ST. CANICE'S CREDIT UNION

Response to Consultation Paper CP109
June 2017

Executive Summary

St Canice's Kilkenny Credit Union Ltd welcomes the opportunity to respond to the Central Bank's Consultation on Potential Changes to the Investment Framework for Credit Unions. From feedback received by the Central Bank on previous responses to consultation papers, the Central Bank has acknowledged the concerns of credit unions in relation to diversification required for the sector's investment opportunities, leading to the issuance of CP109. However, we feel that despite the additional classes of investments offered, high restrictions are to be imposed on the amount credit unions can invest in these classes. Significantly low yields are to be gained on the additional classes, with yields being the biggest concern in the area of investments for credit unions with diminishing investment income in today's climate and for the coming years. More concerning in CP109 is the potential change to the definition of bank bonds which will restrict the investment in authorised bank bonds to an unacceptable level.

While opening up new classes of investments CP109 is not the investment framework to sustain credit unions in the future and will in fact have the opposite effect. There is very limited diversification and narrow portfolios available despite credit unions having strong reserves and a risk appetite to diversify. While it is appreciated some credit unions may not have the capabilities for such diversification the larger credit unions could benefit hugely from it and we suggest a tiered approach be used for investments for ranges of credit unions. Credit unions understand the need for effective risk management and strategic thinking for their member funds but the proposed changes are too restrictive for credit unions to make any level of return on the funds that they are unable to lend out to their members.

Bank Bonds

While views on the proposed amendment to the definition of bank bonds has not been sought, we would encourage more dialogue on the definition with the credit union sector as the change will significantly reduce the level of authorised bank bonds that credit unions can invest in; an investment category which credit unions are hugely reliant on and invested in. Also with the concentration limits proposed for the additional classes of investments in CP109 there will be limited investment opportunities to cater for the ever increasing amount of savings flowing into credit unions from its' members. The amended definition could result in a reduction in investment income for St Canice's Kilkenny Credit Union Ltd of 23%. We suggest bank bonds could be subject to a minimum credit rating of "A" to satisfy any Central Bank concerns over their risk or security. The concentration limit could be revised to a lower percentage of the investment portfolio, such as 50%. This could be open to responses and suggestions from the credit union movement. Also, we suggest credit unions are allowed invest in bank bonds issued from holding companies, in consideration of the minimum credit rating discussed.

Section 4: Potential Additional Investment Classes

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.

There is very limited diversification and narrow portfolios available despite credit unions having strong reserves and a risk appetite to diversify. We would suggest the following to address this:

- Non guaranteed products, including equity investments should be allowed, subject to a 5% limit of the overall credit union investment portfolio, including equity investments through Collective Investment Schemes and Investment Trusts. Reserves could be held at a level above the statutory minimum to the extent of half the equity weighting, e.g., 2.5% above minimum reserves.

- Credit unions should be allowed diversify into State Investment Schemes and Public Private Partnerships. Where the Central Bank may have fears over losses and volatility a reserve could be accumulated for the sole purpose to cover these.

- Access to highly diversified product offerings in terms of global financial markets, unitised property funds, hedging alternative assets such as gold and commodities.

- Access to highly specialised risk managed funds known as Real Return or Absolute Return Funds where primary focus is on capital preservation and stable moderate returns.

- Products offered by life assurance companies are highly regulated retail investment products suitable for a large range of investor types.

- Financial Reserve strengths of Life Companies mean placing business with very stable companies, that have large capital reserves.

- Access to a range of the top asset managers in the world all available under the umbrella of one policy.

- UCITS trading in investments as per section 25 1 (a), (b) and (c) of the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016 should be allowed to be used for liquidity purposes. Documentation on this has been provided to the Central Bank for review.

Also, liquidity is a monthly cost to credit unions with negative interest rates being imposed by financial institutions. The liquidity definition could be revised to incorporate that longer-term investments may be deemed liquid such as state bonds or where longer term investments are traded on a daily basis and mark to market. A suggestion is to ring fence a portion of the bonds on a portfolio, which are mark to market and to be able to cash these in for liquidity purposes if needed. An agreement could be reached for an additional haircut above the mark to market value to also be held for liquidity.

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?

We welcome the introduction of additional investment classes for credit unions to increase the level of diversification, which is limited at present.

The classes being considered by the Central Bank will yield low returns and will not address the existing problem faced by credit unions to make a return on the funds that they are unable to lend out to their members. With ever increasing funds being saved by members in credit unions the majority of these monies are resting in low interest earning investments. While the focus for all credit unions is to increase their loan book, the growth will be slow and until such growth is achieved credit unions are reliant on investment income to support their expenses.

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.

Additional investment classes have been discussed in response to 1. above. While it is appreciated some credit unions may not have the capabilities for such diversification there are others that could benefit hugely from it. By meeting certain criteria set by the Central Bank some credit unions with a assets above a set threshold who possess the necessary skills and systems to manage a more diversified investment portfolio should be allowed to invest in these additional investment classes. Credit unions understand the need for effective risk management and strategic thinking for their member funds but require less restrictive changes to make any level of return on the funds that they are unable to lend out to their members.

