Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Long Term Lending

Guidance for Credit Unions

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1. Introduction

The Central Bank is supportive of credit unions prudently engaging in Long Term Lending (LTL) as part of a balanced loan portfolio. This document sets out the Central Bank's guidance, including its expectations, which credit union boards seeking to develop their business models are expected to consider and address in assessing LTL products and services.

As certain types of LTL present different risk and profitability profiles, a credit union's assessment need to reflect and understand these risks and ensure coherence with the credit union's own strategic plan, risk appetite and capabilities.

Decisions to proceed with investment in new services and / or expansion into new ventures requires critical assessment of the costs and benefits as they apply to the credit union and its individual situation in terms of membership profile, common bond, and operational and financial capacities.

For credit union boards seeking to apply for higher LTL limits provided for by the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (S.I. No. 1 of 2016), the required business plan is expected to be informed by the risk considerations set out in this document. This guidance does not seek to address all aspects of risk inherent in LTL but rather focuses on those areas that the Central Bank deems most pertinent at this time. In terms of our supervisory expectations, we would expect evidence of a structured risk assessment of any potential new business line or product in this area.

The paper is not a replacement for and does not supersede any legislation, regulations, guidelines or standards that credit unions are required to comply with as part of their regulatory obligations, particularly in the areas of risk management, internal controls and corporate governance. Credit unions must at all times refer directly to the relevant legislation, regulation, guidelines and standards to ascertain their statutory obligations and to ensure they are taking appropriate steps to mitigate underlying risks. Key regulatory requirements are referred to in this guidance further below.

In particular, the fundamental requirements imposed on credit unions under sections 35 to 38 of the Credit Union Act 1997 with regard to lending are highlighted, as well as the overarching governance requirements imposed on credit unions under sections 76A to 76K. For instance, under s. 76B, a credit union is required to have a risk management system with governance arrangements and systems and controls to allow it to identify, assess, measure, monitor, report and manage the risks which it is, or might reasonably be, exposed to. Systems and controls must be in place to manage and mitigate the risks identified by the risk management system, and a compliance programme is required to evaluate compliance with all legal and regulatory requirements.

Executive Summary

Traditionally credit unions have focussed on 0-5 year lending to Irish households, and to a lesser extent small businesses and their owners. Credit union lending accounts for approximately 34% of all household credit in Ireland in the 0-5 year category[1]. Close to 86% of all outstanding credit union lending is in this category[2].

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[1] https://www.centralbank.ie/statistics/data-and-analysis/credit-and-banking-statistics/private-household-credit-and-deposits

[2] CBI: Prudential Returns June 2017

Short term lending has certain risk characteristics which most credit unions have developed risk management capacities and capabilities to manage. However, longer term lending has different dynamics. If credit unions are to seek to extend the maturity profile of their lending, there are a range of important considerations that need to be considered and addressed.

This paper sets out the Central Bank's guidance, including its expectations, in respect of assessing these risks. It distinguishes between LTL and mortgages, as a regulated product, within that category of lending. In outlining the principal risk considerations, a risk-based approach needs to be used to expand upon and quantify the challenges to be addressed.

Mortgage lending in particular is a high volume, low margin business activity. A credit union board's assessment of LTL is expected to realistically reflect sectoral factors that may inhibit achievement of necessary economies of scale, including: balance sheet size, common bond constraints, membership profile and related funding considerations.

Moving beyond traditional short term lending represents a step-change for any individual credit union. A movement into a higher proportion of LTL requires appreciation of the associated risks. Credit unions need to illustrate their understanding of the risks and their capacity to manage such risks as they expand their portfolio of LTL.

The role of outsourcing and shared services in supporting new product and business line development, has been a feature of business model development in other jurisdictions and may warrant consideration. In assessing whether to participate in such shared services initiatives, credit unions are expected to consider their individual business model and common bond constraints. Their risk-based assessment should address the ability of the shared services arrangement to deliver desired benefits and value.

The Central Bank's high-level expectations regarding a credit union's appreciation of the key risks, and demonstration of risk understanding and mitigation proposals, are set out in this guidance. All of the guidance in this document requires preparedness for, and demonstration of compliance with, all relevant legislative requirements. Key legislative requirements are referred to in this guidance further below.

Structure

The paper is structured as follows:

- **Section 2** defines LTL and Home Mortgages;
- **Section 3** lists the key risk factors requiring consideration when expanding LTL business, and elaborates further on these. The financial implications and the impact on Return on Assets (ROA) in particular, are referred to and illustrated in detail. For mortgages, a regulated product, there are particular factors requiring consideration in the regulatory / compliance area, which are listed;
- **Section 4** lists a number of factors credit unions need to consider when preparing a business case for increased LTL, recommending a "risk-focused" framework approach;
- **Section 5** concludes with a summary of the elevated risks associated with expanded levels of LTL and mortgages. Supervisory expectations of credit union boards are outlined.

2. Definitions: Long Term Lending & Home Mortgages

Long Term Lending (LTL)

For the purposes of this paper, LTL refers to lending with a maturity greater than five years. This incorporates a wide range of loan purposes and related maturities, from five to twenty-five years in term. LTL in the five to ten-year maturity category has a cross-sectoral risk profile including personal, SME and Agricultural borrowers. Loans may or may not be secured by a charge over property (residential – owner / occupier or non-owner / occupier, land, and / or shares / deposits).

Lending in the five to ten-year maturity category accounts for 11% of all credit union lending. The greater than ten-year category accounts for 3% of all credit union lending. Whilst the overall percentage is low as a proportion of total lending, growth rates are indicative of an increasing trend in longer maturity lending.[3]

A small number of credit unions account for a high proportion of '> ten-year maturity' loans, with 31 credit unions accounting for 63% of the total outstanding. A large number of credit unions have no material '> ten-year maturity' loans at present. Appendix 1 provides more detail of the current sector profile. It is important that credit unions adopt a structured risk-based assessment as longer maturity lending becomes a more material proportion of their total lending, or if they are considering expanding their lending risk appetite to advance more LTL.

Home Mortgages

Under the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 a credit union is restricted to making the prescribed categories of loans including '**house loans'.** Lending is subject to maturity limits and other requirements set out in the regulations[4].

Under the regulations, a 'house loan' is defined as "a loan made to a member secured by property for the purpose of enabling the member to:
(a) have a house constructed on the property as their principal residence;
(b) improve or renovate a house on the property that is already used as their principal residence;
(c) buy a house that is already constructed on the property for use as their principal residence, or;
(d) refinance a loan previously provided for one of the purposes specified in (a), (b), or (c) for the same purpose"[5].

Regulation 15 is specific – "Requirement for House Loans" – A credit union shall only grant a house loan where it holds the first legal charge on the property in respect of which the loan is to be provided.

Mortgage lending also attracts a range of other regulatory requirements. For instance, the Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Housing Loan Requirements) Regulations 2015 (S.I. No. 47 of 2015), introduced in 2015 and revised in

[3] CBI: Prudential Returns June 2017. Five to ten-year gross lending outstanding €491m, a 25% increase in the year to June 2017. Greater than ten-year gross lending outstanding €135m, a 44% increase in the year to June 2017. Credit union total gross lending outstanding grew by 8% in the year to June 2017.
[4] Part 4.
[5] Regulation 2(1).

