

A Hidden Contributor to the Korean Miracle: The Korean Credit Union Movement

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Abstract

Korean credit unions (CUs) are considered to be a hidden contributor to the “Korean miracle”, characterized by remarkable economic growth and relatively low income inequality. The Korean miracle not only generated wealth in an economically strapped and socially under-privileged people, but also contributed to regional community development and the democratization of Korean society. In this study, we analyzed how Korean CUs contributed to the Korean economy and society, and we identified the challenges now facing Korean CUs. We investigated how Korean CUs were established and how they have developed, and we present their remarkable achievements. We analyzed their present characteristics as well as the

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difficulties they experienced during the recent global financial crises, and we discuss the many challenges they face going forward.

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JEL Classification: *G20, G21, G38, H24*

1. Introduction

Korea¹ has achieved remarkable economic growth over the past 60 years, and the nation has been dubbed the “Miracle on the Han River”. The South Korean economy expanded from near zero to over one trillion dollars between 1960 and 2013. The country transformed itself after the destruction of the Korean War into a wealthy and developed country with a globally influential economy and prominent multinational conglomerates, including Samsung, LG, and Hyundai-Kia. Today, Korea stands as a global role model for economic development.

Especially noteworthy in Korea’s remarkable growth is that it was accompanied by relatively low income inequality, compared with other economies that have experienced rapid economic progress. The Gini coefficient, which is an index of a nation’s income inequality, has been relatively low (31.3%, World Bank, 2007) in Korea until very recently, although today there is growing concern over the widening income gap.

Effective economic development and implementation by the government and the role of leading conglomerates (Samsung, Hyundai, and LG) have been frequently mentioned as factors that contributed to the remarkable economic growth and low income inequality in Korea. However, the contribution of the credit union (CU) movement in Korea has not been paid as much attention as it deserves, and the role of CUs should not be overlooked. In particular, the pioneering organizers of the Korean CU movement attempted to proactively establish remedies for the social disadvantages and economic inequalities that typically accompany rapid economic progress. In the 1960s, when the Korean CU movement began, access to official financial institutions like banks was very limited for lower income groups who lacked property and good credit records. These groups

1- Throughout the paper, if not stated otherwise, “Korea” is understood to stand for the Republic of Korea or South Korea.

depended mostly on private loans with high annual interest rates of up to 40%. To overcome this difficulty, low-income groups created cooperative CUs with the stated purpose of the “abolishment of the usurious private loan market”. By establishing CUs, the low-income groups could begin to accumulate wealth, and were able to provide small loans to other members of their community in urgent need of money at reasonable interest rates. In this way, the low-income population began to enter the middle class.

In this study, we analyzed how the CUs were created in Korea, as well as how they have developed over the past 60 years. We investigated what Korean CUs have achieved and the characteristics they have developed, as well as the hardships and restructuring they experienced during difficult economic periods. We also identified several challenges that Korean CUs will face in the future.

2. Creation and Development of Credit Unions in Korea

2.1. Credit union characteristics

A CU is a member-owned financial cooperative¹ that is democratically controlled by its members and operated for the purpose of promoting thrift, providing credit at competitive rates, and providing other financial services to its members. Many CUs also provide services intended to support community development and could be considered community development financial institutions. A CU operates under basic principles that are founded in the philosophy of cooperation and mutual self-help. Although some variation exists in implementing these principles, the concept of human development and the sense of community expressed through people working together to achieve a better life for themselves and their community is at the

1- A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically controlled enterprise.

heart of the movement. [The related law was approved on August 24, 1984, by the World Council of Credit Union (WOCCU) Membership Council].

