BPFI response to the CBI Consultation on Potential Changes to the Investment Framework for Credit Unions – CP109

Introduction

Banking & Payments Federation Ireland (BPFI) is the voice of banking and payments in Ireland. Representing over 70 domestic and international members institutions, we mobilise the sector's collective resources and insights to deliver value and benefit to members, enabling them to build competitive sustainable businesses, which support customers, the economy and society.

BPFI welcome the opportunity to comment on this consultation paper and are open to any further feedback the Central Bank of Ireland may have on our response.

Section 1 – Five Key Areas of Interest for the Banking Sector

When reviewing the potential changes to the Investment Framework for Credit Unions ("CUs") there are five key areas that we have highlighted:

Questionable benefits of Corporate Bonds and Approved Housing Bodies ("AHBs")

The benefits of diversifying into corporate bonds and Approved Housing Bodies ("AHBs") from bank bonds are questionable.

a) Corporate Bonds are 'bail-inable' investments and CU's investments in corporate bonds are subject to potential loss of coupon and principal. Hence, it is not immediately obvious that they represent more secure investments when compared to bank bonds. In addition, bank bond issuers are subject to a significantly higher degree of oversight and regulation when compared to corporate bond issuers.
b) AHB's are a new asset class, and therefore an unknown entity. These are likely to offer significantly less liquidity than traditional fixed income securities. In addition, the expected

long dated nature of AHB's is not a natural ALM matching instrument for CUs. If approved as an eligible investment instrument for CUs, it is probable that the CUs will own a large share of this asset class with a large domestic holding of the asset, again limiting liquidity particularly in secondary markets.

Clear and consistent definition and application of subordinated bank bonds

It is crucial that if restrictions on investments of bank bonds are introduced a clear, consistent application of restricted investment is applied irrespective of the form of subordination i.e. Statutory, Structural or Contractual. For example, Credit Unions should be clearly restricted from investing in Italian/German senior paper[1]. A clear, consistent application of rules will ensure no jurisdiction or form of subordination is disadvantaged.

Clarity required on non-subordinated senior instruments

The guidance on eligible investments would benefit from clarity on the eligibility of non-subordinated senior bank debt e.g. Operating Company senior debt or senior preferred debt. It is our understanding these instruments are eligible investments for Credit Unions, but clear guidance on this within the paper would be beneficial.

Covered bonds should be prioritised given their 'excluded liability' status

As outlined in the document, covered bonds are an 'excluded liability' under BRRD. Hence, relative to other eligible investments included under BRRD, including subordinated senior bank bonds, corporate bonds etc., covered bonds should receive prioritised status as an eligible asset class. Potential solutions would include a minimum level of investment holding.

[1] From the 1st Jan 2017 German senior unsecured bonds are subordinated to other senior unsecured liabilities. Italian will subordinate senior unsecured bonds by applying deposit preference from 1st Jan 2019. Hence, both now have a form of statutory subordination.

Impact of proposed changes on Irish fixed income market

Given the limited size of the domestic fixed income investor base in Ireland (both institutional and retail), Credit Unions are an important buyer of domestic issued bank debt.

Section 2 – Further Comments

Please find below further commentary we believe should be taken into consideration.

1. **Level playing field across Europe**

As outlined in the consultation paper, a number of approaches have been or are in the process of being implemented across Europe with the aim of meeting MREL requirements. The Single Resolution Board ("SRB") has notified some institutions to inform them that the resolution authorities (working together within the Resolution College) have settled on a single point of entry bail-in strategy at a holding company level as the preferred resolution strategy.

From a level playing field perspective, it is important that the subordination point is applied consistently across the various MREL approaches. The European Commission is in the process of harmonising the insolvency ranking but in advance of that harmonisation will German or Italian senior unsecured bonds still be eligible investments for Credit Unions?

Furthermore, under current European Commission proposals it is likely that structured notes and structured deposits will be senior to senior unsecured bonds (see Appendix 2). Limiting the Credit Unions scope to invest in bank MREL paper is likely to result in an increase in their investment in structured notes resulting in a less liquid portfolio and potentially more volatile investment income.

2. Covered Bonds

A covered bond is a debt security backed by a pool of residential mortgages, commercial mortgages or public sector loan assets and eligible deposits and characterised by a twofold bondholder protection mechanism embedded in dedicated national covered bond legislation. It is issued by a credit institution which is subject to specific public regulation and supervision in relation to its covered bond activities. Covered bondholders have a dual claim against (i) the issuer and (ii) the cover pool which must comprise at all times a minimum level of over-collateralisation, each such claim ranking senior to unsecured creditors of the issuer.

