CEO Forum

Capital Workstream
February 2020 & Updated October 2020

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This presentation was developed to give an overview of the strategies available to manage the growth in savings for Irish Credit Unions ("CU"). As well as setting out the options it reviews the effectiveness of each strategy on dampening savings growth. The material was developed under the auspicious of the CEO Forum and was gathered from publicly available sources or direct feedback garnered from the CUs in the Workgroup.

The original presentation was completed in February 2020. It was updated in October 2020 to include the impact of the Covid-19 Pandemic on Savings.

Capital workstream key outputs

1. Analyse strategies to manage the growth in savings for CUs
2. Consider new sources of capital for CUs
3. Consider alternative regulatory capital regimes for CUs
4. Explore an alternative to basic share or saving accounts

- This presentation seeks to deliver upon the first of these key outputs.
- The ensuing analysis provides a commentary on savings growth followed by analysis of the effectiveness of and alternatives to Saving Caps.

The Balance Sheet and Capital workstream agreed on four main outputs:

1. Analyse strategies to manage the growth in savings for CUs
2. Consider new sources of capital for CUs
3. Consider alternative regulatory capital regimes for CUs
4. Explore an alternative to basic share or saving accounts

The full Terms of Reference for the Balance Sheet and Capital workstream are published on the CEO Forum's website https://cuceoforum.ie/balance-sheet-capital/.

This presentation concludes part one of the group's work.

Working Group

• Angela Rice	Link CU
• Aine O Reilly	St Josephs Aviation CU
• Lorraine Greville	Life CU
• Dennis Daly	Tullamore CU
• Michael Ahern	Dubco CU
• Sean Staunton	Progressive CU
• Sean Murray	Comhar Linn INTO CU

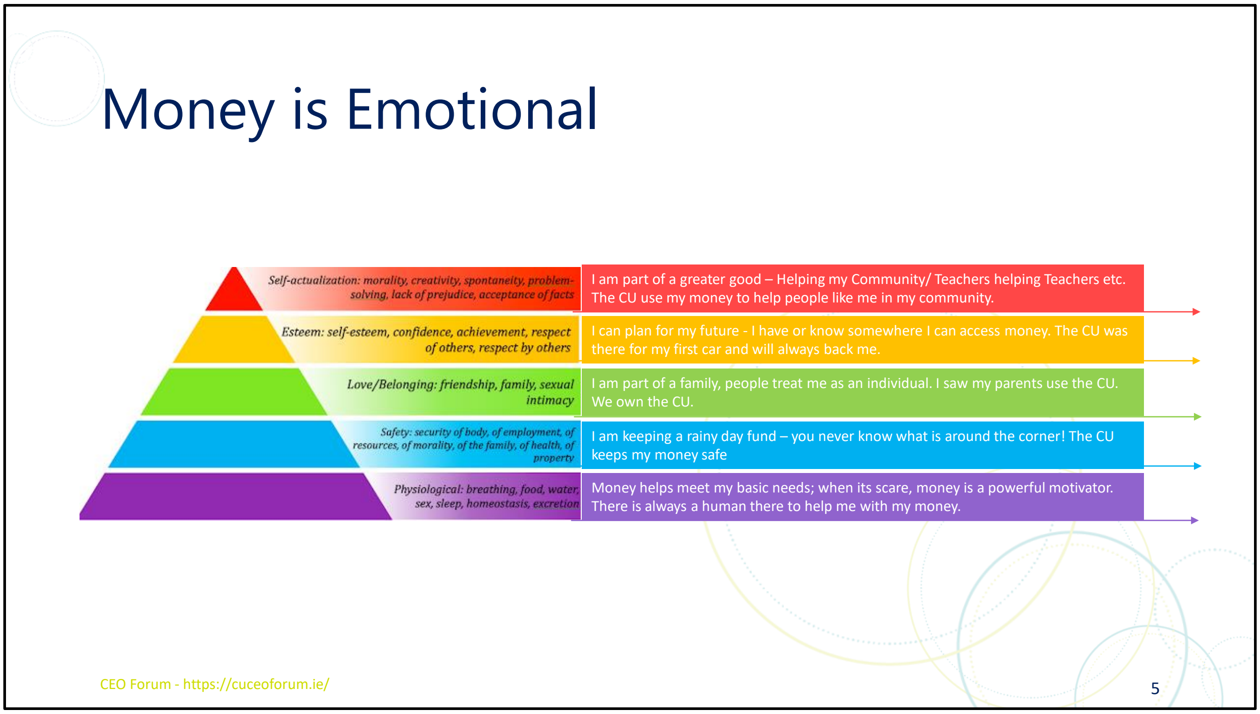
The following were instrumental in contributing to the groups work.

Savings Growth

Background and current environment

The Irish CU sector and the landscape within which it operates is continually evolving. CUs hold a position of trust with customers that give a unique competitive advantage among Irish financial service providers. This trust and loyalty has translated into significant growth in the level of savings balances entrusted by members to their CU.

These slides set the scene and explore the impact savings are having on Irish CUs.



We must understand the significance of money and how deeply important it is to everyone. People are inherently motivated to have their most basic needs met and money frequently enables people to meet these needs. Money is emotional and can be a powerful force.

While money gives freedom and choices; most people find managing their money a struggle, stressful even.

The habits around money tend to be passed down the generations, from parent to child. Routines that are embedded in peoples lives. These behaviours are difficult to change and can only be altered over time.

Savings empower people and helps them feel secure and good about themselves. Having a rainy day fund creates a "safety net" and some certainty for the future. Safety is an innate human need and in particular when it comes to finances.

Savings have always been the foundation of the member / CU relationship; translating into other "firsts" – like college, holiday and car loans.

The general population see CUs as tangible(in most towns in Ireland) and run by people they know. The CU is safe and does good in my community. This localness and familiarity solidifies the feeling of safety and builds trust in the CU.