Specifically, a CU has the following characteristics. First, membership in a CU is voluntary and open to all within the accepted common bond of association that can make use of its services and are willing to accept the corresponding responsibilities. Second, CUs are democratically controlled; CU members enjoy equal voting rights (one member, one vote) and participate in decisions affecting the CU without regard to a member's amount of savings or deposits or volume of business. Third, CU services are directed to improve the economic and social wellbeing of all members. To encourage thrift through savings and to facilitate the offer of loans and other services, a fair interest rate, within the CU's capability, is paid on savings and deposits. After covering costs associated with finance, operating costs, provisions for loan losses, and ensuring appropriate capital reserves, any surplus arising from CU operations belongs to and benefits all members. A surplus may be distributed among members in proportion to their transactions with the CU as dividends on shares or directed to improvements or additional services for members. Fourth, CUs emphasize the building of financial stability; a prime concern of the CU is to build financial strength, including adequate reserves and internal controls that will ensure continued service to its membership (Ward and McKillop, 2005).

CUs differ from banks and other financial institutions in the following ways (Wikipedia, 2013):

- Only members may have accounts in the CU and deposit or borrow money (CUNA, 2007).
- CU policies governing interest rates and other matters are set by a volunteer Board of Directors elected by and from the membership itself. In addition, Board members are elected using a one-person-one-vote system (a single vote for each depositor), regardless of the

amount invested.

- CUs are self-characterized as having "higher moral ground" than banks; CUs aim to be "community-oriented" and to "serve people, not profit". The Credit Union National Association (CUNA) claims the following: "Credit unions exist to help people, not make a profit. Our goal is to serve our entire members well, including those of modest means - *every member counts...* The same *people-first philosophy* causes credit unions and our employees to *get involved in community charitable activities and worthwhile causes*" (CUNA, 2013). This philosophy is well expressed in a small CU's motto: "Where people are worth more than money" (Lanier Federal Credit Union, 2013).
- Credit unions provide a broader range of loans and savings products at a much cheaper cost to their members than do most microfinance institutions.

Historically, people have cooperated for their mutual advantage through the CU movement and to bring hope to economically strapped and socially underprivileged people. The CU movement traces its origins to Germany's Friedrich Wilhelm Raiffeisen (1818~1888), who led the CU movement in rural areas, and to Hermann Schulze-Delitzsch (1808~1883), who focused on urban areas. The CU movement gradually spread to other parts of the world, including Italy and the United States (US) sometime around the early 1900s (Wikipedia, 2013).

2.2 Creation and development of Korean credit unions

A Catholic nun and priest who cared deeply about the Korean poor and who wanted to bring hope to them initiated the Korean CU movement in 1960. In May 1960, an American nun, Sister Mary Gabriella (1900~1993), launched the first CU in Korea, the Holy Family Credit Union, with 27 members, all of whom were employees at Maryknoll Hospital and Catholic Relief Services in Busan, Korea. Sister Mary Gabriella had received training with regard to CUs from the Coady International Institute of St. Francis Xavier

University in Canada in 1957, and she also made use of materials and information from CUNA. In June of the same year, Father Chang Dae-ik (1923~2008) and his followers in the Cooperatives Economic Study Group established the Central Credit Union for Catholics in Seoul. These two early CUs set the Korean CU movement in motion. The Cooperatives Economic Study Group was organized and guided by Father Chang for the purpose of studying and establishing cooperatives. In addition, like Sister Mary Gabrielle, he had been educated about cooperatives by Dr. Coady at St. Francis Xavier University in Canada.

The Korean CU movement, initiated by Catholic Church, then spread throughout the nation. New CUs were established one-by-one by pioneers of the movement in both rural and urban areas. The CU scheme met the needs of poor farmers and the small-scale self-employed. Traditionally, poor Korean farmers in rural areas suffered under high interest rate private loans until they could liquidate their cultivated crops during harvest season. The self-employed also depended on private loans with outrageously high interest rates when faced with an urgent cash need. Thus, the CUs were welcomed as a breakthrough by these people. At that time, CUs were the only route by which economically strapped people could borrow urgently-needed money at a reasonable cost. In May 1965, The Korean Credit Union League, a trade association, was established (Choi, 2010).

