# Consultation Paper CP109

# Potential Changes to the Investment Framework for Credit Unions

## Submission from Bantry Credit Union Limited

## 28 June 2017

Bantry Credit Union welcomes the opportunity to respond to the Central Bank's Consultation Paper on Potential Changes to the Investment Framework for Credit Unions (CP109).

**Key points**

- The potential addition of new investment classes is welcome, particularly in the case of supranational and corporate bonds. However the proposed concentration limits are at odds with the intended diversification benefits. Testing shows that the maximum exposure to supranational and corporate bonds will average circa 8% and 4% of portfolios respectively.

- The introduction of concentration limits linked to regulatory reserves will introduce additional complexity and may be cumbersome from an investment management perspective.

- Concentration limits on the proposed additional asset classes should be incorporated into existing limits which are based on a percentage of the investment portfolio rather than regulatory reserves.

- The counterparty limit should remain unchanged at 25% given the counterparty pressures facing credit unions. The diversification proposals in CP109 are insufficient to warrant any contraction in current limits. In the event that the counterparty limit is amended to 20%, Bantry Credit Union will have to reallocate 6% of its investment portfolio to alternative counterparties.

- CP109 does not factor in the liquidity pressures facing credit unions from an investment perspective. This is disappointing given the representations made to the RCU prior to the publication of the consultation while the reality of capital losses are being experienced as a result of negative interest rates.

- We recognise that risk management is a key regulatory priority for credit unions. At the same time, it must be acknowledged that credit unions are operating within an extremely limited investment universe. Any proposals which contract the investment universe further will increase pressure on a sector that remains vital to the Irish social and economic landscape.

- The Central Bank's proposed amendments to authorised bank bonds are a serious concern in light of changes occurring in bank funding and issuance trends. CP109 and the Regulatory Impact Assessment overlook these developments and propose to prohibit bonds which are likely to dominate senior bank bond issuance over the next five years. We believe that credit unions should be authorised to invest in senior bank bonds, both senior preferred and senior non-preferred.

**Response to Central Bank Questions (Section 7 of CP109)**

Bantry Credit Union endorses the response of our Investment Advisor Davy to the 18 questions in Section 7 of CP109 as set out in Davy's 'Summary Document of Davy Submission on CP109'. The responses are set out below:

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.

   *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.*

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 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 and we propose 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 objectives.*

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?

   *Davy 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.

   *We oppose the introduction of regulatory reserves as a concentration limit. Davy proposes that the concentration limits on supranational bonds is incorporated into the current asset 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?

   *Davy 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.

   *Please refer to question 5 above. Davy proposes that the concentration limit of corporate bonds is incorporated into the current 70% asset class limit of bank bonds.*

8. 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.*

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

   *We feel that special purpose vehicles (SPVs) or collective investment schemes are potentially the most appropriate structures for investments in AHBs. We recommend 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?

    *Risks associated with investing in this 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?

    *Davy believes that the only realistic way of dealing with the ALM issues arising from investments in AHBs 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?

*We recommend 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, a 5% weighting will not pose a 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?

    - *For an investment in social housing to be tenable we accept that a term of up to 25 years will be required.*
    - *We believe 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.

    *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.*

15. 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.*

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

    *Davy 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?

    - *We believe 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.*

- *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.

    *We agree with the proposed timelines for the introduction of potential changes to the investment framework set out in this consultation paper. 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 RCU to give consideration to implementing these changes ahead of the proposed timeline.*