Submission from Farranree Credit Union Ltd on Consultation Paper CP109

We wish to make the following observations and suggestions on consultation paper CP109 dated May 2017:

1. Overall Counterparty Limit

We have reservations that consideration is being given to a reduction in the overall counterparty limit from 25% to 20% of a credit union's total investments that may be exposed to an individual counterparty. The reduction comes at an inopportune time for credit unions particularly with the increasing absence of choice in Irish based financial institutions, indeed these options will be further reduced at the end of June 2017 with the exit of Rabo Direct from the credit union deposit market. Like many other credit unions, we have always pursued a conservative policy in the placing of Members funds with other financial institutions. If the limit is reduced to 20%, it potentially restricts credit unions in making appropriate investment decisions in line with their respective investment risk appetite in the best interests of their Members.

Given this shortage of counterparty options and banks' lack of appetite for short-term funding, we anticipate that credit unions will find it very difficult to source a home for funds which will allow them to observe regulatory counterparty and liquidity limits without potentially inflicting a capital loss on funds as a result of negative interest rates currently.

The justification put forward by the Central Bank in CP109, for the potential reduction in the overall counterparty limit, is an over concentration in existing credit union portfolios and the tendency for credit unions not to use all existing available investment options. We would contend that the existence of a particular investment option doesn't mean that it is right for an individual credit union to avail of it. We would argue that it should remain the prerogative of the board of directors to decide what investment options are best suited to the investment risk appetite of their individual credit union. It is after all Members Savings that are being invested by credit unions and the primary objectives of a board of directors is to protect Members Savings and maintain the financial stability of their credit union.

We would, therefore support the existing overall counterparty limit remaining at 25% of a credit union's total investment portfolio. We would be concerned that if individual credit unions are encouraged to place Members funds into investment options just because they are available, that it may undermine the aforementioned authority and independence of individual boards of directors and consequently dilute the effectiveness of their investment risk appetite which may have unintended ramifications.

2. Liquidity Pressures (re. interest rates)

Unfortunately CP109 does not factor in the liquidity pressures facing credit unions from an investment perspective, due to the current negative interest rate environment. While acknowledging the core mandate of maintaining financial stability as a priority, credit unions are now entirely reliant on overnight deposits/demand accounts and accessible collective investment schemes to meet their short-term liquidity requirements. We contend that this potentially represents capital risk which needs to be minimised as it is contrary to the underlying principle of not taking undue risk with members' savings. This is somewhat disappointing given representations made to the RCU prior to the publication of the consultation.

3. General Commentary

- Nature, scale, complexity and risk profiles of credit unions: The Paper has not appeared to fully consider the nature, scale, complexity and risk profiles of credit unions.

- Risk versus return: The Paper has focused purely on risk and assessed the potential impact of the proposed changes on asset allocation. By consequence, the regulatory impact analysis (RIA) requires further analysis.

- Credit versus duration risk: We are concerned that duration risk is not addressed in CP109 and some credit unions may look to "move out the curve" in order to secure valuable yield in the government, corporate or bank bond universe. In our view, this is potentially the worst point in the interest rate cycle for credit unions to be securing long-term investments.

- Bank bonds – Implications for credit unions as a result of the Central Bank's proposal to amend the definition of bank bonds: Traditional senior bank bonds may no longer be available while CP109 proposes that new types of bond issues (senior non-preferred) will be prohibited. If the Central Bank's proposal is implemented, the measures will effectively close off an authorised investment class which historically has represented an important investment option for credit unions. Credit unions are likely to face additional pressure on income as traditional senior unsecured bonds mature in their portfolios and they seek out new bond opportunities. Credit unions are highly unlikely to maintain 18% of investment portfolios in bank bonds as supposed by the RIA – it is more likely to be materially lower (ref: Davys submission paper).

4. Responses to the Central Bank's Questions (Selected questions only)

Do you have any comments on the current level of diversification in credit union investment portfolios? Are there any barriers to the use of existing diversification options within the current investment framework? If so, please provide details and any suggestions to address these.

We agree with the Central Bank that credit union investment portfolios are too concentrated. At present, credit unions have little choice other than to consider cash deposits or bank bonds.

Do you have any comments on the potential introduction of additional investment classes for credit unions and the appropriateness of the classes being considered by the Central Bank?

We agree with the proposal to include supranational bonds and corporate bonds. However the proposed concentration limits by reference to a percentage of regulatory reserves is almost non-material (Davy Submission Paper) and we propose to switch any change to concentration limits to asset level.

Taking account of the appropriate risk profile for credit union investments, are there any additional investment classes that the Central Bank should consider? If so, please outline the investment classes and why such investment classes are considered appropriate for credit unions.

Yes. Certain credit unions should be allowed to invest in senior bank bonds. The RCU should allow credit unions to assess investments (which are within the prescribed classes authorised by the Central Bank) and decide if they are suitable and based on their own investment objectives.

Do you think it is appropriate for credit unions to undertake investments in AHBs? If so, please provide a rationale.

Credit unions are a natural investor in social housing. Appropriate vehicles must be put in place to make credit unions' investment in social housing meaningful, affordable to credit unions and affordable by housing applicants.

What do you consider to be the risks associated with this type of investment and what mitigants do you feel are available to manage these risks?

Risks associated with investing in this sector may be summarised as, liquidity risk, investment risk, regulatory risk, financial risk and business model risk.

Do you have any comments on the proposal to amend the existing counterparty limit for credit union investments? If you have suggestions, please provide them along with supporting rationale.

As outlined already, we do not feel it is appropriate to reduce the counterparty limit for credit union investments at this time. Diversification proposals in CP109 are insufficient to warrant any contraction in current limits.

Do you have any comments on the proposed transitional arrangement to reduce the counterparty limit to 20% of total investments?

We would propose a 24-month transitional period but believe that the matter of a transitional period should not arise.

Do you have any comments on the use of collective investment schemes for credit union investments?

We advocate the use of collective investment schemes for credit unions.

Are there any barriers to credit unions using collective investment schemes in the existing investment regulatory framework?

It is our understanding that the barriers are predominantly on the supply side and emanate from the investment environment. Under FRS 102, collective investment schemes must be valued at fair value. Many credit unions hold a preference for valuing investments on an amortised cost basis and are therefore reluctant to absorb the mark to market volatility of collective investment schemes. It is difficult for advisers to build critical mass to cover and sufficiently dilute the costs involved in setting up collective investment schemes (Davys Submission Paper).

Conclusion

Finally we thank you for the opportunity to consult on this important subject, and look forward to positive and beneficial changes to the investment framework for credit unions, which will enable growth and success while simultaneously protecting member shares in a safe and secure manner.