaluate your blue ocean idea and get back to the drawing board. Assuming the credit union franchising concept makes it through questions 1–3, we are still stymied by question number 4, specifically the adoption hurdle of the existence of disparate IT systems in smaller credit unions today.

CONSUMER LENDING/MARKETING

Credit unions primarily market based on their local presence and/or affiliation with a specific field of membership. Employees and executives work to attract local funds and to make loans to current members or to new members identified through lending opportunities. This local marketing is not likely to be effectively centralized. Local effort and knowledge may be lost through centralization. In addition, there would be a risk of adverse selection—local lenders making loans but passing on the liability to a centralized organization. Standardizing forms, document preparation, and other lending processes is certainly of value, but a credit union that does so may lose valuable information for local markets. It may also lose the human touch that is so important to a credit union’s success. Assuming that a credit union wishes to retain its local identity, it is not clear how it could outsource strategic planning or major marketing initiatives. Certain marketing materials such as advertising templates, however, could be jointly developed.

HUMAN RESOURCES

Hiring and firing should be retained by the credit union, but certainly some aspects of HR could be outsourced. For example, payroll processing can be purchased as a service from specialized companies, along with certain record-keeping and background-check processes. In order to standardize on a broader scale, a standardized organizational design would probably have to be adopted. Also, it is unclear how tightly coupled organizational design and the IT system are. If a change in organizational design requires a change in the IT system, then an organizational design change will be more difficult and less likely to occur.

ACCOUNTING/IT/SECURITY

Again, the standardization of IT systems would almost surely make this set of activities a candidate for franchising. In the absence of such standardization, franchising these tasks is less likely to be possible.

FACILITIES MANAGEMENT AND PLANNING

Facilities management is clearly a local function, one that is unlikely to benefit from centralization across multiple geographies.

A MODEL ALREADY IN PLACE IN CANADA: THE DESJARDINS GROUP

Desjardins Group is an organization of *caisses populaires* and *caisses d'économie* (types of credit unions). The 549 caisses Desjardins in Quebec and Ontario (527 in Quebec and 22 in Ontario) and their 890 service centers (849 in Quebec and 41 in Ontario) are assembled under a single federation: the Fédération des caisses Desjardins du Quebec.

The Fédération is the organization that supports the caisses Desjardins in Quebec. Its mandate is to provide the caisses with the services they require and to coordinate the efforts of all other Desjardins Group components, some of which report directly to the Fédération, such as Caisse centrale Desjardins, Capital Desjardins, and Desjardins Trust. The Fédération includes four business units:

- Desjardins Card Services (VISA Desjardins).
- Desjardins Electronic Access and Payment Services.
- Desjardins Point-of-Sale Financing Services.
- Desjardins Payroll and Human Resources Services.

Integrated with the Fédération, the Desjardins Bureau for Financial Monitoring and Enforcement is the component that ensures that caisse member assets are well protected. Its audit and inspection service assesses the caisses and all affiliated companies based on recognized financial sector standards and practices. The Bureau is also responsible for the ombudsman.

A SERVICE ORGANIZATION THAT CARES ABOUT DEMOCRACY

The Fédération's presence in the field is bolstered by many regional executive divisions and one provincial office for group *caisses* (credit unions). Each of these units supports a number of caisses in their daily activities.

This network is reinforced by 17 councils of representatives, 16 for the caisses populaires and 1 for the group caisses. The cornerstone of the Desjardins democratic process, the council of representatives

represents the caisses of a region with the Fédération and the community. Among other roles, the council ensures that the concerns expressed by the region's caisses are taken into account by the Fédération.

Each council of representatives is made up of 10 volunteer officers and 5 caisse general managers, for a total of 255 members from the entire network elected by management of their regional caisses. The 17 council presidents are all members of the Fédération's board of directors, which also includes 4 general managers, elected by the council of representatives members, and the president of Desjardins Group, for a total of 22 board members.

CONCLUDING THOUGHTS

This preliminary report did not identify a clear partition of small credit union functions that can easily be outsourced or centralized to a central franchisor. Although many tasks might be outsourced, no clear bundle of activities emerged. The most significant barrier to such franchising is the difference in IT systems among credit unions. If IT systems can be unified across credit unions, it might be possible to let the credit union franchisor handle a significant proportion of accounting and systems tasks. Such a decision might also allow for a standardized organizational design, while freeing up the credit union to develop and market funds and loans within its community. Ideally, the credit union franchisor would also work to develop standardized processes for audit and compliance tasks. It is an open question, however, whether such processes would meet the approval of the small credit union's various stakeholders (regulators and board members).

