January 2019

ILCU RESPONSE TO CP125

CONSULTATION PAPER ON POTENTIAL CHANGES TO THE LENDING FRAMEWORK FOR CREDIT UNIONS

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IRELAND
Irish League of Credit Unions

Background:

The Irish league of Credit Unions ("ILCU") is the largest credit union representative body on the island of Ireland. It was founded to provide representation, leadership, co-operation, support and development for credit unions in both the Republic of Ireland ("ROI") and Northern Ireland ("NI"). Credit Unions affiliated to the ILCU elect the Directors of the ILCU and ultimately determine what the ILCU delivers. The ILCU responds directly to the needs of the affiliated credit unions. As an advocate of the credit union ethos of mutuality, volunteerism, self-help and not for profit philosophy, the ILCU has a vision to influence and inspire the credit union movement to achieve all its objectives-social, economic and cultural-while always respecting the individual's rights and dignity. The ILCU achieves its vision in the following ways:

- Providing Leadership for the movement in philosophy and services
- Fostering and maintaining unity and co-operation between credit unions
- Developing and making available to credit unions and their members, a full range of highest quality financial products and services; and
- Recognising the value of volunteers, staff of the credit union movement, the dignity of credit union members and their value in the community by their contribution to the social development of their local communities

250 registered credit unions in ROI (of a total of 263) are affiliated to the ILCU. Any and all references to credit unions in this document refer to credit unions affiliated to the ILCU.

Introduction:

The ILCU welcomes the opportunity to respond to this consultation on potential changes to the Lending Framework for Credit Unions (CUs").

The ILCU and its affiliate members see this as a significant opportunity to build much needed sustainable income streams whilst at the same time fulfilling the mandate of the movement to support its members and the communities within which it operates.

CUs are facing very significant financial and commercial challenges to their business models. These challenges include; low loan to asset ratios, high levels of loan redemption, low returns on investments and ever increasing investment in governance and legislative/regulatory requirements. The ILCU shares the concern of the Central Bank of Ireland (CBI) at the sectors low Loan to Assets (LTA) ratio and its impact on sustainability given its negative impact on Return on Assets.

70% of CU revenue is interest income almost exclusively from the provision of short term, unsecured loans. 30% of revenue is from investment income which has shown a steady decline over the past 5 years.

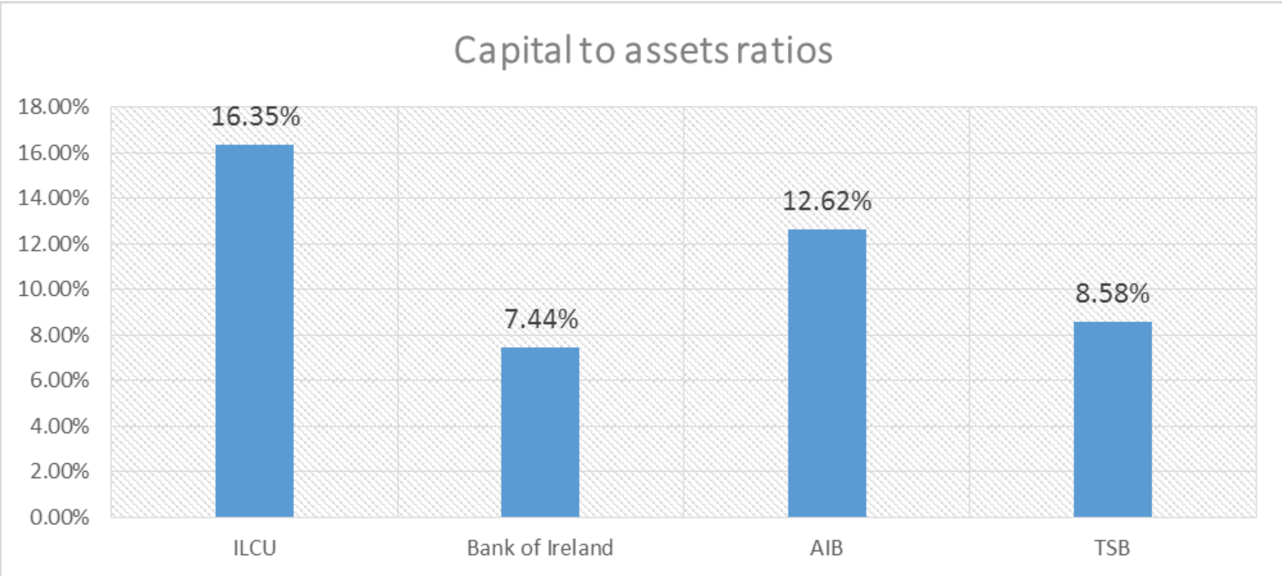
CU Loans as at 30th September 2018 stood at €4.2bn up 7.4% or €289m year on year. However, new loans advanced up to 30th September amounted to €2.2bn. This was offset by loan repayments of €1.9bn in the same period. Average loan outstanding is €6,847. There is some evidence of some scale being added to lending, but loans in general are still at low levels.

One of the challenges facing CUs is the lack of diversification within the loan portfolio, emphasised by the fact that 94% of the loan portfolio is made up of Personal Loans. Competition in the Personal Loan market has stepped up in recent years, both from retail banks re-engaging in the market and new entrants. The growth of PCP lending has hugely impacted the car loan market, and this has had a big effect on CU lending. All this points towards the need for more diversification in the CU loan portfolio, and higher proportions of House Loans and Commercial Loans.

The predominance of small, Personal Loans within the CU loan portfolio, means that this is a very expensive business model which is reflected in the cost/income ratio of 71.3%.

CUs are highly liquid and have very strong solvency ratios. LTAs stand at 27%, which whilst growing slowly, still presents considerable head room for further loan growth.

