
THE CHARACTERISTICS OF A FEDERATED NETWORK OF FINANCIAL COOPERATIVES

BACKGROUND

FINANCIAL COOPERATIVES: THE TWO BASIC MODELS OF ORGANIZATION

Various models of organization for networks of financial cooperatives are found around the world. The current situation, especially in terms of quality of governance, outreach and efficiency, appears to have been influenced significantly by the importance placed on the type of network organization chosen in the past. For example, European federated networks of financial cooperatives present certain characteristics which differ notably from credit unions in the United States.

Two major trends can be outlined. On one hand, there are networks in which the entities have relatively weak links and only share resources to a small extent. In this case, the accent is on the base entities while limiting integration to representation, lobbying and public relations. When resources are shared, this is often done without centralization. Professor Klaus Fischer refers to this as the atomized-competitive (AC) network model.¹

On the other hand, there are networks, often with many components, which are highly interrelated and equipped with apex organizations providing significant integration. Sharing of resources is raised to a high level of partnership and the supervision of base units is highly integrated. These are referred to as federated networks.²

These two theoretical models are at the extremes of a continuum describing actual financial cooperative systems in today's world. The federated network model can be found in Europe (Germany, France, the Netherlands, Austria...). The German (Raiffeisen/Volksbank) model popular among European cooperatives can be described as a federated network. In this system, there is a trend to optimize support efforts and strengthen the democratic rights of local banks for decision making. In the Netherlands, Rabobank has adopted a structure that is characterized by strong integration in terms of representation and operations. The success of German banking cooperatives is partially behind the trend among certain networks, such as *Crédit agricole de France*, to increase system integration.

This tendency is also found among institutions which have been influenced by Europe. In French-speaking Canada, more specifically Québec, the Desjardins Group is an exemplary model of a highly integrated network. Paradoxically, financial cooperative system integration in the rest of Canada remains very weak. The federated network model is also often found in countries in Latin America where European immigration was strong: Argentina, Uruguay, Chile and Brazil.

In Central and West Africa where French, Swiss and Québécois influence is evident, we find networks that very clearly can be characterized as federated.

The atomized model, with a low level of integration, is characteristic of credit unions in the United States, English-speaking Canada and Australia before 1992. This model is also found in Latin America where it has been encouraged through bilateral American and multilateral agency aid programs.

¹ Fischer, Klaus P. 2000. Regulatory environment and financial cooperative performance: atomized-competitive vs. federated networks, *Annals of Public and Cooperative Economics*, Vol. 71, pp. 607-636.

² Idem note 1.

These are not two pure, static models. There are hybrid networks along with others which are undergoing changes. Each system has specific characteristics and its own history. At a given time in its history a network may be characterized as an atomized network and at another as a federated network. For example, the Australian network of savings and credit cooperatives before 1992 was a relatively fragmented, atomized network. After 1992, widespread reform made it highly integrated in terms of resources, services and monitoring. Nevertheless, its current situation is clearly tied more to its previous status than to recent changes.

NETWORKS AND FEDERATED NETWORKS

The network organization model is increasingly popular among businesses. This is the managerial model found at the very source of new economy business deployment. According to Hammer & Champy (1993), there are three trends acting individually and in concert which are inexorably forcing businesses to adopt new practices that are more in line with the new economy: the growing power of clients who demand tailored-made solutions, intensified competition and the need for constant innovation.

Networks are generally defined by the multiplicity of methods of organization used by a minimum of two firms or entities within an institution for mutual profit. Networks may therefore take on very different forms according to the sector of activity in which they operate. Far from being rare, networks are ubiquitous. For professional services such as consulting, investment banking, insurance and accounting, network structures are the rule. These are stable industries in which the business culture, the production function and change management are well understood and where the relative contributions to the network can be controlled and measured.

In the biotechnology sector, networks are used to facilitate innovation. Powell et al. (1996) have observed that industries in which basic knowledge and tasks are complex, and where the sources of expertise are widely dispersed, put priority on innovation within the network rather than within individual firms. The network facilitates organizational learning and contributes to increasing staff knowledge.

In a general fashion, the advantages sought by a network method of organization are as follows: economies of scale, better control of complex procedures and markets, faster response to change, improved business flexibility to markets, control of future technologies, access to a variety of sources of capital and financing, up-to-date expertise, risk reduction, conquest of new markets and a leaner internal structure for business.

