

Risk Today

Issue 7 – Credit Risk in Uncertain Times



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Introduction

A number of recent geopolitical events prompted the topic for this quarter's Risk Today e-zine which looks at credit risk at a time of significant geopolitical uncertainty and volatility. Growing the loan book is probably the number one priority for credit unions (CUs) but this has proven challenging for a large number of CUs to date for a variety of reasons. Add in recent geopolitical events and it just became significantly harder to do so without incurring additional risk.



To be clear from the outset, this discussion paper is not intended to frighten everyone off lending for the next few months. It's about ensuring that each CU continues to take a proactive, risk-informed approach to all their activities and in particular, lending, at this time of acute uncertainty. At the very least, it could be a good time to revisit each CU's risk capacity, risk appetite and risk tolerance in relation to credit risk so the CU can best position itself to assist members in responding to geopolitical events

and associated economic developments in the coming weeks and months while at the same time minimising the risk to the CU itself.

Why Does Geopolitics Even Matter?

As we often hear in the news, Ireland has a small, open economy by international standards which basically means that adverse economic events in other countries can have disproportionate (usually negative) consequences in the Irish economy. The recent, relatively sudden, arrival of a potential trade war around tariffs onto the international event horizon is an example of the susceptibility of the Irish economies, north and south, to events largely outside our control. For Ireland, the key issue behind this development is the substantial trade deficit between the US and Ireland which Reuters state reached 50 billion euros in 2024. To put this in the broader EU context, the goods trade surplus for the whole of the EU was 156 billion euros in 2023.

In 2024, almost €73bn worth of Irish goods were exported from ROI to the US. Medical & pharmaceuticals and food & drink exports are particularly significant for both ROI & NI. Ireland accounts for almost 30% of US imports of medicines and pharmaceutical products. The ESRI estimates that tariffs could cost Ireland more than €18bn (£15bn) in lost trade. The ROI Minister for Finance, Pascal Donohoe, indicated that in a worst-case scenario, between 50,000 and 80,000 jobs that would have been created or kept within the ROI economy will not be. Ulster University economist Esmond Birnie said that a 20% tariff could cost £100m in reduced sales in NI.

This situation has evolved over a number of years as a consequence of conscious political efforts to attract Foreign Direct Invest into ROI & NI by offering attractive corporate tax incentives to foreign

investors. It is currently estimated that in ROI, 20% of all private sector employment in the state is directly or indirectly attributable to FDI¹. NI has also been doing very well in attracting FDI by making a concerted effort in this regard. And while FDI is good for employment, tax revenue, generation of commercial activity, investment in research and development etc., this also means that in certain scenarios, such as goods tariffs, it can expose the economy to shocks. Part of the current challenge for



CUs looking at all of this unfolding is that the effects could well be very industry-specific and potentially very localised in the context of individual CU common bonds. For example, there has been a lot of discussion in the media around the potentially disastrous impact on whiskey distilleries which are highly dependent on the US market. As a result, each CU needs to monitor the situation with its own membership and loan book risk profile as any potential impact will likely vary considerably from one CU to another unlike

previous experiences of national recessions etc. the severity of which were influenced by significant underlying national economic issues which are not present at this time.

What About Credit Risk?

However, anything that has the potential to threaten members' ability to repay their loans is a risk worth monitoring closely. In times such as these, the standard underwriting controls may need to be adjusted to address sudden adverse economic conditions which may lead to heightened CU credit risk, i.e., the risk that members are, or will be, unable to meet their repayment agreements.

You may say that CUs have weathered economic downturns and unexpected shocks before, but the CU movement is faced with a particular set of circumstances today which could combine to create a particularly challenging credit risk scenario. At this moment in time, the range of potential outcomes from ongoing geopolitical events varies day by day. Various economic commentators are running the full range of potential negative to positive outcomes for the economy based on geopolitical events which are being played out in the full glare of the international press. The lack of certainty and the unpredictability around what may or may not happen next is a key issue at the moment. Even as tariffs of 20% on all imports from the EU, 10% on the UK and 25% on cars are announced on 2nd April, it



¹ <https://enterprise.gov.ie/en/what-we-do/trade-investment/foreign-direct-investment-fdi/>

remains to be seen whether they will be implemented as announced or whether there will be reactions from the countries subject to these new tariffs. Or even whether there is room for negotiation with the US on any of these tariffs. As a result, CUs need to consider a range of potential scenarios that could impact on their own specific common bond based on how each scenario might impact on local employment and by extension the possibility of loan repayment challenges arising from the CU's Members. Some examples include:

- **The potential for a US/EU trade war to materialise.** US-owned companies currently operating in Ireland could potentially begin to look at moving their facilities back to the US which could have a significant impact on employment in certain industrial sectors and geographical areas across the island of Ireland e.g., in the pharma industry. It is worth noting that this is not as simple as it sounds, and it is unlikely that it could be done immediately. It could however impact on more immediate investment plans such companies may have had in the pipeline for Ireland. There is also the possibility that a trade war could push companies already struggling financially for other reasons over the edge of viability and hasten their demise.
- **Reduction in US multinationals operating in Ireland.** A crucial factor to keep in mind is that large multinational firms tend to plan well into the future and are unlikely to make any knee-jerk reactions in the short term. No doubt they are all cognisant of the fact that currently a US President is permitted to be elected to serve a maximum of two terms unless there is a constitutional amendment or a successful legal challenge to the current interpretation of the presidential term limit. Either of these two scenarios would likely take a long time to pursue through the courts. On the basis of a four-year presidential term, that is not a long time when it comes to US multinational strategic planning and there is always the possibility that the US position could change drastically when the next President is elected, but it might not, depending on who the next President might be. The problem is that no-one can be certain how this might play out.
- **The potential for producers to pivot sales to other markets.** There is the possibility that some US multinationals could continue to operate in Ireland but look to EU or Asian markets to sell the product produced here, thus avoiding the US import tariffs (although other countries do also operate tariffs) and perhaps open new production facilities in the US to supply that particular market if feasible. There has also been media commentary on the potential for Irish whiskey exporters to re-direct their sales towards Canada, China, Hong Kong etc.
- **Ireland's historical relationship with the US earns exemptions.** While it appears that both the ROI and UK governments believe they maintain a cordial relationship with the US, in these turbulent times, this could change relatively quickly and for ROI, being part of the EU, ROI may not be in a position to carve out exemptions from EU-wide tariffs etc. in any case. It is also



apparent that ROI and NI will be subject to different tariffs assuming they are implemented as announced on 2nd April.

- **Irish and/or non-US owned companies in Ireland experience demand-side issues.** Aside from the more obvious situation with US multinationals, there are also many Irish and other non-US owned companies operating here for whom the US represents a considerable proportion of their market for products or services. Whether it be direct tariffs or simply less demand from the US, there is the potential for a material negative impact on their business because of the political rhetoric around prioritising US domestically produced goods and services in preference to imported goods and services.
- **Supply Chain Exposure.** There is also the potential for Irish and Non-US owned companies producing elements of a larger supply chain to be negatively impacted by either tariffs or the move towards domestically produced alternatives.
- **Tariff war or economic boost.** On the more positive economic side, with the US moving away from its previously very close relationship with Europe on defense matters, this appears to have had a seismic effect on Europe's attitude to defense which could trigger major investment in defense-related industries which could have a positive effect on some European economies e.g. Germany & France, which may also have a wider positive economic effect as they have made it clear they intend to prioritise European-made products in the process. All of which could result in opportunities for research & development, manufacturing, logistics, and various other supply chain products and services across Europe, including Ireland.
- **Economic Boost Timing Mismatch.** One of the key points in relation to the potential for defense spending to be a Europe-wide economic boost, is that while the impact of some of the measures being introduced by the US to promote the concept of 'America First' could be felt in the short term, the EU scaling up of defense spending and the associated economic effects could be significantly slower so there remains the potential for some economic pain across Europe during the transition process in this scenario.
- **Cost of Living Increases.** Even if a CU common bond is not directly impacted by company- or industry-specific negative developments, depending on the scale of the various geopolitical events, there could be implications for the cost of living to increase in Ireland which could in itself have an impact on members' ability to repay their current loans or meet the underwriting criteria for new loans.

The above list is not exhaustive but where some or all of the above scenarios could be applicable to an individual CU, they should be analysed under stressed but plausible conditions. The potential impact will likely vary from one common bond to another. There could also be other CU-specific scenarios which should be included in the CU's analysis. Hopefully the most challenging scenarios will not materialise, but it is particularly important for individual CUs to have a clear understanding of their potential exposure to additional credit risk at a time when they are also considering how best to grow their loan books in a prudent manner. It is not about coming up with a drastic, knee-jerk response to the various announcements, it is about understanding the CU's exposure and exercising appropriate levels of risk management where relevant.