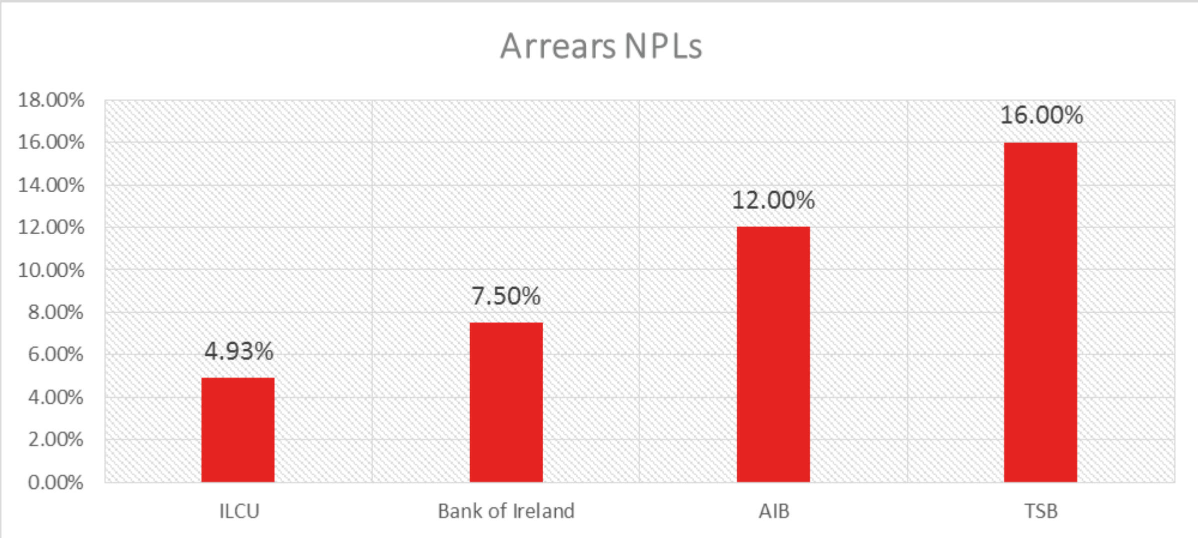
The overall capital ratio is 16.35% which leaves a capital buffer of c. €1bn above the 10% requirement which positions CUs very well to expand in to other sectors. The CU capital position compares very favourably to some of the retail banks in Ireland. We compared capital-to-assets ratios on a "like for like" basis, measuring total capital as a % of total gross asset (not Risk Weighted Assets) The capital-to-assets ratio of ILCU credit unions stands at 16.35% and is stable (2017:16.53%, 2016: 16.13%) . This compares to a capital-to-assets ratio of 7.44% for Bank of Ireland, 12.62% for AIB and 8.58% for Permanent TSB (per the bank's latest 2018 results), see graph below.



Loan arrears stand at €209m or 4.9% (gross) at 30th September 2018. Arrears have fallen steadily for the past 27 quarters from a peak of €925m in December 2011 and fell by 19% in the last year, and by 9% in the last quarter. This improvement reflects the much improved underwriting and credit/arrears management at credit union level, whilst it also reflects the more buoyant employment and economic environment as we near full employment.

The credit union arrears position (Non-Performing Loans) compares very favourably to the Retail Banks in Ireland, see graph below. The overall arrears ratio for CUs is down to 4.93% (World Council of Credit.

Unions (WOCCU) define best practice suggests a target of 5% for CU arrears). As has been widely reported, NPLS in the Retail Banks in Ireland remain very elevated. The CU arrears ratio compares to an NPL ratio of 7.5% for Bank of Ireland, 12.0% for AIB and 16.0% for Permanent TSB (per the banks latest 2018 results). It should be emphasised that the much improved arrears ratio in ILCU credit unions was achieved without resorting to loan sales, which has been common practice in the Retail Banks since the financial crisis.



The ILCU conducted a survey of its members to better understand their views on CP 125 and there was virtually unanimous support for changes to the existing Lending Framework and, in particular, it is strongly felt that the existing limits on longer term lending in the house and commercial sectors restricts individual CUs growth ambitions. The proposed changes do away with term limits and simplify the way limits are calculated and also how they will be monitored by credit unions going forward. In the base scenario, the level of "headroom" increases for House Loans from current level of €267 million (based on current Section 35 rules) up to €636 million, if the base limit of 5% of assets is used. Regarding Commercial Loans, the "headroom" under the proposed changes is €677 million, which is slightly below the current headroom for Commercial Loans (which is based on 50% of reserves limit). Note however, that total commercial loans stand at 3% of a possible 50% of reserves available, so considerable headroom exists currently.

For House Loans in particular, while the additional headroom at 5% of assets level is welcome, analysis shows this does not provide sufficient headroom for certain types of CUs., and does not "future proof" the movement for further expansion into House Lending. We carried out an analysis of higher limits of 10% of assets and 15% of assets. In the case of 10% of assets the headroom increases to €1.42 billion, and in the case of 15% of assets the headroom increases to €2.20 billion.

Regarding Commercial Lending, we formed the view that, as this is a higher risk, more specialised form of finance, with much less security than House Loans we feel the headroom proposed at 5% of assets provides enough room for CUs to expand into Commercial Lending in a controlled way. We would make the point that these rules will need to be subject to regular reviews should circumstances change.

A strategic imperative arising from the review of the Lending Framework Regulations is to facilitate the development of balanced, diversified loan portfolios in terms of sector, risk and maturity diversification, across all CUs and in alignment with international CU norms. A progressive revision of the CU Lending Framework is critical to facilitate the development of a well-diversified/portfolio based approach to credit asset management for the CU sector. The realisation of this objective will ensure a prosperous and sustainable CU movement into the future.

ILCU's views on specific questions put by CBI.

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?

The ILCU welcomes the removal of these maturity limits as do 97% of respondents to the survey on CP125. However, this support is to be taken in the context of a number of responses below.

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

The ILCU is not in favour of this change and would propose a maximum maturity limit of 15 years. Whilst there is only c. €150m in loans outstanding for 10 years +, it is an important niche line of business for CUs, particularly in the home improvement sector which continues to be buoyant.

54% of survey respondents were not in favour of the introduction of a maximum loan maturity of 10 years for unsecured loans.