In August 1972, the Korean Credit Union Act was promulgated, which was a milestone in the development of CUs in Korea. To deal with tax problems and to facilitate the securing of loan rights, pioneers of the CU movement had suggested the necessity of such an act but, for various reasons, the government was slow to enact any legislation. Then, during the legislation process, the US government dispatched an advisor to Korea, and the act moved forward. Thanks to the act, Korean CUs and their association were established legal entities, thereby setting the stage for further

development. In March 1973, the National Credit Union Federation of Korea (NACUFOK, former KCUL) was organized.

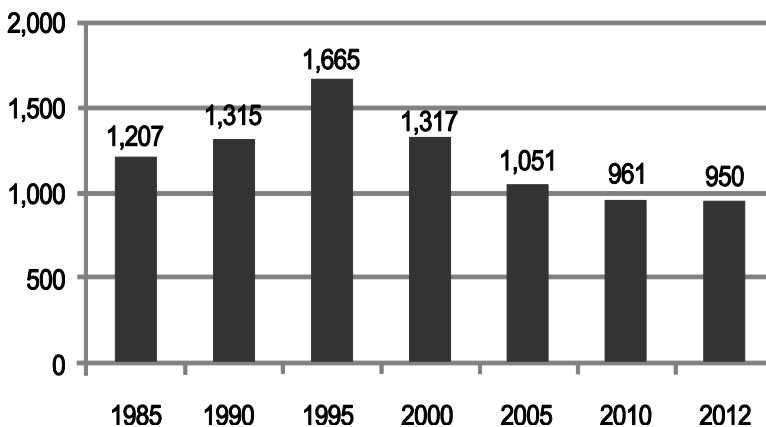
3. Achievements of Korean Credit Unions

Over 50 years have passed since the first Korean CU was established, and their presence and influence has grown rapidly over that time period. The achievements made by Korean CUs over the past 50 years can be summarized as follows:

3.1. The number of CUs

An increasing number of CUs is a primary growth index. The growth trend of Korean CUs by year is shown in Figure 1. As of 2012, the number of CUs in Korea was 950, and the number has declined steadily after peaking in 1995. The decline in the number of CUs is the result of continuous restructuring after the Asian and global financial crises in 1997 and 2008. However, although the total number of CUs has declined, CUs have, on average, become bigger and financially stronger.

Figure 1: The number of CUs by year (1985-2012)

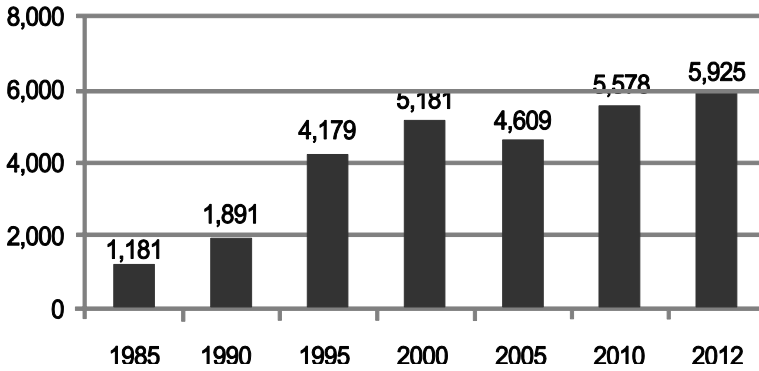


Source: NACUFOK (2013c).

3.2. Members

Figure 2 presents the membership numbers of CUs by year (1985-2012). Membership in CUs has increased to over 5 million in 2012, which is more than 5 times greater than the 1.184 million members associated with CUs in 1985.

