

The Revolving Credit Opportunity for Credit Unions

A think/do research paper

CFCFE

Centre for Community Finance Europe

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June 2018

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A think/do briefing paper

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Published by the

Centre for Community Finance Europe Ltd.

Dublin, Ireland

In Collaboration with Liverpool John Moores University
Liverpool, UK

June 2018



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Publication #CFCFE002, ISBN 978-1-913885-01-4

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Acknowledgements. The Centre would like to thank the following CFCFE members who have provided insights, advice or information in compiling this document: David Dickman, Director Co-op Credit Union (England); Caroline Domanski, CEO No1 Copperpot Credit Union (England); David Fawell, Chair Co-op Credit Union (England); Robert Kelly, CEO NHS (Scotland) Credit Union, Michael Ahern, CEO Dubco Credit Union (Ireland), Michael Byrne, CEO Core Credit Union (Ireland), Gerry McConville, CEO Capital Credit Union (Ireland), Kevin Johnson, CEO Solution Centre (Ireland), and Michael Walshe, Senior Partner Kennedys Solicitors (Ireland). Thanks also to Matt Bland, Head of Policy & Compliance at ABCUL (Britain), James Berry, CEO Bristol Credit Union (England) and John Smith, CEO at Hull & East Yorkshire Credit Union (England).

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Table of Contents

Executive Summary..... 1

Introduction..... 2

1. What is revolving credit? 3

2. The main forms of revolving credit in Ireland and the UK 4

3. Credit union experience with revolving credit 6

4. The business case for revolving credit 8

5. Introducing a revolving line of credit product..... 10

6. Conclusions 21

Appendix A - Risks and Mitigants..... 23

Appendix B - Revolving Credit Capabilities of Core IT Systems..... 25

Membership of the Centre for Community Finance Europe 27

Executive Summary

Revolving credit is an arrangement that allows a consumer to borrow up to a pre-approved credit limit without having to reapply each time funds are needed. As borrowed money is paid back, the amount of available credit is restored so that it can be drawn down again.

Revolving credit is a salient and popular feature of the personal finance markets in Ireland, Britain and internationally, and typically takes the form of personal lines of credit, credit cards and overdrafts. These are core products of credit unions in the US, Canada and Australia.

This paper discusses the concept of a simple line of credit facility that operates much like a 'credit card account without the card' and why it is an attractive product for credit unions in Ireland and Britain and for their members. It describes how this product can be designed, marketed, and operated on a safe and cost-effective basis and how its unique risks can be safely managed.

Revolving credit is provided by a few credit unions in Britain, and practitioners there have been consulted in the development of this paper, along with banking professionals who are experienced with the product in both countries. In addition, professional advice has been taken in relation to pertinent legal and regulatory considerations.

The Centre for Community Finance Europe believes that a revolving credit facility can be a valuable service to credit union members and advantageous for credit unions, if done prudently and responsibly.

Revolving credit has the potential to largely replace the current practice of top-up lending, which performs some of the same functions but at greater administrative expense to credit unions and inconvenience to their members.

Introduction

Irish and British credit unions are seeking new ways to serve their members' borrowing needs. They have low-yielding liquidity available to lend, and there is a gap in the credit union offering for short term, revolving credit.¹

Typical forms of revolving credit in the broader retail financial services market are credit cards and current account overdrafts. Cards and current accounts require significant back-office infrastructures, scale economies and technology, so they are likely to be out of reach to many British and Irish credit unions over the short term.

However, offering a simple revolving line of credit facility is an immediate solution that can give members the convenience of easily obtaining funds as needed, without requiring a plastic card or a current account - and, most importantly from a member service standpoint, without requiring a new loan application to top-up an existing loan.

This type of revolving credit has been introduced in several British credit unions on a limited basis, with varying degrees of success, but it has yet to be deployed by credit unions in Ireland, in part because of misconceptions regarding the legal authority for them to offer it.

This paper seeks to explain, with reference to international experience:

- What a revolving credit facility is and what member needs it meets.
- What the benefits to credit unions would be from offering it.
- How this product can be marketed and sold responsibly.
- What should be considered in relation to pricing and profitability.
- Why revolving credit lending is a legally authorised activity for credit unions in Ireland and Britain, and the regulatory considerations for its offering.
- Requirements for underwriting and credit control specific to revolving credit.
- Other operational and product design considerations.
- The risks associated with the product, and how they can be mitigated.

The paper draws conclusions and makes recommendations for credit unions considering whether to implement a revolving credit product.

¹ It is well acknowledged in Ireland that current credit union loan to asset ratios (which now seem stuck at an average of 27%) and their resultant diminished profitability, is unsustainable. Central Bank of Ireland (2017), *Financial Conditions of Credit Unions: 2012-2017, Issue 2*, Dublin; Centre for Community Finance Europe (2017), *The Irish Business Model: is it still fit for purpose?* Dublin. British credit unions enjoy more robust ratios, but they are still well below those of credit unions in other countries, with an average loan to share ratio of 37% in 2016 compared with international credit union performance of 82%. World Council of Credit Unions (2017), *Statistical Report 2016*, Madison.

1. What is revolving credit?

Revolving credit, also known as ‘open-end’ credit, is a loan with a predetermined borrowing limit that automatically renews as the debt is paid down. Credit cards and overdrafts are the most popular examples of revolving credit in many countries; in Britain, they are the most widely used means by which consumers obtain non-mortgage loans. (Figure 1.) As discussed below, the same is the case for banks and credit unions in the US, Canada and Australia.

In those countries, credit unions and banks also provide personal revolving credit facilities that are not tied to current accounts or plastic cards. This form of revolving line of credit facility is the focus of this paper.

In all forms of revolving credit, the lender determines the individual credit limit for each borrower, who can then obtain and spend those funds as and when needed, and without having to re-apply for additional credit each time.

