Submission from a group of specified credit unions

Relating to Consultation Paper 125

09 January 2019

1. Introduction and background to this paper

1.1. Introduction

1.1.1. This paper is submitted by the following credit unions (hereinafter referred to as “the participating credit unions”):

- Altura Credit Union
- Cara Credit Union
- Caherdavin Credit Union
- First Choice Credit Union
- Killarney Credit Union
- Mallow Credit Union
- Muintir Skibbereen Credit Union
- People First Credit Union
- St. Canice’s Kilkenny Credit Union
- St. Francis Credit Union
- St. Paul’s Garda Credit Union
- Savvi Credit Union
- Synergy Credit Union
- Thurles Credit Union
- Wexford Credit Union

1.1.2. On 1 January 2016, section 11 of the Credit Union and Co-operation with Overseas Regulators Act 2012 (“the 2012 Act”) was commenced which substituted a new section 35 in the 1997 Act and provided regulation making powers to the Central Bank in relation to lending. The Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 (as amended) (the 2016 Regulations) also commenced on 1 January 2016 with Part 4 of the 2016 Regulations setting out lending regulations for credit unions. The 2016 Regulations outline the categories of lending which a credit union can undertake and contains certain concentration and large exposure limits for lending. They also contain specific requirements in relation to lending practices. 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 1997 Act, are now contained within Regulation 14 of the 2016 Regulations. These limits are currently 30% and 10% of gross loans outstanding for 5 and 10 year maturities respectively but may be increased to 40% and 15% where a credit union is approved by the Central Bank of Ireland (“CBI”) to avail of increased limits.

1.1.3. The CBI published a consultation paper (hereinafter referred to as “CP125”) to consult on potential changes to the lending framework for credit unions in October 2018. These proposed changes were informed by the CBI’s statutory mandate in relation to credit unions as set out in section 84 of the Credit Union Act, 1997 (“the 1997 Act”) which requires that the Central Bank shall administer the system of regulation and supervision of credit unions with a view to:

- the protection by each credit union of the funds of its members,
- the maintenance of the financial stability and well-being of credit unions generally.

1.1.4. The CBI notes in CP125 that there has been significant engagement with the sector in relation to the existing lending framework with a particular focus on the impact of existing limits on the capacity for credit unions to undertake longer term lending including house loans. CP125 sets out proposed changes to the 2016 Regulations and CP125 seeks views from stakeholders on the following:

Removal of 5 and 10 Year Lending Maturity Limits:

- 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)?

Maximum Loan Maturity Limit for Unsecured Loans:

- Do you have any comments on the proposal to introduce a maximum maturity limit of 10 years for unsecured loans?
- Do you have any comments on the proposed definition of a secured loan?

Concentration Limits for House and Commercial Loans:

- Do you have any comments on the proposal to require that all commercial loan exposures utilise the concentration limit for commercial lending?
- Do you have any comments on the Central Bank's intention to introduce board reporting requirements for house loans?
- 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?
- 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?
- 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?
- What skills, expertise, operational and risk management capabilities do you consider necessary to support increased lending in house and commercial loans?
- Do you have any comments on the proposed increased combined concentration limit for house and commercial lending of 15% of Total Assets?
- Do you have any comments on the application process referred to above?

Definition of Commercial Loans:

- Do you agree with the proposal to re-name the commercial loan lending category to small business loan?
- Do you have any comments on the proposed definition for a small business loan?

Large Exposures:

- 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?

Transitional Arrangements:

- Do you have any comments on the proposed transitional arrangements?

Liquidity and ALM Considerations:

- 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?

1.2. Background and context to certain authors of this paper

1.2.1. In late 2016, a group of credit unions agreed to explore the concept of longer-term lending for credit unions, in particular, an expanded home loan offering from a credit union context. The participating credit unions were as follows: Bishopstown Credit Union, Drogheda Credit Union, Health Staff Services Credit Union, Naas Credit Union, St Anthony's & Claddagh Credit Union, St Canice's Kilkenny Credit Union, Savvi Credit Union (formerly St Patrick's Credit Union (ESB Staff), St Paul's Garda Credit Union, Tipperary Credit Union, Tralee Credit Union, Tullamore Credit Union and Wexford Credit Union. This culminated in a paper submitted to the Central Bank of Ireland in September 2017.

1.2.2. The paper noted that the 2016 regulations as they apply to maturity limits had a severe restraining impact on the ability of credit unions to maximise core lending greater than 5 years and to penetrate the home loan market as loans over 5 and 10 years are restricted by absolute quantitative limits. The paper attempted to sketch an alternative regulatory framework that would enable credit unions to lend beyond the current maturity limits, in a risk sensitive, measured and prudent manner.

1.3. Initial Comment

1.3.1. The participating credit unions would firstly like to welcome CP125, and emphasise that a progressive, responsive and dynamic regulatory framework is necessary to enable the credit union business model to develop and evolve. The participating credit unions would like to acknowledge, recognise and commend the work of the Central Bank of Ireland that was required to enable CP125 to be published.

1.4. Structure of this paper

1.4.1. This paper follows the direct chronology of CP125, with a section in this paper devoted to each area of focus, as follows:

- In **Section 2** we set out our views on the removal of 5 and 10 year lending maturity limits.
- In **Section 3** we set out our views on the maximum loan maturity limit for unsecured loans.
- In **Section 4** we set out our views on the concentration limits for house and commercial loans.
- In **Section 5** we set out our views on the definition of commercial loans.
- In **Section 6** we set out our views on large exposures.
- In **Section 7** we set out our views on transitional arrangements.
- In **Section 8** we set out our views on Liquidity and ALM Considerations.

1.5. Overall Approach

1.5.1. In providing feedback on the regulations, the participating credit unions are mindful of that the 2012 Act created regulation making powers for the Central Bank and Section 29 of the 2012 Act amended Section 84 of the 1997 Act by inserting the following:

> *(1) In making regulations under this Act the Bank shall have regard to the need to ensure that the requirements imposed by the regulations so made are effective and proportionate having regard to the nature, scale and complexity of credit unions, or the category or categories of credit unions, to which the regulations will apply.*

1.5.2. In this regard, the overall approach of the participating credit unions was to provide feedback on whether it viewed the proposed regulations would be *effective* and *proportionate* with due regard to the nature, scale and complexity of credit unions.