2016 and again in 2017, applies to all regulated financial service providers that provide in-scope housing loans to consumer borrowers. Section 3 (g) of this document - "Regulatory / Compliance Risk" - provides a more comprehensive listing of relevant regulatory requirements in place at the time of the publication of this guidance. Nonetheless, it is incumbent on credit union boards to ensure that all relevant regulatory requirements are identified, understood and complied with.

3. Risk Considerations

This section covers the main risk factors associated with LTL. Mortgages, as a distinct LTL product, present a particular challenge and additional factors need to be considered. Individual credit unions, by virtue of their structure and unique common bond characteristics, will also have those particular factors to assess and consider.

The following is not an exhaustive listing and other risk considerations may emerge for assessment that had not previously been identified or deemed material.

The principal risk considerations referred to in this section are:

(a) Financial Risk;
(b) Credit Risk;
(c) Funding & Liquidity Risk.

Other risks referred to include:

(d) Market Risk;
(e) Governance & Management Risk;
(f) Operational & Conduct Risk;
(g) Regulatory and Compliance Risk.

(a) Financial Risk

Financial Risks – LTL

Expanding LTL carries specific risks to the risk profile of a credit union. If the forecast revenues fail to materialise to the extent anticipated, and / or the associated costs are higher than anticipated, it will be detrimental to the overall financial position of the credit union and its members. It is essential, therefore, that revenue and cost models are comprehensive and realistic.

Revenue Forecasting:

- As there may be a lower gross margin on LTL (compared to short term unsecured lending), assumptions regarding margin need to be checked for reasonableness, as they are key to generating a positive return over time;
- Pricing should reflect return, payback / ROA expectations, pricing for risk and maturity on a secured / non-secured basis. Discipline and consistency are essential in pricing LTL, in view of extended revenue maturities and higher individual loan amounts;
- Credit unions should be in a position to discuss constraints that may limit their capacity and flexibility in pricing. These may restrict credit unions in generating an economic return from the LTL over time, and should be considered in the approach to pricing at the outset.

Costs:

- **Acquisition costs** – specific to LTL
  - Costs at individual credit union level include – recruitment of specialist staff and / or training existing staff, the ongoing service costs unique to LTL. A credit union will need to distinguish between costs incurred in existing core lending activity and incremental costs incurred to acquire new LTL. As specific skill-sets for identified target markets (e.g. SME, Agricultural) are essential, careful consideration is needed in developing the lending skills and capabilities required to prudently expand lending to chosen sectors.

Conservative estimates should be used. Skilling-up or re-training of existing staff may be appropriate. However, the impact on existing core business should be considered, as diversion of effort, resources / skills may adversely affect core lending activity (short term, higher gross margin).

Financial Risks – Mortgages

The financial risks attaching to mortgage lending are quite considerable if scale is not achievable, which may be the case in credit unions with narrowly-based common bond limitations. The level of investment required to operate in a highly regulated market for high value, low margin business, amplifies the financial risks. Failure to consider the nature and scale of the constituent elements will expose credit unions to long-term adverse financial consequences.

Credit unions should give careful consideration to the following:

- **Mortgages – target market(s), sizing, activity planning**
  - Number / volume of mortgages required to justify investment in supporting systems, processes and skills (internal and / or sharing services).
  - Minimum requirements in applications / volumes to deliver the requisite pipeline for conversion to drawdowns by target segment(s).
  - Assumptions regarding approvals / declines, loss of business in pipeline, management of "exceptions" limits (per Central Bank (Supervision and

Enforcement) Act 2013 (Section 48) (Housing Loan Requirements) Regulations 2015 (S.I. No. 47 of 2015 – revised in 2016 and 2017)).
- Implications for revenue of failure to achieve volumes, costs associated with aborted / declined applications, or loss of business post-approval / pre-drawdown ("reflection period").
- Management of the "pipeline" – applications, approvals, contracts, committed funds / new business drawdowns, redemptions, appeals, re-submissions, lapsed approvals

- **Revenue model for mortgages:**
  - With lower gross margin on mortgage lending (compared to short term unsecured lending), the achievable margin is in part determined by the external market (competition and transparency will be influential), where assumptions regarding margin are central to generating positive return.
  - Overall, a credit union's margin on lending will contract as mortgage volumes increase as a proportion of total lending. Therefore, longer term modelling (five-year minimum) is appropriate to forecast the ROA impact from a changing profile of the total lending book. The pace of ROA contraction may accelerate due to the pace of growth in mortgage lending combined with lower margin.
  - Pricing policy should establish where the credit union intends to position itself in pricing to lend. It should address economic return and payback / ROA expectations, using realistic assumptions and expectations. Credit unions need to determine their pricing independently, based on their own cost profile, risk appetite and return expectations.
  - Financial consequences of inappropriate pricing are long term and may be to the detriment of the wider membership. Therefore, discipline in pricing is essential.
  - Credit unions should consider the impact of pricing constraints that may exist due to common bond and any other regulatory requirements. This may limit the capacity to consider certain approaches to pricing, both immediate and over the extended timeframe. Managing LTL products to generate an economic return is an integral element of mortgage lending.

- **Cost Model for mortgages:**
  - Lending costs include;
    - (a) Shared services costs – participation based on entry cost (fixed) and per case costs, non-recoverable costs (declines, not-proceeding approvals, professional fees incurred), if participating in a "shared services" solution, this is likely to entail additional costs. Whilst there will be some duplication in workload, in particular at early stage, reducing this is essential to yield one of the benefits of sharing services.
    - (b) Costs at individual credit union – recruitment of qualified (QFA / APA) or training existing staff, costs are front-loaded at loan origination (elongated process, non-recoverable element in event of declines / customer losses) and ongoing service costs. It is important that credit unions have a clear understanding of their own cost structure as this is an important component in setting an economic price.
  - Marketing costs – Mortgage lending is a competitive market. Credit unions should calculate direct and indirect marketing costs and reflect these in product pricing. Whilst credit unions may benefit from combining resources, localised marketing (e.g. digital, direct channels) requires individual credit union investment.
  - Retention costs – competitors typically target attractive segments (e.g. lower LTV, trader-up, re-mortgage, equity release) through use of incentives (e.g. cashback, discounted rates, payment of legal fees). Retention, at a time in the future, may incur unanticipated costs. Engaging in such practices requires discipline and appreciation of financial impact. Credit unions may have limited

  capacity to engage in such activity, restricting their ability to manage margin and return over the extended timeframe.
  - Compliance costs – legislative requirements applicable to mortgages in particular are demanding and credit unions need to reflect this in their costings and in their pricing of mortgages.

  These costs will differ by credit union. Unrealistic assumptions may result in commitments that are uneconomic and an extended drain on credit union resources and member value.

- **Reserves / capital** considerations include;
  - Recognition of the impact on Income & Expenditure. Credit unions should recognise and have a demonstrable financial capacity to absorb early stage "drag" on ROA and consequences for reserves.
  - Lending sufficient volumes to justify investment and achieve economies through shared services (scale, expertise) requires time and commitment on part of participants. An appreciation of the upfront investment to realise future positive returns should be reflected in strategic planning and related business planning and performance management.