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

The definition proposed requires some clarification and expansion. As follows:

1. Will the proposed regulation be prescriptive on the minimum % cover required for shares pledged and deposits assigned?

2. There are circumstances when a second legal charge can provide adequate tangible security cover if there is sufficient equity after a first legal charge is satisfied. This could be very relevant in the home improvement loan sector.

3. There are circumstances when an irrevocable solicitor's letter of undertaking can provide adequate security e.g. in relation to the sale of an asset or a court award.

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

The ILCU is not in favour of this change. Commercial Loans < €25,000 are more in the nature of micro loans and they are often advanced on the strength of the individual rather than the underlying commercial rationale of the project/business. It is proposed to continue with the practice of not insisting on a business plan and there is no change in reporting suggested. Accordingly, the ILCU would recommend that the provision contained in the 2016 Regulation whereby loans of less than €25,000 are not included in the concentration limit be retained.

5. Do you have any comments on the CBIs intention to introduce Board reporting requirements for house loans?

The ILCU supports this change in reporting.

6. 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?

The ILCU does not favour the proposal to introduce a base combined concentration limit for House and Commercial loans. 60% of survey respondents are also not in favour of this proposal. It is very difficult to see the rationale for such a proposal as these sectors have very different risk characteristics. A House Loan, per the 2016 Regulations, is a loan secured on a property which is the principal residence of a member. These loans are underwritten in accordance with individual CU risk appetite and risk policies having regard to CBI regulations contained in Longer Term Lending-Guidance for Credit Unions, Central Bank Macro Prudential Measures and the 2016 Regulations. Essentially, there are two sources of repayment – the borrower's ability to repay as assessed using Debt Service Ratio (DSR) & Debt to Income Ratio (DTI) and in a doomsday scenario through disposal of the property. Properly underwritten House Loans have a low probability of default as evidenced by the CBI's low risk weighting for capital purposes in Financial Institutions. Moreover, lending to owner occupied borrowers is subject to specific legislation and Central Bank Regulation.

The risk profile and underwriting process for lending to small business/commercial borrowers is very different to lending for house purchase. The profile of commercial businesses can range from retail to agriculture and repayment is determined and reliant on the underlying cash flows of the businesses rather than on the borrower's personal ability to repay the loan.

Accordingly, the ILCU is strongly of the view that neither the base concentration limit nor the increased concentration limit should be combined under the proposed Lending Framework. Rather, a separate base concentration limit should be introduced for each sector – 5% for Commercial Loans and 10% for House Loans.

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

The ILCU is supportive of the proposal to limit the maximum amount of commercial lending which a CU may undertake to 5% of Total Assets as a base concentration limit. This will provide sufficient scope for CUs to grow this line of business to support their objectives.

Head room for Commercial Loans based on 5% of Total Assets is €690m. However, a 5% of Total Assets limit for House Loans is wholly inadequate and does not provide sufficient headroom for CUs to engage meaningfully in this business line.

Levels of additional headroom at 5% limit for House Loans as proposed by CBI - Deemed inadequate by ILCU:

- The table below outlines the headroom at various levels using the latest Sept 2018 data from 240 CUs. In this case we examined House Loans exclusively to establish how much additional headroom would be available, and how many actual House Loans this would facilitate.

- 50% or 119 CUs will have additional headroom of €1 million or less for House Loans under the 5% limit. Accordingly, the maximum headroom they can achieve is €1 million, which would equate to 10 House Loans at €100,000 or just 5 House Loans at €200,000.

- For some CUs at the lowest level the additional headroom would only allow them issue 1 or 2 House Loans.

- Just 2 CUs would get additional headroom of €10 million or more, the maximum being €13 million. At this maximum level, this CU could issue 130 House Loans at €100,000 level or 65 Home Loans at €200,000 level. This particular CU has a very substantial membership. So the 130 House Loans at €100,000 level would represent 0.2% of their membership and the 65 House Loans at €200,000 level would represent 0.1% of their membership.

- The biggest single cohort is the CUs that show additional headroom of between €0.5 and €1 million. There are 55 CUs in this cohort, or 23% of all CUs. For these 55 CUs, the maximum number of House Loans they could issue at €200,000 would be 5.

- Average loan size for first time buyers is €218,700 (Banking and Payments Federation Ireland), so we believe the examples set out in the table below are realistic.

Table showing increases in headroom at 5% limit for House Loans (Sept 2018 data)

Range of increased Headroom	Number of CUs	% of CUs		Top level headroom for this cohort	Max Additional Number Loans €55,000 average	Max Additional Number Loans €100,000 average	Max Additional Number Loans €200,000 average
Increase of > €10m	2	1%		13,000,000	236	130	65
Increase of €6m to €10m	9	4%		10,000,000	182	100	50
Increase of €4m to €6m	10	4%		6,000,000	109	60	30
Increase of €2m to €4m	43	18%		4,000,000	73	40	20
Increase of €1.5m to €2m	28	12%		2,000,000	36	20	10
Increase of €1m to €1.5m	29	12%		1,500,000	27	15	8
Increase of €0.5m to €1m	55	23%		1,000,000	18	10	5
Increase of €0.2m to €0.5m	45	19%		500,000	9	5	3
Increase of under €0.2m or no in	19	8%		200,000	4	2	1
	240	100%					

Headroom by various CU sizes at 5% limit – (i.e. small, medium and large CUs):

- In this table, we analyse large, medium and small CUs and the amount of headroom available for each type.

- For the largest €100 million + CUs, the average increase in headroom is €4.3 million, which would mean, on average, these CUs would have headroom to issue 43 additional House Loans at the €100,000 level, and 22 additional House Loans at €200,000 level.

- These largest €100 million + CUs have an average membership of 32,000. (Some CUs have membership above 50,000). The 43 House Loans at €100,000 level would represent just 0.13% of membership, and the 22 House Loans at €200,000 level would represent just 0.07% of membership.