Irrespective of the size or type of lending, credit risk controls should be reviewed by the risk management function in the context of the potential for material economic shocks in the short to medium term, including:

- All CU staff and volunteers should be listening out for any commentary on local businesses which could be impacted by these geopolitical events and communicating any such information back to the CU.
- All relevant CU staff and volunteers should be monitoring media announcements at national and/or local level which may impact on members' capacity to repay their loans.
- Lending officers should be extra cautious with loan applicants approaching their repayment capacity limits whose income is dependent on any of the 'at risk' groups mentioned in the various scenarios outlined above.
- Debt to income ratios might need to be reviewed to ensure they are fit for purpose during such uncertain economic times.
- CU Loans Officers might seek additional proof of employment if local redundancy programmes are rumored or announced.
- Credit Control Officers will need to closely monitor loan book performance for any early indicators of repayment difficulties on an individual basis and analyse for any associated employment patterns which might indicate a broader issue.
- All member-facing staff should be making efforts to use trigger events to update/confirm member employer details to facilitate more accurate loan book analysis. As we know this will never be 100% accurate as employment/employer details are most accurate at the time the loan



is issued but it could at least give some high-level indication of exposure to 'at risk' companies or industries to help inform the loan provisioning process.

- Loan book provisioning should incorporate analysis of the CU's loan book by employer/industry so that additional provision may be made for 'at risk' groups if deemed appropriate.
- Relevant risks in the CU's risk register may need to be reviewed in the context of the recent geopolitical developments including, for example:
 - The risk of losses due to concentration of lending
 - Poor Loan product pricing
 - Inappropriate loan terms
 - Failure to establish member financial circumstances completely
 - Failure of members to make repayments on their loans
 - Failure of the credit control process
 - The credit union is adversely affected by the effects of financial stress on its members
 - Deficient risk assessment informing strategic decisions around Long Term Lending



As mentioned in the introduction, unfortunately all this economic uncertainty is happening at a time when CUs are making every effort to grow their loan books and many ROI CUs are looking to the mortgage market as the solution to this problem. Therefore, the next few sections will look at this particular issue in more detail as it poses a particular credit risk for CUs as compared with traditional mortgage providers in terms of the potential for a disproportionately material impact on an individual CU's financial status

of a small number of large loans failing or going into material arrears over a relatively short time period. It is important to note that while NI CUs are not currently permitted to offer mortgages, there are broader credit risk management lessons to be learned in terms of engaging in larger, longer-term loans using this example.

Are Mortgages the New 'Silver Bullet'?

Having considered all of the above, if we take the example of a CU that is about to launch a new mortgage loan product or materially expand their existing house loan portfolio in the near future with a view to improving their loans to assets ratio, that CU will likely be underwriting a significant number of these new loans over the coming months. These mortgage applicants will likely be near the limit of their reasonable affordability, which is common for such loan underwriting, but it also means that a large number of them could be exposed to sudden economic shocks as a result. Therefore, stress testing loan repayment capacity will be even more important than ever in these days of such economic uncertainty particularly for the larger, longer-term loans.



A key consideration in the wider context of mortgage lending in CUs in Ireland is that CUs are relatively new to this particular segment of the lending market even if a small number were early adopters and have been offering such loans for a few years now. In comparison to the more established players in this market, CU mortgage loan portfolios are quite literally in their infancy which leads to the first key risk to be considered in this specific context, that of concentration risk in the maturity profile of larger, longer-term loans.

Maturity Concentration Risk

Traditional mortgage providers have been in the market for a very long time now and have mortgage loan portfolios which cover the full maturity profile with loans reaching their full projected maturity on a monthly basis (assuming most mortgage repayments are monthly) with new mortgages replacing those that mature naturally on a continuous basis. In contrast with new entrants to the mortgage market, such as individual CUs, these more established players in the mortgage market are less likely to have significant numbers of mortgages scheduled to mature within a relatively short period of time and will be less financially exposed in the event that a tranche of these loans were to be redeemed early and/or around the same time.

Even relatively new entrants to the mortgage loan market who have bought mortgage portfolios from financial institutions who have left the Irish market are usually buying a portfolio which has been built up over a long period of time so again the loan maturity profile is well spread thus mitigating the maturity/redemption concentration risk.

In many cases, CUs who began offering mortgage loans when first permitted by their regulator reached their secured loan cap quite quickly and have been limited in their ability to spread their maturity profile through natural loan redemption and replacement in recent years other than in cases where the mortgage loans themselves had short maturity profiles from the outset or there were early redemptions which have been replaced by new mortgages. Recent draft regulatory changes to house loan portfolio caps could create the possibility for another sudden influx of mortgage loans up to the new cap. So why does this matter?