CU Objects

Objects of a CU - 1997 Credit Union Act 6(2)

(*a*) the promotion of thrift among its members by the accumulation of their savings;

(*b*) the creation of sources of credit for the mutual benefit of its members at a fair and reasonable rate of interest;

(*c*) the use and control of members' savings for their mutual benefit;

(*d*) the training and education of its members in the wise use of money;

(*e*) the education of its members in their economic, social and cultural well-being as members of the community;

(*f*) the improvement of the well-being and spirit of the members' community; and

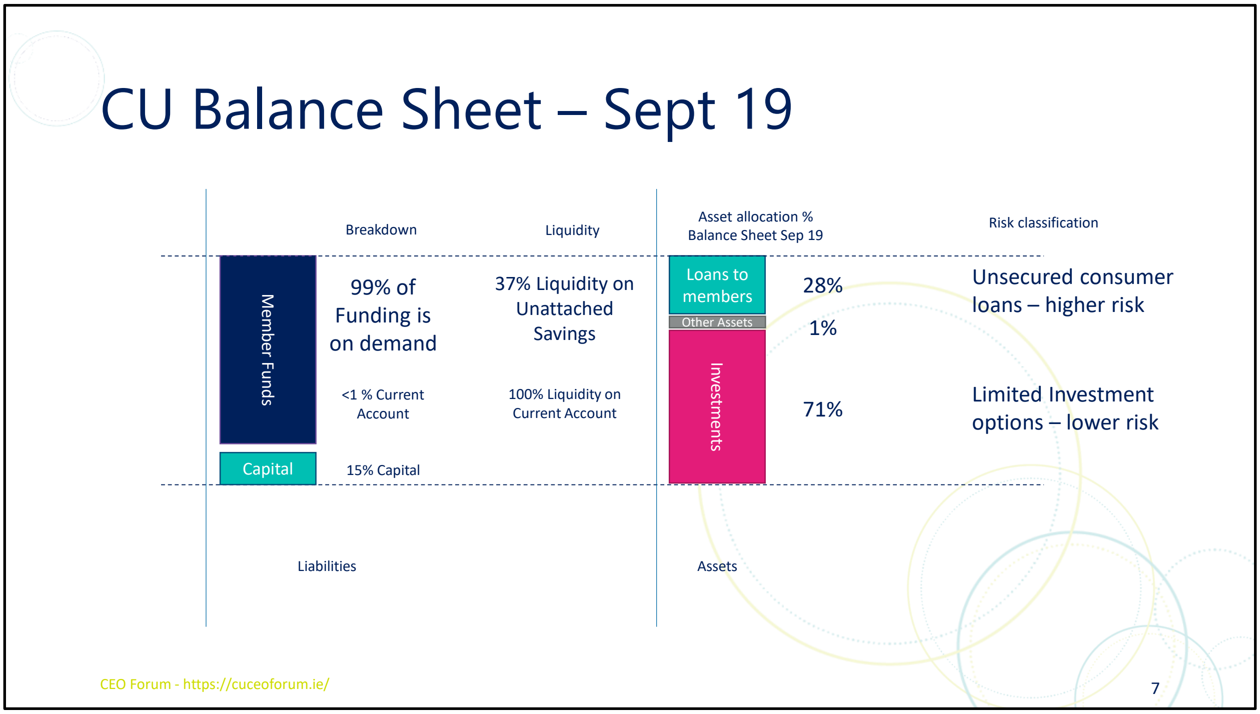
(*g*) subject to *section 48* , the provision to its members of such additional services as are for their mutual benefit.

The objects of a CU are captured in the CU Act and savings are an important feature.

Most members think it is a good thing to save with the CU; my community benefits, the CU keeps my money safe and uses it for good in my community.

But members do not realise it can also put CUs under significant pressure, as we explain in the coming slides.

The problem of savings growth is also a Regulatory challenge, one which all stakeholders need to engage in.

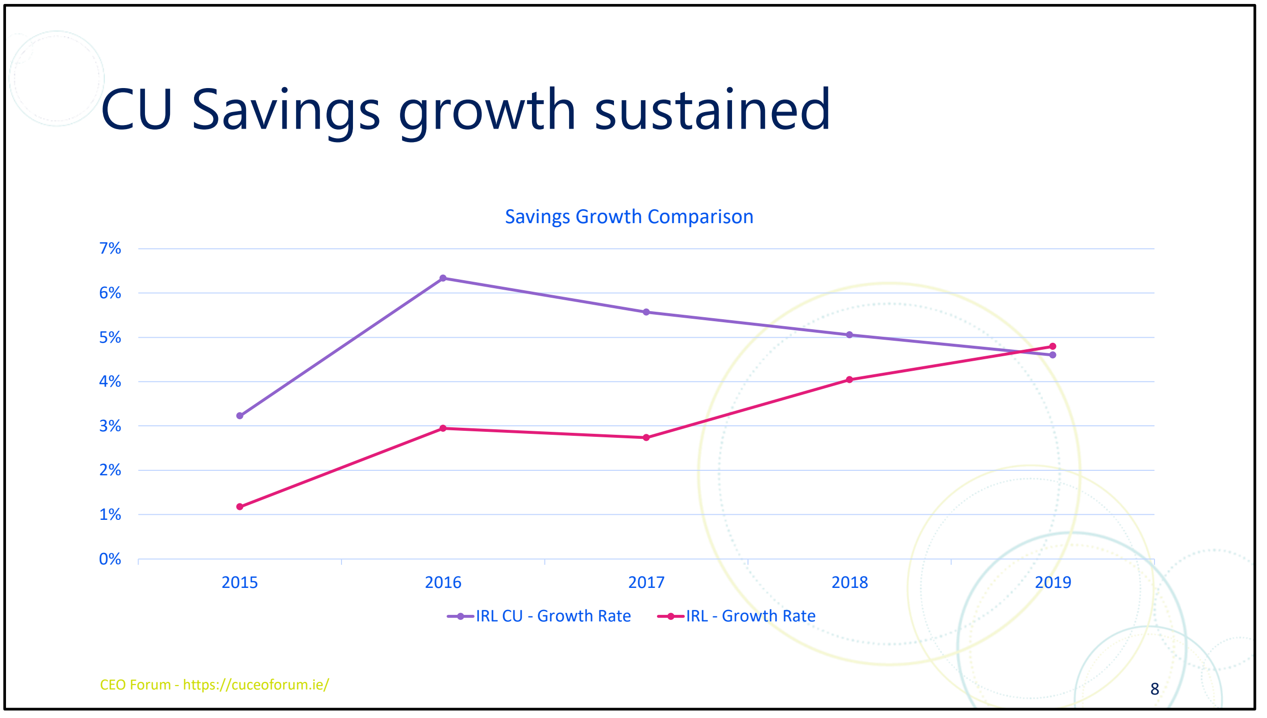


CUs in Ireland have been tremendously successful in building up a large and loyal membership base by following a simple business model – *"Providing a safe place for people to save and lending those funds back into the community"*. In recent years Irish CUs have expanded their services with some moving into adjacent lending markets and others expanding into current accounts. WOCCU best practice guidance would suggest a CU balance sheet should be >60% lent to a mixture of loan types.

But predominantly the CU business model is depicted in the graphic which illustrates the makeup and funding of the Irish CU Balance Sheet.

The Sept 2019 Balance Sheet of the Irish CU sector is the reference point for the graphic
- The majority of Liabilities (Savings) are on demand – but considered a very stable funding base
- Assets are predominantly Unsecured Loans or Investments
- Secured house loans account for approx. 3.6% of the Loan Book | Commercial loans 2.2% of the Loan Book
- The Loan to Asset ratio is 28% and declining.