Interest is charged only on funds that have actually been drawn down. At the end of each monthly billing cycle, the consumer repays some or all of the outstanding principal and interest. However, the monthly statement (just like a credit card) will specify the minimum payment that must be made within 30 days.²

The revolving aspect of the product is that consumers are able to carry any unused balance forward, i.e. the credit limit less loan advances to date plus any repayments equals the amount of credit that is still available. Unlike a standard loan that ends when the balance is paid off, revolving credit typically renews automatically as long as minimum payments are made and the credit limit is not exceeded. If the borrower

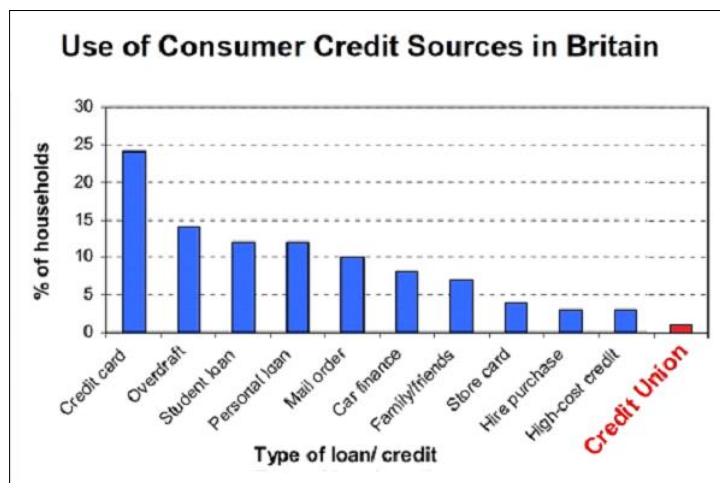


Figure 1. Dept. for Business, Innovation & Skills, "Credit, Debt and Financial Difficulty in Britain" (2012), London.

² An alternative used by some British credit unions is to have a fixed minimum monthly payment based on the total amount of the line. This avoids the need for sending a monthly statement. See section 5.1.

shows responsible use of the product, the lender typically can, at its initiative, increase the credit limit and so inform the member.

However, it is also essential that the revolving credit loan agreement reserves the lender's right to adjust, at its discretion, the customer's credit limit downward, such as when repayments are in arrears or if the lender determines that the customer's creditworthiness has declined. And if that happens, the lender must reserve the right to decline future credit advances that exceed the new, lower limit.

This form of credit contrasts with personal instalment loans, the bread and butter of Irish and British credit unions. These loans, also known as 'closed-end credit', are for a fixed amount, all of which is typically advanced to the borrower when the loan is made.³ Such loans are repayable by a fixed maturity date, typically by means of equal monthly, weekly, or fortnightly payments.

There is no automatic replenishment of the credit available as the loan is paid down. If the member needs additional money before the loan is fully redeemed, it is necessary for a new application to be submitted so that the loan can be "topped up" and replaced with a new loan for the increased principal balance, and with a new repayment schedule.

In Britain and Ireland, top-up lending has been, de facto, the credit union substitute for the revolving credit products offered by their competitors. This paper suggests that, properly deployed, revolving credit will serve the borrowing needs of members on a far more convenient basis, and at lower operational costs, than top-up lending. Indeed, the relative inconvenience of traditional credit union top-up lending may go a long way toward explaining the diminished attractiveness of credit unions as a source of credit for modern consumers who prize the speed and convenience of bank open-end lending and are willing to pay more to get it.

2. The main forms of revolving credit in Ireland and the UK

In the UK, consumers held £64.7bn of outstanding balances on credit cards in August 2017 and made 253.8m transactions.⁴ Overdrafts with the main high street banks accounted for another £6.8bn of outstanding revolving credit.⁵ This compares with

³ Exceptions are loans (e.g. for a university education or for major home improvements) where the total amount of a closed-end loan can be drawn down incrementally as needed.

⁴ UK Finance (2018) Credit Card Statistics December 2017, London.

⁵ UK Finance (2018) Credit Card Statistics December 2017, London. Overdraft figures from UK Finance, reporting on Barclays Group, HSBC Bank Group, Lloyds Banking Group, The Royal Bank of Scotland Bank Group, Santander UK Group, TSB Bank plc, Virgin Money plc; UK Finance (2017) High Street Banks Release November 2017, London.

structured personal loan balances at the main banks of £39.3bn (and for all credit unions at 30 September 2017 of £0.24bn).⁶

Line of credit facilities are on standard offer to businesses. However, the major British high street banks do not ordinarily offer line of credit loans to consumers. The exception is HSBC, which advertises a Flexiloan (Figure 2 below).

<p>✔ Borrow from £500 to £5,000</p> <p>Subject to our assessment of your personal financial circumstances</p>	<p>✔ Only pay for what you use</p> <p>If you don't use your Flexiloan, you don't pay anything</p>	<p>✔ No set up fees</p> <p>We won't charge you to set up your Flexiloan</p>
<p>✔ Flexible repayment terms</p> <p>Flexible monthly repayments between 4%-10% of the loan limit (minimum repayment applies). Lump sum reductions are also accepted.</p>	<p>✔ Easy access</p> <p>You can transfer all or a portion of your loan into your current account yourself via Internet Banking, Express Banking or Telephone Banking</p>	<p>✔ Redraw once you've repaid</p> <p>Once you've repaid your Flexiloan, you can redraw the credit if you need to - just like an overdraft</p>

Figure 2. HSBC Flexiloan summary, <https://www.hsbc.co.uk/flexible-loans>, as at 23 February 018

Credit cards are the source of most revolving credit in Ireland. In August 2017, Irish consumers used 1.4m active credit cards 9.8m times to spend €0.7bn in that month alone. In total that month, €1.7bn of credit card borrowing was outstanding, an amount equal to 39% of all Irish credit union loans.⁷

It is notable that, according to the Central Bank of Ireland, "Credit card utilisation is generally higher for younger borrowers possibly reflecting higher financial sophistication or liquidity constraints."⁸

Overdrafts and store cards are other revolving credit options available in the Irish market, and, together with credit cards, they account for 24% (€2.9bn of €12.2bn) of all consumer lending. That compares with 76% (€9.3bn) for close-ended, unsecured credit from all lenders.⁹

Personal line of credit loans are not generally available from Irish banks, although they are a routine offering for business customers. Credit unions in Ireland do not yet offer revolving credit products.

To summarise: in Ireland, close-ended credit remains the dominant form of non-

⁶ Bank of England (2018) Credit Union Quarterly Statistics Q3 2017, London.

⁷ Irish credit union loans were €4.4bn. CBI (2018) Financial Conditions of Credit Unions 2012-2017, Dublin.

⁸ CBI (2017) Household Credit Market Report H1 2017, Dublin.