A federated network implies more than a simple network method of organization because decision making is shared in the cooperative units and coordination is required for shared activities. The federation is considered as an ascending model of organization in which the members are owners and control the shared unit. Just as the members come together to create a cooperative, the base units join forces to set up a second-tier institution which they will own and for which they will define the roles and functions. The more the basic financial cooperatives develop interrelations among themselves and with the second-tier institution, the faster the network will develop into a federated network model of organization.

WHY THE FEDERATED NETWORK MODEL IS OF INTEREST

Federated model performance

DID believes that the federated model allows networks to perform better than the atomized model, in terms of market penetration stability, financial efficiency, service extension and target clientele outreach.

Preliminary research results³ allow us to advance the hypothesis that the federated network model of organization offers greater advantages. In fact, with only a few rare exceptions, most federated financial cooperative networks perform better than atomized-competitive networks as a whole. This better performance can be observed in terms of market penetration, stability, financial efficiency, amplitude of services and target clientele outreach. In cases where it is not superior as a model of organization, it is at least equal to the performance of atomized-competitive networks.

Moreover, it can also be observed that federated networks are increasing their level of integration: this is the case for Desjardins, Rabobank and the Korean Agricultural Cooperatives Bank. At the same time atomized-competitive networks are tending towards the federated network model. In the United States, various credit unions are building strategic alliances for shared services. In Canada, there is a national strategy aimed at amalgamating provincial federations and strengthening various national systems. It should also be noted that system reform in Australia is taking the direction of a federated network model.

Several models of organization currently exist for cooperatives. These models present distinct and varying levels of integration.

When cooperative financial systems encourage greater integration of their components through the creation of a shared image and shared services, explicit and strict rules of operation, mutual solidarity, self discipline and the power to intervene, they have a greater probability of offering services to more people and achieving better financial performance and greater stability. This document identifies the critical variables of a federated network and the key indicators involved in order to properly identify the components of the model for better evaluation of the level of integration of existing networks.⁴

This document presents the main components of the model describing the advantages and constraints for base units. The dynamics of power between the base units and the second tier is at the heart of network integration. To benefit from the very real advantages of setting up a network, base units must delegate certain powers. The constraints made on base units by the federated model are expressed here in terms of powers delegated to the second tier.

CRITERIA AND INDICATORS FOR A FEDERATED NETWORK

Criteria and indicators for an integrated network

DID identifies four criteria to qualify networks as federated: the sharing of resources; standardization of operations; contractual solidarity; strategies for internal regulations on governance. Each of these characteristics may be found in unfederated networks. The addition of these characteristics will move a network increasingly towards a federated model.

³ Fischer, Klaus P. 2000. Regulatory environment and financial cooperative performance: atomized-competitive vs. federated networks *Annals of Public and Cooperative Economics*, Vol. 71, pp. 607-636.

⁴ A tool to assess network integration is currently being tested at DID.



Key Criteria

1. **Shared resources**
2. **Standardized operations**
3. **Contractual solidarity**
4. **Strategies for internal governance**

This section examines the foundations and elements for each of the criteria.

Sharing of resources

Sharing of resources within federated networks allows for grouping of inputs, Access to support services and collectively-owned property of complementary services. The entities in federated networks have access to resources they would not easily obtain in an atomized model.

Sharing resources, and especially access to shared support services, probably constitutes the main motivation for entities to create alliances. Entities unite to share information and services which they could not obtain otherwise or only with difficulty. A network of financial cooperatives can in no fashion be defined as a federated network without sharing resources. At the core of the federated model, this type of strategy goes beyond voluntary alliances of several entities aimed at cost reduction or global market development benefiting each entity. As the sharing of resources in the network among the base units becomes more intense and strategic, the degree of integration increases.

SHARING RESOURCES

- ✓ Inputs are assembled in groups
- ✓ Access to support services
- ✓ Collective ownership

Inputs Assembled

Assembling inputs is a first level of sharing resources. In a federated network, base units may come together for better negotiating power with suppliers, or to share specialized resources (such as farm credit or commercial lending specialists) or for access to a better labour pool, etc... As integration advances, the shared inputs evolve into federation support services.

Access to Second or Third-Tier Support Services

Second and third-tier (where applicable) organizations in a federated network will offer support services to base units. In an integrated network, certain services will be obligatory. These obligatory services such as compensation, management of liquid funds, risk or interest rates, may be different from one federation to another. The federation trains, supervises, advises, develops products and ensures monitoring of the base units.

It may also manage services such as debit and credit cards, payroll, the transport of currency and commerce. Support from the federation for human resources management within the base units, and more specifically the involvement of the federation in training and selecting staff and directors, is an example of support service. The federation of an integrated network actively participates in the management of staff in the credit unions. A federated network offers its members training programs and will be able to negotiate for training with reputable teaching institutions.