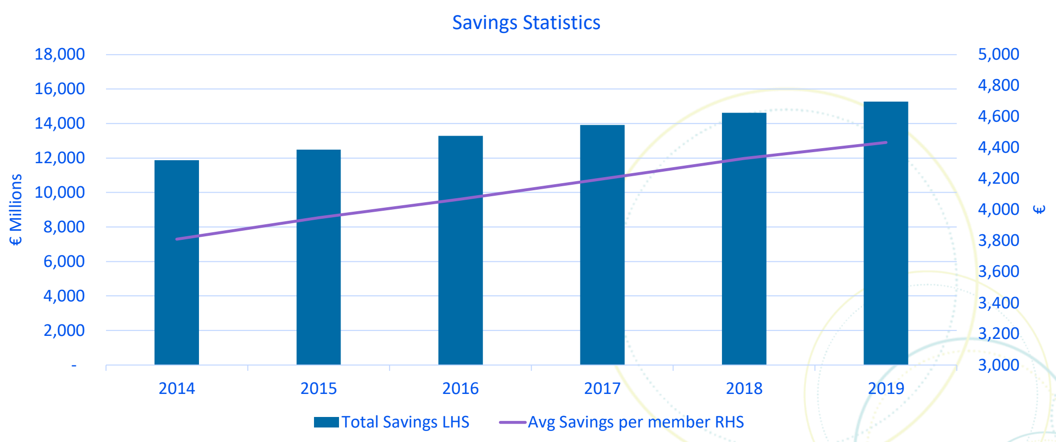
The graphic highlights the macro trend of over-funding of the CU balance sheet (arising as a result of increased savings by CU members above borrowing demand).



CUs have experienced strong growth in savings and have increased their collective share of the savings market year on year up to 2019.

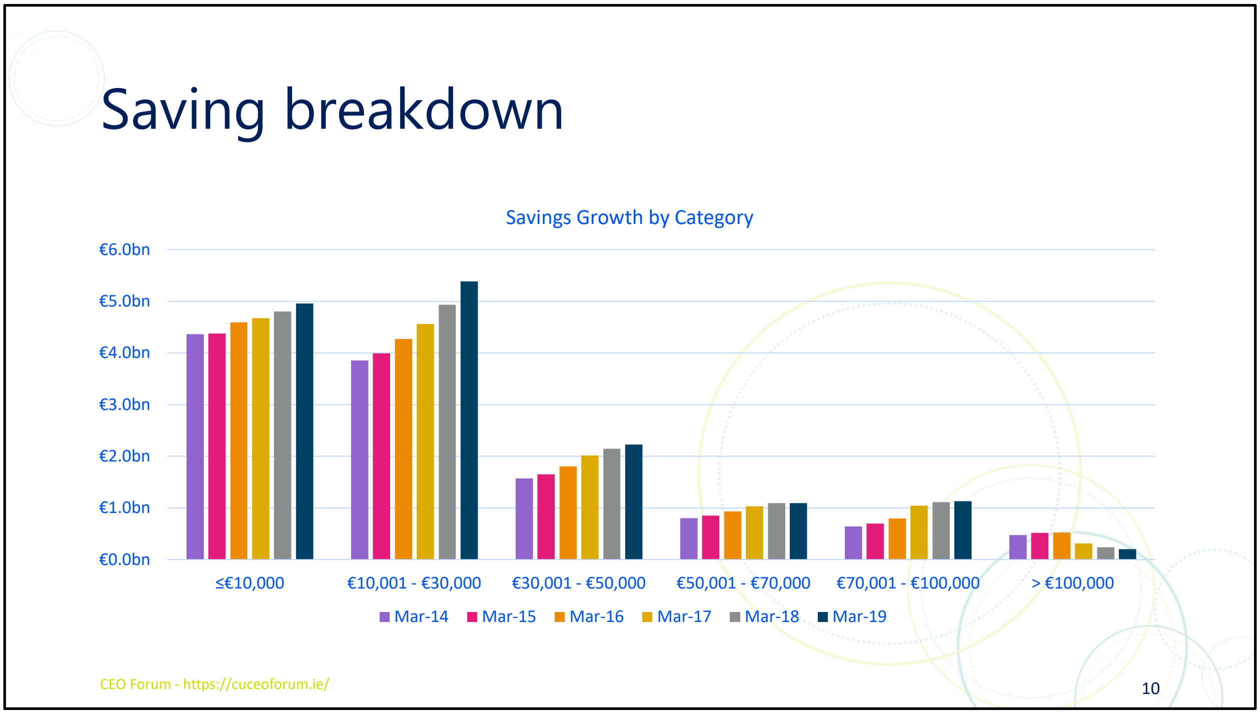
In 2019 growth was just below the Irish consumer growth levels, but remains a consistent growth.

Saving a core competency



The above graph shows how the average saver has also increased their savings balance with the CU and as a result, total Irish CU savings grew from over €12B to over €15B.

CUs have the benefit of a high number of low value savers; average per member savings levels of €3800 to €4500
This money tends to be peoples life savings and is a very stable funding base.



Savings are growing not from a small number of member placing large savings value with the CU but a large number of members saving a small amount. In essence, the objects of a CU encouraging saving.

To highlight the broad spread of savings levels – approx. €10.5B is held by members with balances under €30K

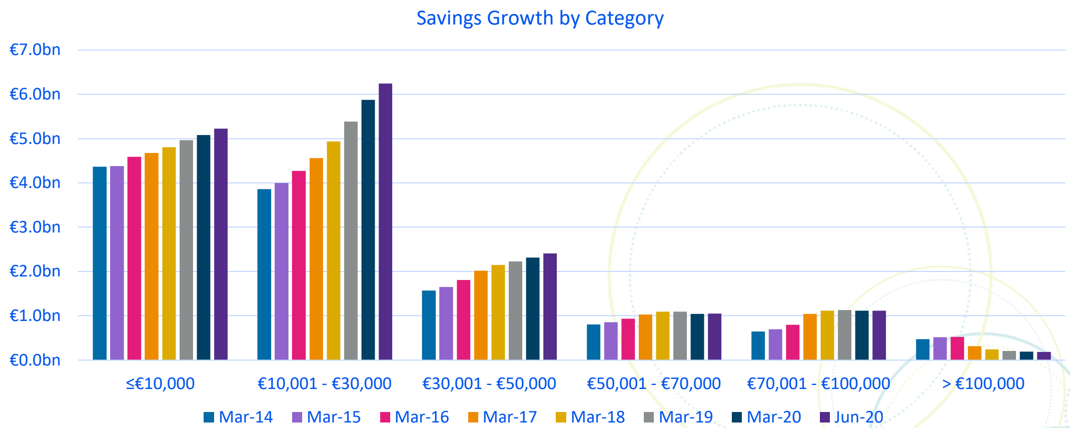
The main growth category is in the €10 – 30K balance.

