Risk Advisory Service

Risk Today

Issue 8 – Long-Term Funding Strategies

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Introduction

Many credit unions (CUs) have either already begun or are considering engaging in longer-term lending for larger amounts than would traditionally have been the case for CUs in the past. There are a number of reasons for this, not least of which is the perennial challenge of growing the loan book in a prudent manner. As a result, the subject of long-term funding strategies to mitigate the associated risk is coming to the fore, or at least it should be, for any CU intending to engage to a material degree in longer-term lending.

Please note that this paper focuses on long-term funding strategies. Any CU decisions regarding engaging in long-term lending in the first place should be supported by a detailed risk assessment and documented in the CU's strategic plan. Please see the **Risk Advisory Service Loan Product Risk Assessment Guidance** issued in November 2023 for more information on how such a risk assessment can be conducted. See RAS members website for all previously issued risk assessment guides etc.

What's the problem?

Fundamentally, the decision to engage in long-term lending must be supported by stable funding and a thorough understanding of the CU's own membership profile. Before any funding strategies are even considered, the CU will need to have assured itself that sufficient demand for long-term lending exists within its current membership profile and the wider common bond. Otherwise, the CU risks that the anticipated demand for longer-term loans does not materialise and the CU is left with a disproportionate level of savings versus loans and lower than projected income levels.

From a purely funding perspective, the issue is that to engage in longer-term lending for larger amounts on an on-going basis, there needs to be sufficient funding in place to meet the demand while at the same time managing the associated risks. And why might that be an issue for CUs? Well unfortunately it is somewhat of a timing issue really in that CUs have only relatively recently come out of a prolonged period of:

- Savings growth at unprecedented rates during and after the pandemic, combined with
- Negative to low rates of return on their investment portfolios,

the combination of which prompted CUs to introduce share caps to address the financial pressure this placed on CUs to meet the associated regulatory reserve requirements/expectations. Assuming that the CU's membership and common bond profiles support a projected strong demand for longer-term lending, the challenge is balancing the need for sufficient savings to fund demand for larger, longer-term loans with the associated risks.

Long-Term Lending Funding Strategies

1. Share Cap Reduction/Removal

At first glance, a simple risk mitigation strategy to address the funding issue would seem to be to reduce or remove any remaining CU-specific share caps below the legislative maximum and encourage members to return to placing additional savings with the CU. But unfortunately, life is never that simple.

An immediate complicating factor is the risk that current geopolitical events could undermine consumer confidence in the economy, which could result in a return to a savings mindset amongst members rather than a borrowing mindset. If concerns materialise about the potential for economic recession due to repercussions from recent geopolitical uncertainty, members could take a more cautious approach to spending, and therefore borrow less. In the short to medium term for example, this could manifest in members postponing changing the car or delaying those home improvements they had in mind for this year.

There is also the potential for redundancy programmes in specific employment sectors or supply chains which could have a disproportionate effect on some CU common bonds. Please see **Risk Today 7 – Credit Risk in Uncertain Times** issued at the beginning of April for more information on this particular aspect of the problem. It is worth noting that there are two aspects to the prospect of rising unemployment as a consequence of geopolitical uncertainty in this context. Firstly, there could be a rise in members experiencing loan repayment issues leading to an increase in loan arrears. On the other hand, redundancy payments could result in an increase in early redemption of loans (both short and long term) resulting in lower than expected loan interest income. This could be particularly challenging on larger longer-term loans where the loan interest income margin is usually tight to begin with. This concentration risk issue will be directly linked to the type of company engaging in any such redundancy programmes in terms of scale of redundancy payments. Relatively generous redundancy payouts could lead to early loan redemption which would also have an impact on the long-term lending funding strategy, particularly if were to result in a smaller than anticipated long-term segment of the loan portfolio.

Basically, the CU needs to carefully consider balancing the risk associated with the desire to fund long-term lending against a potential consumer sentiment downturn in the short to medium-term in light of the current geopolitical environment. There is a risk that significantly reducing or eliminating share caps to attract additional savings at a time of international economic volatility could lead to a material influx of savings which is not matched by a corresponding increase in borrowing.

2. Investment Portfolio Maturity

Another key source of funding for long-term lending is from the adjustment of the CU's investment portfolio i.e. the conversion of longer-term investments into more liquid assets which can be used to fund the anticipated demand for longer-term lending. The primary risk consideration in this regard is the potential for opportunity cost between the projected income from short, medium and long-term investments and the potential interest income from the expansion of longer-term lending.

Any analysis of this opportunity cost must include comprehensive loan product pricing including administration costs, marketing costs, compliance costs etc. associated with such long-term lending. As CUs know, it is not as simple as comparing interest rates for long-term loans against available investment rates at a point in time. This analysis becomes even more complex if the CU has been moving towards longer-term investments to avail of better rates thus increasing the likelihood of a maturity mis-match leading to liquidity constraints or worst-case scenario, liquidity limit breaches.

3. Fixed Term Deposits

The traditional CU business model which is based on unattached shares being available to members 'on-demand' presents significant challenges for planning around longer-term funding. An alternative funding strategy is to use interest bearing deposit accounts to attract longer-term savings which more closely reflect the longer-term loan maturity profile. To manage the interest rate risk, careful consideration needs to be given to ensure that the interest rate offered to members on the deposit accounts does not exceed the projected interest income from the longer-term lending whilst incorporating the various points in paragraph 1 in relation to loan product pricing which could result in a lower than expected interest income.

4. Member Growth

Depending on existing penetration levels within the CU's common bond, it may be possible to increase shares based on attracting new members and encouraging them to save with the CU. Many CUs already have high levels of penetration in their common bond in terms of membership but a significant proportion of the membership may not be regular savers. Perhaps advertising the CU co-operative ethos and underpinning business model of using member shares to lend back into the CU's own community could attract additional funds for lending purposes. Depending on common bond penetration levels this might even be possible whilst retaining some level of share cap if the CU were to be concerned about the impact of the geopolitical risks already mentioned on their specific common bond.

Summary

The Board of the CU must determine for itself what its risk appetite for long-term lending is, based on its own capacity for risk which in turn will have a direct impact on the most appropriate choice, or combination of, associated funding strategies.

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