If credit unions all using the same IT systems chose to consolidate several of the above functions, there would remain the difficulty of pricing such a service. A percentage of assets or a per-transaction fee might be suitable compensation to the credit union franchisor. An alternative might be a cooperative, where the individual credit unions would own the central franchisor and share in its profits. In the final analysis, franchising does not appear to be a feasible strategic move today for smaller credit unions. However, the potential to normalize IT systems across multiple small credit unions holds the promise of a small credit union franchising scheme across a variety of time-consuming tasks. It is important to note that such a system must allow credit unions to retain their local identity and local brand.

Appendix 1: Case Study: We've Been Talking about This for Years⁵

In the 1960s there were two methods of competing in the high jump. One was the “western roll” where one ran to the bar and jumped over it face down. The second was the scissors kick in which the jumper ran at the bar at a shallow angle from the side and went over, butt side down, with a swift kick of each leg to scissor over the bar. Using these methods the maximum performance for high jumping was pretty stable.

Then a competitor at Oregon State “invented” a new method. In this style a jumper runs straight at the bar, jumps face first into the air, rotates and flips his feet over his head to clear the bar. The technique sounds impossible to someone who has not seen it.

Yet the Fosbury Flop, named after the first athlete to excel using it, has now become the “traditional” way to compete in the high jump. The new method allowed athletes to reach heights previously thought impossible. A new era of competition was born.

A HEAD-TURN MODEL FOR CREDIT UNIONS

Is an equivalent breakthrough possible for credit unions? Can a new method, or business model, put the credit union system on a whole new plane? Could this method cause the members to have a whole new level of credit union service—a “head turning” experience that could make credit unions central to consumers’ lives once again?

The breakthrough is possible. Opportunities still abound and new money is pouring into financial services at record levels. Money market funds alone now hold over \$2 trillion in assets and reported growing \$110 billion in January 2001 alone. That one month’s growth is more than 25% of total credit union savings. Member needs are expanding, not shrinking.

What would take credit unions to a new realm? The critical change needed lies in the core assumption: the network of credit unions— not the independent charter, stand-alone organization— must become the focus for the business.

THROUGH A GLASS DARKLY

Until now virtually all measures of success and planning have been for the individual credit union. Each CEO and board sees his or her organization as a ship on a financial services

⁵ Originally published in May 2001 by Chip Filson, President, Callahan & Associates, Inc. Reprinted with permission.

sea. Now the metaphor must shift—it is the flotilla in which the ship is participating that makes the individual ship powerful, and not vice versa.

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But these examples tend to be limited, not guiding strategy. Many credit unions have chosen not to participate in shared branching, first waiting to see if it will succeed. Few see the future of their credit union interlinked with other credit unions. Occasionally a threat, such as federal credit union charters faced with elimination of field of membership options, results in a collective effort. But once resolved, the combined campaign model is dissolved.

As a result credit unions in most instances are being positioned, not doing the positioning, when it comes to defining the future of financial services. Credit unions are playing “catch-up” in diversifying to broader service models, deploying the power of the Internet and gaining more of our members’ financial activities.

If credit unions truly intend to compete with, not just imitate, the models of their competition, then some method must be found to realize the potential value of a linked credit union system. The reason is that the majority of financial services are likely to be provided by large national firms with wide ranging product and distribution options. No credit union will be “large” when viewed against the major players in this market.

FACTORS FOR RESISTANCE

To expand member services, credit unions will need to add to their transaction relationships new kinds of advisory services and off balance sheet solutions. But even in the core business today, credit unions would not be major participants in the transaction model if they were not participants in networks: for ACH debits and credits, for ATM transactions, for direct pay at the member service level, and as part of the Corporate or Federal Reserve systems for corporate settlements. But all financial providers have access to these networks; participation is the price of entry, not a strategic advantage.

A number of factors inhibit CEOs from converting these public network solutions to a force for credit union advantage. For many the stand-alone model is the only career path they see. To convert to a network model would require that the directors and staff understand the goal of the model and see the means to achieve the outcomes, and that management see a career in broader terms than their own credit union’s success.

