

TO: CENTRAL BANK OF IRELAND
FROM: DUBCO CREDIT UNION LIMITED
DATE: JANUARY 2019

RESPONSE TO AND OBSERVATIONS RELATION TO CONSULTATION PAPER CP125 Consultation on Potential Changes to the Lending Framework for Credit Unions

RESPONSES

The Central Bank is seeking views on the following:

1. 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)?
 - a. *We agree with this proposal*
2. Do you have any comments on the proposal to introduce a maximum maturity limit of 10 years for unsecured loans?
 - a. *We do not agree with the proposed change. We suggest that the point might better be made that whilst it is expected that unsecured loans are unlikely to exceed 10 years, where any such loans exceed this term a rationale must be documented.*
 - b. *This Credit Union already strives to match the term of the loan with the purpose of the loan. Examples of unsecured loans that could exceed 10 years are home improvement loans.*
 - c. *If this maximum maturity limit is introduced, we suggest that exceptions that arise due to technical breaches e.g. a decrease in the loan book or the rescheduling of a loan over a longer period, be specifically excluded as breaches of the regulations.*
3. Do you have any comments on the proposed definition of a secured loan?
 - a. *Based on the proposed definition of secured loan, an interpretation could be that a loan with any shares attaching is secured, in which case many existing Credit Union loans, including covered loans, would fall into this category. We believe that a secured loan for the purposes of the exemption limits should exclude funds deposited in a Credit Union.*
 - b. *The use of Credit Union shares within the definition of secured loan could fundamentally affect the current operating model of some Credit Unions. It could discourage Credit Unions from taking shares as security and might result in loans not being issued due to the absence of said security if the 15% limit had already been reached etc.*
4. Do you have any comments on the proposal to require that all commercial loan exposures utilise the concentration limit for commercial lending?
 - a. *No*
5. Do you have any comments on the Central Bank's intention to introduce board reporting requirements for house loans?
 - a. *We hope that any reporting requirements will be proportionate and sensible. The risk of voluminous reporting is that it may result in a lack of focus on matters that are 'exceptional' in nature as they are 'buried' in the volume. Reporting by exception is a common form of reporting in many organisations.*
 - b. *We note that quarterly loan book reviews are already a regulatory requirement. Perhaps as part of the loan book review it could be required that secured loans more than €50,000+ and more than 9 weeks in arrears be reported to the board of directors as part of the quarterly loan book review, together with a brief outline on the status of such loans.*



6. Do you have any comments on the proposal to introduce a base combined concentration for house and commercial loans of 7.5% of total assets?
- We do not understand why house loans and commercial loans are aggregated. The only long-term commercial lending we can envisage is property lending, whereas we expect that most house loan lending will be well more than 10 years.*
 - We regard the higher combined limits of 15% as too low. Given the complexities in assessing both types of lending, organisations should ideally be engaging in such lending on a regular basis. For example, a Credit Union with assets of €100m that does not engage in commercial lending, but which has the 15% exemption could issue 83 house loans if each house loan is c€180k. Up to 50% of this limit will already have been used up under existing limits in some Credit Unions. Repayments on such loans may create a capacity to issue only two or three new such loans annually thereafter, split between commercial and house loans. The credibility of the Credit Union would also be undermined when the Credit Union would inevitably have to refuse good quality home loans to some members due to the 15% limit having been used up, even though they could well have loan to asset ratios of well under 50%.*
 - The combination of commercial lending and house loan lending penalises Credit Unions that have the appetite and expertise to develop sustainable business models under both headings.*
 - We understand that house loan and commercial lending by Credit Unions in other substantial jurisdictions is not restricted in the manner proposed in CP125.*
7. 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?
- We do not agree with this proposal. It makes little sense in the context of a Credit Union building a sustainable business and maintaining specialist lending skills among its staff.*
8. Do you have any comments on the proposal to permit an increased combined concentration limit for house and commercial loans for those Credit Unions which can demonstrate the necessary financial strength, skills, expertise, operations and risk management capability to undertake increased lending in these loan categories?
- We regard the increased limit as too low overall for any Credit Union that wishes to engage in both types of lending.*
 - The Central Bank wishes to ensure the 'financial stability' of Credit Unions. The limits set out in CP125 limit Credit Unions substantially to the current model of unsecured personal lending even though Credit Unions may have significantly more lending capacity. We see merit in encouraging Credit Unions to actively engage in other forms of lending, subject to the usual expertise, risk etc., return on asset impact, and any other requirements.*
 - We observe that Credit Unions currently have enormous exposure to a very limited number of financial institutions for investment purposes. Many such financial institutions have failed in the recent past. We consider that any dilution of reliance on investments by diversifying funds into other categories of lending will reduce risk and is likely to give higher returns, as is evidenced by how Credit Unions operate in other jurisdictions and by comparing the impact of additional lending on Return on Assets compared to the current abysmal investment returns that are available across the sector.*
9. What skills, expertise, operational and risk management capabilities do you consider necessary to support increased lending in house and commercial loans?
- This needs to be assessed on a case by case basis by each Credit Union. However, as already observed we note that Credit Unions should be allowed to have sufficient levels of business to justify, where necessary, the recruitment of experienced staff members if so required.*
 - We would consider utilising a shared services bureau in certain circumstances.*
10. Do you have any comments on the proposed increased combined concentration limit for house and commercial lending of 15% of Total Assets?
- We believe this limit is too low. We observe that Credit Unions in other jurisdictions appear to have naturally developed sustainable business models over the years without similar constraints.*
11. Do you have any comments on the application process referred to above?
- We would welcome transparency and consistency in how applications are processed and clear guidelines in this regard.*
12. Do you agree with the proposal to re-name the commercial loan lending category to small business loan?
- What matters is the definition of small business loan or commercial loan.*
13. Do you have any comments on the proposed definition for a small business loan?
- We believe that the definition is too narrow. For example, an interpretation of a loan to an employee who intends to develop a business outside of hours (e.g. training) could be interpreted by some as not being to a 'business enterprise'. Such an interpretation could even become a point of note during PRISM and audit reviews. What should matter is the person's ability to repay the loan, and not the definition.*