  Specifically, there is a need to analyse and reflect in decision-making and planning how mortgage lending impacts on Income and Expenditure, Balance Sheet and Return on Assets.

Forecasting Financial Implications

A number of examples are illustrated in Appendix 2: "Forecasting Financial Implications – Examples".

These look at a series of financial outcomes (in particular ROA) over time as a result of mortgage lending, and highlight the impact of pricing and other expenses in the short and longer term.

Credit unions will be aware of their own unique circumstances and need to assess whether the impact of mortgage lending will enhance or diminish their overall financial position, as measured by ROA.

Key matters for individual credit unions to consider include, inter alia:
- The capacity to absorb early stage losses associated with mortgage lending – pricing and other costs will determine how long it takes to recover costs and make a positive contribution;
- The ROA impact in the short and medium term from a portfolio of mortgages and the impact on the credit union ROA as a result;
- The scale and extent of associated risks and implications for the overall membership.

(b) Credit Risk

Credit risk should be considered at individual credit union, common bond, regional and national levels. As LTL will extend across personal, small business and agricultural sectors and comprise higher value loans, credit unions need to consider sectoral issues. Furthermore, concentration in particular sectors can increase the overall level of risk.

Mortgages are higher value loans and cumulatively can assume material volume – elevated risk exists as a result. For many credit unions, by virtue of their common bond, the matter of geographic or sectoral concentration should be considered and reflected in the risk policy.

A credit union's **Risk Appetite Statement (RAS)** is expected to specify appropriate parameters and limits and be consistent with its existing risk appetite. Any variation or re-stating of risk appetite necessitated by virtue of expanding LTL requires consideration of the impact on core lending business. A credit union should anticipate the consequences of any change in its RAS and whether this represents an acceptable change in risk appetite. Board approval and a periodic review mechanism is expected (annual approval and reviewed at least semi-annually to consider continued applicability).

Expanding mortgage lending requires common bond issues to be considered. Credit unions should consider whether mortgages represent an appropriate member value strategy, in view of the natural limitation in terms of members directly accessing the particular product. This in turn informs the following matters:

- **Credit policy**, the core values and principles governing the provision of loans should be aligned with the credit union's RAS, applicable credit limits and the markets in which the credit union operates. Board approval and regular review is expected. Regarding mortgages in particular, credit unions need to consider the approach to be taken to matters such as default / arrears (including foreclosure and / or repossession), multi-product holding members (secured versus unsecured facilities) and the treatment of same. Policy, procedures and processes should be designed and implemented prior to embarking upon material mortgage lending – demonstration of alignment with regulatory obligations and consumer protection measures is also necessary, as failure to embed and operate according to such measures heightens credit risk considerably and may result in regulatory sanctions;

- **Credit approval** criteria should include a clear indication of the credit union's target market(s) and specify this by sector(s), including maturity profiling of projected loan drawdowns. Standards of credit assessment should be documented and be consistent with risk appetite. For mortgages in particular, credit unions will have to manage within capacity constraints – a clear statement of how it intends to manage matters such as prioritisation and ensuring they remain within limits is expected;

- **Loan loss provisioning** – a credit union should have effective LTL credit risk management processes, commencing at origination, subject to review periodically through term and in event of arrears and loan default. Increasing volume of higher value, longer maturity loans, elevates the requirement for a more considered methodology, as inaccuracies could result in irregular or unreliable provisions. For most credit unions, mortgages are a new product category and an appropriate provisioning methodology should be adopted, embedded and be consistent and transparent;

- **Measurement of Credit Risk** – a credit union should quantify the level of credit risk exposure by virtue of growth along particular product lines and maturities. Different types of lending carry different levels of credit risk and it is essential that this is reflected in the price charged to the member. The primary measures are:
  - **Probability of default ("PD")** – likelihood that a borrower will default on their obligations.
  - **Exposure at default ("EAD") –** exposure to a borrower at the point of default.
  - Loss given default ("LGD") – the loss associated with a defaulted loan / borrower.
  - **Expected loss ("EL")** – the loss that can be incurred as a result of lending to a borrower who may default. It is the average expected loss in value over a specified period and is calculated by **EL = PD x EAD x LGD.**

  The capability to calculate EL under different economic scenarios becomes increasingly important as LTL and mortgages become material in volume and proportionate to other lending. Pricing for risk is an established methodology that embraces differing measures of credit risk.

  For many credit unions, the above measures will represent a level of detail not previously encountered. Thus credit unions considering expanding LTL and mortgages in particular will be expected to demonstrate an appreciation of credit risk measures, the relevance to their lending business and appropriate credit risk management controls in place prior to engaging in any material expansion in LTL;

- **Credit risk reporting** – a credit union should reflect LTL book growth, maturity profile and quality, in its reporting and management systems. It is expected that a credit union's Credit Risk Framework will set out how it identifies, assesses, approves, monitors, reports and controls LTL credit risk. Expanding LTL and / or mortgage lending requires particular attention to detail in view of higher loan value and longer maturity profile.

(c) Funding & Liquidity Risk

Credit unions are expected to demonstrate an appreciation of liquidity and funding implications arising from an increase in LTL lending, and to identify and mitigate the associated risks.

Credit unions sole funding source are members' shares and deposits, typically on-demand. Funding stability is the necessary counterpart to LTL and investment activity, to ensure liquidity risks are being managed appropriately. Consideration needs to be given to the interplay between a move to greater LTL (and mortgage in particular) and longer maturity investments, which would exacerbate the existing mismatch between the maturity profile of the credit unions' funding and assets[6]. Consideration needs to be afforded to this aspect of balance sheet transformation and the associated need to address funding profiles when expanding lending and investment durations.

While funding and related Asset Liability Management (ALM) considerations need to be addressed by all credit unions, the impact can vary between credit unions. It is expected credit unions will have completed an analysis of their membership profile to appropriately profile funding, identify any concentrations and understand the impact, for example, inter-generational change can have on the credit union's funding.

Minimum Liquidity Requirements (MLR) are currently set for credit unions according to the maturity of their lending portfolio, with a 20% minimum requirement for all credit unions. Those with over 20% of their lending with maturity greater than five years require additional liquidity to at least 30% MLR.

A credit union proposing to grow its LTL business, should consider:

- The maturity mismatch impact of LTL, which may be considerable, and ALM should be fully considered at the outset. Lengthening the maturity of lending and mortgages in particular over an extended timeframe introduces further complexity;
- Individual credit union profiles require modelling, unique to specific circumstances and specific planning is required to manage this, as longer term impact on balance sheet increases. Growth in mortgages (drawn and approved) could result in liquidity constraints and / or limit breaches unless actively managed.

Appropriate plans to mitigate heightened risk should be developed prior to embarking on expansion. Implementation should be concurrent and consistent with balanced growth in related business lines.

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[6] http://www.centralbank.ie/publication/consultation-papers/consultation-paper-detail/cp109-consultation-on-potential-changes-to-the-investment-framework-for-credit-unions. Section 4 Potential Additional Investment Classes

(d) Market Risk

Market risk concerns the risk of loss arising from movements in interest rates, which arises from balance sheet structure, business mix and discretionary risk-taking. Credit unions need to consider the implications of changes in interest rates.