Timing Is Everything

As the saying goes, 'timing is everything' and this can be particularly relevant in risk management. When a new mortgage loan product is launched by a CU, it usually means that the CU processes a significant proportion of their mortgage applications in a relatively short period of time. This means that this cohort of loans will all be underwritten based on the prevailing economic conditions. The vast majority of people who take out mortgages, take out the maximum they can afford based on their current income on the basis that they will continue to earn at least that over the course of the mortgage term.

Traditional mortgage providers have the luxury of knowing they have borrowers repaying mortgages across the full lifecycle including new borrowers, those mid-way through their loan term and those coming to the end of their loan term. This means that at a very general level, they have a continuous, relatively even, churn on the mortgage loan book, which reduces the risk of sudden materially negative impacts on the loan interest income if a significant number of large loans were to be redeemed early or complete naturally around the same time.

Any economic downturns are also going to have more or less of an effect depending on where the borrower is in the lifecycle of the loan and their own personal financial lifecycle. The later in the loan term, the more likely that borrowers are in a better financial position to withstand economic shocks either through life savings, career/salary progression, less competing financial obligations etc. Of course, this does not apply to everyone but it is certainly a risk factor to be considered and that's where the current geopolitical uncertainty could prove particularly problematic for CUs in comparison with traditional mortgage providers who will likely have more of a spread of borrowers across the loan maturity scale.



Fixed versus Variable Rates

Another important distinction between traditional mortgage providers and CUs is that historically CUs have been less inclined to vary their loan interest rates during the term of the loans which is not surprising based on the significant proportion of CU loans being relatively short term, i.e., less than 5 years. But that picture has been changing in recent years with CUs offering longer term loans. With traditional mortgage providers, they are used to monitoring economic conditions on a continuous basis, making associated changes to their variable rate mortgage products and changing the rates on fixed rate loan offerings to manage that loan interest income risk when deemed necessary. They have established processes to deal with this issue and their mortgage loan product pricing reflects that capacity to adapt to market conditions quickly if necessary. This would not have been common practice in CUs, and members would not usually expect this in respect of their CU loans even if the documentation clearly states that the interest rate is variable. This puts more pressure on CUs to get their mortgage product pricing right.

Early Redemption

Another key CU difference in the lending model which impacts on mortgage lending is that CUs traditionally do not impose early repayment penalties. As we know, this is particularly significant in mortgage lending because the cost of underwriting mortgages is significantly more than for traditional CU loans. The due diligence process is more complex and time consuming so the ultimate cost of the loan for the CU is higher, which in turn means it will take longer to claw back that expense from the interest income than it would for traditional CU loans. When added to the fact that such loans normally

attract lower interest rates in the first place, then it can be even more challenging to get the balance right. And this problem is only heightened in the context of early redemptions.

Mortgage Product Pricing

At its core, loan product pricing includes a number of elements including at a minimum:

- Cost of funds
- Credit risk associated with the particular type of lending
- Operational costs of running the CU and delivering the new product
- Cost of capital
- Market structure and competitive environment

As with most loan products, mortgage pricing will have been arrived at incorporating an expected level of delinquency or early redemption which allows the mortgage provider to still make sufficient income from the loan product even if some become delinquent or are settled prior to the original maturity date which reduces the anticipated interest income. But for the reasons mentioned above, CUs may have a different pattern of delinquency based on the relatively short period of time over which their mortgage loans may have been issued and in tranches equating to the timing of hitting their regulatory lending caps. Therefore, their loan product pricing may need to account for that even whilst aiming to compete with the longer established traditional mortgage providers in the market. This is not an easy task but the financial risks to individual CUs due to failure to meet projected loan interest income levels are likely higher than to pillar banks for example simply due to their scale.

What can we do about it?

So to go back to the introduction, all of the above is not meant to be interpreted as a 'Don't Do It' warning. It is about knowing the risks and making informed decisions based on the CU's own specific circumstances. With the changes introduced in the ROI Credit Union (Amendment) Act 2023, and the anticipated changes to the lending limits also in ROI, the path has been paved for many ROI CUs to take a range of approaches to offering mortgages and each CU will be looking at which mechanism suits it best depending on its own

appetite for this type of credit risk. However, for those who are already engaging in mortgage lending or larger, longer-term loans at this time of geopolitical turmoil, it would be prudent to consider whether some of the following credit risk mitigation measures might be worth considering at this time:

1. Make a concerted effort to keep employment details on loan accounts as up-to-date as possible. Encourage all member-facing staff to use trigger events to verify employment status & employer.



