CP125 Potential Changes to the Lending Framework for Credit Unions – Submission from Clonmel Credit Union

Submission by Clonmel Credit Union Limited to the consultation process and input sought.

December 22nd, 2018

This is a matter of significant interest to us as we review our business model, our member proposition and how we will deliver sustainable business growth for the foreseeable future, balancing the requirements of all current members and prospective members within our common bond.

Clonmel Credit Union had been approved an increase to 40% and 15% on Loan Maturity Limits relating to the proportion of total loans which can be outstanding for periods exceeding 5 and 10 years, which were previously contained within the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016. It was one of 15 Credit Unions to have received such approval at the time.

Our strategy is to develop our lending book on a prudent basis, including engaging in new areas of lending, increasing exposure to longer term lending as part of a balanced loan portfolio. This will be supported by strong credit and risk management capability and will enable us to diversify our loan book over time. This capability will effectively enable us to manage and balance credit concentration risks on the book.

Challenges

Like many other credit unions, we are in good financial health and all metrics are well within guidelines. However, the continuing investment climate will continue to hamper our ability to deliver returns to the same extent we have over recent years. In addition, the 'once off' contributions that are made through bad debts recovered will dip as the challenged book washes out. We continue to attract savers at a rate at least similar and indeed greater than loan growth. Given our banking and other financial arrangements, this presents a major challenge.

The imperative to grow the loan book is compelling in this context. It is the most salient method of continuing to deliver income and ROA.

Opportunities

The opportunities are for growth the sectors we currently operate in and in tandem, diversifying our lending proposition in other areas that are attractive.

We are approved to provide mortgage lending and will begin to provide this service to members in early 2019, with a cap of €250,000 per case. LTV and LTI criteria as set out by CBOI will be fulfilled. The proposition will be delivered using the outsourced services of Link for underwriting, fulfilment and future management of the back book, where appropriate.

While a mortgage is a secured lending product, we are very cognisant of the fact that underwriting and provision of such a product requires very prudent and careful management, as the consequences of mortgage default would have very significant implications for a Credit Union, both reputationally and financially. Repossession of family homes is not an appropriate activity for a Credit Union.

We believe that there is a further opportunity in our common bond area in regard to longer term lending to the agri sector. Locally, the sector is strong and typically performs well across the main activities of milk production, beef production and cereal/grain. This is similar to other geographical areas across the country that have a strong agri sector based on the quality of land and natural resources. The Golden Vale area is a case in point.

The impact of Brexit is not known and may present significant challenges for the sector. This is the greatest risk at present to the sector.

Dependencies

Having the correct capability in house is the greatest enabler to diversifying the credit activities of the credit union.

Pricing is a key enabler. Acceptance that we cannot generate a comparable level of return in proposed new sectors is part of the opportunity cost of doing business in these sectors. Pricing is driven by market dynamics.

Mortgage rates of circa 3% are the norm and indeed expensive compared to norms in the Eurozone. Interest rates in the agri sector are trending at circa Cost of Funds plus 2/2.5% margin.

An appropriate lending framework should:

- Effectively manage duration risk and consider broader issues such as asset and liability management;

- Effectively manage concentration risk, both at a loan category and an individual borrower level;

- Facilitate credit risk diversification within loan portfolios; and

- Clearly define the scope and parameters of credit union lending categories.

The Central Bank is seeking views on the following:

Removal of 5 and 10 Year Lending Maturity Limits:

Q1. Do you have any comments on the proposal to remove the 5 year and 10 year lending maturity limits contained in Regulation 14 of the 2016 Regulations (taking account of the other changes to the lending framework)?

Response – Clonmel CU would welcome the removal of the 5 year and 10 year overall maturity lending limits contained in Regulation 14 of the 2016 Regulations and the introduction of a combined concentration limit expressed as a percentage of assets for house and commercial lending. As per the CP125 document, these changes, among others, would enable us to manage the composition of the loan book and extend the categories of lending we undertake, within the set out risk & operational framework and criteria. In essence, we can prudently tailor the overall proposition to take account of local factors (member needs, socio economic trends, potential to grow member base) and develop a well-balanced loan portfolio that will serve to grow our business in a sustainable manner.

Maximum Loan Maturity Limit for Unsecured Loans:

Q2. Do you have any comments on the proposal to introduce a maximum maturity limit of 10 years for unsecured loans?

Response – We broadly support placing a maximum limit of 10 years for unsecured loans. With the appropriate term/repayment capacity/purpose lending proposition, a longer term should not be required by a member. The possible exception being home improvement loans in certain circumstances where the amount of the loan may dictate a longer term. That said, such loans would typically be more appropriate if written as house loans

Q3. Do you have any comments on the proposed definition of a secured loan?

Response – In relation to Legal Charge on Property, the document proposes First Legal Charge. We would recommend also including 'Second Legal Charge of Property' as this can be practical where a larger volume, longer term home improvements loan is being sought and where there is more than sufficient equity in the property in question.

The definition could be expanded at Point 3 to state 'First Legal Charge on a Deposit or other financial instrument'

In addition, should the matter of irrevocable Solicitors Undertakings of a closed nature, be considered also. This would be used in situations where assets have been disposed of and payment is awaited or where insurance and other such claims have been agreed awaiting payment.

Concentration Limits for House and Commercial Loans:

Q4. Do you have any comments on the proposal to require that all commercial loan exposures utilise the concentration limit for commercial lending?

Response – While this would not be an inhibitor for our credit union in the short term, commercial loans less than €25k are primarily lent based on the personal profile and record of the individual proposer. At lower levels, a business plan is not always a reasonable request and should be subject to local discretion.