For mortgages in particular, a higher rate environment may impact in a number of ways:

- It may dampen demand as affordability declines. Credit unions with established internal structures and contractual obligations (e.g. Shared Services) should consider implications of a reduction in demand and the impact of a decline in activity;
- It may raise affordability issues for existing mortgage customers. Arrears, default and restructuring presents specific challenges and requirements in the area of compliance and provisioning.

A specific risk to assess in this regard concerns fixed rate loans, as an increase in interest rates cannot be passed onto borrowers – a particular concern would be if a credit union has advanced or proposes to offer fixed rate mortgages over extended timeframes. At present almost 50 per cent of new Principal Dwelling House mortgages being drawn in Ireland are fixed rate.[7] Assessment of the interest rate risk is essential, as risk mitigation measures available to other providers such as interest rate swap products or other hedging techniques are not available to credit unions.

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[7] http://www.centralbank.ie/docs/default-source/publications/household-credit-market-report/household-credit-market-report-2017h2.pdf?sfvrsn=4

(e) Governance & Management Risk

This arises where a credit union board and management fail to appreciate fully or underestimate the unique and complex characteristics associated with LTL and mortgages.

- Credit union management and boards expanding LTL activity are expected to have reflected on this guidance, and demonstrate an appreciation for LTL risk and associated risk oversight, management competencies and risk management policies, processes and systems. It is also expected that strategy formulation and business planning will incorporate feasible and reasonable consideration of the risks associated with LTL.

For mortgages in particular, credit union boards and management will be expected to demonstrate an understanding and appreciation of:

- Product oversight and governance in the area of mortgages, subject to EBA Guidelines[8];
- If a commitment is made to collaborate in the development and operation of shared services, contractual implications should be considered and quantified. Contractual obligations present particular risk if business flows are below expectations, or cost savings do not accrue from sharing of services, as this increases the cost of lending. Duplication of tasks and failure to achieve cost efficiencies results in higher acquisition and maintenance costs, with implications for the credit union's cost / income ratio and by extension ROA.

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[8] EBA: "Guidelines on product oversight and governance arrangements for retail banking products" EBA/GL/2015/18 15.07.2015

(f) Operational / Conduct Risk

This relates to the risk of loss resulting from inadequate or failed internal processes, people and systems.

As LTL extends across personal, small business and agricultural sectors, and may be unsecured or secured, effective operational risk oversight and management processes are required. Failure to implement internal compliance controls and / or achieve requisite standards exposes credit unions to heightened credit, financial, legal, compliance and reputational risks.

It is expected that LTL operational risks are assessed, specifically documented and managed within the credit union's operational risk management systems.

For mortgage lending, the level of operational risk is material and elevated. Operational risks should be assessed, arising from the following:

- The complex process associated with mortgage lending incorporates multi-party involvement from origination to fulfilment (e.g. valuation, perfection of security, life and property insurance cover), numerous hand-offs and sign-offs, some parts possibly outsourced to shared services facility. The risk of fraud in view of individually large transactions exists, and appropriate measures to mitigate same should be in place;
- Product features require accommodation on credit union IT platform(s) to accommodate any features proposed or developed at individual credit union or specified in borrower contracts;
- Processes regarding matters such as mortgage redemption require standardised procedures to ensure credit union and borrower rights and obligations are recognised;
- Product design principles at individual credit union or at sectoral level carry the risk of design fault if inconsistent feature design principles are applied. Business conduct principles require lenders to ensure that staff have the necessary knowledge on loan agreements and act honestly and transparently in the member's interests;
- Conduct risk arises where staff conduct business in an inappropriate manner that leads to adverse customer outcomes. Inadequate or failed customer-facing or internal processes heighten this risk.

Compliance is mandatory regardless of the scale of mortgage business undertaken. Failure to achieve the requisite standards exposes credit unions to heightened financial, compliance and reputation risk.

(g) Regulatory / Compliance Risk

Regulatory / compliance risk is defined as the risk of regulatory sanctions, material financial loss or loss to reputation which may arise as a result of failure to comply with applicable laws, rules, regulations, standards and codes of conduct.

For mortgages, a regulated product, risks are quite material:
- As regulatory requirements are specific and rigid in interpretation, there is an enhanced risk from failure to adhere;
- Expectations of mortgage providers reflect the complexity of the product and the potential for elevated credit risk. Credit unions engaging in mortgage lending need to reflect this in their compliance programmes.

The following is the key legislation and regulations applying to regulated entities providing mortgages (as of December 2017). It is the responsibility of the credit union board to ensure compliance with applicable legislation at all times:

- **European Union (Consumer Mortgage Credit Agreements) Regulations 2016 (S.I. No. 142/2016) (effective March 2016)**
  - Requires mortgage lenders to ensure their prospective customers benefit from only the highest levels of protection.
  - Customers must receive the prescribed European Standard Information Sheet ("ESIS"[9]) – includes information such as:
    - An explanation and outline of the 'reflection' period – within which time they may compare offers, assess offer implications, obtain third party advice (if necessary), and make an informed decision on whether to accept an offer. The reflection period must be of a minimum 30-day duration;
    - The Annual Percentage Rate of Charge ("APRC") – which replaces the historical APR calculation;
    - An additional illustrative APRC, where the interest rate is variable;
    - Confirmation regarding the status of advisory services.

- **The Minimum Competency Code 2017 (MCC)[10] (see also the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) Minimum Competency Regulations 2017 (S.I. No. 391/2017)[11]) (not currently applicable to credit unions but nonetheless considered sound practice and realistic minimum expectation of credit unions - effective January 2018)**
  - Prescribes minimum professional standards for relevant persons providing in-scope financial services, in particular when dealing with consumers.
  - Aims to ensure that consumers obtain a minimum acceptable level of competence from individuals acting for and on behalf of regulated firms in the provision of advice and associated activities in connection with retail financial products.
  - Applies to regulated firms and persons carrying out controlled functions within those firms who:
    - Provide advice to consumers on retail financial products,
    - Arrange or offer to arrange retail financial products for consumers, including any amendments to insurance cover and the restructuring or rescheduling of loans, or
    - Undertake a specified function.

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[9] Regulation 15 and Schedule 2.
[10] Applies to persons exercising 'controlled functions' on a professional basis.
[11] Imposes requirements on regulated firms to ensure that a person subject to the Minimum Competency Code, acting on their behalf complies with the standards set out in the MCC.

- **EBA Guidelines on Creditworthiness Assessment 2015**[12] **(effective March 2016)**
  - Prescribes requirements relating to a creditor's assessment of a consumer's creditworthiness before concluding relevant credit agreements for immovable residential properties.
  - Ensures consumers are protected consistently across the European Union when interacting with creditors.
  - Establishes requirements for verifying consumers' income, documenting and retaining information, identifying and preventing misrepresented information, assessing consumers' ability to meet their obligations under the credit agreement, considering allowances for consumers' committed and other non-discretionary expenditures, as well as allowances for potential future negative scenarios.