2. The removal of 5 and 10 year lending maturity limits

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)?

2.1. Participating Group Views

2.1.1. The participating credit unions would support the proposed removal of the 5 and 10 year lending maturity limits. The 2016 regulations as they apply to maturity limits have had a severe restraining impact on the ability of credit unions to maximise core lending greater than 5 years and to penetrate the home loan market as loans over 5 and 10 years are restricted by absolute quantitative limits.

2.1.2. The participating credit unions previously have articulated their view that the optimal outcome would be to shift the calibration of the maturity regulations from loans to assets. In the view of the participating credit unions, this would serve the following purpose:

- Ensure greater consistency and predictability of asset maturity in differing economic scenarios.
- Retain an orderly and prudent overall asset maturity profiling.
- Offer a greater degree of holistic and flexible balance sheet management in strategic contexts.

2.1.3. The participating group credit unions note that the recalibration that is proposed looks set to take place by removing the maturity regulation, rather than recalibrating the maturity regulation, and creating a new regulation on loan type which is recalibrated to assets. This will be considered in Section 4 of this paper.

3. The maximum loan maturity limit for unsecured loans

3.1. Participating Group Views

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

3.1.1. The participating credit unions would view the level of unsecured loans over 10 years is unlikely to be significant on a sectoral level. While the participating credit unions understand that there is a risk that the absence of a maturity limit could lead to a credit union taking unduly long positions on loans that ought to be of shorter duration, the participating credit unions would feel that an absolute rule such as is proposed, would be unduly prohibitive to all credit unions, and would be disproportionate to the risks presented.

3.1.2. The participating credit unions would view that there are limited circumstances where unsecured loans may reasonably and prudently extend over 10 years. For example, as part of a credit control measure, a credit union may restructure a loan over 10 years to design a realistic, affordable and achievable repayment plan for a member. Under the regulation as proposed, the credit union would be unduly prohibited from engaging in such a restructuring transaction, and therefore be precluded from taking a reasonable credit control measure, which would be in better interests of the member, and the well-being of the credit union.

3.1.3. However, the participating credit unions are mindful of the regulatory objective to prevent abuse of the absence of a maturity limit. The participating credit unions would view that an alternative measure to achieve this regulatory objective, which would be effective and proportionate, would be as follows:

- Include a regulation that requires a reporting function in the three lines of defence model (for example compliance or internal audit), to independently assess all unsecured loans over 10 years on a periodic basis.
- This report would be brought to the board, and would be capable of oversight by the CBI.
- This would be similar in nature to the current regulatory framework around related party lending.
- In this manner, the credit union's governance infrastructure would be used effectively to mitigate an area of risk in an effective and proportionate manner.
- This would also enable flexibility in credit unions to take long positions on unsecured loans, in the limited circumstances when this arises.
- In addition, the Prudential Return reporting framework could be adjusted to include a reporting obligation on credit unions to report on unsecured loans over 10 years. This would enable the Central Bank of Ireland to easily identify if credit unions are building an excessively long concentration in their unsecured lending book.

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

3.1.4. In so far as the definition of a secured loan refers to a "pledge of shares" or "assignment of a deposit", the participating credit unions would comment as follows:

- The participating credit unions have no objection in principle to this element of the definition.
- The participating credit unions would assume that the definition ought to include "fully pledged" or "fully assigned" or wording to that effect. All credit union loans would have an element of pledged shares (and possibly deposits) and clarification on this matter would be helpful to avoid possible ambiguity. Any partial security limit (for example at a fixed % of shares) would be potentially confusing and challenging to administer.

3.1.5. In so far as the definition of a secured loan refers to a "first charge", the participating credit unions would comment as follows:

- For the purpose of the secured loan definition, that in turn drives the unsecured loan maturity limit regulation, the participating credit unions would view that the definition ought to be expanded to include second charges and liens.

4. The concentration limits for house and commercial loans

4.1. Participating Group Views

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

4.1.1. The participating credit unions do not have any objection in principle to this new proposed regulation as it enables a more consistent approach in overall portfolio management of concentration risk within a credit union's loan book.

4.1.2. The participating credit unions would view that the definition of "commercial loan" is central to this matter, as definition parameters that delineate between personal loans and commercial loans generally become more blurred on smaller loans e.g. take the example of a tradesperson with a small business who runs a business and personal affairs through one bank account borrows €5,000; it can be challenging to categorise such a loan into a clearly defined categories. This will be considered further, elsewhere in this paper.

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

4.1.3. The participating credit unions have no objection in principle to this new proposed regulation.

4.1.4. The credit unions would however comment that the current regulation (as it relates to commercial loan reporting which presumably will simply extend to house loans) is very general and simply refers to "*include details on the performance of loans*". Mindful of the non-executive nature of a Board of Directors, and the general principle that non-executive directors should not become unduly involved in operational matters, the participating credit unions would view that any reporting on house loans (and commercial loans) ought to be terse, refined and mediated and suitably non-executive in its orientation. The participating credit unions are cognisant of the increased (and increasing) reporting burden placed on boards of directors (for example the recent regulatory guidance on provisioning that issued in April 2018) and would be concerned that the volume of the reporting burden may become counter-productive to the broader interest of the movement ensuring volunteer participation and adequate succession capability.

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?

4.1.5. The participating credit unions would question the merits of creating a regulation that aggregates concentration limits for two differing types of lending with different risk profiles and lending practices, which are in turn exposed to differing external forces. The participating credit unions would view that the opportunities and risks in the commercial lending market are not directly correlated to the opportunities and risks in the house loan market, and placing an aggregated cap mixes two differing risk profiles within one regulation.

4.1.6. The participating credit unions would furthermore view that the aggregation of a concentration limit between two differing lending types, would create a layer of operational complexity that may be unnecessary:

- On a practical level, predicting and managing lending volumes in two mutually exclusive lending types to ensure *compliance* with an aggregated limit, may be unduly complex.
- Strategic and financial planning processes would need to factor in an undue interdependence between commercial and house lending.