⁹ CBI (2017) *ibid.*

mortgage lending to households, but revolving credit in the form of credit cards is a significant and growing feature of consumer behaviour, in particular for younger people – a key target market for credit unions. In Britain, revolving credit is even more popular as a proportion of total household debt, especially by means of credit cards, which are increasingly consumers' preferred way of borrowing, rather than personal loans or overdrafts.¹⁰

3. Credit union experience with revolving credit

At US credit unions, revolving credit is more popular with members than traditional personal loans, with \$412.9bn and \$366.5bn of outstanding balances respectively.¹¹ Like US banks, credit unions provide revolving loans in the form of credit cards, unsecured lines of credit (which may or may not be tied to a current account to cover overdrafts), and secured home equity lines of credit (HELOCs).¹²

The latter are revolving facilities whose credit limits are based on the amount of equity borrowers have in their homes, on which a second charge is given as collateral. That feature actually enhances the appeal of HELOCs to some borrowers, since individuals can ordinarily reduce their US personal income taxes by deducting interest paid on home loans.

Also, because they are secured, HELOCs carry a rate of interest that is lower to begin with than for other forms of revolving credit. HELOCs are therefore most suitable to finance large purchases and major home improvements.¹³ Notwithstanding the lower rates and tax deductibility of HELOC interest, however, many US consumers prefer to use credit cards to finance smaller purchases because they don't want to put their homes at risk of foreclosure in the event of default. All the same, while credit cards are popular for buying goods and services at point of purchase and on-line, they are usually an expensive option for consumers who just need to borrow cash.

This is why a straightforward revolving line of credit has long been a key part of the US credit union product mix. **Indeed, US credit unions started switching much of their lending to open-end credit in the 1960's, more than a decade before they**

¹⁰ UK Finance (2018) Update on Lending December 2017, London.

¹¹ Credit Union National Association, Monthly Credit Union estimates, August 2017, Madison.

¹² See, for example, Navy Federal Credit Union (www.navyfederal.org).

¹³ Unlike credit cards and other revolving lines of credit, HELOCs have a time limit during which funds can be drawn down, at the end of which any remaining balance must be repaid, either in a lump sum or amortised over a specified term, typically 10 or 15 years.

began offering current accounts and credit cards.

The change was enabled by credit unions' widespread adoption of automated data processing systems, which early on included support for revolving credit. With the technology sorted, the business and member service cases for revolving credit were obvious and compelling: Since a revolving line of credit is pre-approved, there is no need for the member to apply for a new loan or to sign additional papers to top up an existing one. Hence, administrative costs are lower, and members like the convenience and peace of mind that comes from knowing that they do not have to ask permission and wait for approval if they need to borrow cash, especially on short notice.

Nowadays, lines of credit can be drawn down by phone or via the Internet for electronic transfer into the member's other accounts at the credit union or a bank, or the member can come to the credit union to obtain cash. Credit union debit cards can be used to get cash at ATMs, with the charges going directly against the members' lines of credit, rather than their current

accounts. For members with current accounts, the revolving facility is usually set up to give them automatic protection from incurring an unauthorised overdraft, but it does not have to be. The description of a typical US credit union offering is shown above in Figure 3.¹⁴

As part of their core lending services, Australian and Canadian credit unions also offer credit cards and unsecured credit lines, both for overdraft protection or simply as a convenient way for members to meet sudden needs for cash.¹⁵ In all three countries, revolving credit is ordinarily offered on a variable rate basis, and typically at interest rates that are higher than those on conventional closed-end, fixed-term loans. (See Section 5.2 below for why this is necessary.)

Access Line of Credit

Use an ACCESS Line of Credit for whatever you need – vacation, home improvements, cash or overdraft protection for your checking account. You can borrow up to \$20,000 with competitive rates and terms. Access the cash you need from your line of credit with several convenient options like, use the FTWCCU App or Online Banking to make a transfer, contact our Member Information Center, or visit any FTWCCU Office for a cash advance.

Already a member? Log into [home banking](#) and click on Open an Account.

Not a member - [Apply Now!](#)

Figure 3. Fort Worth Community Credit Union, www.ftwccu.org/home/loans/access

¹⁴ See also, for example, Summit Credit Union, www.summitcreditunion.com/borrow/personal; Baxter Credit Union www.bcu.org/Products/Loans/Other-Loans/Personal.

¹⁵ See, for example, Vancity, www.vancity.com/Loans/TypesOfLoans/LinesOfCredit and Queensland Community Credit Union (www.qccu.com.au/brochure_home-loans_line-credit.pdf).

4. The business case for revolving credit

4.1. Members want it

The reality in both Ireland and Britain is clear: consumers want revolving credit, they use it, and many prefer it for everyday borrowing needs. But if they are credit union members, they must go elsewhere to get it, and they do — usually at higher cost, but at a cost they are willing to pay in return for convenience. In both countries, credit unions have largely opted out of a growing part of the consumer finance market by not offering revolving credit products.

One British credit union CEO says of the product:

“We provide a Flexi-Credit loan product which sets a pre-approved credit limit to be accessed as and when required. Members say they find it handy when extra funds are needed for things like unexpected car repairs or a broken down boiler. In some cases they have avoided resorting to payday lenders, thereby supporting their financial wellbeing.”

4.2. Preparing for payment services

Many of the larger Irish credit unions, and some in Britain, aspire to follow the steps of their North American and Australian cousins by offering payment accounts and debit/credit cards in the near future. To do so, they will necessarily have to offer revolving credit as well. A revolving credit facility is at the core of a credit card account, and revolving credit to offer protection from unauthorised overdrafts is a key component of a payment account/debit card service. Indeed, the Central Bank's specification for the new MCPAS specifically requires provision for handling overdrafts, and revolving credit is the most efficient way to do so.¹⁶

So a critical step in preparing for payment accounts and cards is to begin developing now the operational systems and the skills to offer revolving credit. Introducing a simple, unsecured line of credit loan facility without a card or overdraft connection is a straightforward means to do so.

Because North American credit unions were already adept at this kind of revolving credit, it was far easier for them to take the next steps into overdraft lending and payment cards. This is especially so because revolving credit is the one component of card and current account offerings that must be done internally by the credit union. Most of the remaining pieces must be out-sourced to third-party processors who have the specialised technology, operational scale and necessary direct connections to the payments system.