Collective Ownership

The ultimate expression of sharing resources is the collective acquisition by the financial cooperatives of services which are complementary to their operations. To enter new markets or to obtain specialized internal services, the cooperatives within a federated network may acquire specialized corporations. The function of these corporations will be to generate products, services or other inputs which are delivered to members at the base level. Seen in this manner, a federated network of cooperatives will have shared ownership in a central agency, a security fund, an insurance firm, or a brokerage. Collective ownership requires a commitment from the base units but allows them to offer a complete range of specialized financial products (insurance, trusts, securities, etc...) and investment services.

Sharing Resources

Advantages Sought	Delegated Powers
<ul style="list-style-type: none"> • Obtain best quality resources at lowest cost • Access to support services • Collective ownership of entities offering complementary services with added value 	<ul style="list-style-type: none"> • Choice and organization of resources • Structure and organization of support functions • Structure and organization of complementary services

Standardization of systems

Integration into a network presupposes strong centralization of operational systems, policies and norms, products and the institutional image. Standardization contributes to better performance by stimulating comparison among base units.

System standardization presupposes that base units present a uniform image and operate according to certain understood, obligatory standards. System standardization is one of the most constraining criteria for base units and the one which offers the most structure for a network. This is a central characteristic of the federated network model requiring strong centralization at the organizational level. In an atomized-competitive network, base units are distinct and operate on an individual basis without seeking to consolidate and standardize an image, a system, products or policies.

The strategy for standardization will be one which is most apparent to the members of the cooperatives. In an integrated network, members have a feeling of belonging to their financial cooperative. But the more a network becomes integrated, the more the members feel they are members of the overall financial institution that is the network, rather than their own financial cooperative. For members, the base units which operate according to a set standard become multiple representatives of a single financial institution set up as a network.

In conclusion, an important impact produced by standardization of operations is the easy comparison of base units among themselves and with the industry, provided the standards have been established accordingly. Operating in a similar fashion, even if in different markets, they may compare performance and efficiency. A federated network takes advantage of this by creating a desire to emulate best performance among the base units.

Standardization involves the following elements:

SYSTEM STANDARDIZATION

- ✓ Standardization of operational systems
- ✓ Standardization of policies and norms
- ✓ Standardization of products
- ✓ Institutional image

Standardization of Operational Systems

Standardization can affect various systems to different degrees. The first system affected is often the transaction and loan system. It affects the accounting system, procedures, application forms, control systems and data processing. This first level of uniformity is needed for exchanging data among base units for client services (inter-cooperative transactions). The benefits of uniform technological systems are quickly apparent (transaction systems and management information systems) because of the investment they require and the need for maintenance and improvement. Economies of scale are soon needed at this level both for development and for purchasing hardware and software. Standardizing systems within an integrated network can also affect financial systems, human resource systems, management and marketing systems.

Standardization of Policies and Norms

Standardizing policies and norms constitutes a further step. It is one thing to impose uniform ways to operate, it is another to create the uniformity of principles and direction they are based on. Policies and norms affect performance criteria, credit conditions, hiring policies, etc... In a federated network, the federation is responsible for establishing policies in collaboration with the base units. Once the policies are adopted, the base units are committed to following them.

Standardization of Products

Standardization of products is also a significant step in the process of network integration. Even though the base units may operate in very different markets, they must, in a federated network, draw upon a pool of products conceived and designed according to pre-established norms. In this way, members will receive a given service in a similar way from one unit to another. The base unit decides which products are relevant for its members and informs the network what new products need development. A federated network may increase the optimization of the distribution of products and services by encouraging the sharing of resources among base units.

Institutional Image

A federated network presents a unique banner and adopts national marketing strategies. Even if from a legal viewpoint each base unit is individual and operates on a different permit, they may still present a unified marketing image. Centralization of advertising by the federation plays a major role in maintaining that image. Institutional marketing has considerable influence on public perception of network integration. By adhering to a unique image, the financial cooperatives acknowledge that they are part of a system which is greater than they are: the network.

System Standardization

Advantages Sought	Powers Delegated
<ul style="list-style-type: none"> • Economies of scale • System growth • Rigor • Systematization • Information management • Internal and external benchmarking 	<ul style="list-style-type: none"> • Establishing norms • System definition, maintenance and growth

Contractual solidarity

The degree of integration of a network is partly measured by the contractual solidarity existing among the various units that constitute the network. The homogeneity of the base units should be encouraged in order to provide a balance of power. Dues, sharing, internal security measures and central agencies are all elements that favour the emergence of contractual solidarity.