Many CEOs openly question the role of a network to their business. For them it is unclear how a network will increase member value. The requirements of power sharing and cooperation to make a network model successful seem too slow or bothersome—we'll just do it on our own. Certainly the recent failures of a number of companies trying to build portal solutions using various networking models and the Internet have also caused some to question whether technical breakthroughs for cooperative activity are feasible.

BEYOND NETWORKING TO CREATING A NETWORKED CAPABILITY

I believe that the emerging technical capability to connect via the Internet and credit union willingness to cooperate socially can create a true business network with market power. From merely meeting and sharing ideas about strategies and occasionally pooling resources, credit unions would be able to jointly implement new business processes using a network base. What does this mean?

“Market power” is the collective buying or distribution capability created by credit unions operating from a common network. If connected, credit unions can attract significant non-credit union partners, gain access to IT solutions and resources not feasible for one organization and gain access to a scale and expertise that could never be reached on a stand-alone model.

“Being connected” is the operative term. There needs to be some means of establishing a network integration capability. Two kinds of exchanges are likely to occur in the network. The first will be transactions similar to those occurring now that need to be processed in a tightly coupled or secure environment. The second is data exchanges that can accommodate members' information requests in a more loosely linked mode.

Bits and pieces of this networked model are all over the credit union system. Not only do credit unions belong to the “public” networks listed earlier, but they also have limited areas where they have put the success of part of their business into a joint effort. For example, many credit unions rely on partners for mortgage processing, service bureau solutions for their back office processing, and CUSOs for off balance sheet products.

WHO WILL BE FOSBURY?

Most innovative efforts require a leader. Someone has to take the concepts and the partial examples now in place and begin to show how the evolution can be accomplished. This will most likely occur for a small group of determined credit unions rather than as a flash of insight across the movement.

This effort will be at the boundary of many kinds of innovation. A new network will need to go beyond automating existing transactions to address the limitations in existing DP systems for sharing data and identify potential revenue opportunities for the network.

A person who does this is not likely to be seen as a leader, but more of a rabble-rouser. For not only would this leader be working to unleash the value of credit unions in a new way, the model would change the way most credit unions prefer to do business today.

Maybe that's the place for each credit union to start. When is the last time you were asked to be part of a network to do something important, but declined because you thought you could do it better yourself? One of these days, an effort like this will have lifted a group of credit unions to a new height. Then we'll all see the opportunity.

Appendix 2: List of Time-Consuming Tasks/Functions Derived from CEO Interviews

Time-Consuming Tasks/Functions	Risks, Drawbacks, and Opportunities of Outsourcing
<p>1. Compliance testing and internal audit</p> <ul style="list-style-type: none"> • Developing policies and testing for compliance (i.e., audit) applies across all departments. • People being audited resent the auditor and it's hard to keep auditors focused on auditing, given that they also do compliance. • BSA is a huge undertaking, as are CTR and SAR filings; league provides a comprehensive BSA compliance review. LSC has an automated compliance function that works fairly well. 	<ul style="list-style-type: none"> • Credit union would need to plan farther ahead in order to receive approvals in a timely fashion. • Would cost more—CPA firms are expensive. • Outsourced audits may not be as comprehensive as those done by staff. • Providing access to confidential information (privacy) would be a drawback. • Lack of efficiency would be a drawback. • Suppliers must know the credit union systems. • It would be nice to have a third-party provider perform an annual compliance audit on loans.
<p>2. Consumer lending</p> <ul style="list-style-type: none"> • Applications, interviewing, underwriting, and dispersing are spread across many staff. [At my credit union] three people do this full-time, and seven do this in addition to other functions. • There is also a lot of work to be done in regards to documentation preparation and processing loans from indirect dealer applications, which typically have high volume and high denial rates. The CEO spends 40% of time on indirect loans. 	<ul style="list-style-type: none"> • Must provide consistency of underwriting. • Must provide transparency of service, so members think they are talking to credit union staff. • Cost would be a drawback. • Access to call centers. • Potential loosening of the approval matrix (making some loans that shouldn't get approved) would be a risk. • Lack of control over process would be a drawback (credit union likes to provide the “human touch”). • For loan documentation preparation, supplier must provide flexibility to allow for last-minute changes.