- For medium sized CUs between €40m and €100m, the average increase in headroom is €1.7 million, which means, on average, they could issue just 17 House Loans at €100,000 level or 9 House Loans at €200,000 level. These are low multiples for credit unions with assets up to €100m.

- For these medium sized CUs, the average membership is 13,000, so the 17 House Loans at €100,000 level would represent 0.13% or their membership. Likewise, the 9 House Loans at €200,000 level would represent just 0.07% of their membership.

Table showing headroom at 5% House loan limit for various sizes of CUs

CUs > €100m assets	Amount		Number of extra loans (€100,000 size)	Number of extra loans (€200,000 size)
Average increase in headroom	€	4,339,316	43	22
Highest increase in headroom	€	12,757,988	128	64
Lowest increase in headroom	€	1,031,391	10	5
CUs €40m to €100m assets	**Amount**		**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€	1,726,422	17	9
Highest increase in headroom	€	4,308,173	43	22
Lowest increase in headroom	€	166,945	2	1
CUs Under €40m assets	**Amount**		**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€	553,756	6	3
Highest increase in headroom	€	1,625,777	16	8
Lowest increase in headroom	€	1,981	0	0

ILCU Proposal on lending limits:

The ILCU views that it is appropriate to introduce a separate base limit of at least **10%** of Total Assets for owner occupied House Loans. Such a change would create total headroom of €1.42bn. Headroom of this magnitude is essential if CUs are to focus and invest in this business activity bearing in mind that this capacity is likely to be utilised over a 3-5 year period i.e. €280-€450m pa. If CUs are to seriously engage in this business they must invest in IT architecture, staff training and development, marketing etc. The business case for such investment must be predicated on an ability to grow this product line in a consistent manner over the medium term, rather than on a stop start basis which would curtail effective market growth and also result in cost inefficiencies.

To put this in context, growth rates of €300-€450m pa would only represent 3-5% of the new mortgage business written annually.

If the CUs advanced the entire €1.42bn, (together with Commercial Loans at 5% of Total Assets) this would increase their total loan books to c. €6.3bn.

Therefore, House Loans would still represent less than 25% of total loan book as against:

- **AIB**: 55%
- **BoI:** 58.4%
- **PTSB:** 75.0%

Levels of additional headroom at 10% limit for House Loans as proposed by ILCU:

- 68 or 28% of CUs, would get additional headroom of at least €6 million under the higher 10% limit. This compares to just 11 CUs getting additional headroom of at least €6 million under the 5% limit.
- The €6 million in headroom only allows 60 additional House Loans at the €100,000 level and just 30 House Loans at the €200,000 level.
- Under the higher 10% limit, 97 or 41% of CUs would get additional headroom of at least €4 million.
- 156, or 66%, of CUs would get additional headroom of at least €2 million, equivalent to a minimum of 20 House Loans at €100,000 level.
- Even at the higher 10% level, there are 84 or 35% of CUs, who get additional headroom of under €2 million. So the very maximum this cohort could achieve is €2 million or 10 House Loans at €200,000 level. Some of the CUs at the lowest levels would only be able to issue single figure numbers of House Loans at 10% level.

Table showing increases in headroom at 10% limit for House Loans (Sept 2018 data)

Range of increased Headroom	Number of CUs	% of CUs	Top level headroom for this cohort	Max Additional Number Loans €55,000 average	Max Additional Number Loans €100,000 average	Max Additional Number Loans €200,000 average
Increase of >€20m	6	3%	31,000,000	564	310	155
Increase of €10m-€20m	23	10%	20,000,000	364	200	100
Increase of €6m to €10m	39	16%	10,000,000	182	100	50
Increase of €4m to €6m	29	12%	6,000,000	109	60	30
Increase of €2m to €4m	59	25%	4,000,000	73	40	20
Increase of €1.5m to €2m	23	10%	2,000,000	36	20	10
Increase of €1m to €1.5m	34	14%	1,500,000	27	15	8
Increase of <€1m	27	11%	1,000,000	18	10	5
	240	100%				

Headroom by various CU sizes at 10% limit – (i.e. small, medium and large CUs):

- For the largest €100 million + CUs, the average increase in headroom is €13.3 million under the higher 10% limit (up from an average of €4.3 million under the 5% limit).
- This would mean the largest €100 million + CUs would on average have headroom to issue 133 House Loans at the €100,000 level, and 67 House Loans at the €200,000 level.
- For the largest €100 million + CUs, at the higher 10% limit the CU with the lowest additional headroom has €7.8 million. For this CU, despite having assets of over €100 million, it could only issue 39 additional loans at the €200,000 level.
- For medium sized CUs, with assets between €40m and €100m, the average increase in headroom is €4.9 million (up from an average of €1.7 million under the 5% limit). This group could, on average, issue 49 additional loans at €100,000 level, and on average 24 House Loans at €200,000 level.
- Average membership among the medium sized CUs (€40m to €100m) is 13,000. So on an average basis, the 49 additional loans at €100,000 level represents just 0.4% of membership, and on average the 24 House Loans at €200,000 level represents just 0.2% of membership.
- Again, among the medium sized CUs, the lowest level of additional headroom available is €1.4 million, which would equate to 7 House Loans at the €200,000 level.

Table showing headroom at 10% House loan limit for various sizes of CUs				
CUs > €100m assets	**Amount**		**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€	13,314,069	133	67
Highest increase in headroom	€	30,805,015	308	154
Lowest increase in headroom	€	7,835,582	78	39
CUs €40m to €100m assets	**Amount**		**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€	4,870,588	49	24
Highest increase in headroom	€	9,225,162	92	46
Lowest increase in headroom	€	1,410,849	14	7
CUs Under €40m assets	**Amount**		**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€	1,587,741	16	8
Highest increase in headroom	€	3,502,267	35	18
Lowest increase in headroom	€	66,672	1	0

Impact on loans/assets at a macro level if additional headroom was approved:

The current loan book (which is 94% personal lending) stands at 27.0% of assets. In the 4 scenarios below, we analyse how much the LTA might increase at an aggregate/macro level if additional headroom on House Loans was approved. We assume that the 5% commercial limit is sufficient in these scenarios and just look at the impact on LTA if more headroom is approved on House Loans and if this headroom was maxed out by CUs. If a maximum of 15% of Total Assets was approved, the total headroom for House Loans would increase to €2.196 billion.