It is important to note that covered bonds are at the heart of the financial tradition of Europe, playing an important role in funding strategies for the last two centuries and proving to be a cost-effective and reliable long-term funding debt instrument, characterised by key safety features, including a strict legal and supervisory framework, asset segregation and an actively managed cover pool.

By providing a reliable funding tool, covered bonds have played a key role in increasing the supply of credit and hence supporting the economies in which covered bond issuers operate. The resilient nature of covered bonds is recognised in the regulatory treatment that the product enjoys. This includes exemption from bail-in, favourable risk weighting treatment and better liquidity treatment than other funding instruments[2].

3. Importance of Credit Unions as an investor in Irish bank paper

Funding by Irish Banks in Debt Capital Markets has been primarily achieved by accessing non-domestic investor base in wholesale markets. As outlined in Appendix 1 the average domestic participation for senior deals is 32% across European countries (ranging from 11% in Nordic region to 57% in Germany).

In a recent study by HSBC estimated that Irish pension funds only invest 1% of their bond portfolio in domestic corporate bonds versus approximately 20% in the Eurozone.

[2] ECB repo eligibility, LCR etc.

Table 1: European pension fund assets

	Pension* fund assets (EURm)	% bond allocation	All bonds (EURm)	% domestic corporate bonds	EUR-denominated domestic corporate bonds** (EURm)	% non-domestic corporate bonds	EUR-denominated non-domestic corporate bonds*** (EURm)	Total EUR corporate bonds (EURm)
EUROZONE								
Netherlands	1,210	60%	726	17%	98.8	4%	23.2	122.0
Germany	201	50%	100	33%	26.5	9%	7.2	33.7
Ireland	116	49%	57	1%	0.5	4%	1.8	2.3
Italy	112	42%	47	10%	3.8	11%	4.2	7.9
Spain	104	54%	56	23%	10.3	3%	1.3	11.7
Finland	103	40%	41	13%	4.3	13%	4.3	8.6
NON-EUROZONE								
Switzerland	723	38%	275	11%	0.0	40%	66.0	66.0
Denmark	119	53%	63	0%	0.0	19%	7.2	7.2
Total	2,689		1,366		144.1		115.2	259.4
Total (scaled up for countries not in HSBC dataset*)	2,965							286.0

Source: HSBC estimates, OECD, Mercers
Note: Data as at end-2015
*Our dataset includes the eight largest European countries by pension fund assets – those with more than EUR90bn of pension assets. This accounts for 90.6% of European pension fund assets.
**We assume that 100% of domestic corporate bonds owned by Eurozone countries are EUR-denominated. However, we assume 0% of domestic corporate bonds held by non-Eurozone countries are EUR-denominated.
***We assume that 80% of non-domestic corporate bonds owned by Eurozone countries are EUR-denominated and 60% of non-domestic corporate bonds owned by non-Eurozone countries are EUR-denominated.

In Ireland, there is neither a large nor a well-developed retail bond market. See Table 2 below, which highlights an average bond holding of €2.8k per household in Ireland versus a Euro average of €18.2k. Irish household savings are heavily skewed towards pension and mutual funds versus other Euro area countries.

Table 2: Financial Assets – Euro thousands per Household[3]

Financial Assets - Conditional Medians

(EUR thousands)	Euro area	BE	DE	EE	IE	GR	ES	FR	IT	CY	LV	LU	HU	MT	NL	AT	PL	PT	SI	SK	FI
Total Financial Assets	10.6	28.5	16.5	2.1	5.5	2.0	8.0	11.6	7.0	15.8	0.4	32.1	3.4	22.1	21.4	15.4	2.0	5.1	1.1	2.6	9.0
Deposits	5.9	12.5	6.7	1.2	3.8	2.0	4.0	7.0	5.1	12.3	0.3	15.4	2.8	13.2	8.9	11.9	1.1	3.4	0.6	1.8	5.0
Mutual Funds, total	12.3	28.8	14.8	1.1	20.0	N	10.3	7.0	26.3	11.2	N	44.5	13.1	20.4	8.9	15.1	3.0	8.2	3.0	5.8	4.2
Bonds	18.2	12.4	10.8	N	2.8	N	12.0	12.5	25.0	N	N	55.7	13.1	15.0	12.7	11.7	1.8	10.0	N	N	15.0
Shares, publicly traded	7.0	10.0	9.8	1.4	4.0	N	6.7	6.1	7.6	0.1	N	15.3	3.3	6.7	7.2	10.4	1.9	2.2	1.6	0.4	4.7
Money owed to households	3.0	7.0	2.0	0.6	1.4	1.6	7.6	3.1	5.0	11.5	0.7	8.0	0.8	4.1	5.0	2.1	0.7	5.0	3.0	2.0	M
Voluntary pension / whole life insurance	13.0	16.7	13.5	2.2	44.7	3.2	8.0	12.0	14.0	9.6	0.9	24.5	6.5	14.8	50.7	9.1	1.0	4.9	4.0	2.7	5.5
Other types of financial assets	3.0	73.0	2.0	2.5	6.0	N	12.0	2.0	18.0	N	N	30.3	N	N	23.8	10.0	2.3	0.6	11.4	0.6	2.2