Q5. Do you have any comments on the Central Bank's intention to introduce board reporting requirements for house loans?

Response – Agreed

Q6. Do you have any comments on the proposal to introduce a base combined concentration limit for house and commercial loans of 7.5% of Total Assets?

Response – The provision and management of house and commercial loans is very different. If the credit underwriting is properly applied ensuring that all house loans are within policy guidelines, particularly in regard to incomes and DSR, the potential default risk is minimised and managed.

In regard to Commercial loans, the enterprise is typically more exposed to market forces and other external factors which can impact negatively on the performance of the enterprise and its ability to service associated debt. Therefore, it needs to be managed in a different manner.

We would recommend a 5% limit on Commercial loans for the foreseeable future with an increased limit of 7.5/10% for housing loans. It may be appropriate to have different level limits for different sized credit unions.

In relation to Clonmel CU, the limits proposed will not impact on our operations in the short and indeed medium term, as we will introduce house loans for the first time in 2019.

Q7. Do you have any comments on the proposal to limit the maximum amount of house or commercial lending which a credit union may undertake to 5% of Total Assets within the base combined concentration limit?

Response – At this point, the limit is sensible for our Clonmel Credit Union in regard to house loans, given the marketplace within which we operate and the fact that we are just beginning to provide such loans. However, the 5% limit may become a constraining factor into the future and should be kept under review. As per Q6, we would recommend a 5% limit on Commercial loans for the foreseeable future with an increased limit of 7.5/10% for housing loans.

In respect of commercial loans, 5% is reasonable as this type of lending requires a different skills/knowledge set that is currently not widely available in Credit Unions. As this sector of our business develops, a new approach to managing the back book will be required. This will entail capability in our people, technology and data analytics.

Q8. Do you have any comments on the proposal to permit an increased combined concentration limit for house and commercial loans for those credit unions who can demonstrate the necessary financial strength, skills, expertise, operations and risk management capability to undertake increased lending in these loan categories?

Response – Response at Q6 in regard to concentration limits already addressed.

We fully support the proposal to permit increased limits to certain credit unions who have a proven and demonstrable competency in terms of managing significant loan books.

This would have to be done on the basis of a very specific business case outlining the strategy, target sectors locally, with specific deliverables and objectives outlined and a specific and robust implementation plan that addresses the additional resources that would be required.

These resources will be:

Human resources with the proven levels of skill and capability in credit delivery and management:

- Customer/Member Interview skills/model
- Credit Assessment and application process
- Financial Analysis and loan recommendation/approval
- Fulfilment & Perfection of Security

IT & System Resources

- Data analytics capability to enable effective management of a larger, more complex credit operation from a risk perspective.
- Ongoing MIS provision to enable timely measurement, monitoring and reporting

External/Outsource

- Credit Review resources who will undertake periodic assessment of the standards of credit management applied in the credit union
    - Are standards set out in credit policy being applied appropriately and consistently
    - Is the standard of credit application assessment to the level required
    - Is the fulfilment process in line with policy
    - Is ongoing credit and risk management process robust and fit for purpose
    - Provide recommendations for enhancement and remediation

A comprehensive financial and risk plan would be required calling out the risks associated with this type of lending and have the capabilities and systems to mitigate these risks appropriately.

From an ongoing credit and risk management perspective, there should be a clearly prescribed level and model of data analysis applied to the commercial lending portfolio. This is/will be a new activity for many credit unions and having the appropriate and timely data is a critical enabler to prudent management.

Q9. What skills, expertise, operational and risk management capabilities do you consider necessary to support increased lending in house and commercial loans?

Response – As above, included in Q8. Apart from the skills/capability gaps that may exist in some credit unions, a robust IT platform that enables ongoing data analytics and timely provision of concise management information is the critical enabler. Without that, the ability to deliver on monitoring, managing and reporting and to effectively manage the risk, is hindered.

Q10. Do you have any comments on the proposed increased combined concentration limit for house and commercial lending of 15% of Total Assets?

Response – Similar to responses in Q 6.

Q11. Do you have any comments on the application process referred to above?

Response – The application process as outlined is robust. From an implementation perspective, further iterative detail will be required.

Definition of Commercial Loans:

Q12. Do you agree with the proposal to re-name the commercial loan lending category to small business loan?

Response - Yes. The name 'Small Business Loan' makes more sense in the marketplace and has associations with the values and ethos of the Credit Union. 'Small' is where we come from and who we are.

Q13. Do you have any comments on the proposed definition for a small business loan?

Response – It is sensible and straightforward.

Have we considered whether loans can only be made to the owner in his/her own name or should we also consider lending to the limited company where such an entity exists to manage the business.

We would propose that loans are to the owner only. Should a limited company exist then the owner would invest the loan funds by way of Directors Loan.

Large Exposures:

Q14. Do you agree with a large exposure being prescribed as an exposure to a borrower or group of borrowers who are connected of 2.5% or greater of the regulatory reserves of the credit union?

Response - There is no change to the maximum large exposure limit of 10% of regulatory reserves. Agreed that reporting is now required at a lower level of 2.5% of regulatory reserves.

Transitional Arrangements

Q15. Do you have any comments on the proposed transitional arrangements?

Response - Agreed and sensible

Liquidity and ALM Considerations

Q16. Do you have any comments on liquidity and broader ALM considerations for credit unions wishing to increase the proportion of their loan books held in house and commercial loans particularly where those loans have longer maturities?

Response – With entry into longer term lending by way of housing loan or small business loans, we will need to closely monitor and factor this into our investment management and policy. This will ensure that we comfortably remain liquid, even in stressed scenarios.

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