Loan diversification scenarios

	Loans		€	4,187,983,248	
	Total Assets		€	15,513,922,892	
	LTA			26.99%	
					As % Assets
	Current House Loans		€	130,659,229	0.84%
	Current Commercial Loans		€	87,909,164	0.57%
1	Headroom House Loans	5%	€	645,036,916	
2	Headroom Commercial Loans	5%	€	687,786,981	
3	Headroom House Loans	10%	€	1,420,733,060	
4	Headroom House Loans	15%	€	2,196,429,205	

If we assume that CUs maxed the 5% limit on House Loans, the LTA could move from current 27.0% to 31.2%.

In scenario 2, we assume that the 5% of assets limit for each type of lending can work independently, for a max of 10% of assets. If the 5% of assets for House Loans and Commercial Loans were both maxed out, the LTA would move up to only 35.6%.

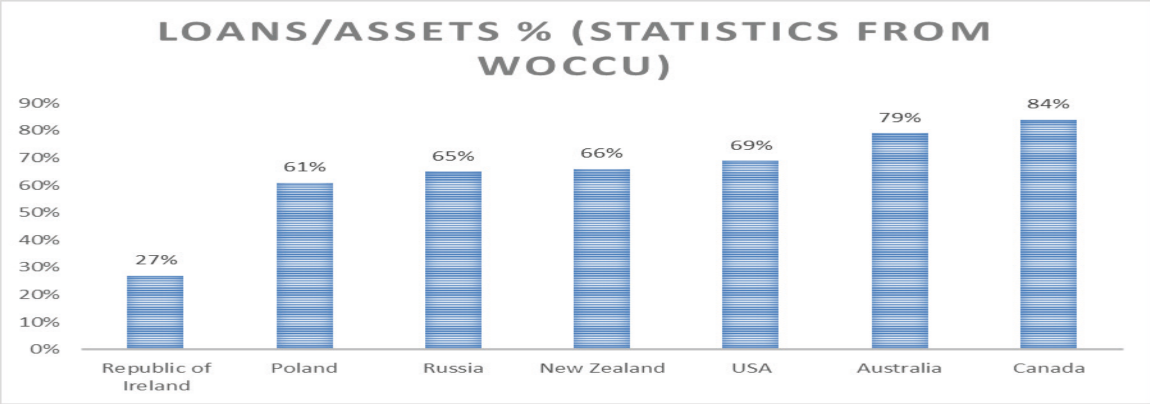
1	If 5% Headroom on House Loans maxed out		
	Total Loans	€	4,833,020,164
	LTA		31.15%
2	If 5% Commercial and separate 5% House Loans limit in place (10% combined)		
	If 5% Headroom on House Loans + 5 % Commercial Loans maxed out		
	Total Loans	€	5,520,807,144
	LTA		35.59%

In scenarios 3 & 4 below, we assume that commercial lending stays within the 5% level, and examine the impact of additional headroom if the House Loan limit was increased to 10% and 15%.

Assume House Loan limit is extended to 10%, and the Commercial (5%) and House Loan limits are maxed out, the LTA would increase to 40.6%.

Assume a House Loan limit of 15% (and again both limits were maxed out) the LTA would increase to 45.6%. Even at a House Loan limit of 20% (and again both limits are maxed out) the LTA would increase to 50.6% which is still extremely low by international standards.

Table 7



3 If 5% Commercial and separate 10% House Loans limit in place		
If 10% Headroom on House Loans + 5 % Commercial Loans maxed out		
Total Loans	€	6,296,503,289
LTA		40.59%
4 If 5% Commercial and separate 15% House Loans limit in place		
If 15% Headroom on House Loans + 5 % Commercial Loans maxed out		
Total Loans	€	7,072,199,433
LTA		45.59%

As CUs operate as autonomous independent units, sector wide lending headroom analysis overestimates the real impact as underutilised capacity is prevalent across the sector. It is not possible to optimise sector capacity as there will always be under/overcapacity. This analytical approach can penalise the better equipped and more progressive CUs, so it is important to build in sufficient scope to ensure that certain CUs are not penalised.

Impact on loan book diversification scenarios:

One of the main issues currently is the lack of diversification in the loan book with 94% of the loan book made up of short term Personal Loans.

In scenario 1 & 2, we assume CUs have a limit of 5% for both Commercial and House Loans and these are maxed out. In this scenario, the % of the loan book in Personal Loans would drop to 71.6% and Commercial and House Loans would make up 28% of the loan book combined.

Current profile			
Personal Loans	€	3,951,540,647	94.35%
Commercial Loans (All)	€	87,909,164	2.10%
House Loans	€	130,659,229	3.12%
Other	€	17,874,208	0.43%
Total	€	4,187,983,248	

Scenario 1+2: 5% House Loan and 5% Commercial maxed			
Personal Loans	€	3,951,540,647	71.58%
Commercial Loans (All)	€	775,696,145	14.05%
House Loans	€	775,696,145	14.05%
Other	€	17,874,208	0.32%
Total	€	5,520,807,144	

In scenario 3, we assume a 10% House Loan limit. House Loans would then make up 24.6% of the loan book and the Personal Loan % would drop to 62.8%. In scenario 4, we move to a 15% House Loan limit, House Loans would then make up 32.9% of the loan book and the personal loan % would drop to 55.9%.

Scenario 3: 10% House Loan and 5% Commercial maxed			
Personal Loans	€	3,951,540,647	62.76%
Commercial Loans (All)	€	775,696,145	12.32%
House Loans	€	1,551,392,289	24.64%
Other	€	17,874,208	0.28%
Total	€	6,296,503,289	

Scenario 4: 15% House Loan and 5% Commercial maxed			
Personal Loans	€	3,951,540,647	55.87%
Commercial Loans (All)	€	775,696,145	10.97%
House Loans	€	2,327,088,434	32.90%
Other	€	17,874,208	0.25%
Total	€	7,072,199,433	

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 who can demonstrate the necessary financial strength, skills, expertise, operations and risk management capability to undertake increased lending in these loan categories?