An important aspect of a federated network is the need to establish formal agreements among the various members in the system, thus developing network solidarity. When the system is mature, it presents an image of a unified financial institution to onlookers.

Solidarity is expressed through various elements as follows:

CONTRACTUAL SOLIDARITY
<ul style="list-style-type: none"> ✓ Control over opening service outlets ✓ Balancing base unit size ✓ Dues ✓ Communicating vessels ✓ Internal security measures ✓ Central agency

Control over Opening Service Outlets

Alphonse Desjardins made the right decision in choosing parishes as locations: The caisses populaires-credit unions expanded with support from the clergy and today their networked territory is larger than that of non-cooperative banks (translation).⁵

By controlling where service outlets are located, the apex curbs the expansion of the base units. This control is based on geographic or tightly defined market criteria. The possibility of opening a service outlet for a base unit within an integrated network is normally limited to a few local points of service. A base unit cannot expand beyond its defined territory or a specific number of members. This measure is aimed at limiting competition among base units by preventing encroachment. No base unit can expand into the territory of another base unit or another federation, and in this manner it expresses its solidarity with other network entities. According to this principle, it is impossible for a base unit in a highly integrated network to expand its activities onto a national scale.

Balancing Base Unit Size

The size of base units in federated networks tends towards a relative homogeneity in order to avoid unbalanced representation within the network. This element becomes highly important during amalgamations.

Dues

Entities must be obligated to pay dues to the second-tier institution in order to belong to the federated network and enjoy access to its services. Along with affiliation, the fee becomes one of the two basic elements in the contract established between the federation and the base units. The rules establishing the dues for each base unit may vary from one network to another. It is not unusual for the fee strategy to include an equalization formula among base units.

Communicating vessels

In a federated network, liquid surpluses may be made available to base units by the federation. By sharing, units in need of liquid funds may benefit from surpluses in other units. This mechanism encourages optimization of financial resources in the network and in certain cases will encourage a certain amount of social intermediation. The federated network will establish formal management rules for this mechanism by specifying the remuneration for each party.

Internal Security Measures

For effective management of potential crises among any of the base units, federated networks set up security mechanisms. These include contingency funds, insurance funds and guarantee funds mainly designed to provide coverage against the unforeseen and offer risk sharing for the entities. Creation of this type of mechanism is often associated with the supervisory authority of a federation over the base units.

Central Agency

A federated network may set up a central agency for access to external sources of funding. The central agency functions as the main bank for the local base units and may be in charge of managing the liquidities for the financial cooperatives and on occasion raise funds in capital markets. The central agency plays the role of financial agent on international markets. It may also contribute to risk sharing among network entities when the level of lending requires it.

⁵ Malo, Marie-Claire. 2001. La gestion stratégique de la coopérative et de l'association d'économie sociale, *Revue des études coopératives, mutualistes et associatives*, No. 282, pp. 84-94.

Business development on a national level or accompaniment of clients or members for international business quickly stimulates the need for a central agency.

Contractual Solidarity

Advantages Sought	Powers Delegated
<ul style="list-style-type: none"> • Respond to external requirements by presenting a network image • Balanced representation • Internal and external recognition • Optimization of financial resources • Access to capital markets • An outlook greater than just local affairs • Protection of network against weakness of certain units 	<ul style="list-style-type: none"> • Overall management of part of the financial resources of the network • Global market coverage • Control over base unit size

Setting up internal rules and strategies to strengthen governance

Federated networks are characterized by a structure for democratic representation and centralized authority, by an apex organization whose roles and responsibilities are complementary to those of the base units, by implementation of a surveillance service; and by mechanisms for affiliation and disaffiliation.

Setting up internal rules and strategies to strengthen governance is another characteristic of a federated network.

Governance is defined as the system (values, obligations, rituals, procedures) regulating the nature of the relationship among various parts of the organization (members, staff, executives, directors) and protecting their interests.

The internal rules and strategies set up to strengthen governance may cover various aspects. The following deserve mention:

STRENGTHENING GOVERNANCE THROUGH INTERNAL STRATEGIES AND REGULATIONS

- ✓ Structure for democratic representation and centralization of authority
- ✓ Respecting the principle of subsidiarity
- ✓ Surveillance
- ✓ Mechanisms for affiliation and disaffiliation

Structure for democratic representation and centralization of authority

Despite the fact that they delegate certain powers to their second-tier organization, base units must continue to play a role in making the decisions which affect them. Federations differ in their degree of uniformity and the extent of their centralization or decentralization. The centralization which characterizes highly integrated structures is mainly based on the principle of grouping specialized skills at the second tier thus giving base units access to expertise that would otherwise be difficult to access and which contributes to making them more competitive. The increasing complexity of financial activities obliges base units to place their confidence in the decisions adopted within specialized institutions since the competitive position of base units will depend in part on the activities of these institutions. A federated network will centralize many of its functions while ensuring ongoing validation of its decisions and orientations by the base through consultation mechanisms and effective democracy.