¹⁶ Central Bank of Ireland, Member Personal Current Account Services - MPCAS Application Form (Nov. 2016), Dublin.

But whether or not a credit union expects to offer payment services in future, the business and member service cases for getting started now on revolving credit are compelling.

4.3. Convenience and flexibility to the member

It has long been conventional wisdom among personal finance providers that what people hate most about dealing with them is having to bare their souls to strangers to ask permission to get money, and then suffering through the anxiety of waiting for a decision. Consumers prefer revolving credit because they only need to take that unpleasant step once.

Convenience to the member also flows from not having to make multiple visits to the lender every time borrowed funds are needed, as well as being spared the work of filling out a new application each time. Where the credit union already provides telephone and mobile phone banking, it can allow open-end borrowers to use those electronic means to request advances for direct transfer into their bank current accounts.

Some US credit unions have concluded that simply providing that capability is actually more cost-effective and practical than trying to offer plastic cards that compete with banks. Let the bank bear the operational and security costs of issuing and maintaining the card. The credit union can profit — and benefit the member — by serving simply as a lower cost source of funds that can be easily moved into a bank current account for debit card transactions from there.

4.4. Cost efficiencies for the credit union

The flip side of convenience to members is the cost efficiencies that revolving credit brings to the credit union. This is particularly so for serving those members who routinely get top-up loans. For some community credit unions in Ireland, those loans can account for a substantial portion of their total lending.

As discussed in section 5.4 below, there are costs involved in monitoring credit lines and evaluating member credit worthiness periodically. But those costs will likely be less (or at least no more) than the costs of collecting a new application and other documentation each time a member needs a top-up.

U.S. credit unions began adopting open-end credit even for car loans when they realised that it was no more work to underwrite and open up a revolving facility (even if the entire credit limit was borrowed straight out for the car), than it was to do the loan in the usual closed-end way. But then, if the member needed more

credit after the loan had been paid down a bit, additional funds could be advanced without the administrative expense of writing a new loan.

Of course, doing so prudently requires the credit union to carefully monitor the performance of its outstanding open-end facilities, so that some members don't draw down additional credit just to make the minimum payments on their existing balances. (Mitigating this risk will be discussed in section 5.4.) But the experience of credit unions in other advanced countries demonstrates that this can be done effectively, making revolving credit a safe, profitable core part of their loan portfolios.

4.5. Budget management

Lastly, it should be noted that many credit unions already use a form of open-end credit for their bill-paying budget account services. A revolving credit facility as described in this paper should be considered as a means to augment a well-implemented budget account service, by adding a tool for members to manage their household spending when the unexpected occurs.

This is a loan product ideally suited to help members deal with ups and downs in their cash flows, for short term, low value items of expenditure, such as car insurance or season tickets, or an emergency such as car repairs. Without the availability of revolving credit, many of these members are turning to much costlier sources like credit cards or even to 'payday lenders' for those kinds of loans.

5. Introducing a revolving line of credit product

5.1. Product design

British credit unions already offering revolving credit facilities typically set them up with an initial credit limit bespoke to the member of between £500 and £3,000, although some with payroll deduction offer up to £5,000. For administrative simplicity, some British credit unions set credit limits (and move them up or down) based on a stepped schedule of fixed levels, such as £500, £1,000, £1,500, and so on. Usually, the credit limit represents the maximum total amount a member would be allowed to borrow via any loan product, less any other loans outstanding.

When the arrangement is first put together, some credit unions give the member a credit limit that is actually lower than what they might be prepared to offer, with the idea of raising it later to a pre-approved internal limit, based on confirming through subsequent monitoring that the facility is being used appropriately.

Once the line is approved, withdrawals can be made at any time within the overall limit, although British credit unions typically require withdrawals to be for at least a minimum amount, such as £20. Some members may choose to use the facility often,

some only a few times a year, and others might not draw down any of the available credit but just keep it in place for emergencies.

To the extent funds are outstanding, the borrower is required to make at least a minimum payment monthly. Just like credit cards, US credit unions often require minimum amounts that are newly calculated each month at the amount that will fully amortise the current outstanding balance over a standard period of time, such as 36 months. This requires having the necessary IT capability to manage a line with a variable payment schedule and to provide members with monthly statements that show their current balance and the new minimum that must be paid within 30 days.

As simpler approach is used by some British credit unions, which require a fixed minimum monthly payment based on the credit limit rather than on the balance actually outstanding. The fixed amount is set to be high enough to fully repay any balance up to the maximum in no more than 12-36 months. This avoids the need for a monthly statement. Figure 4 is from Commsave Credit Union, a British industrial, where repayments are made over a 12 month schedule.

Members can, of course, opt to 'over-pay' and settle early. A regular contribution to savings can also be required alongside the repayment.

Credit Limit	Weekly Payments	Monthly Payments
£500	10.00	40.00
£1,000	20.00	80.00
£1,500	30.00	120.00
£2,000	40.00	160.00

Figure 4: Commsave 'Orbital Revolving Loan', www.commsave.co.uk/orbital-revolving-loan, as at 23 February 2018

Consistent with the convenience at the heart of this product, advances should be available using debit cards (where offered) or by same day electronic transfers to a nominated bank account. Advances can be requested either through self-service online facilities or by otherwise contacting the credit union.

5.2. Pricing the product

Appropriately pricing the product is perhaps the most challenging aspect of revolving credit. This will be particularly the case for Irish credit unions, since they are constrained by primary legislation to charging no more than 1% per month on the unpaid balance.

The average interest rate in Ireland for major bank credit cards is 14.9%¹⁷, while

¹⁷ September 2017, from CBI (2017) *ibid*.

authorised overdraft loans range from 11.85% to 15.55% plus annual fees between £25 and £30 (with higher rates for unauthorised borrowing)¹⁸. Bank revolving credit products are therefore priced higher than the statutory limit for credit unions.

In Britain, bank credit cards average APRs of 18%, while many banks now make a daily charge for authorised overdraft borrowing that is not counted as interest for APR purposes, making comparison difficult.¹⁹ HSBC offers its revolving credit loan at 17.9% for limits between £500 and £5,000, compared with 21.9% and 6.1% respectively for £1,000 (minimum) and £5,000 personal loans.²⁰ In relation to these price points, British credit unions have greater flexibility due to their higher legal limit for interest rates.