Whilst the ILCU is supportive of a mechanism which would enable certain CUs avail of an increased concentration limit, as argued above, it is not in favour of combining the concentration limit for house and commercial loans.

Rather it strongly favours having separate concentration limits for these two very distinct sectors.

The ILCU believes that this application process should be robust, whereby individual CUs would have to demonstrate that they have a carefully thought out business strategy which supports the provision of longer term House Loans. This strategy must be underpinned by appropriate governance policies relating to risk appetite, credit policy and asset and liability management.

These policies must in turn be supported by a strong track record in credit assessment and underwriting skills and experience. Post approval, the CU must also be able to demonstrate a track record of satisfactory fulfilment of conditions of sanction in accordance with credit policy.

The ILCU believes that applications for an increased concentration limit should not be restricted to CUs with assets in excess of €100m as it is quite feasible that CUs with assets of less than this could access the resources and systems necessary to meet the criteria set. The ILCU has recently set up the Home Loans CUSO service, which provides operational support to affiliated credit unions in the processing and fulfilment of residential mortgages based on a standardised, consistent and reliable methodology.

Indeed, many of the industrial CUs would have lower risk profiles as repayments can be deducted at source from wages and salaries.

9. What skills, expertise, operational and risk management capabilities do you consider necessary to support increased lending in House and Commercial loans?

As the ILCU does not favour an increase in commercial loans over and above the 5% limit proposed (although this should be subject to review if circumstances change), this section deals with an increased limit for House Loans only. It is critically important that CUs embrace the sentiment and the criteria set out in the CBI document 'Longer Term Lending – Guidance for Credit Unions' (December 2017)

9.1 Governance at CU level

The Board of each CU proposing to engage in higher level of longer term house lending should have:

9.1.1 A detailed Business Plan including a robust risk assessment together with a cost/benefit analysis of growing this business line.

9.1.2 A Risk Appetite Statement which would set limits and time lines in relation to the growth of the business. Said limits and related time lines to be clearly communicated to line management and a process developed to monitor growth against limits set.

9.1.3 Credit Policies which will include key lending criteria and best practice guidelines having regard to Longer Term Lending – Guidance for Credit Unions, Central Bank Macro Prudential Measures and 2016 Regulations. In addition, the credit policies should incorporate the findings of the Central Bank Thematic Review of House Loans in credit unions issued in January 2018. Any exceptions to policy need to be reported to the Board.

9.1.4 An Asset/Liability Management Policy which would reflect the impact that longer term lending might have on the CUs liquidity position.

9.1.5 An independent Credit Review Process as a second line of defence to regularly review the overall performance of the loan book to ensure compliance with legislative requirements, internal credit policies and best practice guidelines and limits per the Risk Appetite Statement. The credit review function will report regularly to the Board on these matters.

9.1.6 A Credit Provisioning Policy should be adopted, embedded and be consistent and transparent.

9.1.7 An Operational Risk Plan to ensure that internal processes, people and systems are adequate to support growth in house loans.

9.1.8 Arrears Management and Support unit for the proactive management of distressed cases

9.1.9 A fit for purpose IT System to provide accurate and timely credit risk management information to support the monitoring, management and reporting of all lending activity, but particularly any increased exposure to house and commercial lending.

9.2 Credit Assessment

To apply these policies, and to ensure professionalism in credit management, lending officers engaged in underwriting in the house loan sector should be appropriately qualified and have considerable credit experience, particularly lending through business cycles.

Underwriting best practices to be documented and adhered to by lending officers. Such best practices to include, inter alia:

- Assessment of borrower's ability to repay (DSR/DTI)
- Confirmation of borrower's income and supporting evidence
- Establishing balance of funds, if applicable
- Stress testing for future increases in interest rates

9.3 Fulfilment

Lending officials need considerable fulfilment expertise to ensure that the facility and all terms and conditions of sanction are properly documented in a facility agreement, and that all precedent conditions and terms of approval are fully complied with prior to draw down.

These include, acceptance of the facility agreement, execution of security, which in the case of house loans will be a first fixed charge on the property, adequate insurance/assurance cover, suitable valuations underpinned by a standard letter of engagement to valuer which ensures that they have a duty of care to the credit union and that they have appropriate Professional Indemnity Insurance.

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

As previously argued, the ILCU does not support a combined concentration limit.

However, the ILCU views that it is appropriate to permit an increased concentration limit of 15% for House Loans, in addition to a 5% limit for Commercial Loans, for those CUs which can demonstrate the necessary financial strength, skills operations and risk management capability to undertake increased lending to this sector.

The ILCU is of the view that 5% of Total Assets for Commercial Loans should provide adequate headroom in the medium term. However, this is predicated on loans of less than €25,000 continuing to be excluded from the concentration limit of 5%.

Levels of **additional headroom at 15% limit for House Loans as proposed by ILCU:**

- 104 or 43% of CUs, would get additional headroom of at least €6 million under the extended 15% limit. This compares to 11 or 5% of CUs, getting additional headroom of at least €6 million under the 5% limit.
- Under the 15% limit, 142 or 59% of CUs, would get additional headroom of at least €4 million. That would mean 59% of CUs could issue at least 40 additional house loans at the €100,000 level.
- There are just 47 CUs who get headroom of €2 million or less, under the 15% extended limit. This compares to 176 CUs getting headroom of €2 million or less, under the lowest 5% limit.
- Again, the CU with the maximum additional headroom would have additional headroom of €49 million. This would mean they would issue a maximum of 490 additional House Loans at €100,000 level, and 245 additional House Loans at the €200,000 level. These 490 loans would represent 0.8% of its 58,000 members, and the 245 House Loans would represent 0.4% of its members.