The question is – **Is this not a good thing?**

CBOI research tells us that Savings Caps tend to be > €30K. This is addressing less than 15% of savings in CUs

When considering Savings Caps - we need to ask "What are the Savings Caps addressing"?

Savings Covid-19 period



Savings Amount	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Jun-20
Total	€11.7bn	€12.1bn	€12.9bn	€13.6bn	€14.3bn	€15.0bn	€15.6bn	€16.2bn

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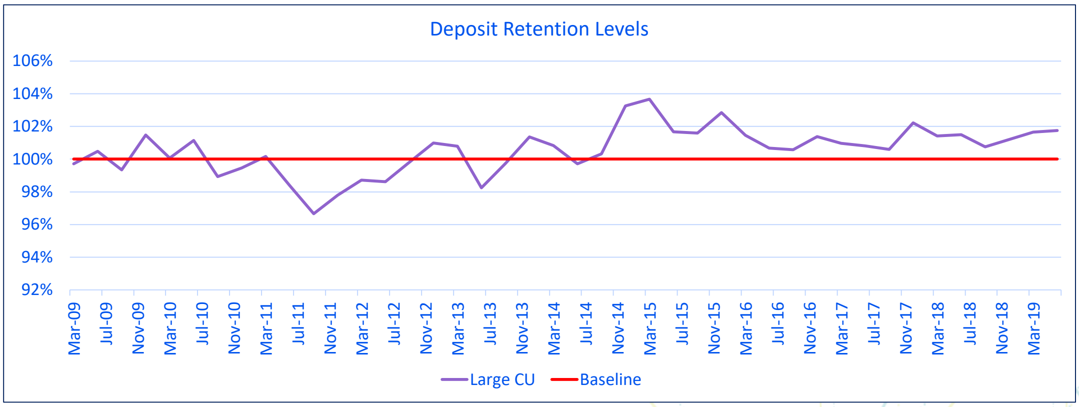
The impact of Covid-19 is starkly illustrated in these savings growth figures. A total of €610M was saved in CUs from March to June 2020. Savings growth during this six month period was the same as savings growth for the previous full year (Mar-19 to Mar-20).

Deposit retention levels



$$\text{Retention rate} = \frac{\text{Current Aggregate Balances - Aggregate Balances in New Accounts}}{\text{Previous Quarter's Aggregate Balances}}$$

Under the Basel model, CU funding is considered very stable.
The ten year graph for a community CU demonstrates this “stickiness” and highlights how funding tends to stay with the CU for long periods.

Savings narrative

- Experience is lots of Savers saving a small amount of money
- Aggregate savings continue to increase regardless of limiting measures
  - 2016 Regulation limiting savings above €100K
  - 70% of CUs have already implemented lower Savings Caps average of €50k
- CUs implemented caps to:
  - Slow savings growth ultimately to
  - Protect capital position
- CU Funds are Sticky and tend to remain in the CU

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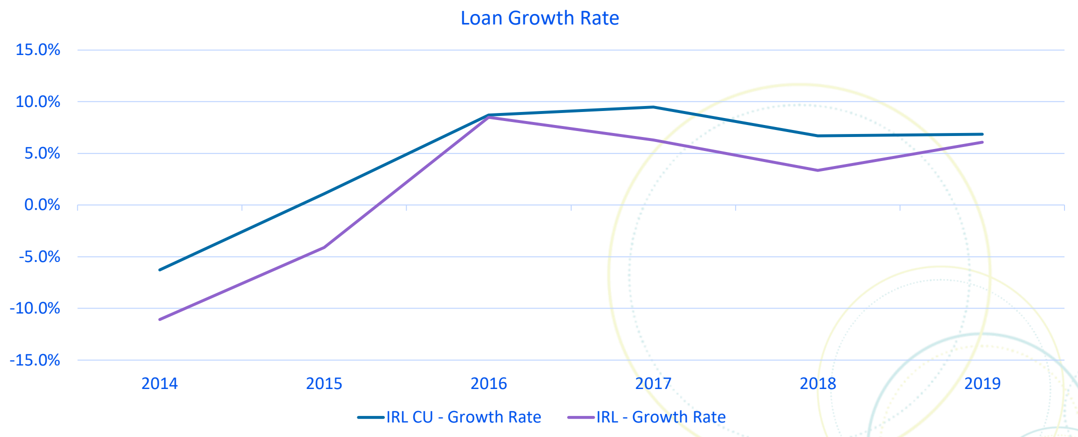
The growth in savings has continued against a 3-5 year backdrop of increased limitation on CU savings.

The growth is due to many small savers consistently increasing their balances in the CU.

In 2016, the CBOI limited CU holding savings above €100K and many CUs (70%) have implemented actions to cap savings at lower levels in their CU.

CUs also outperform lending growth - Increasing market share



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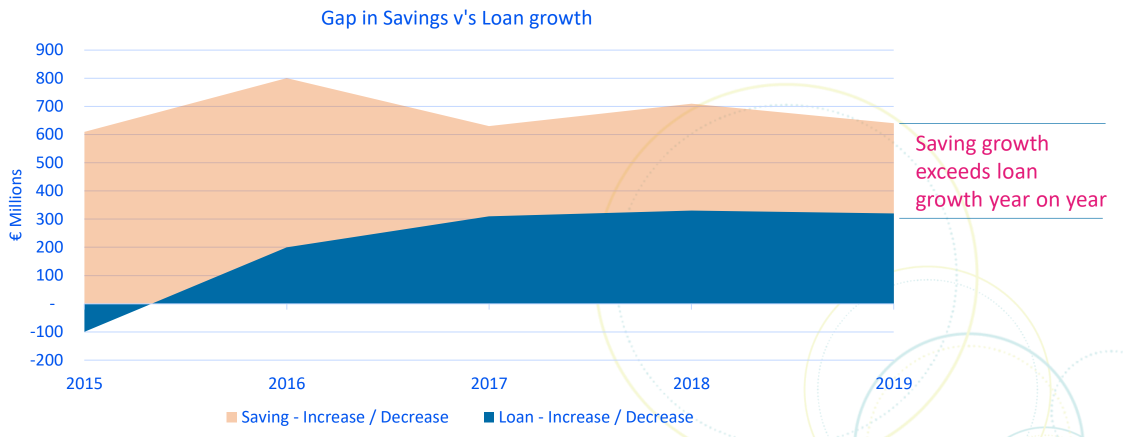
CU lending remains strong, and Irish CUs have also increased market share of the personal unsecured lending, on a consistent basis.

Growth in the % lent to members is the primary goal for CUs to manage Balance Sheet overfunding. Irish CUs have a very limited footprint in the Mortgage, SME business or secured Car Finance markets.

What CUs do with the excess savings must be part of the overall answer, but may not be the complete answer.