<p>3. Human resources</p> <ul style="list-style-type: none"> • Writing and modifying job descriptions. • Modifying the performance appraisal process. • Attending to HR compliance. • Conducting skilled interviews, applicant screening, and background checks. • Payroll processing and record-keeping. 	<ul style="list-style-type: none"> • Must learn the plan and the credit union's culture. • All HR duties except hiring and firing could be outsourced. • Coaching and solving employee issues would need to remain in-house.
<p>4. Accounting</p> <ul style="list-style-type: none"> • Paying and tracking bills. • Cataloging, seeking, and securing approvals. • General ledgers, reconcilements, and investments, once approvals are obtained. 	<ul style="list-style-type: none"> • Approvals would still need to be secured by someone in-house (or process would need to be changed). • Biggest risk would be errors.
<p>5. Facilities management and planning</p> <ul style="list-style-type: none"> • Negotiating contracts for building maintenance (cleaning, snow removal, etc.). • Dealing with complaints. • Hiring and supervising. • Space management and reallocating staff to temporary space while upgrades are in progress. 	<ul style="list-style-type: none"> • Supplier not fully understanding the credit union's culture would be a drawback. • Supplier not always being readily available would be a drawback. • Would need supplier to sign a confidentiality clause if doing similar work for other financial institutions. • Cost would be a drawback.
<p>6. Marketing/Advertising</p> <ul style="list-style-type: none"> • Strategic thinking, creative, writing, production, designing, and mailing marketing pieces and public relations materials. 	<ul style="list-style-type: none"> • Would want to retain control over strategic aspects in-house. • Cost would be a drawback. • Loss of effectiveness would be a risk (agency may not know/understand local market like credit union does).
<p>7. IT/Security</p> <ul style="list-style-type: none"> • Ensuring compliance with BSA. • Ensuring security of hardware and software (but not the Website). • Major moves and reconfigurations are already outsourced. 	<ul style="list-style-type: none"> • Huge security risk. • Would not consider entrusting outside vendors with these tasks.

<p>8. Collection</p> <ul style="list-style-type: none"> • Calling, resolving problems, and repossessions (cleaning vehicles and securing titles). • Recommending charge-offs. 	<ul style="list-style-type: none"> • In this area, culture and philosophy don't really matter. • Consistency of effort. • Must treat members with respect, maintain member rapport, and minimize charge-offs. • Supplier must ensure an appropriate outcome. • No risk. • Supplier would need to understand the credit union's policies and procedures. • Cost would be a drawback. • Loss of flexibility is a risk. • Wouldn't trust performance to anyone else.
<p>9. Managing inventory of office supplies and forms</p> <ul style="list-style-type: none"> • Takes 70% of one staff person's time. • Submitting orders of customized forms and office supplies. • Receiving, distributing, and storing inventory. 	<ul style="list-style-type: none"> • Small credit unions would use different supplies and forms than larger credit unions (that is, inventories would differ). • Delivery and distribution could be outsourced depending on types of inventory required
<p>10. New accounts</p> <ul style="list-style-type: none"> • Deposits and investments. 	<ul style="list-style-type: none"> • Function is somewhat customized. • More routine than lending.
<p>11. Card services</p> <ul style="list-style-type: none"> • Ordering and processing. • Chargebacks and disputes. 	<ul style="list-style-type: none"> • Would want to keep this in-house.
<p>12. ATM balancing and replenishing</p> <ul style="list-style-type: none"> • Requires a portion of staff time at each location. 	<ul style="list-style-type: none"> • Cost would be a drawback.