Respecting the Principle of Subsidiarity

Respecting the principle of subsidiarity presupposes the existence of a second-tier institution. This criterion designates the principle of sharing responsibility between the tiers. Within a federated network, the role of the second tier is to fill in and extend the activities of the base units. Respecting this principle leads to maintaining conformity with the attributions of each tier; what the base units are able to do on their own and through their own means must not be transferred to the federation. According to the principle of subsidiarity neither the federation nor a second-tier entity should become a substitute for base unit initiative and responsibility. This principle requires that the autonomy of the first-tier entities be subordinated to the general good. Two streams exist: on one hand this must lead to limits on second-tier intervention and on the other hand it must lead to the development of second-tier expertise when base units are unable to properly reach a common goal. In other words, the two tiers must take the same direction.

Subordination is the basic concept for subsidiarity. When a base unit is obviously in need, the federation must make the effort to provide advice and direction. In this manner subsidiarity appears as a principle in which the social order is built from bottom to top so that the federation only intervenes as a last resort. This principle constitutes a safeguard for balancing responsibility and democratic representation in order to avoid the abuses of centralization. Respecting the principle of subsidiarity is not expressed in a uniform manner since the division of responsibility will vary in relation to the mission of the institution. The principle of subsidiarity seeks to optimize resources and avoid overlap.

Surveillance

An integrated network facilitates the method of organization for internal supervision. Whether it is delegated or auxiliary, the organization's surveillance method may become a major characteristic of a federated network. A federated network allows for part of the regulatory and supervisory function to be delegated by the state agency for regulating and supervising networks of cooperatives. A federated network generally issues strict prudential norms, has unrestricted access to information, sets up its own security fund, gives itself power to intervene and supervise cooperatives that are delinquent or in difficulty. This delegated supervisory function may take various forms. At Desjardins, there is an independent bureau answering directly to the president and the appointment or firing of its head must be decided at the general meeting of the *Fédération nationale* in accordance with the government supervisory agency. For the German Raffeisen federation there is an independent legal entity with its own board of directors.

Affiliation and Disaffiliation

Tight control over the mechanism for affiliation and disaffiliation constitutes another characteristic of federated networks which see it as a contract between the base units and the second tier. Within a federated network, affiliation constitutes an essential condition for belonging to the network and is a voluntary act.

Strengthening Governance Through Internal Rules and Strategies

Advantages Sought	Powers Delegated
<ul style="list-style-type: none"> • Strengthening of systems governing the nature of the relationship between various parts of the organization and protection of member interests • Protection against excessive centralization • Functional independence of entities 	<ul style="list-style-type: none"> • Development of expertise and specialized functions • Respect for the principle of subsidiarity by the second tier • Supervision and control

CONCLUSION

In conclusion, financial cooperatives tend to be described as organized systems with elements designed for representation and shared operational structures for which the strategic principles and the main lines of action are developed based on group policies and directives creating unity in action.⁶ A federated network places priority on development strategies based on the integration of activities, the awareness of a shared goal and unity of action.

⁶ Côté, Daniel. 2001. *Les holdings coopératifs: Évolution ou transformation définitive?*, Éditions De Boeck Université, Bruxelles, 413 pages.

The following table summarizes the main features of a federated network and its components.

<i>Key Criteria and Components</i>	
<i>Sharing of resources</i>	<ul style="list-style-type: none"> ▪ Inputs are grouped ▪ Access to support services Collective ownership
<i>System standardization</i>	<ul style="list-style-type: none"> ▪ Standardization of operational systems ▪ Standardization of policies and norms ▪ Standardization of products ▪ Institutional image
<i>Contractual solidarity</i>	<ul style="list-style-type: none"> ▪ Control over opening of service outlets ▪ Balancing base unit size ▪ Dues ▪ Communicating vessels ▪ Internal security mechanism ▪ Central agency
<i>Strategies for internal governance</i>	<ul style="list-style-type: none"> ▪ Structure for democratic representation and centralization of power ▪ Respecting the principle of subsidiarity ▪ Surveillance ▪ Affiliation and disaffiliation