Section 4.1: Bonds issued by Supranational Entities

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?

We welcome the diversification offered through the potential introduction of supranational bonds to the list of authorised classes of investments for credit unions. However, the yields associated with these bonds are extremely low and whilst they may assist some credit unions who are struggling with their counterparty limits they will do very little to address the diminishing investment income issue that credit unions face.

We agree with the maximum maturity limit of 10 years.

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.

The concentration limit of 50% of the credit union's regulatory reserve will be acceptable by the larger asset sized credit unions who have significant reserves built up over the years, in particular bearing in mind the low yields to be earned on these investments as there won't be a desire to investment large amounts in them. However, the proposed concentration limit will severely limit the middle to low asset sized credit unions to diversify into supranational bonds. The basis for the change in the concentration limits being based on a percentage of regulatory reserves instead of the overall investment portfolio has not been addressed in CP109.

Section 4.2: Corporate Bonds

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?

We welcome the diversification offered through the potential introduction of corporate bonds to the list of authorised classes of investments for credit unions. However, similar to supranational bonds the yields associated with the “A” rated corporate bonds are extremely low and will do very little to address the diminishing investment income issue that credit unions face.

We agree with the maximum maturity limit of 10 years.

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.

The concentration limit of 25% of regulatory reserves for corporate bonds is quite low even for credit unions with high levels of reserves. Where there is a desire to invest in corporate bonds depending on the yields available the level would need to be increased. As discussed above the concentration limit of 25% of the credit union’s regulatory reserve will be acceptable by the larger asset sized credit unions who have significant reserves built up over the years. Investment will be dependent on the yields to be earned and risk involved with these investments.

Section 4.3: Investments in Approved Housing Bodies

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

It is appropriate for credit unions to undertake investments in AHBs. Being involved in a project that benefits the community is what the ethos of the credit union movement is all about. We would be filling a social void and keeping in line with the social element of our strategic plan. Members are saving more money with the credit union than the credit union can lend out hence a social housing project is a vehicle to invest these surplus funds while benefitting the community, but also fully protecting the members’ funds and earning a return for the credit union.

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

We believe a structure where the credit union lends to the Housing Finance Agency would be the most appropriate and seamless investment, or through local government schemes, thereby protecting the funds invested.

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?

There are two main risks, which are external risks:

1. That the AHB is unable to repay the loan.
2. Regulatory risk in that AHBs regulation is currently based on a Voluntary Regulation Code.

In order to mitigate these risks, as discussed in 9. above a structure where the credit union lends to the Housing Finance Agency would be the most appropriate or local government schemes, thereby protecting the funds invested. Secondly a statutory regulatory framework should be put in place for AHB's.

Any other risks related to the development of the new product and asset liability management are internal to the credit union and can be mitigated internally.

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

Investment in AHB's will be over a longer term and with credit union member savings being 'on demand' we would suggest the development of a fixed term savings product for members to counteract the mismatch of the balance sheet asset versus liability.

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?

As discussed in 11. above the mismatch can be addressed by the development of a fixed term savings product for members, also addressing ALM requirements. Stable credit unions will be able to meet their liquidity requirements as most have much higher liquidity than the regulatory requirements. A tiered basis for a concentration limit for varying asset sizes would be most appropriate, ranging from 10 to 25% of investments.

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?

We agree with the restriction to Tier 3 AHBs, but the preferred investment would be directly to the Housing Finance Agency. We also agree with the 25 year maturity limit.

Section 4.4: Other Considerations

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.

While CP109 indicates credit unions have a tendency not to utilise all available investment options there have been no issues that have arisen from the current limits. While the larger asset based credit unions should have no problem with an amended limit there may be increased difficulty for the smaller credit unions which is worth factoring into any final decision made. Also with the introduction of additional investment classes counterparty percentage holdings should reduce naturally for credit unions and address the Central Bank worries on this area.

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

The reduction of the counterparty limit from 25% to 20% is acceptable. However, consideration should be given to keeping a higher limit for Irish State Securities. While the larger asset based credit unions should have no problem with the limits there may be increased difficulty for the smaller credit unions which is worth factoring into any final decision made.

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

Collective investment schemes allow credit unions invest in a pool of assets classes, however, the required asset classes in the collective investment scheme are those in section 25 1 (a), (b) and (c) of the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016. Credit unions can investment directly in these asset classes themselves and earn a better return, hence there is no motivation to invest in a collective investment scheme. We would suggest expanding the asset classes allowable in collective investment schemes beyond section 25 1 (a), (b) and (c), subject to criteria on volatility, and there may be greater take up across the sector.

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

As discussed in 16. above while credit unions can invest directly in the same classes of investments as those grouped in a collective investment scheme, there is no motivation to invest in collective investment schemes, when a better return and reduced costs can be achieved through the direct investment.

Section 6: Next Steps

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.

It is difficult to ascertain the appropriateness of the timelines until all submission responses on CP109 have been received, understood and suggestions by credit unions researched into by the Central Bank.