4.1.7. With regard to the 7.5% limit, given the interdependence of the 7.5% of the 5% limit, the limits in their generality, will be considered in answer to the next question.

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?

4.1.8. The participating credit unions would view that the quantitative cap is central and the most judgmental and sensitive element of the entire proposed credit framework. In this regard, the participating credit unions have a number of comments to make.

4.1.9. The structure of the proposed new regulation, in effect enables a credit union to issue house loans to a total 5% of total assets **or** commercial loans to a total to 5% of assets. However, if a credit union utilises one capacity (house loans or commercial loans) the other capacity reduces to 2.5%.

4.1.10. With regard to the house loans limit:

- The general argument put forward by the movement relating to the current 10% rule over the past number of years, is that the capacity to issue long loans has contracted with the general reduction in the loan book of the movement.

- This appears accepted in CP125, in that the paper accepts that the regulation is *pro-cyclical* and peaks and troughs with general credit flows driven by external macro-economic factors.
- In this regard, the recalibration of the rule relating to long term lending from loans to assets is warmly welcomed by the participating credit unions.
- With regard to the actual quantitative measure (while this is admittedly inherently arbitrary and judgmental), the following analysis could be made with regard to the 5% limit:
- The current loan to asset ratio of the movement is 28% of assets (as at September 2018).
- In this regard, the general operation of the current maturity limit is that it restricts the long term element of a credit union's loan book to 2.8% (i.e. 28% * 10%).
- The proposed limit is 5%, which represents a doubling of the current limit.
- Given that the movement was (generally) 50% lent, pre-crash, the 10% rule pre-crash would have broadly equated to 5% at that point (i.e. 50% * 10%).
- In this regard, one could argue that the proposed rule effectively corrects the downside impact of the existing pro-cyclical rule, rather than creating any additional capability.
- Mindful of the investment that the movement has made in its governance and risk management framework, a restoration of long term lending capability to what was available (theoretically) 10 years ago, is arguably a modest and limited regulatory concession.
- If a credit union has 5% commercial lending, this limit further contracts to 2.5%, effectively resulting in little change to the capability of the credit union (e.g. a form of zero sum game).
- The participating credit unions note that the 5% limit incorporates all maturity profiles. Under the existing rules, a credit union could have an element of house loans in the 5 to 10 year bracket (30%) as well as the over 10 year bracket (10%). The new proposed house loans limit would be indiscriminate to time horizons, and hence credit unions may find their house loans capability more restricted due to this characteristic, when the level of house loans between 5 and 10 years is added to loans over 10 years.

4.1.11. For these reasons (namely that the recalibration should extend beyond a pro-cyclical corrective measure mindful of the general reform of the movement over the past 6 years, and, must be cognisant of house loans in the 5 to 10 year bracket), the participating credit unions would view that the general limit for house loans should extend to 7.5%.

4.1.12. With regard to the commercial loans limit:

- The current regulatory reserve level must be retained at 10%. The current commercial lending capability is correlated to 50% of the regulatory reserve, which broadly equates to 5% of total assets.
- In this regard, the proposed limit of 5% of assets, results in a stand-still position.
- This obviously is reduced to 2.5% if the credit union utilises its 5% in house lending, and this would result in a reduction in commercial lending capacity.
- This is in turn exacerbated by a widening of the definition of "commercial lending", which would reduce the capacity further, from current capability.

4.1.13. For these reasons, the participating credit unions would view that the general limit for commercial loans should be retained as a standalone 5%.

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?

4.1.14. The participating credit unions welcome the proposal to increase the limit beyond the standard entitlement. The participating credit unions would however comment that there is little indication of the parameters or criteria that enable credit unions to avail of the extended limits, and hence, are somewhat blind to what is required to avail of the extended limits, and assess the likelihood of the extended limits being achievable.

4.1.15. The participating credit unions would point out that if the general rule (lower limits of 5% and 2.5% etc.) is to be extended (as argued above), the participating credit unions would expect a proportionate increase be made to the upper rule.

4.1.16. The participating credit unions would make one further suggestion:

- Mindful of the time-lag that is inevitable with any regulatory change (consultation, feedback, drafting of a Statutory Instrument, law-making etc.), any further recalibration of the limits is likely to take significant time.
- Mindful that the CBI will have absolute control over which credit unions are eligible for extended limits in any event (i.e. the ultimate gate-keeper in all scenarios), is there merit in not quantifying the extended limits, and leave this at the discretion of the Central Bank of Ireland?
- This would avoid a situation, where, at some point in the future, the movement has advanced close to the limit, and has to "pause" (which is operationally difficult and damaging to members) while a lengthy consultation process takes place to adjust the limits again.
- Leaving the upper limit unquantified, may position a more dynamic and responsive regulatory framework, while still ensuring regulatory supremacy on which credit unions avail of the higher limits.

4.1.17. With regard to the quantum of the proposed overall 15% limit, the participating credit unions would make a number of comments as follows (with numbers rounded for ease of illustration):