Table showing increases in headroom at 15% limit for House Loans (Sept 2018 data)								
		Number of CUs	% of CUs		Top level headroom	Max Additional Number Loans €55,000 average	Max Additional Number Loans €100,000 average	Max Additional Number Loans €200,000 average
Increase of > €20m		23	10%		49,000,000	891	490	245
Increase of €10m-€20m		44	18%		20,000,000	364	200	100
Increase of €6m to €10m		37	15%		10,000,000	182	100	50
Increase of €4m to €6m		38	16%		6,000,000	109	60	30
Increase of €2m to €4m		51	21%		4,000,000	73	40	20
Increase of €1.5m to €2m		30	13%		2,000,000	36	20	10
Increase of €1m to €1.5m		9	4%		1,500,000	27	15	8
Increase of <€1m		8	3%		1,000,000	18	10	5
		240	100%					

Headroom by various CU sizes at 15% limit – (i.e. small, medium and large CUs):

- For the largest €100 million + CUs, the average increase in headroom is €22.2 million (up from an average of just over €4.3 million under the 5% limit). On average, these CUs would have headroom to issue 222 House Loans at the €100,000 level, and 111 House Loans at the €200,000 level.

- These largest €100 million + CUs have an average membership of 32,000. (Some CUs have membership above 50,000). The 222/€100,000 House Loans would represent just 0.7% of membership, and the 111/€200,000 House Loans would represent just 0.4% of membership.

- At the higher 15% limit, the largest CUs could cater for less than 1% of their members with the additional headroom on an average basis.

- The highest amount of additional headroom is €49 million, the next highest is headroom of €43 million and the 3rd highest is €39 million.

- The lowest level of headroom for the largest €100 million + CUs is €13.5 million. So for this CU, despite having assets above €100 million, the maximum number of House Loans at the €200,000 level would be 68.

- For medium sized CUs, with assets between €40m and €100m, the average increase in headroom is €8.0 million (up from an average of just over €1.7 million under the 5% limit). This group could, on average, issue 80 additional House Loans at €100,000 level under the extended 15% limit, and 40 House Loans at €200,000 level.

- Average membership among the medium sized credit unions (€40m to €100m) is 13,000. On an average basis, the 80 House Loans at the €100,000 level represents just 0.6% of membership, and the 40 House Loans at the €200,000 level represents just 0.3% of membership.

- So even at the higher 15% limit, medium sized credit unions could cater for less than 1% of their members with the additional headroom.

Table showing headroom at 15% House loan limit for various sizes of CUs			
CUs > €100m assets	**Amount**	**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€ 22,180,957	222	111
Highest increase in headroom	€ 48,852,042	489	244
Lowest increase in headroom	€ 13,508,715	135	68
CUs €40m to €100m assets	**Amount**	**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€ 8,045,236	80	40
Highest increase in headroom	€ 14,142,151	141	71
Lowest increase in headroom	€ 3,442,315	34	17
CUs Under €40m assets	**Amount**	**Number of extra loans (€100,000 size)**	**Number of extra loans (€200,000 size)**
Average increase in headroom	€ 2,642,197	26	13
Highest increase in headroom	€ 5,456,317	55	27
Lowest increase in headroom	€ 111,215	1	1

11. Do you have any comment on the application process referred to above?

The ILCU agrees in principle with the process referred to in CP125.However, the outline is high level and the ILCU would like to get a better understanding of the expectations of the CBI in relation to the minimum criteria necessary for approval for the increased concentration. It would also be appropriate for the CBI to outline maximum timelines for the communication of a decision, assuming it has received all relevant information.

The existing application form under the 2016 Regulations, whilst detailed, may require some enhancement.

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

The ILCU is supportive of this amendment.

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

The definition “a loan made for the purpose of financing the working capital or capital investment needs of owner managed small business enterprise” is reasonable. However, there are circumstances where this definition will constrain legitimate opportunities e.g. where a business is owned and controlled by a member but not necessarily managed by them.

It is our understanding that a small business enterprise will be defined as: *An enterprise which employs fewer than 50 persons and which has an annual turnover and an annual Balance Sheet total which does not exceed €10m.*

The ILCU does not support the blanket prohibition on lending for buy to let properties for either residential or commercial purposes.

Whilst caution is required in lending into this sector, when carefully executed it can be a very important niche. The risk characteristics can be materially mitigated by lending only to very well established members at conservative LTVs, and where cash flow via rental income can be clearly established, verified and stress tested to ensure repayment capacity. A secondary source of repayment can also be established by only lending to financially strong members who are financially sophisticated. Moreover, in a doomsday scenario, enforcement is relatively straight forward in this category, which provides a third source of repayment.

It is recommended that CUs would not necessarily be proactive in this sector, but would only respond to approaches from very well established members. Examples of this might be a small business premises, owned personally by a member who is also the owner manager of a small business/company operating from this premises.

Any lending in this category can be included in the concentration limit for commercial loans.

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

There is no change to the maximum large exposure limit of 10% of regulatory reserves. However, reporting is now required at a lower level of 2.5% of regulatory reserves. The ILCU is supportive of this amendment. The definition of connected borrowers remains the same.