[3] ECB Household Finance and Consumption Network survey (HFCN)

To date, Credit Unions have had limited involvement in primary markets but have been significant participants in bank senior secondary markets, thereby providing welcome market liquidity and also limiting spread widening in times of market wide volatility. This Credit Union demand for paper in secondary markets provides an important counterbalance to the lack of domestic participation from other market counterparts (in both primary and secondary markets). Further reducing the scope of domestic institutions to provide funding to Irish banks will, all else being equal, lead to higher funding costs for Irish banks with potential knock-on impacts to the cost and availability of credit to the real economy.

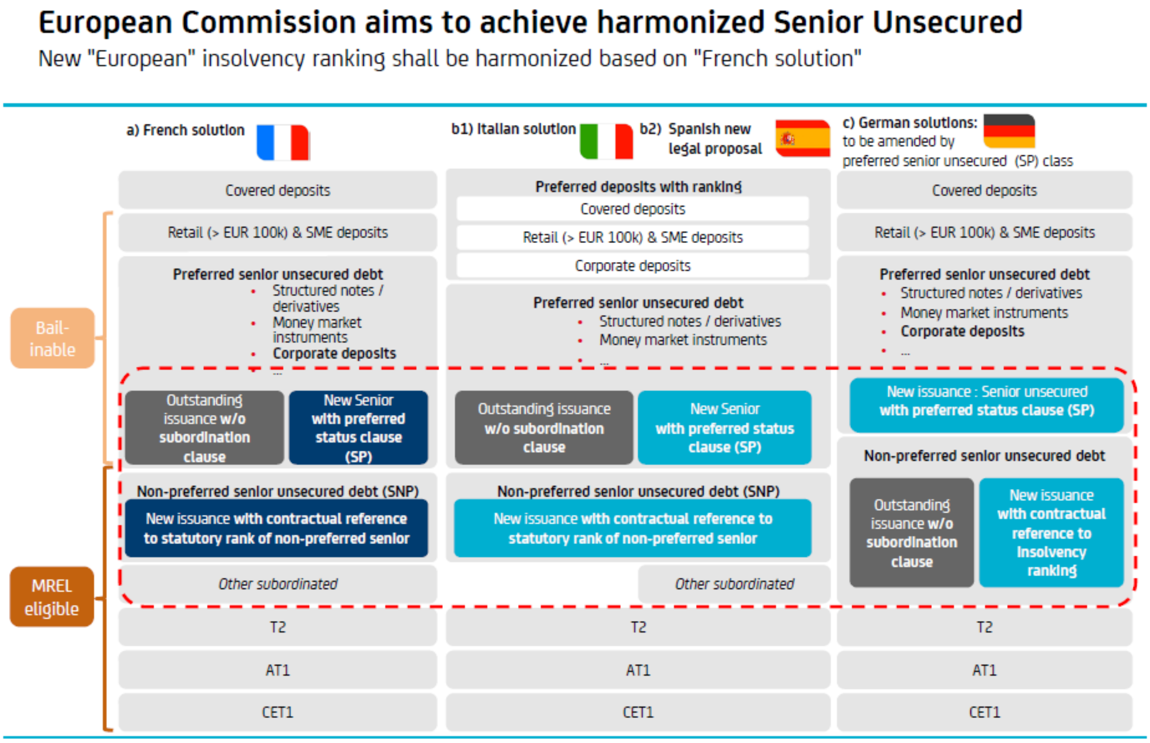
Appendix 1 – Domestic participation in Euro Senior Fixed Rate (2016/2017)[4]