- The movement wide assets currently stand at €18bn.
- The movement loan to asset ratio is stated at 28%, or, approximately €5bn.
- We understand that this equates to a market share of 34% of the Irish unsecured personal loans market.
- On the basis that the current loan to asset ratio of 28% is widely accepted to be unsustainably low, one could reasonably state that a desired loan to asset ratio ought to be 70% (the US loan to asset ratio, as a leading credit union economy, was 69% at 30 September 2018 as per the National Credit Union Administration). This implies that the movement should be strategically positioning itself to lend a further €7.6bn into the Irish economy (i.e. €18bn at 70% less the current €5bn loan book) to bring the national loan book to €12.2bn.
- The unsecured Irish loans market simply is not big enough to support this level of lending. Even if credit unions dominated the unsecured loans market (an improbable and undesired outcome for a range of factors), the movement would still remain under lent.
- In this context, the current extended limit of 15% for commercial and home loans, while welcome, must be set in this broader macro-economic context. It is questionable that the scale of the extended limits are sufficient, to address the longer term strategic positioning of the movement. The current 28% loan to asset ratio, augmented with a 15% extension into home and commercial loans, does not adequately right-size the loan to asset ratio. It enables a capability of €2.7bn (€18bn at 15%) and falls short in addressing the lending gap of €7.6bn needed to create a more sustainable loan to asset ratio.
- Separate to this, there are other compelling portfolio risk management factors that are relevant. The movement ought to be able to diversify its concentration risk profile from (more risky) unsecured lending to (less risky) secured lending, assuming adequate underwriting and ALM structures and capabilities are put in place.
- In this regard, the participating credit unions would argue that the extended limit should be set in the context of the home loans market itself. If the Irish mortgage market is estimated at €110bn, a realistic and achievable credit union market share may be positioned at 5% (i.e. €110bn at 5% is €5.5bn), coupled with a commitment by the movement to design, create and operate suitable risk management capabilities and infrastructure (primarily credit risk management and ALM structures).
- This is set in a broader economic context of credit unions being (arguably) overcapitalised by reference to the statutory minimum capital level of 10% (as well as by reference to the USA net worth ratio of 11.21%). With assets in a cycle of growth, the capital ratio is likely to enter a cycle of dilution, as reserves are outpaced by the velocity of asset growth, exacerbated by a structural inability to diversify its product and income profile. This does present a significant risk to the overall stability of the movement. The only option the movement appears to have is to restrict savings, which is anathema to the overarching operating principle of serving members' socio-economic needs, which include a trusted depositary for savings. This also would appear to be inconsistent with trends in the wider financial services industry where retail funding sources are viewed to be more favourable than other funding sources, particularly retail deposits.
- In this regard, the participating credit unions would urge careful consideration of the extended 15% limit (if there needs to be one), and to ensure it is positioned as a strategic rightsizing measure (which the CBI retains regulatory supremacy over in any event), rather than a restrictive limit solely designed to mitigate risk.

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

4.1.18. The participating credit unions would view that the capabilities would fall into three broad categories:

- Standardised consumer oriented and risk sensitive lending frameworks.
- Asset Liability Management Frameworks.
- Robust three line of defence oversight to include risk, compliance and internal audit.

4.1.19. Each of these are now briefly described:

4.1.20. Standardised *consumer oriented risk sensitive lending frameworks* would include:

- Systematic, disciplined and structured lending practices that appropriately manage credit risk.
- Systematic, disciplined and structured lending practices that appropriately comply with consumer protection and macro-prudential rules.

4.1.21. *Asset Liability Management* Frameworks will be separately referred to in Section 7 anon.

4.1.22. The *Three Lines of Defence Model* describes responsibilities for effective risk management and control as follows:

- Management is primarily responsible for monitoring and controlling processes, and is the first line of defence in risk management.
- The second line of defence consists of separately established risk, control, and compliance oversight functions that ensure properly designed processes and controls are in place within the first line of defence and are operating effectively.

- Functions, such as internal audit, that provide independent assurance over processes and controls are considered the third line of defence.
- Assuming effectiveness, each line of defence contributes to healthy organisational governance by ensuring objectives are achieved in the context of the legal, regulatory and market environments. Both the second and third lines provide oversight and/or assurance over risk management activities.
- The three line of defence model would be recalibrated to provide relevant assurances over commercial and house lending.

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

4.1.23. As stated above.

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

4.1.24. The participating credit unions have commented above that there is little indication of the parameters or criteria that enable credit unions to avail of the extended limits, and hence, are somewhat blind to what is required to avail of the extended limits, and assess the likelihood of the extended limits being of achievable.

4.1.25. Notwithstanding this, the participating credit unions would comment as follows:

- The participating credit unions would welcome an expedited guidance note with clearly defined and transparent regulatory expectations with regard to what is needed to reach the upper limits.
- The participating credit unions would welcome a “glide-path” that would enable credit unions to position themselves in a measured but structured manner to avail of the extended limits (be it a forum, work-shop, hot-house of some sort).

5. The definition of commercial loans

5.1. Participating Group Views

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

5.1.1. The participating credit unions would hold concerns with an expansion of the definition of a small business loans as is suggested.

5.1.2. As stated earlier, the participating credit unions would view that the definition of "small business loan" is challenging in a credit union context, as definition parameters that delineate between personal loans and commercial loans generally become more blurred on smaller loans e.g. the example previously given of a tradesperson with a small business who runs a business and personal affairs through one bank account borrows €5,000. It can be challenging to categorise such a loan into a clearly defined categories. Is this loan a personal loan or a commercial loan?

5.1.3. With regard to general risk profiling, it is also subjective whether there is additional risk with smaller loans that sit in a blurred position between commercial and personal contexts. To illustrate, in an economic downturn, the tradesperson, the employee of the local supply shop that supplies the tradesperson, or the teacher that teaches the child of the tradesperson, are all arguably exposed to wider economic forces e.g. in a severe economic downturn, all three actors will be likely to see a reduction in their income levels and a lessening of their repayment capacity to repay a loan. This is separate to a commercial loan for a specific commercial venture, with business plans, projections, and a more focused business objective which has a specific business venture risk.

5.1.4. This area is hugely difficult to categorise, and a better way to profile the risk is likely to be based on a quantitative measure, in that loans that have characteristics of personal lending and commercial lending, are generally defined by being small. As a practical measure, the participating credit unions would view that "small business lending" should have a *de minimus* measure (suggested at €25,000) whereby only loans that exceed €25,000 can be capable of being "small business" loans. This would be easier to operate and regulate, without any compromise on general risk management contexts.

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

5.1.5. With regard to the proposed prohibition on buy-to-let properties, the participating credit unions would view this to be an unnecessary prohibition, and, assuming a credit union has sufficient credit risk management capability it should be allowed to continue to provide credit for buy-to-let properties.

6. Large exposures

6.1. Participating Group Views

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?

6.1.1. The participating credit unions agree in principle to the proposed 2.5% single exposure limit.

7. Transitional arrangements

7.1. Participating Group Views

Do you have any comments on the proposed transitional arrangements?

7.1.1. The participating credit unions agree in principle with the transitional arrangements.

8. Liquidity and ALM Considerations

8.1. Participating Group Views

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?