14. 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?
- a. *We regard the limit as being unrealistic for many Credit Unions. CP125 cites an example where a maximum loan to a €60m asset Credit Union member could be no more than €150,000. This limit takes no account of the Ability to Repay of the member or the value of the security, which should be primary concerns.*
 - b. *We also observe that with respect to house loans that such loans would be secured, whereas it is possible that not all commercial loans would be secured.*
 - c. *We believe that if limits are being introduced, that the limit on secured loans should be higher than on unsecured commercial loans. The level of security should also be factored in. For example, this Credit Union would be much more comfortable issuing a €200k home loan with a 70% loan to asset ratio than a €200k commercial loan that is secured on an item of plant that is only of use to the borrower, which is often the case as many plant items are custom made.*
15. Do you have any comments on the proposed transitional arrangements?
- a. *No*
16. 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?
- a. *We are concerned that in assessing liquidity and broader ALM considerations that the Central Bank sometimes fails to see the uniqueness of the Credit Union model. During the financial crisis members tended to leave funds with their Credit Union. There is also the matter of the deposit guarantee scheme, Credit Union savings insurance and the personal relationship / loyalty that exists between members and their Credit Union. In this context we suggest that an ALM model that recognises the reality of the Credit Union business model should be introduced, and not one that seeks to imitate the banking model.*

OBSERVATIONS

A. DIVERSIFICATION OF RISK / DILUTION OF RELIANCE ON CERTAIN CATEGORIES OF LENDING & INVESTMENT

We observe that the Central Bank shall administer the system of regulation and supervision with a view to the maintenance of financial stability and well-being of Credit Unions generally. We cannot see any rationale for restricting Credit Unions from more extensive commercial and longer-term lending, given that such lending diversifies / dilutes the % of reliance on unsecured lending and spreads the risk of investment default away from a very limited number of financial institutions and across many individual borrowers. We observe that credit risk diversification is noted in CP125 but the spreading of risk away from investment categories is not acknowledged. We observe that the greatest actual risk to materialise in Ireland ever has been under the 'investment' category – that being the 'failure' of the Irish banking system.

B. THE MIXING OF COMMERCIAL AND SECURED LENDING AS IF THEY SHOULD BE REGARDED AS ONE CATEGORY

The Central Bank document states 'Given the longer-term nature of house and commercial lending ...'. Commercial lending aside from property related lending tends to stretch for periods of between one and ten years, with lending in the 3-5-7 year bracket being most common, which matches the useful lives of the assets being financed e.g. plant and machinery, fixtures and fittings, etc.). House lending tends to be for periods well more than 10 years.

C. LENDING SECURED ON PROPERTY

The prohibition of lending on non-home property should be reflected upon. We suggest that a more subtle approach, such as a % maximum loan to value ratio of somewhere between 50% and 75% at the time the loan is being issued should be considered, supported perhaps by a second valuation where the loan is more than a specified amount (say €100,000).