- **EBA Guidelines on Arrears and Foreclosure 2015**[13] **(effective March 2016)**
  - Ensures consumers are protected consistently across the European Union when interacting with creditors.
  - Establishes requirements in terms of policies and procedures for the early detection and handling of payment difficulties including staff training, engagement with consumers, provision of information and assistance to consumers, resolution process and documentation of dealings with consumers and retention of records.

- **Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Housing Loan Requirements) Regulations (S.I. No. 47 of 2015) (as amended)**
  - Regulations for lenders of housing loans secured on residential property in the State, imposing Loan to Value ("LTV") and Loan to Income ("LTI") ratios.

- **Consumer Protection Code 2012 (not currently applicable to credit unions (unless acting as intermediaries) but nonetheless considered sound practice and realistic minimum expectation of credit unions offering mortgages)**
  - Sets out the requirements that regulated firms must comply with when dealing with consumers in order to ensure a similar level of protection for consumers, regardless of the type of financial services provider.

- **Code of Conduct on Mortgage Arrears (CCMA) 2013 (not currently applicable to credit unions but nonetheless considered sound practice and realistic minimum expectation of credit unions offering mortgages)**
  - Sets out the framework that lenders must use when dealing with borrowers in mortgage arrears or in pre-arrears.
  - Requires lenders to handle all such cases sympathetically and positively, with the objective at all times of helping people to meet their mortgage obligations.
  - Lenders must operate a Mortgage Arrears Resolution Process ("MARP") when dealing with arrears and pre-arrears borrowers.

- **EBA Guidelines on Product Oversight and Governance Arrangements for Retail Banking Products 2015**[14] **(effective January 2017)**
  - Details Guidelines on product oversight and governance arrangements for the retail banking products that fall into its consumer protection remit, which are: mortgages, personal loans, deposits, payment accounts, payment services, and electronic money;
  - Guidelines provide a framework for robust and responsible product design and distribution by manufacturers and distributors;

[12] EBA/GL/2015/11
[13] EBA/GL/2015/12
[14] EBA/GL/2015/18

- Requirements for manufacturers with regard to their internal control functions, the identification of the target market, product testing, disclosure, product monitoring, remedial actions, and distribution channels;
- Requirements for distributors related to the distributor's governance, the identification and knowledge of the target market, and information requirements.

It is the responsibility of regulated entities to satisfy themselves that they fully conform with all applicable legislative and regulatory requirements. Responsibility rests with the credit union board in these matters.

4. Application Process – Increase in Lending Maturity Limits

The Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (S.I. No. 1 of 2016) prescribe limits on LTL (> 5 year, subject to limit of 30 per cent of the total gross loan book balance outstanding in relation to all loans made by the credit union; >10 year, subject to a limit of 10 per cent on the same basis. This increases to 40% and 15% respectively with Central Bank approval). Applying for an increase in these limits requires credit unions to submit an "**Increase in Lending Maturity Limits Application Form (longer term lending limits)**",[15] incorporating:

- A detailed business case
- Annual arrears information to support application
- Board Approval

It is expected that a business case prepared by a credit union will be consistent with this guidance. The Central Bank expects credit unions to illustrate an appreciation of the principal risks in expanding LTL, and mortgages in particular. The business case should reflect this appreciation and the mitigation measures proposed to manage such risks. Qualitative considerations include assessment of governance and risk management evidenced through PRISM.

In considering whether to expand the proportion of LTL to be advanced, credit unions should assess the following:

(a) Is there a demand for LTL, and mortgages in particular, from the members? If so, how is this being expressed, and what are members' expectations regarding how their credit union can fulfil this?
(b) Does the credit union have the capability to deliver and manage increased volumes of LTL, and mortgages in particular, a highly regulated product?
(c) Can LTL / mortgages make a positive financial contribution to the credit union?
(d) What is the impact likely to be over the medium to longer term for the credit union and the overall membership?
(e) Is the business case for this particular product consistent with the credit union's Business Model, and reflected in the Strategic Plan?

In preparing a business case, it is essential that credit unions consider the full range of implications. From a supervisory perspective, a risk-based framework is appropriate for assessment. This paper lists the principal risk considerations, with further elaboration as appropriate under particular headings. It also outlines the supervisory expectations relating to mortgages in particular, as a regulated product.

[15] https://www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/credit-unions/applying-for-approvals/long-term-lending-application-form.pdf?sfvrsn=3%20

5. Conclusion

The credit union lending model has traditionally been short term (less than five years). As credit union boards consider further increasing LTL and expanding or commencing mortgage lending it is important that they identify the risk factors specific to LTL and also those unique to mortgages. Credit union boards should appreciate and incorporate these in their strategic planning, business execution, governance and management systems and policies and processes.

Increasingly, it is expected that credit unions will proceed with product opportunities that can demonstrably add to earnings, if not immediately, over a reasonable timeframe. Failure to achieve an economic contribution will diminish the credit union's overall ROA, and ultimately be of detriment to members.

Credit union boards considering expanding their mortgage business in particular will be expected to demonstrate a strong appreciation of:

- Product pricing and cost of funds, including the real cost of funding that will apply over the life of the new lending product(s);
- The estimated developmental and operational costs that will be incurred in support of the new products, both in-house and also if taking a collaborative approach to sharing services;
- Clear understanding of their own cost structure and the specific impact of scaling up to write mortgages;
- Expected impact on profitability of new mortgage products, both short term and over extended timeframes;
- The cumulative effect of new business acquisition, taking account of any product incentives, both short term and into the future;
- The regulatory burden regarding mortgages in particular; and
- The impact on members at individual credit union level.

Credit unions proposing to expand their LTL are expected to demonstrate an appreciation of risk considerations in their planning and operating processes. Mortgages, as a highly regulated product present additional risks for credit unions, regardless of the scale of involvement. Whilst it is not exhaustive, this paper stresses the requirement for robust business planning using a risk-based framework.

It is expected that credit unions boards and management will consider all the risks to which they will be exposed. It is their responsibility to ensure that they can demonstrate they understand the financial and other risks and to have the appropriate systems and processes in place to manage and control those risks, prior to undertaking such business.

Appendix 1: Long Term Lending – Credit Union Participation

A small number of credit unions account for a high proportion of sector lending with a maturity greater than ten years. A large number of credit unions have minimal lending with time remaining to maturity greater than ten years.