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

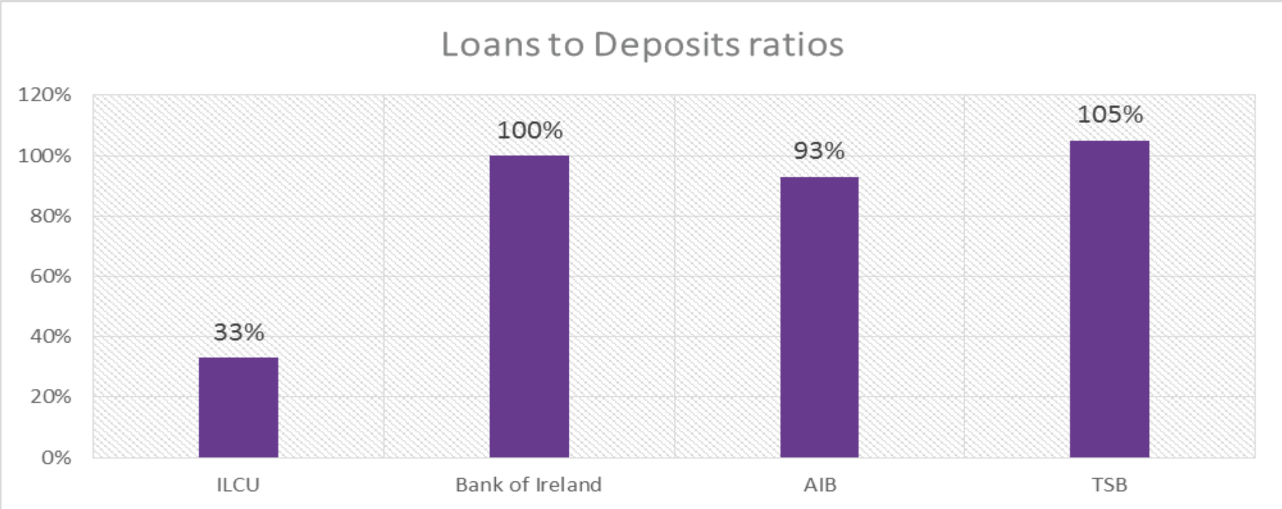
The ILCU agrees with the transitional arrangements proposed.

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.

The current model where there is a very rapid flow back/repayment of almost all loans underpins the very liquid position of the sector. This will potentially change somewhat over time as the % of loans with longer maturities increases.

New loans advanced in the 9 months to 30th September were €2.2bn, which resulted in total loans outstanding at that date of €4.2bn. This was an increase of only €0.289m year on year. Accordingly, flow back/repayments amounted to €1.9bn for the same period. Whilst this is a relatively labour intensive business model, it nonetheless underpins the very liquid position for CUs. With longer term lending, flow back will be less rapid but it must be borne in mind that under the revised ILCU proposals, the vast majority of CU lending will still remain short term.

CUs currently have savings of €12.90bn which has grown by almost €2.4bn since the height of the financial crises in September 2008. This trend indicates a very high level of trust from savers especially during difficult conditions. CUs are covered by the Deposit Guarantee Scheme ("DGS") which guarantees deposits up to €100,000 per person per institution. The vast majority of CU savers are protected by the DGS as the average deposit stands at €4,156 with only 1,100 (savings of €155m) out of 3.1m savers exceeding the €100,000 mark.



CUs have a requirement to hold 20% of savings in liquid assets (<3 months) and this currently amounts to €2.625bn. This can increase to 30% depending on the % of loans > 5 years. The ILCU is of the view that this requirement is sufficient to support longer term lending at the levels proposed.

However, CUs with increased and increasing levels of longer term lending, must factor this into their investment policy to ensure that they remain liquid and able to meet depositors demand, especially in stressed scenarios.

Summary:

Question	Agree	Disagree	Proposed
1. Remove 5/10 year maturity cap	*X*		
2. Max maturity 10 years for unsecured loans.		*X*	Max of 15 Yrs.
3. Definition of secured loans	*X*		With some expansion
4. All commercial loans to utilise concentration limit		*X*	Retain status quo
5. Board reporting for house loans	*X*		
6. Base combined concentration limit		*X*	Separate Limits.
7. Max limit of 5% for House and Commercial loans within 7.5% combined limit.		*X*	1. Commercial limit ok. 2. House limit @ 10%.
8. Skill, expertise etc.	*X*		
9. Increased combined concentration limit for House and Commercial @ 15%		*X*	Separate limits: 1. Commercial @ 5% 2. House @ 15%
10. Application Process	*X*		
11. Re-name commercial loan	*X*		
12. Definition of small business loan	*X*		
13. Large exposure definition	*X*		
14. Transitional arrangements	*X*		
15. ALM considerations	*X*		

Conclusion:

The concerns of the ILCU and the CBI overlap considerably in relation to the Lending Framework for CUs. CUs are facing very significant financial and commercial challenges and the existing limits act as a constraint. There is currently insufficient capacity to build a viable business line, particularly in House Loans, given the significant investment required to develop and support such a business line.

The ILCU and the CBI share the view that all lending should be prudent and well managed and in line with individual CU strategy, capabilities and risk appetite.

There is also a shared concern in relation to the low LTA ratio and the need for CUs to prudently develop and diversify their business.

Whilst the proposal by the CBI to change the Lending Framework is welcome, the ILCU believes that some of the changes proposed do not go far enough to enable a majority of CUs to make medium and long term plans in relation to creating robust and sustainable business models.

1. The ILCU disagrees with the proposal to combine limits for House Loans and Commercial Loans.

2. Whilst the ILCU is supportive of a 5%/Total Assets limit for commercial loans, it believes that a 5%/Total assets limit for house loans provides insufficient headroom. This limit would only provide additional headroom across the sector to write approx. 200 loans at the average First Time Buyer loan of €218,000. This number of loans, spread across the sector over a number of years could not justify any material investment in this activity. As proposed, the Concentration limit will not facilitate either portfolio diversification or enable strategic Business Model development.

3. The ILCU proposes a base concentration limit 10%/Total Assets for House Loans. Even at this level, the capacity created across the sector would only facilitate approx. 400 loans over a number of years.

4. The ILCU proposes an increased concentration limit of 15%/Total Assets for House Loans for CUs that can demonstrate the appropriate skills, expertise, operational and risk management capabilities. The ILCU proposes that such applications for increased limit should not be restricted to CUs with Total Assets > €100m

5. The ILCU proposes a review of the Regulatory Framework limits within three years of Implementation.

The changes proposed by the ILCU reflect the improved risk management frameworks evident across the sector, although it is recognised that this can be improved further. This fact, combined with the higher regulatory standards, can facilitate a prudent and gradual growth and enhancement in Balance Sheet volume and diversification. The ILCU would like to see the 3 year review suggestion referenced in CP125 to be embedded in the Regulation.