Lisduggan District Credit Union Limited

Submission on CP109: Consultation on Potential Changes to the Investment Framework for Credit Unions

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Contents

Executive Summary

Lisduggan District Credit Union limited (LDCU) welcomes the opportunity to make a submission on “CP109 Consultation on Potential Changes to the Investment Framework for Credit Unions”.

LDCU is concerned that CP109 is silent on the liquidity pressures facing credit unions from an investment perspective, given the reality of capital losses are being experienced as a result of negative interest rates.

LDCU believes the counterparty party limit of 25% should remain unchanged.

LDCU believes that concentration limits of additional asset classes (supranational and corporate bonds) should be incorporated into existing concentration limits.

LDCU is opposed to the introduction of regulatory reserves as a concentration limit as it is not directly correlated to the investment portfolio and its use in the manner proposed is likely to create complications in terms of management of asset concentration limits. LDCU believes that there is no relevant investment rationale for this measure to be introduced.

LDCU is concerned that growth assets have effectively been removed from the investment classes. LDCU acknowledges the necessity to treat risk management as a priority, however, the ability to earn meaningful returns on investments has been severely restricted.

LDCU welcomes the potential addition of new investment classes. However, LDCU believes the proposed concentration limits do not achieve any meaningful diversification benefits.

LDCU currently holds bank bonds as part of its investment portfolio. CP109 overlooks the impending change in bond markets while, at the same time, proposing to prohibit investments in the replacement bonds. As a consequence, LDCU will be put at severe investment return disadvantage due to lack of alternative diversification options.

LDCU welcomes the inclusion of a regulatory impact assessment (“RIA”) and cost benefit analysis but believes the RIA is inadequate because investment income implications have been entirely disregarded in the RIA and it is unreasonable to assume that investments can be analysed without reference to return. Also, LDCU notes with concern that the RIA assumes that the level of bank bond investments will remain static in the future which is not realistic given the proposed prohibitions. This renders the RIA incomplete and does not fairly represent the reality or impact of the proposals outlined.

LDCU believes that contracting the investment universe will not increase lending to members. Rather, it will increase pressure on a sector that remains vital to the Irish social and economic landscape.

Responses to the Central Bank's Questions

1. 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.

LDCU agrees that credit union investment portfolios are too concentrated, particularly in the case of bank deposits. Factors outside of the control of LDCU have caused this over-concentration; primarily the contraction in investment regulations and also financial market conditions. The range of authorised investments in current regulations is very restrictive and over several years has been incrementally reduced so that no growth assets are permitted.

In the prevailing exceptional market conditions, LDCU has little choice other than to consider cash deposits or bank bonds. The yields available on EU government bonds, means these have not been investable in recent years because LDCUs risk appetite is not supportive of significant duration risk or alternatively credit risk.

2. 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?

LDCU agrees with the proposal to include supranational bonds and corporate bonds as they will provide some diversification benefits to our investment portfolio.

However, the proposed concentration limits by reference to a percentage of regulatory reserves is and we suggest to switch any change to concentration limits to asset level.

3. 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 decisions.

4. Do you have any comments on the potential to include supranational bonds in the list of authorised classes of investments set out in credit union investment regulations with a minimum credit

rating requirement and maturity limit?

LDCU agrees with this proposal, together with proposed minimum credit rating and maturity limit.

5. Do you have any comments on the suggested concentration limit for credit union investments in supranational bonds? If you have suggestions, please provide them along with supporting rationale.

LDCU opposes the introduction of regulatory reserves as a concentration limit and proposes that the concentration limits on supranational bonds is incorporated into the current class level of 70%.

6. Do you have any comments on the potential to include corporate bonds in the list of authorised classes of investments set out in credit union investment regulations with a minimum credit rating requirement and maturity limit?

LDCU agrees with this proposal, together with proposed minimum credit rating and maturity limit.

7. Do you have any comments on the suggested concentration limit for credit union investments in corporate bonds? If you have suggestions, please provide them along with supporting rationale.

LDCU opposes the introduction of regulatory reserves as a concentration limit and proposes that the concentration limits on corporate bonds is incorporated into the current class level of 70%.

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

LDCU believes that credit unions are a natural investor in social housing.

LDCU believes that appropriate vehicles must be put in place to make credit unions' investment in social housing meaningful to credit unions and affordable by housing applicants.

9. What would the most appropriate structure for investments in AHBs be e.g. investment vehicle?

LDCU believes that special purpose vehicles (SPVs) or collective investment schemes are potentially the most appropriate structures for investment in AHBs. LDCU recommends that the Central Bank opens an application process that accepts proposals with assessments conducted on a case by case basis.

10. 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?

LDCU believes that risks associated with investing in the sector may be summarised as liquidity risk, investment risk, regulatory risk, financial risk and business model risk.

11. How can the ALM issues associated with such investments be addressed by credit unions?

LDCU believes that the only realistic way of dealing with the ALM issues arising from investments in AHB's is to provide the investment through a collective investment vehicle which is large and accessible to all credit unions.

12. Given the existing mismatch between the maturity profile of the sector's funding and assets and the likely maturity profile of such investments, the Central Bank is of the view that the concentration limit would need to be set at a level that reflects this. Do you have any views on what an appropriate concentration limit would be for such an investment? What liquidity and ALM requirements could be introduced to mitigate these risks and potentially facilitate a larger concentration limit?

LDCU recommends a concentration limit of 5% initially to be reviewed for potential upward revision as the sector develops over the next few years. Creating an explicit ALM match for credit unions is problematic. We see the duration of AHB investments as remaining an outlier in ALM terms as it is not possible in our view to duration match AHB investments and the loan book of credit unions. Rather, investment in AHBs needs to be looked at on a portfolio basis and in this context, 5% weighting will not pose significant risk in ALM terms, as the overall investment portfolio duration remains relatively short.

13. Do you have any comments on the proposal to include investments in Tier 3 AHBs in the list of authorised classes of investments set out in credit union investment regulations with a 25-year maturity limit?

LDCU accepts that a term of 25 years will be required for an investment in social housing to be tenable.

LDCU believes that there may be other options worthy of consideration such as a development between credit unions and the NTMA of a department with expertise in this area and examination of the market models used in other countries.

14. 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.

LDCU does 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.

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

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

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

LDCU advocates the use of collective investment schemes for credit unions.

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

LDCU believes that the barriers are predominantly on the supply side and emanate from the investment environment. Under FRS 102, collective investment schemes are regarded as complex investments and therefore must be valued at fair value. Many credit unions hold a preference for valuing investments on an amortised cost basis and therefore may be reluctant to absorb the mark to market volatility of collective investment schemes.
LDCU believes it is difficult for advisers to build critical mass to cover and sufficiently dilute the costs involved in setting up collective investment schemes. Authorisation process in the Central Bank may represent a barrier for advisers.

18. Do you agree with the proposed timelines for the introduction of potential changes to the investment framework set out in this consultation paper? If you have other suggestions please provide them, along with the supporting rationale.

LDCU agrees with the proposed timelines for the introduction of potential changes to the investment framework set out in CP109. However, we would argue that changes are required which are not set out in this consultation paper, particularly in respect of liquidity, and we would urge the Registry of Credit Unions to give consideration to implementing these changes ahead of the proposed timeline.