In part – but only in part – the higher rates charged by banks for open-end credit are justified by the fact that bad debt losses are higher than for other forms of consumer lending. At British banks, write-offs for credit cards in the 4th Quarter of 2017 were 0.22% compared with 0.03% for other forms of consumer credit.²¹ In the US, credit card charge-offs were 3.61% compared with 0.84% on other consumer loans.²²

Banks can also justify charging more because of the much higher operating costs of credit/debit card and current account processing. Those include, for example, fraud losses from lost and stolen cards, administrative costs associated with merchant charge backs, the cost of the actual cards and of securely issuing them, etc. The biggest 'cost' is from providing the card as a convenient payment tool to the large proportion of consumers who pay off their card balance in full every (or most every) month and therefore produce little or no interest income.

This last factor and the higher bad debt experience of banks (and US credit unions) with open-end credit strongly suggests that **credit unions should charge more for revolving credit than they do for ordinary loans**. This is necessary to cover the higher level of charge-offs they will likely incur on this product (all other things being equal) and the costs of setting up and monitoring lines that are never used. The alternative is to apply more stringent credit standards to revolving credit, but that would be at the opportunity cost of limiting revolving loans to a smaller group of qualifying borrowers.

The actual charge-off costs for banks and North American credit unions on open-end credit suggest the risk premium does not need to be more than about 2 to 3% per

¹⁸ As at 16 February 2018, www.moneyguideireland.com/interest-rates-on-overdrafts.html

¹⁹ August 2017, from UK Finance (2017) Quarterly Market Trends Q3 2017, London.

²⁰ HSBC, *ibid.*

²¹ Bank of England (2018), Bank Stats, Tables A5.6 (total balances) and C2.1 (write-offs), London

²² Federal Reserve Bank of New York (2018), Quarterly Report on Household Debt, New York.

annum. Banks charge substantially more than that, in part because of the higher operational costs of plastic cards and current accounts, but also because they can get away with it: People will pay more for convenience. That gives most credit unions the room to charge enough more to cover increased bad debt risks while still giving members a better deal than the banks do.

For those Irish credit unions whose rates on ordinary loans are already at the legal maximum, charging a risk premium for revolving loans will not be possible, and such credit unions should be very cautious in considering this product. Their only practical strategy might be to limit lines of credit to being no more than the amount of savings specifically pledged by the member as collateral. Doing so would at least give those members the convenience advantage of revolving credit at a cost much less than they would pay for a bank credit card. An alternative would be limiting access to revolving credit to long-standing and trusted members.

The good news is that the rates now charged by many (if not most) Irish credit unions have dropped far below the legal maximum, which has been essential for them to remain competitive. For now at least, they have the room to charge enough on revolving credit to cover its additional risk, while still giving their members a much better deal than they could get elsewhere.²³

Because of the inevitable risk of market rates going up (or down) significantly, it is essential for revolving facilities to be set up under loan agreements that allow for a variable rate of interest being charged on new advances. Typically, the loan agreement limits rate changes to track a well-established, independent index.

A limited survey of British credit unions offering revolving credit showed pricing in a range between 12.7% and 42.6% APR (the latter being the legal limit), with industrial credit unions tending to be below 20% and community credit unions above.

The goal (as with any lending product) must be to price revolving credit at a level that is at least as attractive as the competition while assuring that it produces a positive margin, so that it is not cross-subsidised at the expense of those members who choose not to use it. With revolving credit, the pricing challenge is impacted by

²³ Going forward, Irish credit unions should consider urging their representative bodies to lobby for an amendment to primary legislation that would relax the limit on the interest they can charge. While many think of today's historically low interest rate environment as being the 'new normal', there is no guarantee that will continue. The ability to charge more than 1% per month on higher risk loans is essential to guard against the future possibility of much higher market rates, which would necessarily entail correspondingly higher costs of funds for credit unions.

its being a loan product:

- where charge-offs may be at higher levels than conventional lending,
- where some member's actual borrowing may produce insufficient income to cover the cost of setting up and monitoring their facilities, and
- which requires active ongoing administration in the form of regular reviews.

Banks (as well as credit unions in North America) typically charge a fixed annual fee for putting a revolving credit facility in place, regardless of whether or how much it is used. However, it would be problematical for Irish and British credit unions to do so since, in both countries, the interest rate maximum permitted by law includes all costs charged to the member for the loan.²⁴

Ordinarily, it's not that hard to set competitive pricing on credit union products. Banks typically charge consumers too much, so pricing the product a bit lower is the default starting point. In Ireland, however, there is no bank product that is directly comparable to the revolving facility that is the subject of this paper.

This suggests that credit unions should begin by offering revolving credit on a limited, pilot basis, thereby gaining the experience that will inform their understanding of actual operational and charge-off costs. This is the prudent strategy any business may need to follow when introducing a product that is brand new to the local market. Only by giving it a try at a scale where risk can be safely contained is it really possible to learn what the true costs are – and whether the market will accept the product at the price necessary to cover those costs plus an appropriate profit margin.

5.3. Sound underwriting

It is the consistent experience of banks (and credit unions in other countries) that, all other things equal, revolving credit carries a higher risk of bad debt loss than standard consumer instalment lending. The primary mitigation strategy is to charge enough more in interest to cover the greater cost of charge-offs on revolving loans.

Assuming the relative credit risk of revolving credit is mitigated through pricing, the underwriting process to be used does not differ materially from what is involved in underwriting a standard instalment loan. The normal tools used for determining the member's capacity and likeliness to pay should be employed. Credit limit assessment

²⁴ Credit Union Act, 1997, Sec. 38 (Ireland); Credit Union Act 1979, Ch. 34, Sec. 11(5) (Great Britain). Charging fees for a line of credit is another area in which credit unions may wish to obtain flexibility in primary legislation, so that they can offer revolving credit on a commercially sensible basis. In Ireland, the authority for the regulator to approve 'Additional Services' under Sec. 48 of the Act may be the route for the charging of additional, non-interest fees just for obtaining a line of credit.

should also take into account other loans and credit facilities with the credit union, as well as the member's borrowing elsewhere. In that latter connection it might be wise to review statements (and available credit limits) for any credit card accounts the member might have. The need for this overall affordability and suitability assessment is noted in Britain's responsible lending guidelines.²⁵

Some British credit unions use a credit reference agency as a resource to help with underwriting decisions. Irish credit unions would expect to report on this product to the central registry, once it's fully operational. To the extent available, credit scores should also be sought.