<p>13. Basic training</p> <ul style="list-style-type: none"> • Compliance and cash-handling training. • Sales and services. 	<ul style="list-style-type: none"> • Provider must be familiar with each specific credit union, its product/service set, compliance issues, sales and service culture, and the credit union philosophy. • Might get pushed to back burner in a busy environment. • Member service training involves unique processes and culture, great detail, and security issues. • Provider must be familiar with the DP systems. • Could be done remotely or electronically.
<p>14. New product development (R&D)/Innovation</p> <ul style="list-style-type: none"> • Researching for cost-effective solutions when creating and introducing new products/services. 	<ul style="list-style-type: none"> • Provider would need to understand the nuances of unique credit union data processing systems, of which there are 6–10. • Would be important for an in-house staffer to keep abreast of new developments. • Cost would be a drawback.
<p>15. Website development and maintenance</p> <ul style="list-style-type: none"> • Maintenance and design often falls to the marketing department. 	<ul style="list-style-type: none"> • Would be difficult to maintain a Website without the background knowledge. • Changes often need to be made quickly.
<p>16. Administrative support for senior executives</p> <ul style="list-style-type: none"> • Organizing meetings. • Typing loan documents. 	<ul style="list-style-type: none"> • Typing duties could easily be transferred.
<p>17. Managerial/Supervisory</p> <ul style="list-style-type: none"> • Scheduling. • Employee conflict resolution. • Coaching, mentoring and monitoring performance. 	<ul style="list-style-type: none"> • Must be hands-on with employees.
<p>18. Reception and general member service</p> <ul style="list-style-type: none"> • Answering phone inquiries. • Directing members as they enter the branch. 	<ul style="list-style-type: none"> • Could be outsourced but probably not with greater cost efficiency. • Would present privacy, confidentiality, and security concerns because provider would have electronic access to member accounts. • Credit union would need to provide on-the-job training because a documented decision matrix does not currently exist.

<p>19. Mortgage lending</p> <ul style="list-style-type: none"> • Interviewing. • Taking applications. • Originating loans and processing is already outsourced to a CUSO; one full-time staff. 	<ul style="list-style-type: none"> • Processing could be outsourced, but the other tasks could not be effectively outsourced because the service would appear too impersonal.
<p>20. Check imaging</p>	<ul style="list-style-type: none"> • Paper is easily lost. • Would require quality control.
<p>21. Paying taxes and insurance for real estate portfolio</p>	<ul style="list-style-type: none"> • Done more quickly. • If computerized, the accuracy rate can increase. • Many credit unions already outsource this function.
<p>22. Back-office share draft processing</p> <ul style="list-style-type: none"> • Manual process at the end of each day to look at files that don't post or are overdrawn and decide what to return and what not to return. 	<ul style="list-style-type: none"> • Security and privacy concerns—would need to grant an outsider access to member accounts. • Outsiders don't know members and can't grant exceptions based on knowledge that they don't have.
<p>23. Address changes and returned mail</p> <ul style="list-style-type: none"> • Contacting members to ensure validity of changes. 	<ul style="list-style-type: none"> • Security and privacy concerns—requires access to member database.
<p>24. Insurance tracking</p> <ul style="list-style-type: none"> • Routinely confirming that member-owned vehicles are insured. • Following up with members who don't show up on insurance list. 	
<p>25. Pulling daily deposits together at day's end</p>	<ul style="list-style-type: none"> • Needs to be done on-site.
<p>26. Agricultural loan maintenance</p> <ul style="list-style-type: none"> • Annual inspection and inventory of livestock (e.g., counting cows) and equipment. 	<ul style="list-style-type: none"> • Takes staff 1,200 hours.
<p>27. Reviewing credit union financials/Asset-liability management (ALM)</p>	<ul style="list-style-type: none"> • Extremely hands-on. • Takes 10% of CEO's time.

Appendix 3: Research Protocol

filene Time Utilization Worksheet
RESEARCH INSTITUTE Interview Protocol

SMALL CREDIT UNION TIME UTILIZATION EXPLORATORY RESEARCH

Thank you for agreeing to be interviewed for the Filene Research Institute study about how staff time is utilized at small credit unions. Ironically, we're asking you to expend some of your valuable time in preparation for our interview on [enter day, date] at [time]. However, I guarantee that this pre-work will make for a more efficient use of time during our interview.

Prior to the interview, please prepare a list of the most time-consuming tasks or functions that your credit union performs on an ongoing basis. The list should be arranged in descending order by a rough estimate of the percentage of total staff time spent. Please do not include the teller-line (drive-up or lobby) function of serving your members.

Task/Function	% of total time spent
1.	
2.	
3.	
4.	
5.	
6.	
7.	
8.	
9.	
10.	