8.1.1. The participating credit unions would refer to the September 2017 submission which (in their view) dealt extensively with ALM. The position of the group has not changed, and in this regard, the content of the September 2017 paper will be extracted and set out below, as it relates to ALM. Statistical information is set out below, as prevailed in September 2017.

8.2. 2017 Paper (in italics)

Introduction

8.3. Asset Liability Management ("ALM") can be broadly defined as the policies, systems and processes employed to address the risks faced by an institution due to a mismatch between assets and liabilities either due to liquidity or changes in interest rates. While interest rate risk and liquidity risk are distinct concepts, they are associated. Interest rate risk refers to the current or prospective risk to a credit union's capital and earnings arising from adverse movements in interest rates. When interest rates change, the present value and timing of future cash flows change. This in turn changes the underlying value of a credit union's assets and liabilities and hence its economic value. Liquidity risk broadly refers to the risk that a credit union does not hold sufficient assets in a liquid form to meet its liabilities as they arise.

8.4. This section of the position paper will be structured as follows:

- *Firstly, an overview of the funding structure, liquidity practices and interest rate charges in Irish credit unions will be set out.*
- *Secondly, the possible challenges that a greater level of longer term loans would present to the funding structure, liquidity practices and interest rate charges in Irish credit unions is set out.*
- *Thirdly, contexts from two credit union economies (the USA and New Zealand) are introduced.*

Funding Structure, Liquidity Practices and Interest Rate Charges in Irish Credit Unions

8.5. Banks will typically raise funds in four principal markets, and will be charged a cost for doing so. The four markets would typically be retail markets (e.g. deposits from customers), wholesale markets (e.g. bond products), official sources (e.g. ECB monetary policy operations) and capital (e.g. ordinary equity investors, preference equity investors, subordinated instruments).

8.6. The funding structure of credit unions is different to banks, and credit unions can only source funding from members (i.e. a limited form of retail funding). Credit unions in Ireland cannot access wholesale money markets or official sources of funds and there is currently no centralised liquidity facility for Irish credit unions. It is important to note that retail funding is generally considered to be more stable and sticky than wholesale funding. In the aftermath of the global financial crisis where wholesale markets suffered chronic and severe contractions in liquidity, there has been a shift to orientate banking funding bases from volatile wholesale markets to more stable retail markets.

8.7. In December 2010, the Basel Committee on Banking Supervision issued Basel III: International framework for liquidity risk measurement, standards and monitoring. This coincided with its release of enhanced capital standards and completed the reformed framework called for by G20 leaders. Collectively, these new global standards, referred to as Basel III, were intended to strengthen the resilience of global banking institutions. Basel III introduced two new liquidity ratios that were intended to ensure that banks hold sufficient liquidity aside for crisis situations. In so doing, Basel III did set out a detailed level of information of the characteristics that define the stability of funding. Key principles arising from Basel III on what characterises stable funding, could be summarised as follows:

- Retail funding is viewed as more stable than wholesale funding.
- Within retail funding, there is a sub-hierarchy of funding. Retail funding can be further categorised (in descending order of stability) as follows:
- Fixed Term Deposits
- Stable Deposits
- Less Stable Deposits
- Stable retail deposits are generally deposits from individuals that are covered by a deposit guarantee scheme and either from depositors with established relationships with a bank, or the deposits that are in transactional accounts (e.g. accounts where salaries are automatically deposited). Less stable retail deposits would include but not be limited to; deposits from individuals that are not covered by a deposit guarantee scheme, large deposits and high net worth individual deposits.

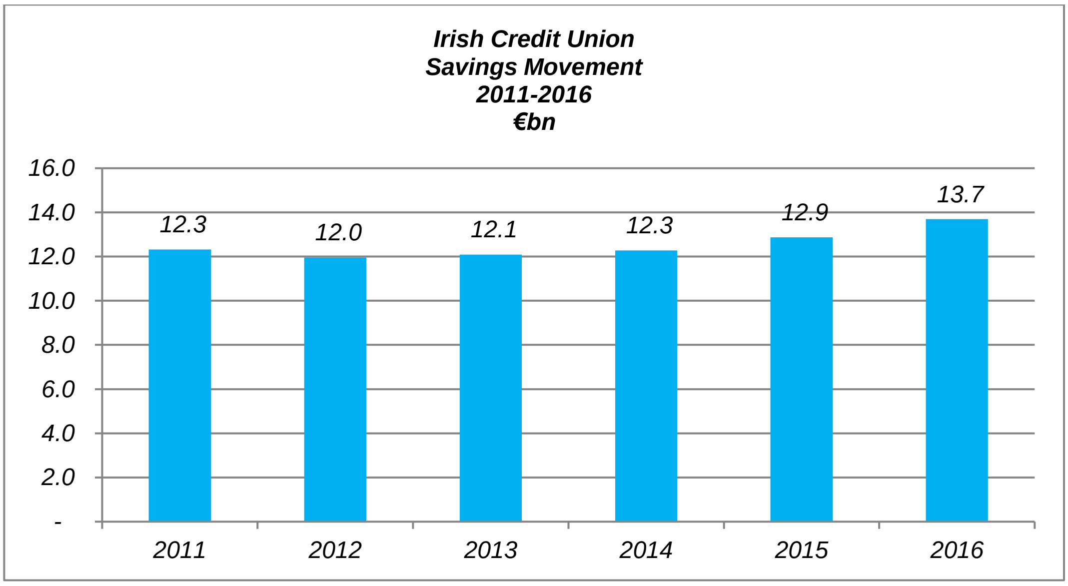
8.8. *The funding base of Irish credit unions is made up almost entirely of demand shares. In addition, it is almost entirely covered by the deposit guarantee scheme. Generally, the following could also be said:*

- The credit union funding base is made up of depositors with long established relationships with the credit unions.
- The credit union funding base is not transactional (although this may change soon with the recent development of the Member Personal Current Account Service by the Central Bank of Ireland to allow eligible credit unions to offer these accounts and associated payment services and instruments such as debit cards).