The EU's new Payment Services Directive 2 (PSD2, also known as 'Open Banking') promises to bring much greater transparency to consumer financial arrangements, and that transparency will support more robust and accurate assessments of borrower needs and risks in relation to this product. PSD2 will make member balances and transactions with other providers potentially more visible to credit unions, which will erode some of the advantages previously held by the banks.

5.4. Monitoring and credit control

As discussed in section 5.2, revolving credit carries a higher risk of bad debt losses than conventional consumer loans. To keep those losses under control (so they are covered by the correspondingly higher rate of interest they earn), revolving credit facilities require more robust and disciplined monitoring and credit control systems because of the literally open-ended nature of the risk exposure they represent.

It is essential that strong internal controls be implemented to assure that:

- Credit lines are reviewed at least annually to identify members whose creditworthiness has deteriorated, whose credit limits should be reduced and/or for whom new advances should be stopped.
- This should be supplemented by regular monitoring of credit reports, credit scores (if available) and other relevant information that might flag up the need to perform an interim review.
- A system should be in place for noting pertinent information in the respective member's credit file, so that it is readily available at the next periodic review.

²⁵ FCA (2018) Consumer Credit Sourcebook, Chapter 5 Responsible Lending, London. Paragraphs 5.3.1.8 and 5.3.1.9.

- If there is doubt, the credit union should consider requiring the member to furnish new credit documentation (bank statements, etc.) to reassess the line and determine whether it should be continued, limited or ended.
- New credit advances must be stopped immediately as soon as the member goes into arrears by more than a few days on this or any other credit union loan. That requires robust credit control systems that report arrears on revolving credit accounts as early as possible.
- In terms of the credit union's overall credit control efficacy, it is essential that early arrears on revolving credit accounts be dealt with quickly — not only to prevent 'runaway accounts' but also as a red flag that the member's other loans might need to be closely monitored.

The periodic credit review process provides an opportunity to ensure that the member is using the product correctly, that this form of credit remains suitable for the member's requirements, and that the credit limit and repayment schedule are still the right ones – or amended upwards or downwards as appropriate. Although not required explicitly in responsible lending guidelines, the review helps fulfil the credit union's ethical obligation to look after the best interests of its members.²⁶

The review could be conducted directly with the member, as part of a wider 'financial health check'. Credit unions in the US and Britain, however, ordinarily perform the review without the member present, based on an account activity review, credit reports, and any known changes that reflect on creditworthiness.

5.5. Marketing the product

The primary target for a revolving line of credit facility is those members who routinely use top-ups to obtain relatively small loan advances. But there may be even more members who have chosen to get the revolving credit they need from a bank or other source and who do not even consider going to the credit union for this kind of day-to-day borrowing.

Sales communications need to be particularly clear, as members will be less familiar with a non-card-based revolving credit facility. The difference from a standard personal loan needs to be explained, together with the pricing and repayment arrangements. For example, most, but not all, British credit union websites sampled for this review made clear the 'term' over which the set repayments on their revolving loans were structured.

²⁶ Periodic reviews are essential for revolving credit to replace top-up lending on a prudent basis. The credit risk mitigation strategy for top-up lending is that a new loan application is made and new credit information supplied, with an appropriate underwriting review, each time a top-up is issued. Periodic reviews of revolving lines mitigate the risk of allowing advances without a new credit review.

The experience of some British credit unions that have introduced the product but have yet to see significant take-up is that it is critical that staff understand revolving credit and its role in the lending portfolio. If they do not, and systematically default to offering a regular personal loan, they will not identify where open-end credit might better fit a member's requirements. This 'selling to need' is the most effective form of communication to members.

The key opportunity for credit unions – which should be the centrepiece of their marketing and sales efforts for revolving credit – comes from providing their members a service that people want and for which they must pay more if they go to a bank or other lender instead.

5.6. Responsible sales

Like credit cards and overdrafts, a revolving credit facility carries credit, compliance and reputational risks if it is misunderstood, misused, or mis-sold. This can happen if the borrower soon spends a substantial part (or all) of the available credit line, keeps spending as payments are made, and thus maintains a balance at or near the limit. Hence, the loan is never really paid down, despite regular repayments.

When that happens, repayments can become an enduring cost for the individual, and the principal an enduring debt. This 'debt trap' is a downside to the use of credit cards by some consumers, since minimum payments on bank credit cards are potentially just 3% or 5% of outstandings.²⁷

Britain's Financial Conduct Authority (FCA) has recently introduced rules to address 'persistent debt' where credit card customer repayments are lower than the fees and interest for a period of 18 months or more.²⁸ Lenders will be required at that point to warn customers to change their repayment behaviour. After 36 months in persistent debt, lenders will have to offer consumers a way to repay their balance over a reasonable length of time, and if this cannot be achieved, interest and charges may have to be waived.²⁹

²⁷ Financial Conduct Authority (FCA) (2017), High-cost credit, including review of the high-cost short-term credit price cap, July 2017, London; StepChange (2017) Stuck in the red, London; FCA (2016) Credit card market study Final findings report, London and Bank of England Research at Bank Underground blog <https://bankunderground.co.uk/whos-driving-consumer-credit-growth/>, Jan. 2018.

²⁸ Rules set out at www.fca.org.uk/ps18-4-helping-customers-persistent-debt, 26 February 2018.

²⁹ FCA (2018) Consumer Credit Sourcebook, paragraphs 5.3.1.8(c) in relation to minimum payments, and 5.2.1.2(b) and 5.3.1.6(b) in relation to reasonable repayment period.

To avoid this risk on revolving credit, repayments should be defined such that principal balances and interest (based on the credit limit) would be paid off in full within a suitable timeframe, e.g. 30 months, if additional draw downs are not made. This means that even if members continue to draw down credit while making repayments, they are always within sight of settlement. If the full amount is not utilised, the repayment is completed even faster.

Credit unions need to mitigate the compliance, reputation and credit risks of mis-selling by employing proper staff training, underwriting, monitoring and credit control practices that are suitable to the unique characteristics of revolving credit.