The following illustrates:

- Tables 1 to 3: Credit union participation by band and by size (Total Assets). Tables and charts based on June 2017 Prudential Returns as reported by credit unions.
- Figure 1: Credit union participation, with respective profile of '> 10 Year Lending as % Total Lending', in bands from '0% to 2.5%' to '10% or greater'
- Figure 2: > 10 Year Lending profile by credit union Total Asset size
- Figure 3: > 10 Year Lending by credit unions > €100m Total Assets

Table 1 | '>10 Year' Gross Lending, as a proportion of Total Lending, by Total Asset size – number of credit unions by band

Number of Credit Unions				
% Lending Over 10 Years Band	**Over €100m Total Assets**	**€25m to €100m Total Assets**	**Under €25m Total Assets**	**Total**
Over 10%	2	1	2	**5**
7.5% to 10%	8	5	2	**15**
5% to 7.5%	5	5	1	**11**
2.5% to 5%	12	20	6	**38**
0% to 2.5%	25	94	87	**206**
Total	**52**	**125**	**98**	**275**

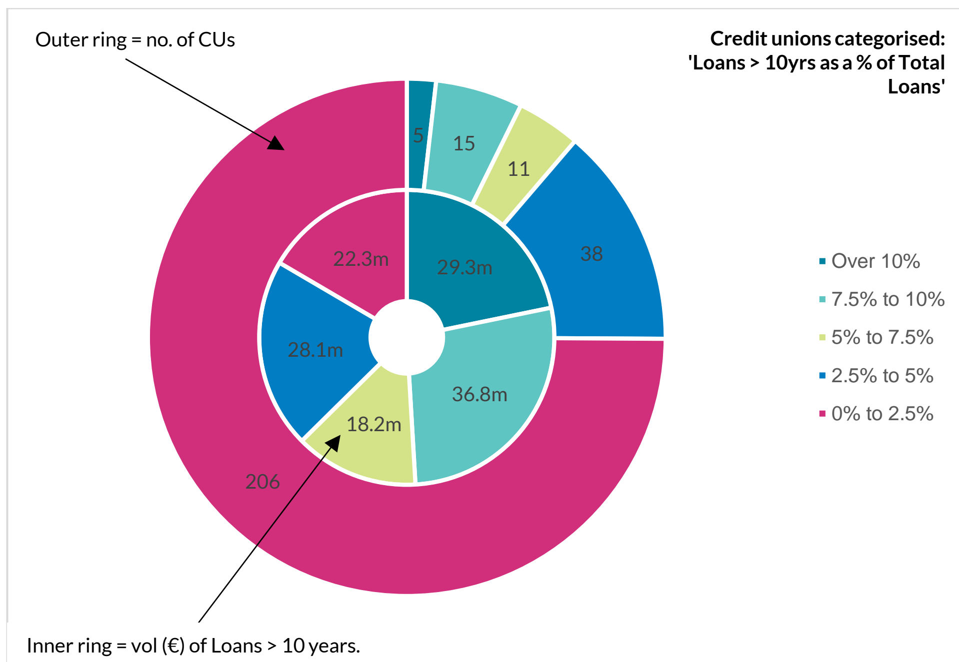
Table 2 | '>10 Year' Gross Lending, as a proportion of Total Lending, by Total Asset size – total volume by band

Total Sector Gross Loans > 10 years				
% Lending Over 10 Years Band	Over €100m Total Assets	€25m to €100m Total Assets	Under €25m Total Assets	Total
Over 10%	26.5m	1.7m	1.2m	**29.3m**
7.5% to 10%	30.3m	5.5m	0.9m	**36.8m**
5% to 7.5%	15.6m	2.4m	0.2m	**18.2m**
2.5% to 5%	18.3m	9.2m	0.6m	**28.1m**
0% to 2.5%	12.6m	8.1m	1.6m	**22.3m**
Total	**103.3m**	**26.9m**	**4.6m**	**134.7m**

Table 3 | '>10 Year' Gross Lending, as a proportion of Total Lending, by Total Asset size – percentage of total by band

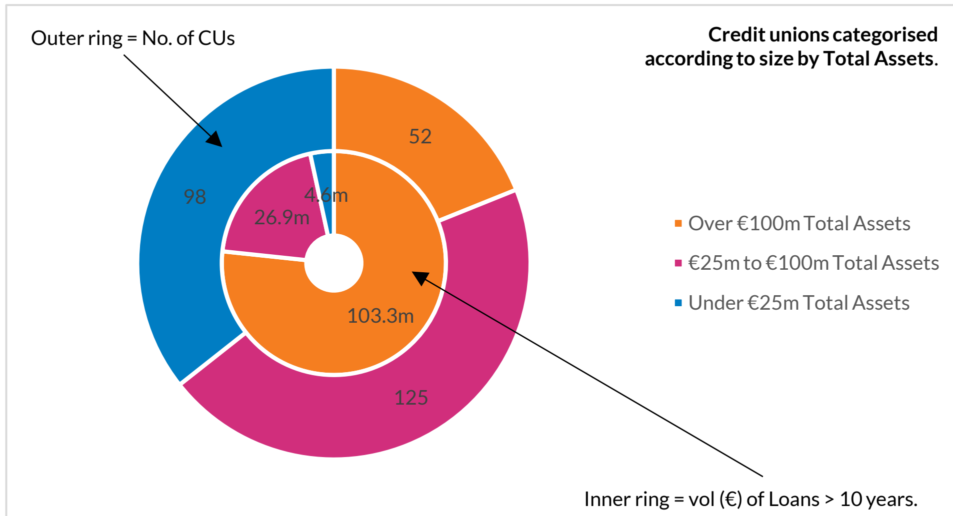
% of Total Sector Gross Loans > 10 years				
% Lending Over 10 Years Band	Over €100m Total Assets	€25m to €100m Total Assets	Under €25m Total Assets	Total
Over 10%	20%	1%	1%	**22%**
7.5% to 10%	23%	4%	1%	**27%**
5% to 7.5%	12%	2%	0%	**14%**
2.5% to 5%	14%	7%	0%	**21%**
0% to 2.5%	9%	6%	1%	**17%**
	77%	**20%**	**3%**	**100%**

Figure 1 | Credit Union Participation



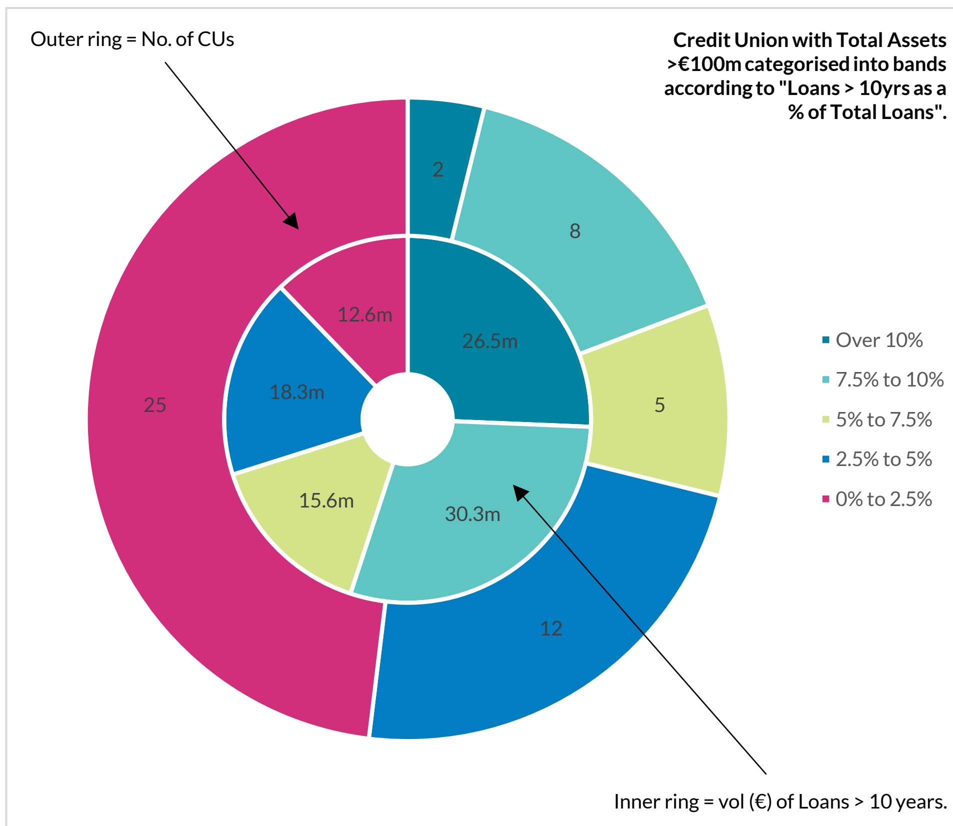
As illustrated, a small number of credit unions account for a high proportion of >10 year lending at present. The credit unions (5) which account for the highest individual exposures (over 10%), account for €29.3m, or 22% of the total. A further 15 account for €36.8m, which is 27% of the total. 206 credit unions (75% of the sector) have minimal individual exposure (0% to 2.5%), accounting for 17% of the total.