8.9. *In this regard, contextualising the funding structure of Irish credit unions in Basel III hierarchies, it is reasonable to comment that the Irish credit union funding base is made up of the more stable category of retail deposits, and within this, it is largely made up of what is characterised as "Stable Deposits" due largely to the existence of the Deposit Guarantee Scheme. To enhance the stability of the funding structure, two further steps could be taken:*

- Develop fixed term savings products
- Embed transactional accounts into Irish credit unions.

8.10. *Stepping aside from theoretical analyses of the structure of Irish funds, the quantitative data does demonstrate a strong level of stability, or "stickiness" in the Irish credit union funding base. This is illustrated overleaf where the level of movement on the funding base is set out over the past six years to 2016. The stability in the savings base is especially notable, given the severe reduction in dividends during this period, a period which witnessed an adverse and dislocated economic environment.*



8.11. *Liquidity is a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. To remain viable, a financial institution must have enough liquid assets to meet its near-term obligations, such as withdrawals by depositors/ shareholders. Liquidity risk is the funding risk that, due to a lack of sufficient stable sources of funds, a credit union will be unable to continue meeting member demands for share withdrawals and/or new loans.*

8.12. *In the context of Irish credit unions, sources of liquidity are found primarily in bank deposits and in investments that can be readily sold without significant delay or market loss. The general liquidity rule in Ireland is that liquidity requirements are fixed at a minimum of 20% of unattached savings. The average level of liquidity in Irish credit unions was 41.9% as reported by the Credit Union Advisory Committee in 2016. This was characterised as "excessive".*

8.13. *The current average yield earned by credit unions on loans is approximately 9%. This yield is generally earned on personal unsecured short-term loans. With a current cost of funds of sub 1%, this implies an interest yield differential or spread of 8%. Within this 8%, the credit union will cover operating costs and loan losses.*

Challenges to the Funding Structure, Liquidity Practices and Interest Rate Charges in Irish Credit Unions Arising From a Home Loans Beyond Current Maturity Limits

8.14. *The first challenge relates to the **funding structure**. The savings base of Irish credit unions is primarily demand based. While in the context of Basel III it is largely comprised of high grade stable deposits, and in historical* *quantitative data contexts, it is clearly "sticky", the funding structure is demand based, and potentially capable of being withdrawn overnight. This is a challenge to be overcome.*

*8.15. The second challenge relates to **interest rates**. The interest rates on home loans currently lean above and below 4%. This is contrasted to current yields in the Irish credit union movement of 9% on personal loans. This results in a much tighter interest spread or interest differential. The interest yield on a home loan would need to be fully loaded with the relevant elements of an interest charge. Provision would need to be made as appropriate for the cost of funds, the credit risk associated with home loans, operational costs, cost of capital and competitive market forces. These factors need to be considered over longer-term horizons. If credit unions fail to price lending appropriately, it can profoundly impact margins in short, medium and long-term horizons. This is a challenge to overcome.*

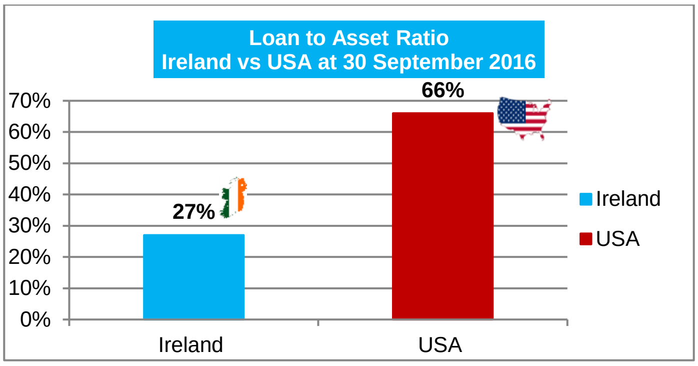
Contexts from USA

8.16. The National Credit Union Administration of the USA ("NCUA") issues macro-prudential information relating to federally insured credit unions. At 30 September 2016, the asset base of the 5,844 USA credit unions was US$1.277 trillion. The loan book was US$847 billion i.e. 66% lent. On the loan book of US$847 billion, US$421billion related to real estate loans. In this regard, 50% of the loan book was property related, or 33% of the total asset base was property related. The investments were largely made up of short term investments. Of the total investments of US$266 billion, only USA$28.6 billion, or approximately 11% of investments extend over 5 years.

8.17. The other side of the balance sheet, the funding structure, is made up of a more complex structure of savings products. There are a number of different savings products offered by USA credit unions with a mix of maturity profiles: share accounts, current accounts, money market accounts, share certificate accounts and pension accounts.

8.18. The evolution of the USA savings structure has taken place over the past 40 years. Up to 1977, USA credit unions made small denomination personal loans, funded by simple savings accounts. In 1977 a range of deregulating measures were put in place in the USA through the Federal Credit Union Act, one of which enabled credit unions to make mortgage loans of any maturity. Credit unions were also allowed to sell mortgages on a secondary market. This was coupled with a number of other measures including lowering capital reserve requirements and expanding savings product types.

8.19. Notwithstanding this, in broad balance sheet structure terms, the following can be learned from the current USA balance sheet. The total level of long term assets on one side of the balance sheet is broadly 33% of total assets. On the other side of the balance sheet, the core savings that are for fixed term would be share certificates and pension accounts. At 30 September 2016, these amounted to 26% of the entire funding structure, or 22% of the entire asset base. On a dollar for dollar basis, the situation could be simplified as follows: long term assets of US$420 billion (33% of asset base) are matched by fixed term liabilities of $276 billion (22% of asset base). At 30 September 2016, the loan to asset ratios of the Irish credit union movement and the USA credit union movement can be contrasted as follows:



USA loan book of $847 Billion comprised as follows…

USA Loan Mix, Sept 16	*$bn*
Real Estate	*421*
Auto - Used	*112.2*
Auto - New	*178.1*
Credit Cards	*50.2*
Student Loans	*3.8*
Other Loans	*81.8*
Total	***847.1***

8.20. The NCUA issued a final rule on liquidity management following the financial crisis. The USA rule stratified credit unions into three layers based on asset size. The rule does not appear to specify a prescriptive absolute liquidity requirement. Rather it outlines a series of general governance requirements to ensure that a credit union had a board-approved framework for managing liquidity and a list of contingent liquidity sources that can be employed under adverse circumstances. Credit unions must have a management process for identifying, measuring, monitoring, and controlling liquidity risk that is commensurate with its respective needs. In addition, large credit unions must have processes to evaluate adverse liquidity. Finally, large credit unions also must be part of a centralised liquidity mechanism that will provide liquidity for credit unions in emergency situations.