But - Savings still exceed loan growth



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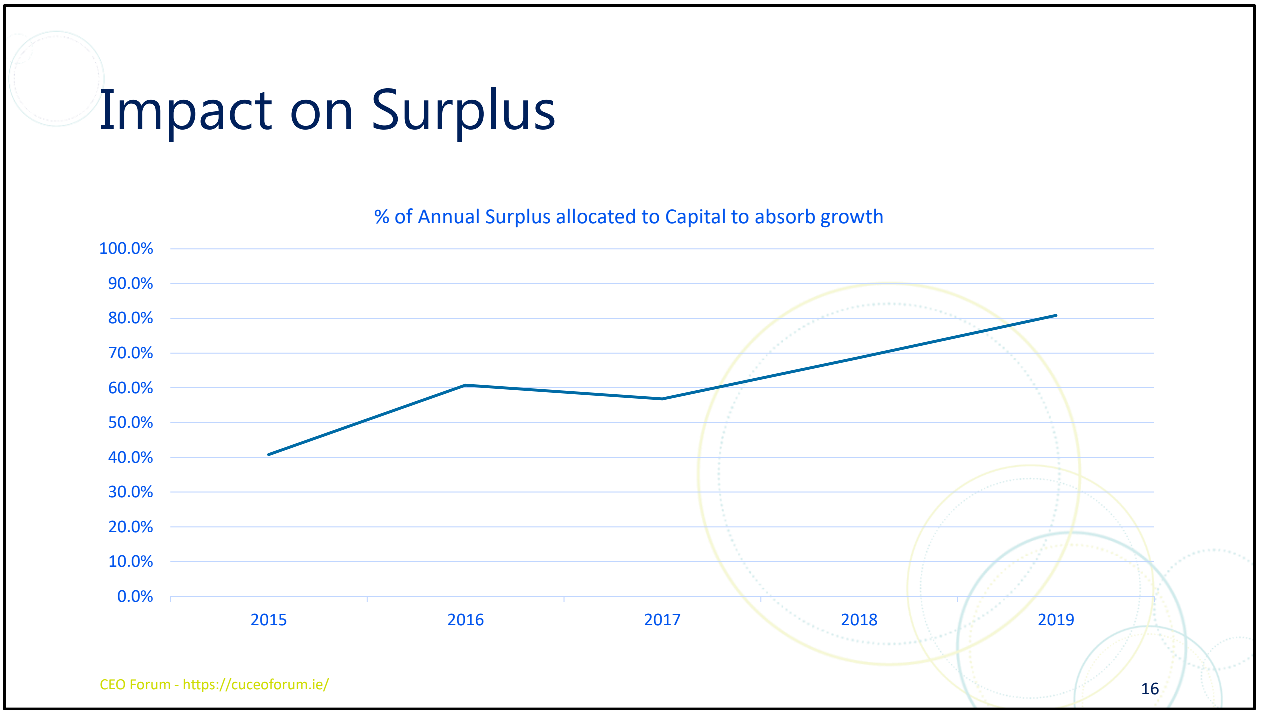
Savings still exceed loan growth, this graph overlays the € value in the growth of Savings versus the growth experienced in lending to members.

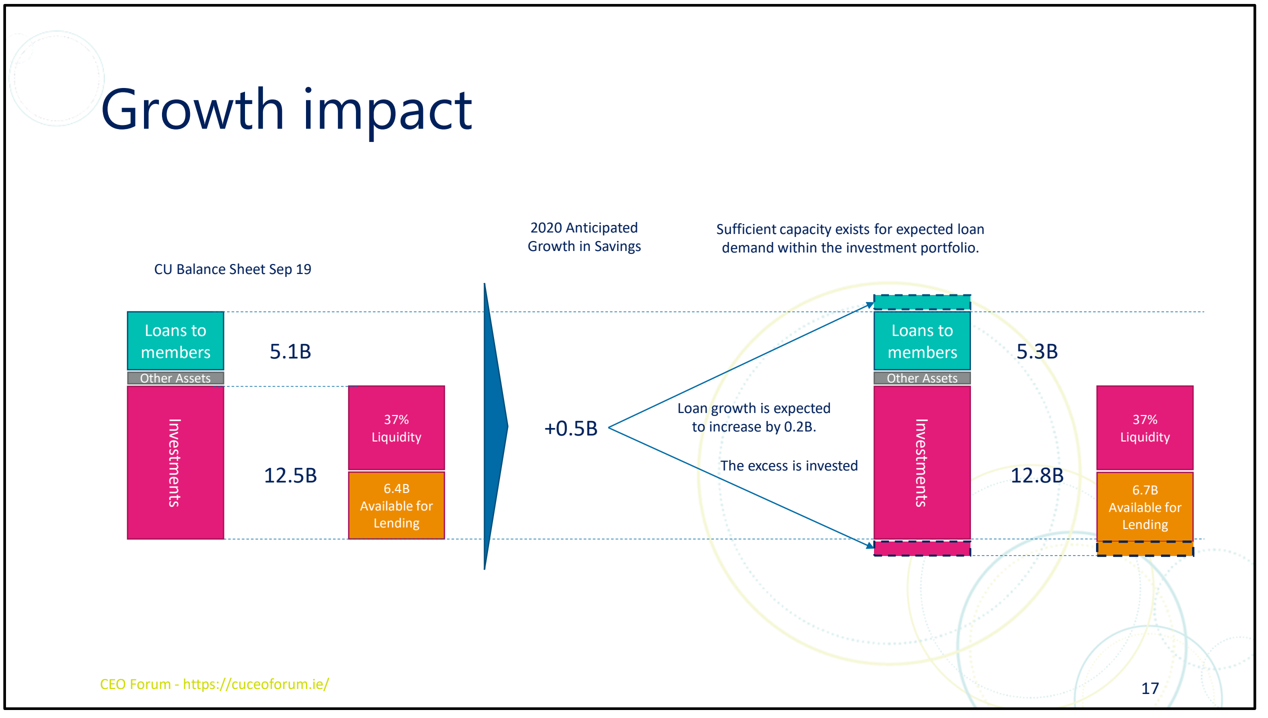
CUs continued to be “overfunded” and the Loan to Asset ratio continues to decline on an annual basis.



These growth factors result in a requirement to increase the % of annual surplus required to support minimum capital requirements.

The Minimum Reserve Requirement of 10% additional capital for each Euro saved means CUs are allocating more and more annual surplus to standstill on minimum capital requirements. This graph shows the level of annual surplus that is required to maintain the minimum 10% capital requirement. In many cases, CUs hold a stronger capital % and should realistically be allocating more of the surplus as capital to maintain their ratios.

Capital requirements are limiting the ability of CUs to invest in additional services and the long term trend will result in weakened balance sheets.



Modelling the growth in savings expected in 2020. CUs already have significant excess funds available for lending with saving growth exceeding loan growth year on year. Sufficient capacity for expected loan demand already exists within the investment portfolio. As a result CUs will allocate new savings into its investment portfolio.