[4] Source: Bond Radar/Bloomberg

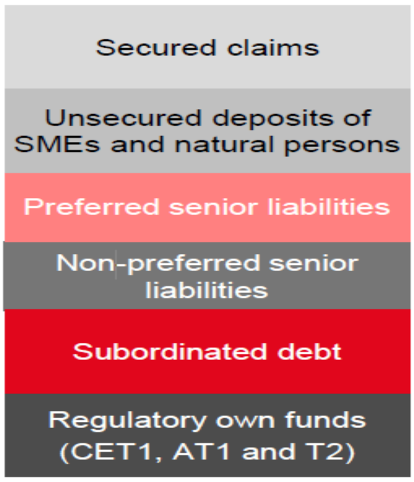
EUR Senior Fixed Rate (2016/2017)

Issuer	Volume (m)	Coupon	Tenor	Region	Domestic Bid
KBC	1250	0.75	5	Benelux	20%
NIBC BANK NV	500	1.5	5	Benelux	23%
KBC	750	1	5	Benelux	11%
ING	1250	0.75	5	Benelux	13%
NIBC BANK NV	300	2.25	4	Benelux	37%
ABN AMRO	500	0.625	6	Benelux	28%
RABOBANK	500	0.125	5	Benelux	28%
				Av. Benelux	**23%**
BNP PARIBAS	1000	1.125	7	France	44%
BNP PARIBAS	1000	E+85	6	France	27%
SOCIETE GENERALE	1250	E+85	5	France	18%
CREDIT AGRICOLE	1500	1.375	10	France	24%
BFCM	1250	1.625	10	France	50%
BNP PARIBAS	1000	1.625	10	France	62%
BFCM	1500	0.25	3	France	19%
BNP PARIBAS	750	0.75	7	France	23%
CREDIT AGRICOLE	1500	1.25	10	France	25%
SOCIETE GENERALE	1000	0.75	7	France	22%
BNP PARIBAS	1000	1.5	12	France	51%
CREDIT AGRICOLE	1000	0.75	7	France	16%
				Av. France	**32%**
DVB BANK	500	1	5	Germany	42%
NORD LB	750	1	5	Germany	85%
DEKABANK	1000	E+50	2	Germany	64%
DEUTSCHE PFANDBRIEFBANK	500	1.25	3	Germany	46%
DVB BANK	500	1.25	6	Germany	64%
DEUTSCHE PFANDBRIEFBANK	500	1.125	4	Germany	62%
DEUTSCHE KREDITBANK	500	0.625	5	Germany	70%
COMMERZBANK	1000	0.5	7	Germany	30%
BERLIN HYP AG	500	0.5	7	Germany	53%
				Av. Germany	**57%**
MEDIOBANCA	750	0.75	3	Italy	41%
INTESA SANPAOLO	1000	1.375	7	Italy	19%
ICCREA BANCA	600	1.5	3	Italy	79%
BCA POP VICZA	1250	0.5	3	Italy	34%
VENETO BANCA	1350	0.5	3	Italy	44%
INTESA SANPAOLO	1500	E+95	5	Italy	24%
MEDIOBANCA	1000	E+80	5	Italy	30%
				Av. Italy	**39%**
SVENSKA HB	1000	0.25	5	Nordics	8%
SWEDBANK	750	0.3	6	Nordics	3%
SPAREBANK 1 SMN	500	0.5	5	Nordics	9%
NYKREDIT	500	0.375	3	Nordics	12%
OP BANK	500	0.375	6	Nordics	24%
SBAB	500	0.5	5	Nordics	12%
				Av. Nordics	**11%**
BBVA	1000	0.625	5	Spain	13%
SANTANDER CF	1250	0.875	5	Spain	26%
BBVA	1500	E+60	5	Spain	42%
CRITERIA CAIXA	750	1.5	6	Spain	20%
BBVA	1000	1	5	Spain	16%
SANTANDER	500	0.25	3	Spain	20%
				Av. Spain	**23%**
RBS	1500	2	6	UK	48%
HSBC	1250	2.5	11	UK	27%
HSBC	2000	1.5	6	UK	30%
RBS	1500	2.5	7	UK	41%
BARCLAYS	1500	1.875	5	UK	21%
NATIONWIDE BS	1250	0.5	3	UK	28%
HSBC	2000	0.875	8	UK	22%
				Av. UK	**31%**

Appendix 2[5]



Bail-in hierarchy according to BRRD



Covered bonds and covered deposits

Existing senior unsecured debt, derivatives and bank and wholesale deposits

[5] Source: UniCredit

Follow up

Please do not hesitate to contact Banking and Payments Federation Ireland to discuss any aspects of our submission.

We would also appreciate the opportunity to meet and discuss our response.