8.21. With regard to interest yields, the NCUA macro-prudential report indicates that the yield on loans was 5.3% and the cost of funds was 0.26%, indicating a spread differential of 5%. These are blended rates incorporating real estate, auto and personal lending, and, multi-termed savings products. It is likely that the disaggregated spread differential on real estate would be leaner (on the basis that yields on real estate loans would be lower, and cost of funds on term deposits would be higher).

Contexts from New Zealand

8.22. The credit union movement in New Zealand traces its origins back to the 1940s. In the late 1990s the number of credit unions in New Zealand totalled 111. In 2001 a new and more demanding regulatory regime was imposed on the credit union movement in New Zealand and that initiated a cycle of mergers. Soon after 2001, the number of credit unions had halved. This cycle of mergers has continued since then. Based on the most recent World Council of Credit Unions ("WOCCU") statistical report for 2015, there are 13 credit unions in New Zealand with an asset base of US$673m. This suggests the average asset size of a New Zealand credit union is US$52m. New Zealand credit unions are regulated by the Reserve Bank of New Zealand, as "Non-Bank Deposit Takers". New Zealand credit unions prepare high quality annual reports, which are aligned to FRS102 and have detailed disclosures on the maturity profile of assets and liabilities. The Register of the Reserve Bank of New Zealand indicates that there are 13 credit unions in New Zealand. We obtained the annual report of 9 of the 13 credit unions, with a combined asset base of NZ$961m. This equates to US$691m which would indicate, based on WOCCU data that we reviewed over 90% of the asset base.

*8.23. The total assets, as referred to above, were NZ$961m of which NZ$619m, or **64%** was lent out. The funding structure was comprised of deposits amounting to NZ$774m. Loans over 5 years amounted to 25.51% of the entire loan book. Deposits over 3 months amounted to 22.52% of the deposit base.*

8.24. The credit unions all had extensive disclosures of policy and notes relating to interest rate risk. To illustrate, one credit union articulated its policy as follows: "The policy of the Credit Union to manage the risk is to maintain a balanced "on book" strategy by ensuring the net interest rate gaps between members loans and members shares are not excessive. The measured gap in each 3-month range to be maintained between 3.0% and 7.0% of the *difference between loans and members deposits. The gap is measured monthly to identify any large exposures to the interest rate movements and to rectify the excess through targeted fixed rate interest products available through investment assets, and term deposits liabilities to rectify the imbalance to within acceptable levels. The policy of the Credit Union is not to undertake derivatives to match the interest rate risks. The Credit Unions exposure to interest rate risk is set out in Note 18 which details the contractual interest."*

8.25. *Similar to the USA, the Reserve Bank of New Zealand does not appear to have a prescriptive rule based liquidity measures. The regulatory requirement is set out in the "Quantitative Liquidity Requirements Guidelines". Credit unions are required to specify the quantitative risk metrics used to meet its quantitative liquidity requirements. These are stated to include: (a) a liquidity coverage ratio – to measure the extent to which the credit union holds sufficient liquid assets able to meet withdrawals of some proportion of its liabilities; and (b) a mismatch ratio – to measure the extent to which the maturity profile of the credit union's funding matches the maturity profile of its lending.*

Overview of Current Regulatory Framework for Extending Limits

8.26. *Currently Section 14 of the 2016 Regulations provides that the basic rule is that loans over 5 and 10 years cannot exceed 30% and 10% respectively. Section 14 provides that if the bank so approves, the 30% and 10% limits can be extended to 40% and 15% respectively. The criteria by which the extension assessed, is not stated in the 2016 regulations.*

8.27. *However, an explanatory note issued in 2007 by the Central Bank of Ireland relating to Section 35, the predecessor to Section 14 of the 2016 Regulations, provided that the Central Bank would enable the extended limits provided it was satisfied that the credit union had necessary controls and safeguards in place, and, provided it could demonstrate the following ratio in relation to arrears and reserves:*

- Loan Arrears are less than 5%.
- Total reserves are greater than 8% and statutory reserves are greater than 6%.
- Systems of control and safeguards.

8.28. *In addition, after the 2007 explanatory note, "Section 35 Regulatory Requirements" issued in 2010 and required that credit unions with loans over 5 years extending over or equal to 29% must retain liquidity of at least 30%.*

8.29. *Therefore, consolidating this regulatory framework, one could present the current regulatory framework as follows; to extend the maturity of your loan book, the Central Bank of Ireland expects the following:*

Measure	Requirement	Type	Comment
A1 Arrears	5%	Quantitative	A measure of credit risk
Capital	8%	Quantitative	A measure of solvency
Liquidity	30%	Quantitative	A measure of liquidity
Controls and Safeguards	N/a	Qualitative	A measure of governance

8.30. *It is also important to note the development and evolution that has taken place in the Irish credit union movement since these measures were designed (2007-2010):*

- Reserve requirements have changed with 10% capital being the minimum standard. Today, an 8% reserve level would be deemed undercapitalised under the current regulatory framework. In addition, credit unions now have operational risk reserve requirements.
- The governance infrastructure of credit unions has been transformed with the 2012 Act. Now credit unions have strengthened governance infrastructures with risk management, compliance, internal audit, and strategic planning frameworks to support their business models.

8.31. *Finally, it is not unreasonable to state that the credit union movement is now approaching the area of longer term lending from a position of greater reserve and liquidity strength. With average capital levels of 16% and average liquidity levels of 41%, the movement is far better capitalised and more liquid than it has been in recent times, or when contrasted to the mature credit union economies of USA, Canada, Australia, South Korea and New Zealand.*

Proposed Strategic Response

8.32. *The participating credit unions' core proposal is to propose a multi-stepped and staged pathway by which credit unions can commence an orderly sequenced evolution to lend greater levels of long term loans beyond current regulatory limits. This could be done over three time horizons as follows:*

- Step 1 (Immediate):
  Recalibrate the current limits to better reflect current and future balance sheet structures mindful of the economic, legal and regulatory developments in the movement since 1997 (the Act) and 2007 (the Explanatory Note) by recalibrating the existing maturity limits to assets, rather than loans.