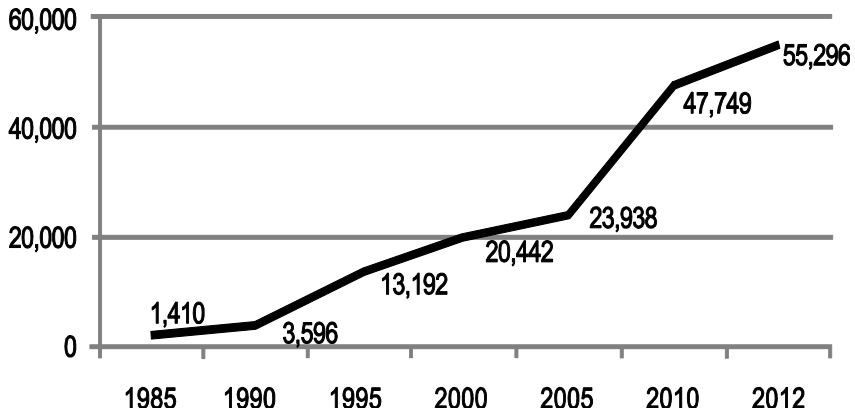
Figure 2: Membership of CUs by year (1985-2012)



Source: NACUFOK (2013c).

3.3. Total assets

Figure 3 illustrates the trend in growth of total assets of Korean CUs. As shown in the Figure, total Korean CU assets were KRW 55 trillion (USD 50 billion) as of 2012. Assets have increased remarkably since 2009, when the upper limit for a tax-free installation savings per member increased from KRW 20 million (USD 18 thousand) to KRW 30 million (USD 27.3 thousand). According to Korean tax law, interest income accrued from installation savings (up to KRW 30 million per member) in member-owned financial cooperatives (i.e., CUs in the Korea Federation of Community Credit Cooperatives) is tax-free to promote wealth formation in low- and middle-income groups.

Figure 3: Total assets of Korean CUs (1985-2012)

Unit: KRW billion

Source: NACUFOK (2013c).

3.4. Asset size

Table 1 lists the number of CUs by asset size. As indicated in the Table, a trend towards bigger CUs has occurred. In 1985, CUs with less than KRW 1 billion in assets accounted for more than 80% of Korean CUs. However, by 2002, 410 CUs (43.2%) operated with assets greater than KRW 50 billion (USD 45.5 million). As of July 2013, the largest CU in Korea (Chungwun Credit Union in Daegu City) had KRW 683.4 billion (USD 620 million) in assets.

Table 1: Number of CUs by asset size (1985-2012)**Unit: KRW billion**

year	No. of CUs	Less than 1	1-5	5-20	20-30	30-50	More than 50
1985	1,207	979	214	14	0	0	0
1990	1,315	514	613	188	0	0	0
1995	1,665	324	559	624	94	48	16
2000	1,317	103	264	620	156	108	66
2005	1,051	41	140	422	201	142	105
2010	961	10	76	197	119	215	344
2012	950	9	60	169	113	189	410

Source: NACUFOK (2013c).

3.5. Number and assets of CUs by size

There are three different types of CUs, including community CUs, employee CUs, and group/association CUs based on a common bond. Common bond CUs can be further categorized based on administrative district, economic zone, life zone, workplace, or group (Goo, 2007). Table 2 presents both the number and the assets of CUs by size (1985-2012). As shown in the Table, as of 2012, the breakdown of Korean CUs was as follows: 677 community CUs (71.2%), 159 employee CUs (16.7%), and 114 group/association CUs (12.0%). Since 1985, a steady decline in the numbers of employee and group/association CUs has occurred.

Table 2: Numbers and assets of CUs by size (1985-2012)**Unit: KRW billion**

Year	No. of CUs				Asset			
	Total	Community	Employees	Group	Total	Community	Employees	Group
1985	1,207	518	331	358	1,410	741	248	421
1990	1,315	549	330	436	3,596	2,012	518	1,066
1995	1,665	744	368	553	13,192	7,607	1,251	4,335
2000	1,317	818	252	247	20,442	16,031	1,580	2,830
2005	1,051	675	200	176	23,938	19,147	2,085	2,706
2010	961	671	164	126	47,749	41,192	2,643	3,914
2012	950	677	159	114	55,296	48,181	2,941	4,174

Source: NACUFOK (2013c).