Figure 2 | Profile by Credit Union Size – Total Assets



These charts illustrate participation by credit union, as measured by Total Asset size. Larger credit unions (>€100m Total Assets - 52) account for €103.3m or 77% of all '> ten year lending'.

Figure 3 | > 10 Year Lending by Credit Unions >€100m – Total Assets



Whilst credit unions with Total Assets >€100m account for a high percentage of overall lending with a maturity greater than ten years, many larger credit unions have limited exposure and operate at present comfortably within existing limits. The ten credit unions with the highest volume and proportion of 'greater than ten year' lending account for €56.8m or 42% of all sector lending in this maturity category.

Appendix 2: Forecasting Financial Implications – Examples

Credit unions are independent in pricing of products and features attaching, and each has a unique cost profile[16]. Credit unions should estimate financial outcomes using assumptions drawn from industry information, sectoral trends and most importantly knowledge of their own cost profile. Pricing based on risk appetite and achievement of a target return requires a realistic and prudent approach, as inappropriate or inaccurate assessment may result in pricing decisions with long term adverse implications.

The following analysis is presented to assist credit unions in ensuring they undertake a comprehensive and realistic assessment of the revenues and costs, over the extended timeframe. It is expected that credit unions would undertake a rigorous approach prior to engaging in any new business with substantial risks and requiring material investment. The purpose of the worked examples, as set out in Figures 4-7 below, is to emphasise the criticality of considering the inputs over the extended timeframe. It is essential to understand and appreciate the impact of decisions regarding product design and pricing, the management of costs (direct and indirect, marketing and non-marketing) and longer term commitments.

ROA is a leading financial indicator of credit union viability. Consequently, the approach taken is to estimate the ROA resulting from the acquisition and management of a portfolio of mortgages over an extended period. It can be assessed what the impact on the credit union is from the introduction of mortgages over time, and whether it will enhance or diminish ROA over time.

Figure 4 | Standard Variable Rate Mortgage – ROA

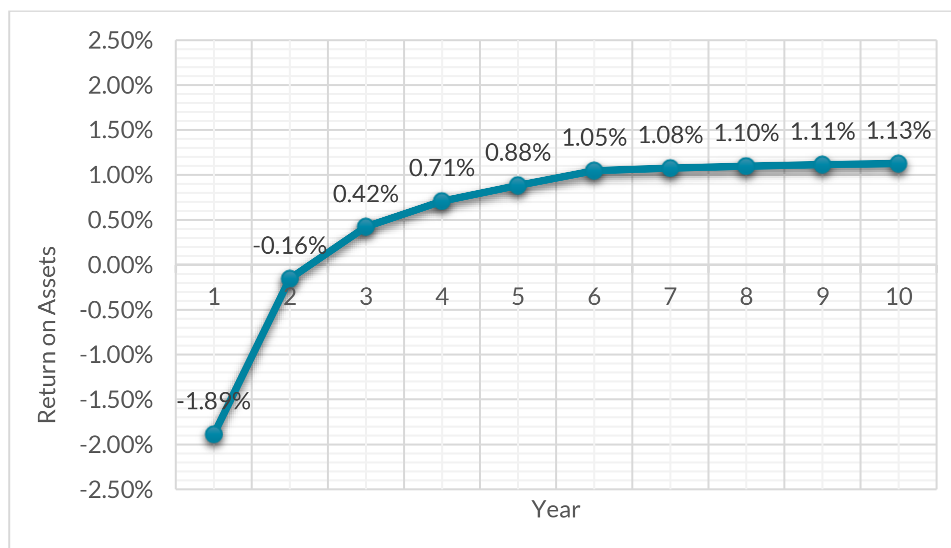


Figure 4 is indicative of the ROA over a ten year period, assuming pricing based on the average Standard Variable Rate (SVR)[17] and costs reflecting the estimated expense incurred acquiring and managing a portfolio of mortgages. The resulting contribution (and ROA) is negative for a period of time, the duration of which is determined by pricing and the nature and extent of acquisition costs in particular. Medium to longer term, the return achieved will be influenced by factors within and possibly also outside the control

[16] Credit Union Act 1997 S38.1.(a) - the rate of interest a credit union may charge on loans is capped at one per cent per month.
[17] Household Credit Market Report H1 2017, Central Bank of Ireland

of the credit union. Credit unions will need to consider how their approach to pricing and management of costs (including the costs of incentives to mortgagees) will impact on ROA, and whether the medium to long term return compensates for the investment made.

Figure 5 | Reduced SVR Impact

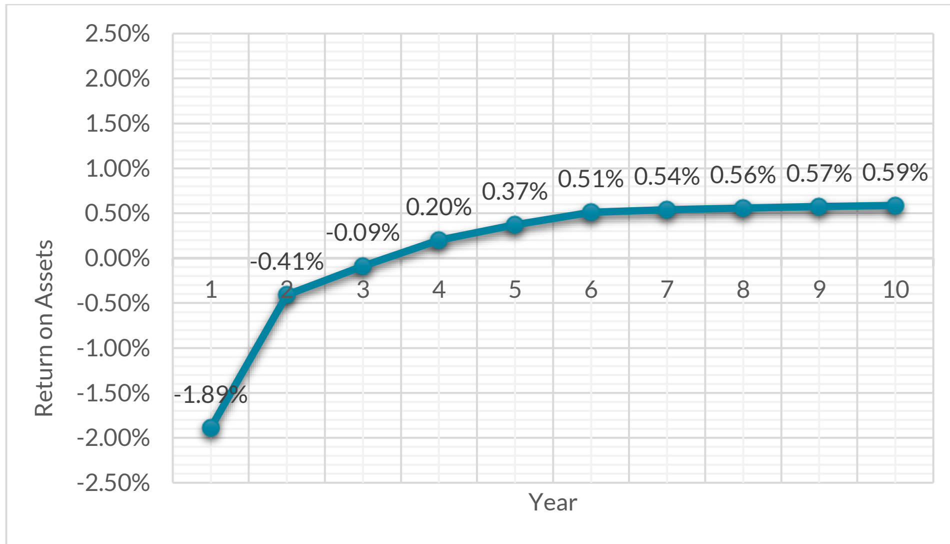


Figure 5 illustrates the impact of acquiring new business at a lower SVR and also re-pricing the back-book, with no change in funding cost. The average SVR declined by 0.25% between Q1 2016 and Q1 2017[18]. This can have a material impact on ROA over time. It may have been forecast that the lending margin would remain constant and thereby compensate for the early year(s) expense. Differential pricing and/or employment of alternative pricing models (e.g. Fixed Rates or LTV-based pricing) may not be possible for credit unions, or may introduce an additional element of risk. Risk assessment should be undertaken in advance and risk mitigation measures considered.