2. Identify whether there are any large employers in your common bond which may be exposed to a potential trade war with the US. These could be either US multinationals or Irish owned businesses whose market is predominantly US based. It could also be businesses which rely on US goods as part of their supply chain and retaliatory EU tariffs on US products could have implications for such businesses.
3. Review the CU's loan book to identify what proportion of the loan book could be exposed to negative developments in employers identified in 1 above. Even if employment details on borrowing members is not 100% correct, this analysis will give CUs some idea of the proportion of the loan book which may be affected as some borrowers may no longer be employed there but others who were employed elsewhere when they applied for their loan may work in one of these companies now. It is simply an indicator of a worst case-scenario in terms of the proportion of the borrowing members which could be affected by such geopolitical developments.
4. Review the CU's top loans by size to identify if any of these are linked to employers identified in 1 above.
5. Review connected party loans to identify where multiple family members who are financially dependant on each other may be exposed to the same employers identified in 2 and 3 above.
6. Consider identifying any loans identified in 2, 3 and 4 above for a higher level of monitoring to flag any early indications of repayment difficulty to ensure credit control intervention can be as prompt as possible.
7. Consider whether additional loan provisioning might be appropriate for loans identified in steps 2, 3 and 4.
8. Review the CU's current mortgage product pricing to determine where the cost break-even point is and determine if this is reasonable based on the various factors discussed in this e-zine. This determination will also be influenced by the proportion of the CU's loan book in that category either currently or planned into the future.
9. Depending on the outcome of the interest rate pricing review, the CU could consider whether it might be appropriate to increase their current mortgage interest rate, assuming the loan agreement permits this. If the mortgages were offered on a variable rate basis, the CU may have options regarding varying the rate for existing mortgage holders and/or new mortgage applications if worst-case scenarios were to materialise. It is worth remembering that the CU might need to be prepared for an initial element of complaint/reputational damage if changing rates during the term of the loan has not been the practice for the CU up to now.
10. If the CU is considering step 9, I would recommend preparing a multi-scenario financial analysis based on a range of interest rate options, with the associated projected changes to interest income levels and, importantly, the various associated cost break-even points.
11. The CU could consider investigating where it would be possible to introduce early redemption penalties going forward (again, depending on the CU-specific mortgage offering arrangements,



T&Cs, etc.) which could incorporate an element to cover the cost of the loan and potentially a minimum element of interest income on the loan.

12. Going forward - if the CU has not already done so, when processing mortgage applications, consider making a conscious effort to have a reasonable spread in the maturity profile of mortgage loans to minimise the 'natural' concentrations of loan maturities. There is very little the CU can do to prevent a group of unrelated loans being redeemed by Members at the same time by coincidence.

Conclusion

The Chinese curse "may you live in interesting times" seems particularly fitting for the times we are experiencing now. All of the above underlines the point that we are living through a time of unprecedented geopolitical uncertainty where even the most eminent economists and economic & political commentators appear to have no definite view of where this is going. Concerns are being expressed from a range of sources about the potential for the cost of living in Ireland to rise in response to these geopolitical events so CUs need to consider that there is the potential for some or all of the above to have an effect on members' capacity to repay their loans in the short, medium and long term.

Increasing a CU's proportion of larger, longer-term loans may well be a key strategy for achieving long term viability, but it needs to be entered into in the full knowledge of the associated credit risks so that those risks can be mitigated to within the risk capacity and appetite of the individual CUs. Otherwise, there could be material challenges along the way which could have been avoided from the outset or at least mitigated to an acceptable level along the way.

Having said all of the above, it is important to bear in mind that the effects of the current period of economic upheaval will not be evenly distributed across all sectors of the ROI & NI economies. Even if imposed as planned, it is unclear as to how long any such US tariffs will remain in effect. The main piece of advice is to analyse your own CU's situation, plan accordingly and try not to overreact. The picture is changing on a daily basis at the moment and the key strategy is to keep a close eye on developments and do your best to ensure that everyone involved in lending decisions



in particular are well informed so they can continue to apply their skills, knowledge and expertise to managing the risk within the lending process, particularly in respect of those larger, longer term loans.

If you would like further information on any of the above, please contact Sandie O'Leary by email at sandie.oleary@calgrisk.com or on +363 86 1762363.