4. Characteristics and Structure of the Korean Credit Union Movement

4.1. Characteristics and structure of the Korean credit union movement

The Korean CU movement has developed several unique characteristics, which has contributed to its success:

4.2. Bottom-up movement.

The Korean CU movement began as a grassroots, or bottom-up, social movement. Ordinary Korean people organized and managed CUs through their own efforts, although they were often led by civic-minded campaigners who recognized the importance of mutual help and cooperatives to break the cycle of poverty in a capitalistic society. The establishment of Korean CUs differed from that in many other developing countries, where governments initiated CUs as an instrument of economic development policy. Although

the Korean CU movement received some foreign aid in its earliest years, the budget of NACUFOK has since been fully covered by membership fees. Thus, Korea CUs, which are based on the spirit of self-help, are a role model for the development of CUs in developing countries.

4.3. Emphasis on education

The success of the Korean CU movement can be largely attributed to education. Training and education have been emphasized on various levels. A particular level of education was often mandatory for full CU membership. Furthermore, leadership opportunities exist for members; members are encouraged to serve as Board members, executives, and presidents. For this purpose, the Credit Union Training Center (CUTC) was established in 1981 with help from a German foundation (the Konrad Adenauer Stiftung), which had a tradition in the Raiffeisien movement¹. The CUTC now offers a wide range of programs and courses to educate members and employees (managers, directors, and even CU presidents) as financial specialists. For example, the CUTC MBA program has turned out 1,557 graduates (as of Feb, 2013), thereby serving as a human capital source for Korean CUs and playing a pivotal role in the future of the CU movement.

4.4. Contributions to democracy

The achievements of the Korean CU movement are not limited to business performance and ameliorating low income equality in Korea. The Korean CU movement has also contributed to societal and cultural development (Choi, 2010). In particular, CUs enabled their members to practice democratic principles. CU members enjoy equal voting rights (one member,

1- In 1864 Friedrich Wilhelm Raiffeisen founded the first rural CU in Heddesdorf (now part of Neuwied) in Germany

one vote) and participate in all major decisions affecting CUs. This experience in democracy within CUs contributed to the diffusion of democracy throughout Korean society.

4.5. Interest in social contribution

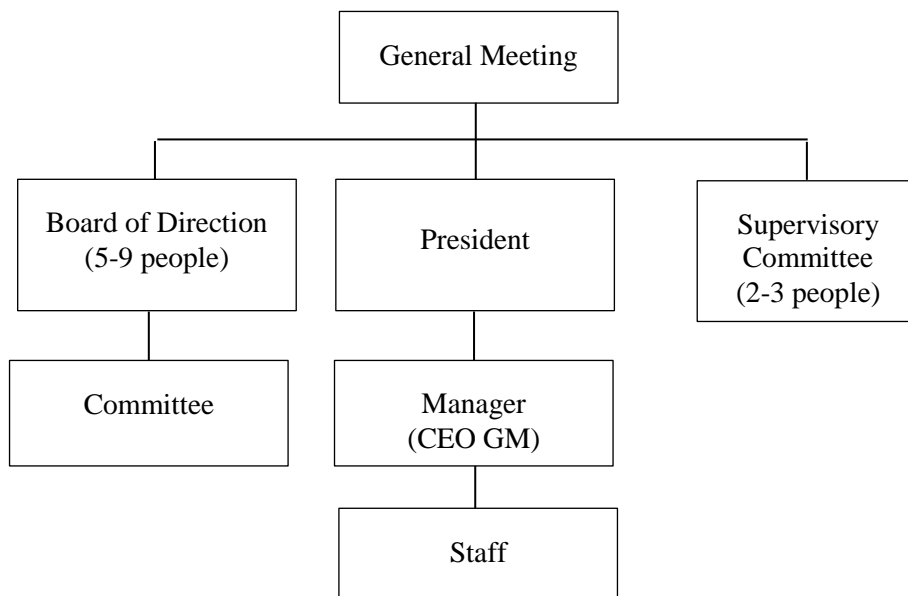
Korean CUs provide help for their members in need, and they share their profits with communities as well as members. Through social welfare projects as well as regional community development projects, such as farmer's markets and shopping malls, Korean CUs provide support for both members' businesses and the regional economy. Meanwhile, Korean CUs also focus efforts on art and cultural projects, environmental conservation, lifelong education, and scholarship programs.