Figure 6 | Fixed Rate Mortgages

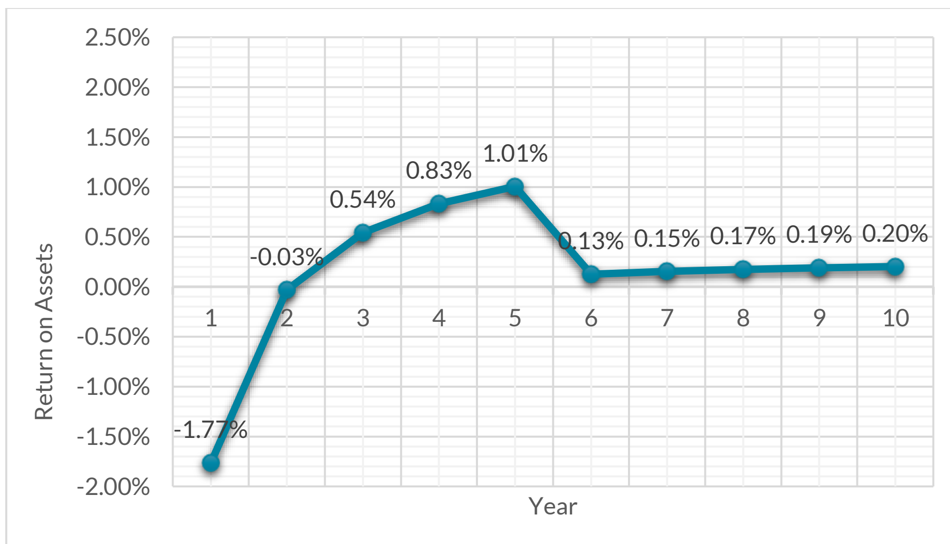


Figure 6 illustrates the impact of fixed rate pricing over an extended timeframe (10 years), where funding costs increase at a time in the future (after five years). As the risk cannot be hedged, there is a potential exposure to changes in the funding cost. This could result in a negative return over the period when the anticipated return would be positive.

[18] Household Credit Market Report H1 2017, CBI

Reduced funding costs increase the prepayment risk (if no penalty mechanism exists for early repayment of fixed rate loans), as later years' revenues to compensate for the acquisition costs will be foregone. The funding implications of long term fixed rate commitments without considering consequences could be considerable, however unlikely that may seem at the outset.

Figure 7 | Compound Effect

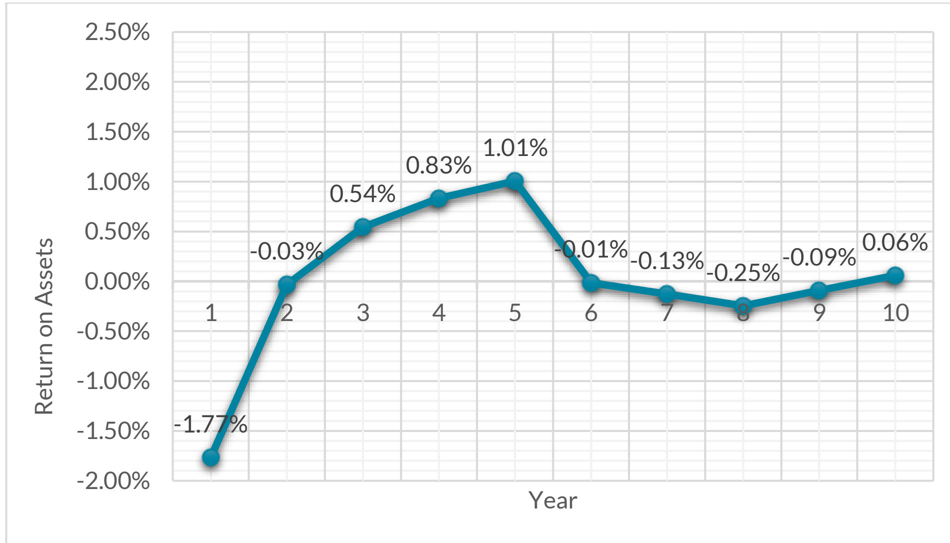


Figure 7 illustrates the effect of an increase in arrears, with loss of revenue. Whilst an annual provision figure for bad debts has been anticipated, elevated loan losses, combined with an exposed funding position (per Figure 6) compounds the adverse outcome over the longer term.

With a low gross margin product, the ROA achievable will be within a narrow range. The implications of inappropriate pricing and other product-specific decisions, whilst apparent in the acquisition phase, could also be detrimental over the longer term. Stress testing is an integral element of risk measurement, and a key component in quantifying the nature of risk mitigation measures required.

Table 4 | Forecasting Financial Implications | Assumptions

COST	AMOUNT	DESCRIPTION
Average Loan	€197k:	Based on First Time Buyer, Second and Subsequent Buyer and Buy To Let average 2016 (per Household Credit Market Report H1 2017, CBI)
Mortgage numbers (per annum)	50 (yr1)	Annual growth 2%
Customer Rate	3.38%	Average SVR Q1 2017 per Household Credit Market Report H1 2017, CBI)
Cost of Funds	1.0%	Rate should reflect cost of funds over long term
Acquisition Costs: Year 1 (New Loans)	2.0%	Marketing – Incentives (cashback, legal costs, etc.), direct advertising, digital marketing, promotional material, direct and contribution to shared service marketing
Acquisition Costs: Year 1 (New Loans)	1.5%	Administration – at individual CU + shared service centre ("SSC") charge, workload, from application through approval. Includes allowance for declined

COST	AMOUNT	DESCRIPTION
		applications, approvals that do not convert to drawdowns, etc. (unrecoverable costs / workload).
Service Costs (p.a. – balances under management)	0.375%	Maintenance Costs – credit union / SSC charge
Recovery costs (per case)	0.125%	Includes workload in-house, compliance with Code of Conduct on Mortgage Arrears ("CCMA") and Mortgage Arrears Resolution Process ("MARP"), dealings with member(s) and representatives, up to and including transfer back to performing loan status or to legal (in-house or out-sourced) for recovery
Debt Provision (p.a. – balances under management)	0.25%	Increases in debt provision are for illustrative purposes
Attrition (from year 6)	10% p.a.	Redemptions, re-mortgages (new loans), write-offs / downs (reductions in performing balances)
Interest Rebate	0%	Assumed at zero. Individual credit unions differ regarding member Home Mortgage qualification for rebate – inclusion will suppress ROA

Assumptions used are for illustrative purposes. Other direct or indirect costs should be quantified and included.