New savings in 2020 will likely be invested rather than lent back to members. This further weakens the loan to asset ratio and in turn the Capital %.

Future impact on Income and Surplus

- Saving growth is exceeding loan growth year on year, as a result CUs are investing all of these new savings into their investment portfolios
- CUs now experience negative returns on new money invested (example ignores operating costs)

Negative Interest Rates - New Savings €			
Narrative		ROI	€ Value
New Savings amount			**1,000,000**
Liquidity - Short Term	37%	-0.50%	- 1,850
10 Yr Irish Govt Bond	63%	-0.15%	- 945
Net Income			**- 2,795**
Regulatory Capital Requirement	**10%**		**100,000**

- Resulting in
  - Continued erosion of CU capital requirements
  - Impossible to generate minimum capital requirements in current environment?

Looking at the return from investing the overfunding on the previous slide. CU Investment options are limited and returns on short term and medium term investments are negative.

As well as savings growth eroding the CUs capital strength, investing the overfunding at negative returns is also reducing the surplus of CUs.

In 2020, Irish CUs are no longer in a position to generate a positive margin on excess savings making it impossible to generate minimum capital requirements in both the current and future environment. This results in continued erosion of capital strength.

The CU is losing money. However, our members “emotional” connection continue to see it as a good thing to save with the CU.

Business model challenges

2018	Average All	Average €260m-€370m	Average €180m-€230m	Average €110m-€140m	Average €40m-€80m
Total income	5,418,315	9,895,164	5,828,053	4,025,828	1,855,929
Total costs	3,761,747	6,282,153	4,356,064	3,009,586	1,300,132
Net income 2018	**1,656,568**	**3,613,011**	**1,471,989**	**1,016,242**	**555,796**
Return on assets 2018	**0.92%**	**1.12%**	**0.71%**	**0.78%**	**0.95%**
Stressed model					
Total income	4,188,218	7,314,223	4,429,131	3,366,703	1,602,663
Total costs	4,530,914	7,384,864	5,295,674	3,650,377	1,665,279
Net income / (deficit) 2023	**(342,696)**	**(70,641)**	**(866,543)**	**(283,674)**	**(62,617)**
Return on assets 2023	**-0.2%**	**-0.0%**	**-0.4%**	**-0.2%**	**-0.1%**

Stressed model assume Investment returns of 0.25%; One off gains or losses removed; Bad debts normalised to 1% of New Loans and other factors remain as per 2018.

Many CUs are likely to be under pressure in the next 3 to 5 years to generate any surplus due to several factors including

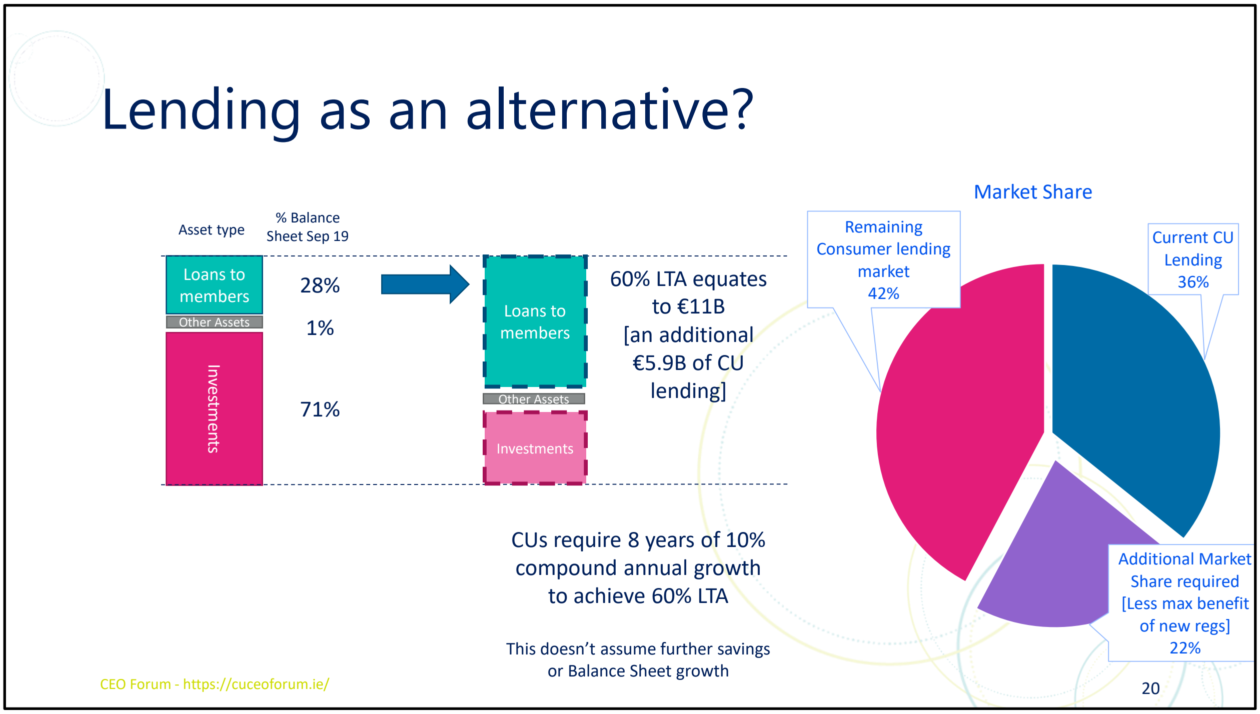
1. low and negative investment yields,
2. increasing cost bases and
3. the impact of provisioning writebacks coming to an end.

There are current and future business model challenges for CUs. Taking a sample of 2018 CU results and adjusting for Investment returns reducing to 0.25% and normalising other factors, most CUs return on assets will over time turn negative.

We must acknowledge that there are business model challenges:

- Loan growth
- Low interest rate environment
- Cost to Income ratios

But also compounded by the capital challenge presented by the relentless savings growth.



Let us consider what level of lending is required to meet a 60% loan to asset (LTA)ratio for Irish CUs.

- CUs would need to lend an additional €5.9B to reach 60% lent.
- That equates to 8 years of 10% compound annual growth assuming savings remain the same.

Currently - Secured house loans equate to approx. 3.6% of the Loan Book and Commercial loans approx. 2.2% of the Loan Book

At a 60% LTA ratio – The CUs would need to increase

- Personal Lending by €3.4B (or a further 22% of the Personal Loan market share),
- Maximise its capacity for Secured Lending (House & Commercial) to €2.5B | reaching the extended regulatory limits of 15%,

Internationally, Ireland is sometimes seen as an outlier due to not having a larger % lent. However, international comparisons are not always equal. International loan books are made up of a much higher % of secured or commercial loans –

- US – Balance Sheets are 67% Lent | Loan books are 50% mortgage lending & 33% secured car lending
- Canada – 83% Lent | Loan books are 61% mortgage & 34% commercial or agri lending
- Australia - 81% Lent | Loan books are 91% mortgages

Irish CU loan books are restricted to 7.5% combined for mortgages and commercial lending with extended limits available of up to 15%.
Irish CUs are already phenomenally successful unsecured lenders.
While it is acknowledged that increasing lending is part of the answer, it is not a complete solution.