4.6. The structure of the Korean Credit Union Movement

At present, Korean CUs exist in a two-level structure: primary CUs and national CUs (NACUFOK).

4.6.1. Primary credit unions

Primary CUs in Korea are organized as shown in Figure 4. Each CU consists of a General Meeting, a Board of Directors, Auditors, etc. The General Meeting, which is the top decision-making organization within the CU system, determines basic guidelines for operation. Meanwhile, the Board of Directors, President, and the Auditors share various operational functions. This structure holds each part in check, helping to strike a balance and, ultimately, safeguard the rights of the CU membership.

Figure 4: Primary Credit Union Structure

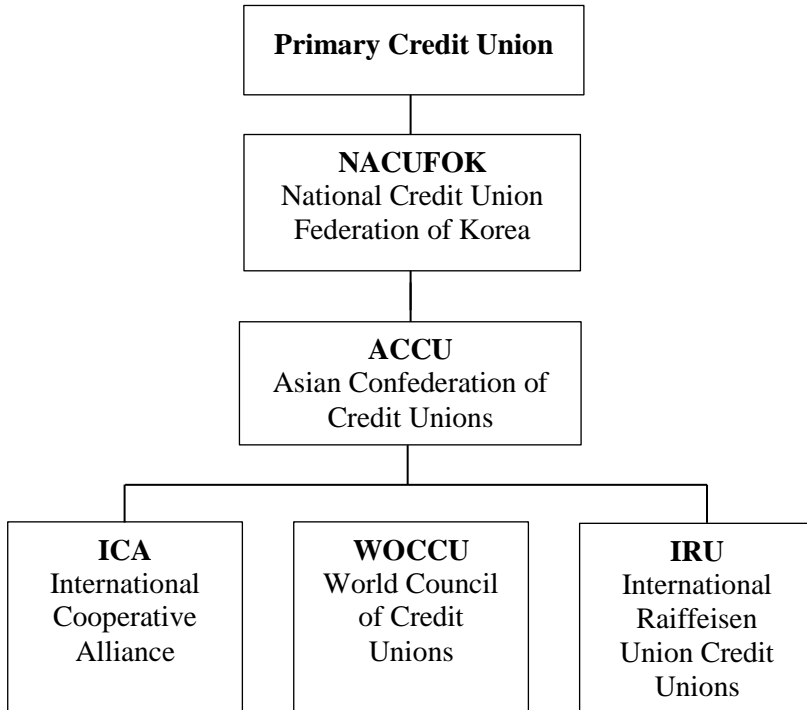
Source: NACUFOK (2013b)

4.6.2. National Credit Union Federation of Korea

The National Credit Union Federation of Korea (NACUFOK) is a non-profit organization. NACUFOK was established in 1964 and is an apex trade association, financial intermediary, and business organization comprising all CUs. Today, NACUFOK is based in Daejeon, Korea. As a trade association, NACUFOK represents member CUs to the government, regulators, and the international CU society. It conducts publicity, supervision, management consulting, and education. As a financial intermediary, NACUFOK manages an inter-lending service as a central financial facility, and it invests surplus funds in high-grade mutual funds, government and corporate bonds, and other securities. In addition, NACUFOK offers a variety of mutual insurance services to members with 76 products & 1,035,313 contracts via credit

unions. NACUFOK's solvency margin ratio, adapted to the EU-based solvency margin method, is 393.73% (as of Dec. 31, 2012). Figure 5 shows the structure of NACUFOK and its affiliated organizations.

Figure 5: NACUFOK and its affiliated organizations



Source: NACUFOK (2013b).

5. Restructuring and Challenges Facing Korean Credit Unions

5.1. Hardship and restructuring

5.1.1. The largest crisis in the Korean Credit Union Movement

The growth of Korean CUs was not achieved without difficulty. As the financial industry has been deregulated and globalized since 1970s,

competition among domestic and global financial institutions has become fiercer. This heightened competition created financial troubles for many small and less competitive CUs. Moreover, a “moral hazard” associated with directors and employees that occurred in some CUs led to a deterioration in the situation.

