MOORE

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THE CP125 FEEDBACK STATEMENT: AN INTERNAL AUDIT PERSPECTIVE

And so it begins....

The Central Bank of Ireland issued the Feedback Statement on CP125 on 21 November 2019 setting out the new proposed regulations which will be commenced at the beginning of 2020 (and yes, the roaring 20s are now only 6 weeks away). The Central Bank comments on page 47 of the Feedback Statement that the amending regulations "*represent significant and fundamental structural framework changes and will provide sufficient capacity and flexibility to enable safe and sound business model transformation*". In this author's opinion, this comment captures it in a nutshell. The design of the new regulatory framework as it relates to lending is indeed, significant and fundamental, and is also of a scale to enable business model transformation. All participants in the Irish credit union system should allocate a few hours of "me-time", find a quiet corner, and read the Feedback Statement from cover to cover. This is a big thing.

This article is not intended to be a strategic overview of CP125. Furthermore, this article is absolutely not intended to be a summary of CP125 (on this particular subject matter, there is no substitute for a full read). This article is intended to be an initial commentary, set from the perspective of internal audit, on what CP125 means on a practical level. Internal auditors, could be loosely characterised as the "controls people". So when looking at the sweeping changes that will be made through CP125, what challenges do we see as they relate to systems of internal control, and broader policies and procedures?

The big ticket items

Making complex things simple is a far more difficult task than making simple things complex. With that in mind, we will firstly take a deep breath and attempt to simplify the key changes in CP125:

- The 30% cap on loans over 5 years, and the 10% cap on loans over 10 years, are now gone. They will no longer exist. Collective maturity caps, rest in peace.
- In place of collective maturity caps, come maturity caps at individual loan level. Unsecured loans cannot exceed 10 years. Secured loans cannot exceed 35 years. This is the general rule. There are some small print exceptions (e.g. unsecured loans may creep over 10 years if rescheduled/ restructured). But overall, the Irish credit union DNA needs to have this hard-coded: unsecured loans cannot exceed 10 years, secured loans cannot exceed 35 years. This is the new grundnorm.
- In addition, there are new caps that limit the level of loans that credit unions can issue, by

loan *type*. And this is the major shift of CP125. When you look at your loan portfolio now, the *type* of loans that you issue, become much more in perspective. This is not new (under the old regulations, there were caps on loans by certain type; commercial loans, community loans and loans to other credit unions). But now there is a major new entrant to the club and that is house loans. And the limits for house loans and commercial loans (rechristened as "business loans") have been set at progressive levels (the limits for community loans and loans to other credit unions remain the same). This is at the heart of CP125. This is where the shifting of the plates occurs.

- Now, house loans and business loans, collectively, cannot exceed 7.5% of total assets (the "outer limit"), and business loans within that, cannot exceed 5% of total assets (the "inner limit"). If your credit union has >€50m in assets and has a regulatory reserve ratio >12.5%, then the outer limit increases to 10%, yet the inner limit remains at 5%. And, beyond that, if your credit union has assets >€100m, there is a capability to increase the outer limit further again, to 15%, based on a regulatory approval process should you meet certain criteria.
- CP125 does however, provide a backdoor cameo "re-entrance" of sorts for the limit on loans over 5 years through liquidity requirements. The general regulatory requirement for liquidity is 20% of unattached savings. That baseline currently increases to 25% and 30% if the aging of a credit union loan book stretches beyond 20% in respect of loans over 5 years (based on a stratification set out in regulations). These stratified liquidity rules will continue, and the draft regulation provides that where a credit union's liquidity falls shy of these requirements, the credit union will be required to cease lending over 5 years. In this manner, one could argue that a form of a collective maturity limit will live on, as a subsidiary of a liquidity rule.

That effectively is it. On a quantitative level, the impact of CP125 should not be underestimated. Here are some contextual illustrations:

- A €70m credit union with a 16% capital ratio and a 28% loan to asset ratio, goes to bed on New Year's Eve with an ability to do loans over 10 years at 2.8% of its assets (i.e. €1.96m). On New Year's Day, it wakes up, technically able to lend 10% of its asset base (€7m) on secured house and secured business loans, provided the loans do not exceed 35 years (and all relevant applications are made to the Central Bank and its reserves are allocated appropriately).
- A €70m credit union with 29% of its loan book over 5 years goes to bed on New Year's Eve (sweating it will have to turn away unsecured home improvement loans as it is dangerously close to its 30% cap) and wakes up on New Year's Day to realise the 30% cap is now gone. It now needs to make sure that none of those unsecured personal home improvement loans are over 10 years (and satisfy itself that they cannot be classified as house loans or business loans).

The challenges for systems of internal control

The key challenge that leaps off the page of the 2020 Regulations in this author's view is the concept of "definitions". Now, there are four critically important terms that are at the heart of how the new regulatory framework operates:

- What is a secured loan?
- What is an unsecured loan?
- What is a business loan?
- What is a house loan?

While these are all defined in the draft regulation, the main challenge for all participants in the credit union system from 2020 onwards will be one of demarcation. Demarcation lines need to be drawn on loan books to map portfolios by type, and systems of control need to be put in place to police these new borders. When credit unions approach their new limits, red lights need to pulse. The classification of loans by secured, unsecured, business, house and personal will be a critical new area of focus. In this regard, some considerations would be:

- What changes are needed in ICT banking systems?
- What changes are needed in credit policies?

- What changes are needed in credit procedures?
- What training is needed?
- What changes are needed in oversight?
- What changes are needed in reporting?

Beyond that, there are lots of other matters that will need to be considered from a review of CP125 as they relate to systems of control:

- It looks like the 2020 regulations will also revoke Section 35 Regulatory Requirements as they relate to provisioning, to enable alignment to FRS102. In addition, what constitutes a "large exposure" has been revised. Provisioning frameworks will need to take note.
- Capital and liquidity are now key to the new limits. Capital, reserve, liquidity, investment and ALM policies will need to take note.
- Reporting on house loans and business loans will now become a bigger area of interest under the new regulations. Management information policies need to take note.

This is just a high level overview, from a first sweep of the Feedback Statement. An aperitif before the meal begins. There are likely to be many more challenges as the regulations play out.

What is our role?

We have made much about "definitions" above. At Moore, we will firstly remind ourselves of the Institute of Internal Auditors definition of internal auditing as *"...an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations...*". With that in mind, we will be busy over the coming weeks designing work programmes to include control objectives and control expectations as they relate to the 2020 Regulations so we can play our part and provide assurance, and above all, endeavour to add value and help credit unions adjust to the exciting new landscape.

Game on....

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