D. UTILISATION OF OVERALL ANALYSES TO JUSTIFY INDIVIDUAL RESTRICTIONS

The utilisation of overall analysis to justify restrictions in the sector or that gives the impression that significant capacity is being released when some Credit Unions will never utilise it or have already fully utilised it, punishes progressive Credit Unions and by default damages the sector as a whole.

E. CENTRAL BANK CONCERN WITH RESPECT TO LOAN TO ASSET RATIOS

We observe that the document refers to '...Central Bank ... concerns at the sector's loan to assets (LTA) ratio and has cited it as one of the key sustainability challenges ...'. We note that some observers believe the unsecured lending market is at saturation, that unsecured lending is being diluted by (unregulated) PCP's and store credit loans, that other financial institutions and new market entrants are intent on eroding the share of unsecured lending that Credit Unions undertake and that there is a potentially imminent threat to unsecured lending from fintech operations. In this context of a potential future reduction in unsecured lending that Credit Unions may undertake, due to factors beyond their control, the additional 15% lending as a % of assets that may be facilitated would appear to be commercially restrictive.

F. RISK OF LONGER TERM LENDING

We believe that the risks the Central Bank fears from longer term lending may in many cases be unwarranted given:

- Secured loans are secured, by their very nature
- Previous issues in Ireland point to Credit Unions being significantly safer than other financial Institutions. At the height of the financial crisis Credit Unions needed financial support of €30m across c420 Credit Unions (€71,000 per Credit Union) whilst banks required financial support of €64.6bn across 6 institutions (€10.7bn per Bank). Or to put it another way, for every €1 a Credit Union cost the exchequer a bank cost the exchequer €150,000. There have been significant improvements within the Credit Union sector since 2012, particularly in underwriting and the use of 'Ability to Repay' methodology, including stress testing for house loans, which would lead one to believe that even the risk of a €30m default across the sector has further decreased.
- An enhanced house loan limit could potentially include guidelines on loan to asset ratios for any loans issued more than the 15% loan to asset ratio. A suggestion we make is that a condition of lending where a Credit Union's long-term lending exceeded 15% of assets could be that all additional loans issued where the 15% limit has been reached must have a loan to asset ratio of 80% or less, without exception. This would be more restrictive than current guidelines.

G. THE CONTRIBUTION FROM LOWER MARGIN SECURED LENDING

Whilst it may appear that secured lending is much less profitable than unsecured lending, this is often untrue when secured lending is being assessed on a marginal basis. For example, if a Credit Union has on average a net return on longer term lending of (say) 2.4% across the term of the loan, and the Return on Assets within that Credit Union currently stands at 0.8%, that Credit Union will treble (2.4%/0.8%) its return on assets for the new secured lending. Therefore, from both a Return on Asset and sustainability perspective secured lending is likely to make significant sense for Credit Unions.

H. THE RISK OF DEFAULT FOR A CREDIT UNION

If a Credit Union achieves (say) a net return of 2.4% on secured lending, for the Credit Union to suffer a 100% loss (zero return) on house loans in a period the Credit Union would have to suffer 1 default for every 41 secured house loans in issue (100%/2.4%), with no recovery of the security at all. Given that house loans are secured, and the prudent and professional underwriting undertaken by Credit Unions, such a rate of loss would appear to be unlikely. Recent Irish experience would appear to suggest that significant reasons for loan default in the past were poor underwriting and loan to asset ratios that were too high, with loan to asset ratios of more than 100% being available from some financial institutions.

I. CENTRALISED LIQUIDITY MECHANISM

This Credit Union would welcome a centralised liquidity mechanism. It would meet many of the liquidity concerns of Credit Unions and the Central Bank.

J. CENTRALISED LONG-TERM LENDING SHARED SERVICES FACILITY

This Credit Union would consider utilising a shared services lending facility, provided it made commercial sense.

K. THE LACK OF REGULATION OF DIRECT COMPETITORS OF CREDIT UNIONS

We note that certain categories of lending that compete directly with Credit Unions are unregulated or are more lightly regulated than Credit Unions. We would like to see this anomaly addressed.

L. UTILISATION OF THE 15% LIMIT – THE MIX BETWEEN COMMERCIAL LENDING AND HOME LOAN LENDING

We are advised by our representative organisation CUDA that Credit Unions which can avail of the 15% limit may lend the full 15% in either category of loan. We agree with this approach. Given that we are an Industrial Credit Union this point is important for us in that the vast majority of our current members are employees.

M. SECOND CHARGES ON LOANS

It would appear to us that in certain circumstances where the primary charge on a home is with another financial institution that a second charge on a loan (such as a home improvement loan) would make commercial sense for the Credit Union and reduce the risk of an otherwise unsecured loan.