5.7. Operational considerations

Beyond the product-specific training and process issues implied above, the experience of North American credit unions with revolving credit (and of those British credit unions who offer it) is that this is a relatively straightforward loan product for staff to sell and administer.

The key requirement is an IT system designed to support a revolving loan account. Ideally, that would enable the credit union (as do core systems in North America) to truly offer 'a credit card without the card' for which new minimum payment requirements are communicated via a monthly statement and on which interest rates on future advances can be easily adjusted if necessitated by market conditions.

However, depending on the limitations of its IT provider, it may be necessary for credit unions new to this product to follow the practice of British credit unions by using a fixed minimum repayment amount and a constant rate of interest. (See section 5.1.) If done on this basis, credit unions in Britain on various software platforms have confirmed that revolving credit is a relatively simple product to set up and run.

In researching this report, CFCFE sent a very brief questionnaire to the major software providers to the credit union sectors in Ireland and Britain, enquiring as to their capabilities in relation to revolving credit. Responses were received from five of them and are reported verbatim in Appendix B.

A critical step for credit unions looking to offer revolving credit is to contact their provider directly and assure that it can effectively provide the necessary support for the specific product design the credit union wishes to offer.

5.8. Capital and liquidity

Conceptually, revolving credit involves basically the same capital and liquidity considerations as other lending. However, it is essential that before approving individual credit limits, each credit union establish a pre-determined and well-controlled maximum on the aggregate credit limits that can be granted, to assure

itself of having the liquidity necessary to fund that total commitment, should it be called upon.

In effect, that means maintaining the same liquidity and capital levels as would be needed if all approved credit lines were fully borrowed. This requires having appropriate board policies, internal controls and the right asset/liability monitoring tools in place to assure compliance.

In Ireland, it is also necessary for credit unions to monitor credit lines so that amounts outstanding do not exceed Section 35 limits. As a practical matter, this is achieved by requiring repayment schedules that will fully repay principal and interest in under five years, so that the credit union does not inadvertently exceed legal limits on longer-term lending.

5.9. Board policies

It should go without saying that the foregoing assumes that all relevant board policies will be reviewed and amended as needed to account for the special characteristics of revolving credit. This needs to be done before a revolving credit product is introduced, and the policies involved must be reviewed thereafter at least annually. Virtually every board policy relating to lending, credit control, risk appetite, asset/liability management, liquidity, provisioning, data protection and so on will need to be assessed, as well as others that may be pertinent to revolving credit.

5.10. Legal and regulatory considerations

In Britain, revolving credit has been offered for several years, including by some of the regulator-defined (and more closely supervised) 'Large Credit Unions'. Although the PRA's Credit Union Handbook provides no specific guidance, it appears that the regulator has no objection. Hence, the authors believe that the legality of revolving credit can be considered a settled question for British credit unions (subject, of course to compliance with the other rules applicable to any loan).

In Ireland, Section 35(4) of the Credit Union Act, 1997 states:

"Every application to a credit union for a loan shall be in writing and shall state the purpose for which the loan is required and the security (if any) offered for it."³⁰

³⁰ As renumbered by Sec. 11, Credit Union and Co-Operation with Overseas Regulators Act 2012 ("CUCORA"). Previously, this sentence was in Sec. 35(7) of the 1997 Act.

These same words have been in the Credit Union Act for many years, and there is a not uncommon misconception that this effectively forecloses revolving credit since each draw-down from the line is thought to be for a different 'purpose.'

However, the reality is that an application for a revolving credit line is precisely an application for the 'purpose' of having a pre-approved loan facility from which funds can be immediately borrowed whenever needed. Alternatively, the application could simply state that the purpose of the loan is 'household expenses', which would be both fully accurate and fully compliant with the literal requirements of section 35(4).

Nevertheless, to the extent there could have been any doubt in the past, the question is now clearly resolved by new language added to the 1997 Act by CUCORA. Section 35(2) now states:

"A credit union may make a loan to a member for such purpose as the credit union considers appropriate, upon such security (or without security) and terms as the rules of the credit union may provide." ³¹

And by Sec 37C(1)(d), which states that the credit agreement must set out "the date or dates on which the loan is to be provided (unless unascertainable at the time of the agreement)" – the last being, of course, exactly the case for a revolving credit facility.

The Centre has taken advice from a senior legal adviser, who has confirmed the correctness of the foregoing conclusion, namely that revolving credit is already fully authorised for Irish credit unions by primary legislation.

Of course, a loan made pursuant to a revolving credit facility is, in all respects, a loan that must comply with all the other requirements of primary legislation and regulations that are applicable to credit union loans in Ireland and Britain, respectively.

In addition, credit unions will need to develop new loan agreements for revolving credit that explicitly provide for loans being drawn down from time to time, and repaid in accordance with a schedule that may change in the credit union's discretion for future advances. Among other things, the loan agreement needs to explicitly permit the credit union to stop further draw-downs and/or amend the credit limit at any time, up or down, at its sole discretion.

Because of the inevitable risk of market rates changing significantly, it is essential for revolving facilities to be set up under loan agreements that also allow for a variable rate of interest being charged on new advances, based on an appropriate index and

³¹ This COCURA change eliminated the requirement found in the prior Sec. 35(1) that loans must be made for "a provident or productive purpose."

with reasonable advance notice to the borrower.

6. Conclusions

Revolving credit loans are attractive to members, operationally feasible, and legally authorised for credit unions in Ireland and Britain. They address the common member desire for personal credit that is convenient and available whenever needed. For credit unions, revolving loans eliminate the cost and administrative burden of requiring new documentation for top-ups.

Revolving credit is neither operationally complex nor costly to develop, and it does not carry inordinate levels of risk when done properly. However, by their nature revolving credit loans carry a higher likelihood of default, and that risk needs to be mitigated by charging interest rates higher than would be charged on conventional loans.

Revolving credit also requires robust controls for monitoring credit quality and for immediately shutting down new loan withdrawals as soon as a delinquency occurs. However, the other risks of the product can be mitigated in much the same ways as the risks of any other credit union lending. A table summarising those risks and their corresponding mitigants is shown in Appendix A.

All the same, it may be prudent for credit unions to introduce revolving credit initially on a limited, pilot basis, so they can determine their actual costs and credit risks before finalising product design and pricing for a wider launch.