The first and largest crisis Korean CUs experienced in their history was the 1997 Korean financial crisis, during which the Korean economy defaulted and required bailout by the International Monetary Fund (IMF). The 1997 crisis was a finishing blow to many ailing CUs. Influenced by restructuring plans, recommended by the IMF for the revival of the economy, many Korean companies also collapsed. As a result, many primary CUs with invested money in collapsed company bonds were also driven to insolvency. As of November 1997, there were 239 problematic CUs, the so-called “management guidance-needed CUs”, which were defined as having “non-performing loans of more than double their net asset” values.

At that time, NACUFOK had its own system, the “Safety Fund System” that was autonomously established in 1984 to protect deposits by members when CUs went into bankruptcy. The Safety Fund System scheme was funded by member CUs in proportion to the amount of loans outstanding and was used to pay back deposits in case of CU bankruptcy. However, the rising number of problematic CUs during the 1997 financial crisis imposed a heavy burden on the Safety Fund; the amount of deposits to be paid went far beyond the capabilities of the Fund, and the Korean CU system was in danger of losing its credibility.

5.1.2. Government intervention and the restructuring of CUs

During the 1997 crisis, CUs were not the only institutions facing trouble. The Korean government was worried about chain bankruptcy and actively intervened in many types of financial institutions. It integrated the various deposit insurance functions operated by financial institutions on their own

into the Korea Deposit Insurance Corporation (KDIC). The KDIC is a deposit insurance corporation that had been established in 1996 in South Korea to protect depositors and maintain the stability of the financial system. In December 1997, the Korean government modified the Depositor Protection Act to include CUs in the KDIC. Under this Act, all CU deposits of up to KRW 50 million (combined principle and interest) were insured; this move by the government helped to calm CU members' anxiety and resulted in the stabilization of the CU system.

From April 1998 to December 2003, the KDIC injected public funds amounting to KRW 4,757.9 billion (USD 4.3 billion) for the restructuring of as many as 327 CUs. Although many Korean CUs survived following restructuring, significant losses also occurred. The KDIC sued 4,146 directors and employees of 325 CUs for various violations, claiming KRW 588.8 billion (USD 535.2 million). As a result, many CUs were closed or merged to create larger institutions, and the total number of Korean CUs decreased to less than 1000. However, the biggest loss was damage to the self-management model, which is one of the principal operating rules of CUs. In return for the public funds, CUs had no choice other than to submit to the control of financial authorities, such as the Financial Services Commission (FSC) and the Financial Supervisory Service (FSS)¹. Today, all Korean CUs are subject to the same governmental regulations as banks and securities companies. Table 3 illustrates the changes in operating bodies for funds used for protection of deposits.

1- All Korean financial institutions are regulated by two government organizations: the FSC and FSS.

The Financial Services Commission (FSC), formerly the Financial Supervisory Commission, is the South Korean government's top financial regulator. It makes financial policies and directs the Financial Supervisory Service.

The Financial Supervisory Service (FSS) is South Korea's integrated financial regulator that examines and supervises financial institutions under the broad oversight of the Financial Services Commission

Table 3: Changes in operating bodies for deposit protection

Name	Operating body	Period
Safety Fund	NACUFOK	1.1.1984 – 3.31.1998
Redemption Fund	Korea Deposit Insurance Corporation (KDIC)	4.1.1998 – 12.31.2002
Deposit Protection Fund*	Korea Deposit Insurance Corporation (KDIC)	1.1.2003 – 12.31.2003
Depositor Protection Fund	NACUFOK	1.1.2004 – present

* This fund was temporarily established for the restructuring of the CUs for one year.