Conclusion

- The tsunami of savings feels unstoppable
  - The ‘average saver’ has a balance of €4,500
- Credit Unions are not banks
  - People behave differently with CUs
  - It would appear to us that the savings pattern and reason for saving is different and
  - CU savings tend to be sticky
- Unless the objects of the CU model are changed it is unlikely that savings growth will reduce in the near future

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Savings are unrelenting, and may even present an existential crisis for the CU.

There is a need to engage in this issue at a collective level with all stakeholders in the sector and with the wider society – how do you solve the trend of increasing savings levels, can CUs be productive with the excess funds and what role do capital requirements play?

Analysis of Savings Caps

Analyse strategies to manage the growth in savings for CUs

Consider now the impact and implementation of Savings Caps.

Savings Caps

- Macro analysis shows that 70% of CUs have a Savings Cap
  - Yet savings levels continue to grow
- Broadly, CUs with Savings Caps experience one year of reduced growth followed by resumed growth in following years.
  - Dec19 – CBOI Financial Conditions paper agrees
- There appears to be few effective alternatives to successful dampen savings growth
  - Current caps are focused on < 15% of the Savings Balance

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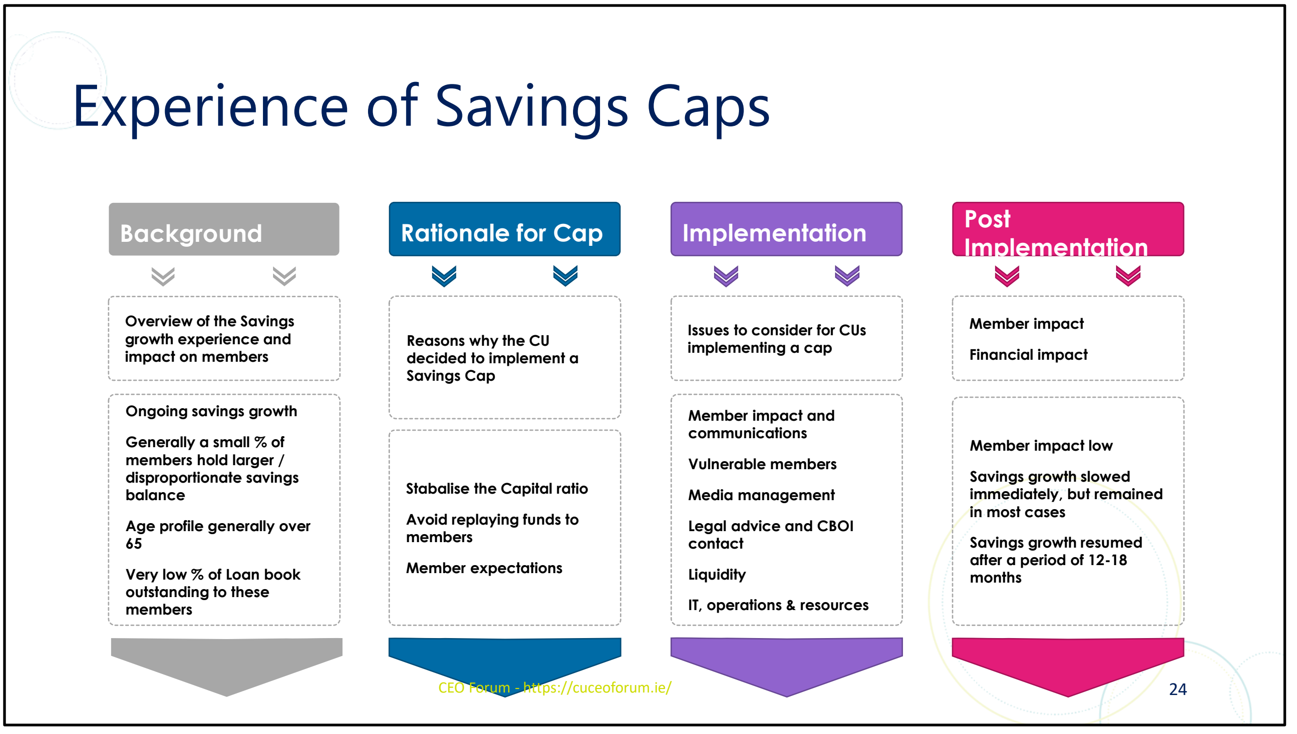
The workstream noted that the 2019 CBOI survey indicated that the average Savings Cap was €50,000; this level addresses less than 15% of the CU savings market.



The workgroup looked at the implementation of caps by CUs across 4 broad headings.

1. Background, 2. Rationale for implementing the caps, 3. Implementation process, 4. Post implementation

At the outset, why would a CU want to return money to members, given that a CU is a not for profit, community-based lender? It is as a result of two factors:

- The overfunding of total assets referenced earlier (or put another way a persistent loan to asset ratio of <30%)
- The formula for calculating capital