The experience of banks in Ireland and Britain, and well as at North American, Australian and British credit unions, shows that revolving credit can be offered safely and profitably. Consumers want it and will pay more to get it. Credit unions can profitably provide it at a lower price than their competitors and thereby give their members a true credit union advantage.

Credit unions can deploy revolving credit in the short term to better serve their members and to increase their lending. It is indeed 'low hanging fruit'. We hope this paper will be a useful starting point for them to pursue this opportunity.

Appendix A - Risks and Mitigants

References are to sections of this paper where the item is discussed. All mitigants presume the presence of effective policies, procedures, and internal controls to ensure that they are consistently and effectively employed.

RISKS	MITIGANTS	REF.
CREDIT RISK	• Clear, consistently applied underwriting policies and procedures at least as robust as are prudent for a regular loan of the same size as the credit limit.	5.3
	• At least annual review of the member's credit facility, with the limit lowered upon indications of credit-worthiness deterioration (or increased if appropriate).	5.4
	• Effective IT and operational systems to assure that advances outstanding do not exceed the credit limit.	5.5
	• Effective credit control and systems that prevent further drawn-downs when arrears occur.	5.4
	• Cancelling lines if required.	5.4
FINANCIAL RISK	• Pricing adjusted for risk, to assure that additional interest is received to cover potentially greater losses.	5.2
	• Requires measurement/evaluation of expected/actual credit losses to determine the risk premium needed.	5.2
LIQUIDITY RISK	• Controls to prevent the aggregate amount of credit lines approved from exceeding the maximum set by policy, to assure that liquidity is available.	5.8
	• Monitoring of agreed limits, as well as actual draw-downs, against liquidity ratios.	5.8
MARKET RISK	• Revolving loan agreement allows the interest rate charged on new advances to be changed in the credit union's discretion, to respond to market conditions.	5.2
	• Monitor market pricing to avoid inbound migration of high risk borrowers if market rates rise.	5.2
OPERATIONAL RISK	• Confirm details of IT capabilities with providers, and ensure that IT processes make for an excellent member experience together with effective internal controls.	5.7
	• Document and test written operating procedures.	5.7

RISKS	MITIGANTS	REF.
COMPLIANCE RISK	<ul style="list-style-type: none"> • Loan application, loan agreement and other documents/procedures reviewed by legal counsel. • Avoid conduct risk through <ul style="list-style-type: none"> • Effective communication of the product via accurate marketing materials, and • Monitoring and staff training to prevent mis-selling of the product. • Application should state that loan purpose is for revolving credit or household expenses. • Applicable Board policies amended (and reviewed at least annually) to appropriately cover revolving credit. 	<p>5.10</p> <p>5.5</p> <p>5.6</p> <p>5.10</p> <p>5.9</p>
REPUTATIONAL RISK	<ul style="list-style-type: none"> • Rates, terms and conditions that are fair and publicly defensible. • Accurate and clearly stated advertising and disclosures. • Effective controls to prevent mis-selling. 	<p>5.5</p> <p>5.5</p> <p>5.6</p>
UNKNOWN RISKS	<ul style="list-style-type: none"> • A consumer revolving credit facility is new to the market (Ireland in particular), so there may be risks that are as yet unknown ('unknown unknowns'). These risks can be mitigated by testing the product on a pilot basis before wider launch. 	<p>5.2</p>

Appendix B - Revolving Credit Capabilities of Core IT Systems

	1. Does your system currently support revolving (open-end) credit accounts?	2. How many of your CU clients (approximately) use this capability?	3. Does your system automate the periodic review of a revolving credit account?	4. If your answers to 1. or 3. are 'No', do you plan to add the capability within the next year?
Fern Software	Yes – Fern has implemented a Re-loader Loan Product (Revolving Credit, whereby a member can cyclically draw against the available balance)	Currently 1 large UK CU. With a further 2 planned by Q2 2018	For its initial conception – No. Period is fixed at 36-month term	Re. 3 - this will be amended to allow a flexi term – Q2 2018
Kesho Systems	Yes	Although it is an integral part of the system and available to all our credit union clients, only some 15 - 20 make use of that loan product.	Working on a two or three year review cycle we base the revolving credit limit on affordability and leave the parameters up to individual credit unions (i.e. if a member is able to repay £15 per week the credit union may set his/her limit at, say £250.00).	-
SIT	Yes revolving products are available.	As Portfolio Plus is user-defined parameter driven clients would have the ability to configure a revolving type product without SIT's engagement so we would have to reach out to obtain this information.	There is a review date or a maturity date that can be used depending on the preference of how the CU sets up the product is setup.	-
Wellington	Yes	None	Yes	

	1. Does your system currently support revolving (open-end) credit accounts?	2. How many of your CU clients (approximately) use this capability?	3. Does your system automate the periodic review of a revolving credit account?	4. If your answers to 1. or 3. are 'No', do you plan to add the capability within the next year?
ice cube	No	N/a	No	Not specifically, however, overdraft facilities are part of the MPCAS requirements which are being finalised to be completed within the next year.

Membership of the Centre for Community Finance Europe

Founding Members provided the initial funding required to launch CFCFE in 2017.

Credit Unions

1st Alliance (Scotland) Bronze

Altura (Ireland) Founding

Bristol (England) Bronze

Capital (Ireland) Founding

Capital (Scotland) Gold

Central Liverpool (England) Founding

Clockwise (England) Silver

Comhar Linn INTO (Ireland) Founding

Commsave (England) Founding

Co-operative Family (England) Bronze

Core (Ireland) Founding

Dubco (Ireland) Founding

Dundalk (Ireland) Founding

Enterprise (England) Founding

First Choice (Ireland) Founding

Health Services Staffs (Ireland) Founding

Hoot (England) Silver

Just (England) Silver

Life (Ireland) Founding

London Mutual (England) Founding

Manchester (England) Bronze

Member First (Ireland) Founding

NHS (Scotland) Founding

Number One Police (England) Founding

Plane Saver (England) Founding

Progressive (Ireland) Founding

Savvi (Ireland) Founding

South Manchester (England) Bronze

St. Anthony's & Claddagh (Ireland) Founding

St. Jarlath's (Ireland) Founding

Tipperary (Ireland) Founding

TransaveUK (England) Bronze

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