Response to Consultation Paper 109

Consultation on Potential Changes to the Investment Framework for Credit Unions

Executive Summary & Observations

Our overarching view of the proposed changes to the investment regulatory framework is that whilst we view the proposals as broadly well-intentioned, their design will render them unsuccessful in achieving their objectives, and will, in some cases, further limit credit unions in effectively managing investment risk.

Our key observations are as follows:

- The concentration limits that are linked to the regulatory reserve are too conservative to truly allow for meaningful diversification of investment risk in the vast majority of credit unions;
- The proposed amended definition of bank bonds is likely to significantly reduce the range of compliant bank senior debt.
- Of the three proposed new investment classes, corporate bonds are the only one likely to offer any attractive new options for credit unions to diversify investment portfolios, but these options will be rendered ineffective

Ballincollig Credit Union would like to extend its thanks to Padraig O Sullivan (Cygnus Investment Advisors) in assisting us in understanding the implications of the potential changes to the investment framework for credit unions proposed under this consultation paper.

Potential Additional Investment Classes

No.	Question	BCU Response & Observations
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.	It is our view that the current concentration of investments in financial institutions is not consistent with appropriate diversification of investment risk. However, the current level of diversification in credit union investment portfolios represents the most logical distribution of assets given the current regulatory framework, low interest rate environment and demand for consumer credit.
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 potential introduction of additional investment classes for credit unions but feel that those proposed are far too restrictive to offer any real benefit in terms of portfolio diversification or return. The proposed maximum percentage of the regulatory reserve that may be invested in the new investment classes are set too low. Whilst we appreciate the importance of striking the right risk-reward balance there is little rationale provided for limiting investments to such low percentages of the regulatory reserve.
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.	We agree with the broad points made by the Irish League of Credit Unions in relation to the potential additional investment classes. It is our view that the following investment classes should be permitted: • Centralised Mortgage Lending; • Centralised SME Lending; • Equities; and • State Sponsored Projects.

Bonds issued by Supranational Entities

No.	Question	BCU Response & Observations
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?	Allowing investments in bonds issued by supranational entities is unlikely to open up a very wide range of new investments. Firstly, the number of such entities issuing euro-denominated bonds would be quite limited. Secondly, while the strong credit ratings would be positive from a risk perspective, it would be reflected in very low yields. In that regard, these bonds would be similar to bonds issued by very highly rated countries (e.g. Germany, Netherlands, France etc.) which are already permitted, but the reality is that in recent times credit unions have invested in such bonds to a very limited extent due to the exceptionally low, or negative, yields.
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.	According to the Central Bank's figures, the limit of 50% of a credit union's regulatory reserve which would apply to bonds issued by supranational entities would equate on average to 8.3% of a credit union's investment portfolio.

Corporate Bonds

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<tr><th>No.</th><th>Question</th><th>BCU Response & Observations</th></tr>
<tr><td>6</td><td>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?</td><td rowspan="2">Permitting corporate bonds is one of the key positive proposals contained within CP-109 that could offer credit unions significant investment options in A-rated companies issuing bonds in Euro. This development could assist credit unions in significantly diversifying their portfolios and reducing the unhealthy concentration in Irish deposit-taking institutions. Despite this potential, the current proposal falls short of offering any meaningful change to the current investment framework due to the extremely low concentration limit of 25% of a credit union’s regulatory reserve. For Ballincollig Credit Union Limited, this would equate to well under 4% of our total investments at present, and our balance sheet structure would mirror general sector trends.

For this investment class to provide any sort of potential for portfolio diversification it should be set at a limit of at least 100% of the regulatory reserve.</td></tr>
<tr><td>7</td><td>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.</td></tr>
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Investments in AHBs

No.	Question	BCU Response & Observations
8	Do you think it is appropriate for credit unions to undertake investments in AHBs? If so, please provide a rationale.	Credit Unions currently have huge surplus funds, a situation that is likely to persist in the medium to long term. The Credit Union Operating Principles include that of Social Responsibility, and it would be our view that any reasonable initiative contributing to the embodiment of this principle should be facilitated by the regulatory framework. We appreciate the need to ensure that such ventures are undertaken with conformance to robust risk management processes, but believe that this can be achieved by credit unions at this time.
9	What would the most appropriate structure for investments in AHBs be e.g. investment vehicle?	We believe that AHBs could be provided through a special purpose vehicle.
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?	SPVs often expose investors to novel risks and as such we appreciate the need for these types of investments to have conservative concentration limits to protect against unreasonable risk-taking. Historically, SPVs have often existed in an information vacuum and as such they may present a new risk profile for investment decision-makers in credit unions but the use of an SPV in a credit union context would obviously be limited to particular purposes such as social housing which would allow for a more robust analysis of risks underlying the investment vehicle and associated activity. The key risk for the proposed investment will be the ability of the AHBs' to repay the money borrowed. We support the proposed model set out in the ILCU Response to this consultation paper as it addresses this and associated challenges.
11	How can the ALM issues associated with such investments be addressed by credit	As part of the central management of the SPV, the mix of projects would be

	unions?	designed to ensure a balance in the portfolio in terms of length of term and a mix between acquisition and construction projects to ensure appropriate liquidity and keep risks within stated appetites. While investments in an SPV for social housing would by their very nature be longer--term investments we believe we can easily meet our liquidity requirements across the rest of our investment portfolio, as we have done comfortably over the past number of years.
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?	It is our view that the concentration limit for AHBs should be 50% of total regulatory reserves and that at this level there would be no rationale for introducing further liquidity or ALM requirements.
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 proposed maturity limit.

Counterparty Exposure Limit

No.	Question	BCU Response & Observations
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.	On balance, we have no issue with the proposed change in counterparty limits. However, we would qualify that with our previous comments in relation to the restrictiveness of the proposed concentration limits which we believe should be reconsidered by the Central Bank before publishing draft regulations.
15	Do you have any comments on the proposed transitional arrangement to reduce the counterparty limit to 20% of total investments?	We feel that where a credit union currently has in excess of 25% with a counterparty, and where there will not be sufficient maturities within a year to get below 20%, the credit union should be allowed to hold all investments until maturity and not be forced to make early encashments.

Timelines

No.	Question	BCU Response & Observations
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.	In relation the proposed additional investment classes we would welcome their introduction as soon as possible. However, we do not agree that the reduction in counterparty limits should proceed at this time given the limited pool of domestic deposit-taking institutions.