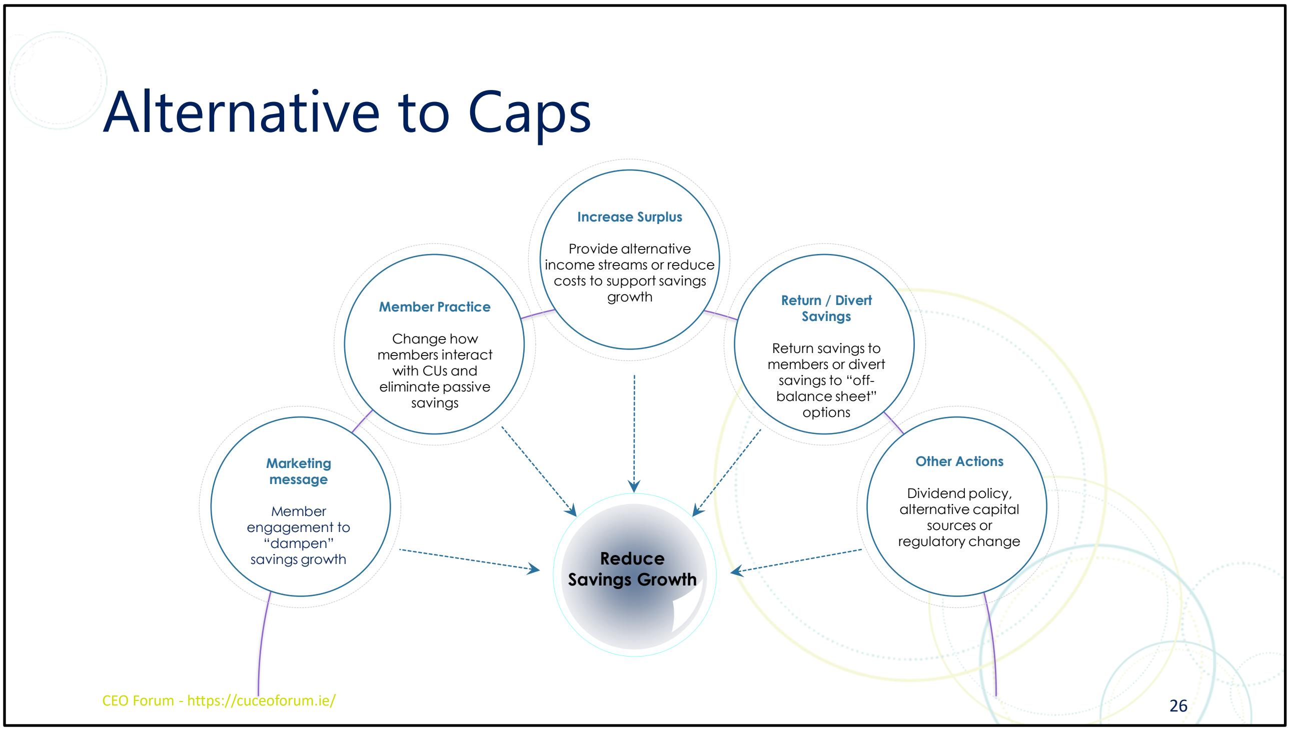
The primary driver for all CUs that implemented a cap was to protect their capital position. The protection came from changing the mathematical equation in calculating the capital % as opposed to any underlying improvement in the CUs risk profile or business case.

The workstream identified that caps might have been initially successful in slowing savings growth, but that savings growth reignited after a relatively short period of lower growth levels. Even in CUs where funds were returned to members above the cap, savings growth quickly recommenced.

Other considerations

- Impact to vulnerable members of society of implementing a cap
- Refunded money is just circulating around between other CUs
- Members find ways around the cap
  - Money split across family members
  - Money diverted to MPCAS accounts
- A counter intuitive message to the Objects of a Credit Union

There are some other real world considerations for CUs when implementing caps. Important to plan for the system changes and how you will handle exceptions.

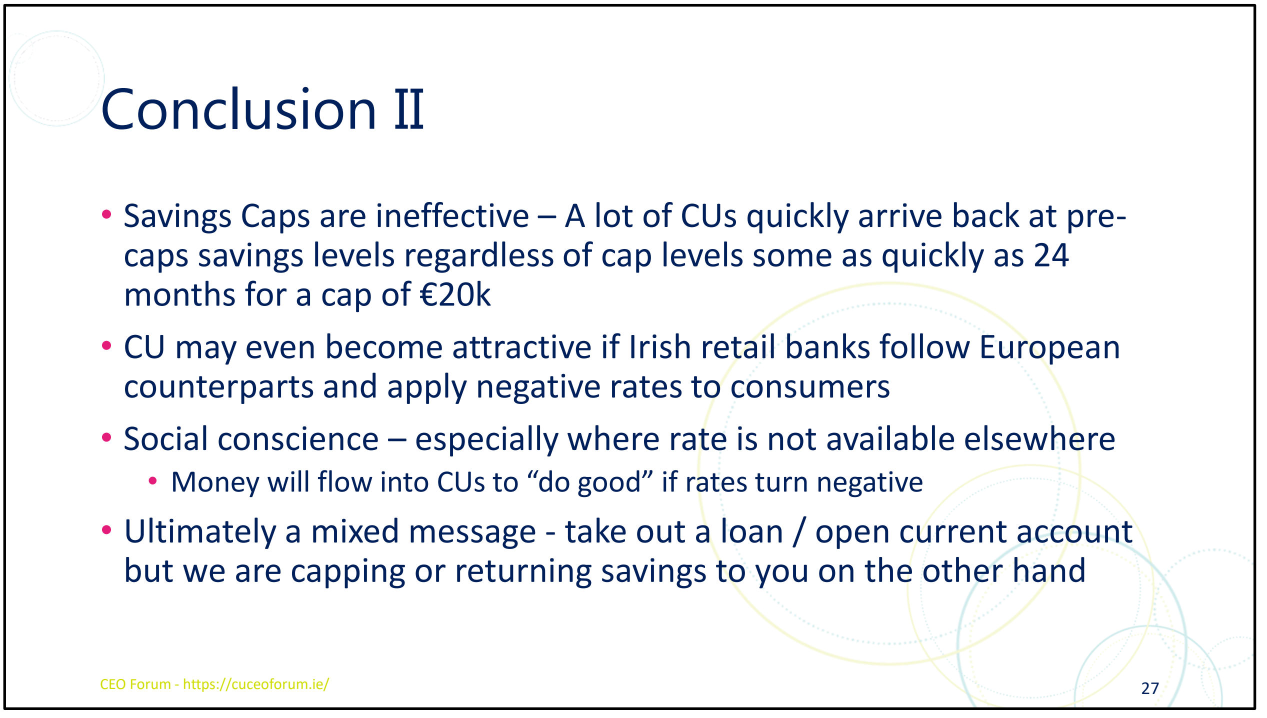


The workstream explored what alternatives exist for a CU that wishes to address its capital requirements as a result of growing assets.

There are some options/alternatives to implementing a Savings Cap. The actions identified broadly fall into a number of categories:

- Return savings | Immediately reduces the members balance in the CU
- Increase surplus | Provides for long term growth in capital to support savings growth
- Marketing | Member engagement to "dampen" growth
- Member practice | Change how members interact with the CU to reduce savings growth
- Other Actions | Regulatory change; Alternative regulatory requirements or treating certain savings as capital

These options are outlined in the attached table – Savings Cap alternatives.



The nature of the saving held by CUs should be considered and the impact that "dampening" saving has on the overall relationship and indeed the CUs strategic asset – the trust and loyalty of the CU. There are high numbers of low-value savers [average per member savings levels of €3,800 to €4,500]. These savings tend to be members' life savings. It is unclear how implementing caps and restrictions on members savings will damage this strategic asset.

Ultimately members are receiving a mixed message from the CU - take out a loan / open current account on the one hand, but we are stopping you from saving regularly (we are now seeing of €10,000) or indeed in some cases returning savings to you on the other hand savings caps.

The implementation of savings caps is found to be ineffective. A cap provides some short term relief a wider view must be taken on the CU business model. A more productive use of member funding must be found along with adjusted capital requirements linking the capital requirement with assets and the underlying asset quality.

Next Steps

1. new sources of capital for CUs
2. alternative regulatory capital regimes for CUs
3. explore an alternative to basic share or saving accounts

This work may provide further insight on how Irish CUs move ahead against the rising tide of savings.