As seen in the Table, the Depositor Protection Fund returned to NACUFOK in January 2004. This shift in operating body was made based on the rationale that the restructuring of problematic CUs was nearly complete and that the operation of a depositor protection fund that considered the characteristics specific to CUs was needed for their revitalization. According to the present Depositor Protection Fund System operated by NACUFOK, all members' deposits (shares, installment savings, checking deposits) of up to KRW50 million (USD 45 thousands) in combined principle and interest are safeguarded by the CU in case of bankruptcy.

5.2. Challenges

Although Korean CUs have developed successfully, they are also now facing many challenges:

5.2.1. Deteriorating business environment

The business environment surrounding Korean CUs has been deteriorating in recent years:

- Deposits to Korean CUs have recently increased enormously, because installment savings of members are tax-free up to KRW 30 million

(USD 27.3 thousand) based on the Tax Reduction and Exemption Control Act (of Korea). However, in the recent financial markets in which low interest rates are the norm, CUs have had difficulty identifying investments that generate sufficiently high revenues.

- The market for CUs has decreased as a result of penetration by the big banks into the financial market, which had previously been enjoyed exclusively by mutual financial organizations like CUs.
- Excessive governmental regulations have de-motivated the business activities of many CUs.
- Korean CUs are never free from household debt, which is considered potentially explosive in the Korean economy.

5.2.2. Revision of governance

The cooperative governance of primary CUs and NACUFOK needs improvement. In primary CUs, management functions are concentrated in the Board of Directors and the President; however, the system would benefit from decentralization so that only direction or supervision of CUs is undertaken by the Board and the President, leaving routine management to professional managers. Furthermore, the controlling function of NACUFOK should be separated and strengthened further.

5.2.3. Rapidly clearing out the problematic credit unions

Potentially problematic credit unions should be removed quickly from the system. Autonomous mergers with healthier CUs should be recommended prior to bankruptcy. To accomplish this goal, expansion of the Merger Fund of NACUFOK is needed (Kim, 2010).

5.2.4. Enhancement of the competencies of managers and employees

Insolvency in many CUs can be directly attributable to the poor performance of their managers and employees. Thus, managerial and technical competencies need to be developed to contribute to the continuous growth of the CU system.

5.2.5 Active development of core youth members

The existing membership of CUs is aging. Core youth members, under 30 years old, who are highly committed to their CUs must be actively encouraged for the future, especially in the urban sector.

5.2.6. Strengthening the ownership of members

Community-based financial cooperatives must be close to their members both physically and psychologically. Various kinds of efforts should be made to strengthen and foster a sense of ownership and attachment to CUs.

6. Conclusion

We investigated how Korean CUs were established, developed, and achieved remarkable results. The present features of Korean CUs were also analyzed, as were the problems they experienced and the many challenges they face going forward. In this study, we demonstrated how Korean CUs have contributed to the wellbeing of economically strapped and socially underprivileged Koreans, as well as to regional community development and the democratization of Korean society. In fact, the Korean CU movement has been an overlooked factor in the Korean miracle and an unacknowledged contributor to the development of Korean society. However, Korean CUs now face a dilemma with respect to their core identity as financial cooperatives.

Pioneers of the Korean CU movement were focused on improving the situation of poor farmers and economically weak urban dwellers. They were mostly idealists, with dreams of building a society in which all members could grow strong together, but they were sometimes limited in their ability to develop their unions into financially sound and competitive institutions.

Other aspects of CUs have been greatly emphasized since the late 1990s, when the restructuring of CUs began in earnest. Many CUs became more conscious of the importance of profitability to their survival. Profit became a

top management priority, despite the fact that the original spirit of CUs was to serve people, not profit. As such, the identity of CUs as economic institutions was emphasized over their role as an instrument of social development.

Much controversy remains over how CUs should be conceived. This economic institution vs. social development instrument debate is at the core of the present identity crisis in the Korean CU movement. However, we firmly believe that this identity crisis is a natural and healthy phenomenon, because the balancing of profitability and social development is a perennial problem facing CUs. We believe that this identity crisis is needed for the process of growth and will enable further development of Korean CUs. Despite identity issues, Korean CUs remain vitally important to the economically strapped and socially underprivileged sectors of both urban and rural populations in Korea.

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