Interview Guide

Introduction

- I. Introduce self, working on behalf of Filene ...
- II. Thank you for making time for the interview ...
- III. Conducting some exploratory research with a small number of CUs with <\$150M in assets, the purpose of which is to identify the most time-consuming functions or tasks performed at the CU in order to develop potential strategies for assisting smaller credit unions.
- IV. Should take less than an hour of time ...
- V. Recording interviews for review by self and other researchers working on the study. Assure confidentiality and no sales as a result of info they provide.
- VI. Their name and CU name will not be attached to the specific information they provide in written report.

Warm-up question

- I. In addition to the daily business of serving members, what are the one or two most critical strategic projects or initiatives that your credit union is currently planning for, or implementing, in the coming year?
For each:
 - a. Which positions at your credit union are leading and involved with this project/initiative?
 - b. Roughly what percentage of total staff time will you and your staff spend on this project/initiative during 2006?
 - c. Are you using any outside suppliers to implement this project/initiative? [Probe for division of labor for time spent, internal vs. external.]

In-depth questions

Now let's talk about the other functions and ongoing tasks on which you and your staff spend considerable amounts of time. In preparation for this interview, we asked you to think about and jot down a list of the top 10 or so most time-consuming tasks and functions that your credit union performs on an ongoing basis. Let's work from the most to least time-consuming tasks/functions on your list. We may only have time to discuss the top five or six time-consuming tasks during today's interview.

-
- II. Other than serving members, what function do you believe requires the most time over the course of a year? [Probe for specificity if necessary.]
- a. Roughly what percentage of total staff time do you and your staff spend on [insert function mentioned above]?
 - b. Is most of this time routine—that is, doing the same thing over and over again—or is it highly specialized/customized each time staff performs this function?
 - c. I realize that there's always room for improvement, but in your opinion, is this task/function carried out in a highly efficient manner, or is it cumbersome and inefficient? [Probe for sources of inefficiency.]
 - d. Is this task/function performed entirely in-house?
[If yes]:
 - i. Would it have to be performed entirely in-house, or is this a task/function that you could consider outsourcing if an ideal solution were available? Why? [Probe for whether the task/function is or could be standardized vs. whether the CU requires a personalized/customized approach.]
 - ii. What are the major risks to outsourcing this task/function? [Probe for the following:]
 - 1. Does this task/function require training or personnel specific to your credit union?
 - 2. Does this task/function require equipment adapted (or specific) to your credit union?
 - 3. Would outsourcing this task/function violate member privacy regulations?
 - 4. What are the potential implications of errors caused by the third party?
 - 5. How would outsourcing this task/function potentially affect your credit union's brand?
- [If they partially outsource]:
- iii. Is this arrangement working well for your credit union, or would you prefer to have an external provider take on more or all of this task/function? [Probe for whether the task/function is or could be standardized vs. whether the CU requires a personalized/customized approach.]
 - iv. What are the major risks to outsourcing this task/function? [Probe for the following:]
 - 1. Does this task/function require training or personnel specific to your credit union?
 - 2. Does this task/function require equipment adapted (or specific) to your credit union?
 - 3. Would outsourcing this task/function violate member privacy regulations?
 - 4. What are the potential implications of errors caused by the third party?
 - 5. How would outsourcing this task/function potentially affect your credit union's brand?
- III. What is the next most time-consuming task/function at your credit union?
- a. Repeat a–d for each until time (~30 minutes) is exhausted or we reach the end of the CEO's list.

IV. Probe on the following if not previously mentioned by CEO:

a. What about...?

- i. ...basic training—applicable to most or all employees
- ii. ...new product development (R&D)/innovation
- iii. ...marketing/advertising
- iv. ...Website development and maintenance
- v. ...IT
- vi. ...collections
- vii. ...compliance

b. For each:

- i. How does time spent on this task/function compare to the others you've mentioned?
- ii. Is this a task/function that is already outsourced? [If not:] Could it potentially be outsourced? Why?

Wrap-up question

We've spent quite a bit of time talking about the most staff-intensive day-to-day functions at your credit union. So as not to leave you in a state of depression, I've got one last question:

- V. If you had the opportunity to reduce time spent on these daily activities, how would you reallocate your staff resources? That is, what one or two projects, activities, or initiatives would you strengthen or add if you had the capacity to do so?

Conclusion

Thank you for time spent today. Since this is exploratory research, the Filene Research Institute won't be publishing a formal report based on these interviews, but they will use the information I'm gathering to make a determination of potential next research and development steps. Your contribution is very much appreciated.

filene

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