- Step 2 (Short - Medium Term):
  Create enhanced asset liability management tools to better manage funding risk and interest rate risk and support the delivery of long term loans with robustly designed economic models and robustly designed credit risk frameworks.

- Step 3 (Medium – Long Term):
  Create centralised infrastructural supports to include funding vehicles to enable alternative funding sources and/or secondary markets for asset backed loans, and, centralised delivery platforms coupled with risk based capital.

8.33. *This is set out in graphical form overleaf:*

Area of Focus	Asset Liability Management		Operational Delivery	
Key Risks	**Liquidity Risk**	**Interest Rate Risk**	**Credit Risk**	**Capital Risk**
	Risk in funding long term assets from short term savings	Risk of mismatch in interest rates given narrower spread differential	Risk of poor credit risk management leading to credit losses	Cascading impact of credit losses on capital reserves and stability

Strategic Response In Multi-Stepped Horizons

Step 1 *(Immediate)*

Recalibration of current limits to be calculated based on assets and not loans

Step 2 *(Short- Medium Term)*

- ***Element 1**: Using Basel III grading of funding stability, improve structural stickiness of funding base by: 1. term deposits, 2. transactional accounts. Coupled with improved first world quality ALM monitoring processes*
- ***Element 2**: Consider creating a "Minimum Net Interest Rate Spread Differential" to mitigate risks that excessive rate gaps would emerge between members' loans and members' savings. Coupled with improved first world quality ALM monitoring processes*
- ***Element 3**: Demonstrate robust economic model with fully loaded elements of interest charge: cost of funds, credit risks associated with the lending, incremental operational costs cost of capital, and, market structure/ competitive environment factors*
- ***Element 4**: Create "Pilot Scheme"/ Hot House whereby credit unions will increase exposure in measured and proportionate manner, supported by IA/ RMO/ CO to review longer term exposures and long term loan quality and regular arrears vintage testing*

Step 3 *(Medium – Long Term)*

- *Diversify inherent concentration risk in retail funding base, by creating structural alternatives to retail funding base*
- *Centralised delivery platforms*
- *Introduce risk based capital framework whereby capital levels are directly correlated with the riskiness of asset classes*

8.34. Each of these steps will be described.

Step 1 – Recalibration

8.34.1. [Redacted as superseded by CP125]

Step 2 – Enhanced Asset Liability Management, Financial and Credit Risk Management Tools

8.35. Element 1 relates to managing funding risk. The participating credit unions would view that enhancing the savings base with term deposits and transactional accounts is a critical evolutionary step to enable longer term lending. Term deposits and transactional accounts are a feature of more advanced credit union economies. Term deposits are categorised as the most stable form of savings under the Basel III framework. Term deposits would further augment the stickiness and stability of the Irish savings base. Furthermore, introducing a fixed cost of funds would enable more clarity on interest rates and better interest rate risk management. As well as enhancing the stability of savings and introducing greater visibility into the cost of funds, it would also strengthen liquidity as unattached savings would change into term deposits, and the liquidity would strengthen (as the denominator in the liquidity formula would reduce). Furthermore, the requirement to offer a transactional account would further enhance funding stability and this is viewed to be a key inherent measure in the stability of the core savings base of mature credit union funding bases. The longer-term evolution of savings products may require future consideration/ revision of the broader legal and regulatory framework as they relate to savings.

8.36. Element 2 relates to managing interest rate risk. The participating credit unions would view that introducing a measure to manage interest rate risk would act as a further evolutionary step to enable longer term lending. The participating credit unions would view that a "Minimum Net Interest Rate Spread Differential" would mitigate risks that excessive gaps would emerge between members' loans and members' savings rates. The gap or interest spread would be measured to identify any large exposures to the interest rate movements and to rectify the excess through targeted fixed rate interest products available through investment assets, and term deposit liabilities to rectify the imbalance within acceptable levels.

8.37. Element 3 relates to the design of an economic model to price interest rates. The interest rate charged would be designed to be appropriately loaded with the constituent elements of interest charge:

- cost of funds
- credit risks associated with the lending
- incremental operational costs
- cost of capital, and;
- market structure/ competitive environment factors

These elements would be adjusted to suit the economic profile, funding structure and business models of credit unions. In this manner, credit unions may have structural competitive advantages over "green field" competing lending institutions e.g. well-capitalised funding bases, and, embedded operational cost bases. The participating credit unions are confident that there is a sustainable and profitable underlying economic model and would view that the credit union does have competitive advantages to leverage upon, including but not limited to strong capital buffers, competitively priced funding sources and competitive operating cost models.

8.38. Element 4 relates to the creation of a measured and proportionate pathway for credit unions to evolve in credit risk management contexts, by a pilot scheme/ hot house whereby credit unions would increase exposure in long term lending supported by its governance framework. In this manner, internal audit, risk management and compliance would adjust its work plans to review longer term exposures and long-term loan quality with regular qualitative reviews and quantitative arrears vintage testing. This would provide independent assurance that credit risk is being appropriately managed.

Step 3 – Centralised Infrastructural Supports

8.39. In longer term horizons, the participating credit unions are cognisant that an alternative funding source outside of individual retail savings bases of Irish credit unions would further mitigate liquidity and funding risk. Unlike banks, credit unions cannot access wholesale money markets, or, raise capital. While steps can be taken to enhance stickiness in a credit union's fixed funding base, steps can be taken in longer term horizons to create alternative funding sources:

- Through the creation of a centralised liquidity facility to provide credit unions with an alternative source of funding beyond their own funding base, and/or
- Through the creation of an alternative secondary market
- This could also be coupled with additional centralised delivery supports complimented with risk based capital frameworks as the business model evolves.

END OF PAPER