Credit Union Managers Association

CUMA Submission on CP109

Consultation on Potential Changes to the Investment Framework for Credit Unions

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Credit Union Managers' Association

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Executive Summary

CUMA, the representative body for credit union managers in Ireland, welcomes the opportunity to make a submission of views on the Central Bank's 'Consultation on the Potential Changes to the Investment Framework for Credit Unions'.

CUMA notes the Central Bank's commitment to review the appropriateness of the investment framework for credit unions while ensuring no undue risk to members' savings. CUMA is concerned with the marginal nature of the changes proposed in the name of greater diversification. We are of the view that the proposal to further restrict bank bond access will strongly outweigh the benefits of allowing limited access to supranational bonds, corporate bonds and AHB (Approved Housing Bodies) special purpose vehicles. Furthermore, international investment markets have evolved in recent years with enhanced level of risk management sophistication. The proposal is silent on how credit union investment books can use this greater sophistication in a risk conscious manner to improve diversification. The credit union movement's income is under pressure from:

- declining investment returns,
- negative-to-meagre loan growth,
- reduced demand for personal borrowing and
- cost inflation to facilitate regulatory evolution and business model development

A more modern approach to investment management may result in marginally higher returns while maintaining a very low risk investment profile.

CP109 and its analysis of existing credit union investment portfolios show an acute over concentration in exposure to the banking sector and specifically the delicate Irish banking sector.

91% of current credit union investments are placed with bank counterparties – 73% on deposit in Credit Institutions and 18% held in Bank Bonds.

Furthermore, 70% of investments are held with just 5 counterparties with other available counterparties obviously less attractive to warrant such concentration.

This exposes the credit union sector greatly to any downturn in the highly integrated Irish banking sector and a turn in the interest rate cycle following 10 years of reductions in the ECB base interest rate.

Marginally increasing access to Supranational and Corporate Bonds, while reducing portfolio counterparty limits from 25% to 20% as proposed, will be ineffective in genuinely addressing this over-exposure to the Irish banking system. The vulnerabilities of the Irish banking sector relative to its peers is evident in the 2016 European Banking Stress Tests. These tests saw the sector as one of the weakest in the Eurozone in terms of:

- Common Equity Tier 1 ratio projected shortfalls by 2018,
- Requirements to restructure their capital base to ensure Basle III compliance by 2018 and
- Stubbornly high non-performing loans.

This overexposure to the Irish banking sector is further exacerbated by liquidity ratios and the exclusion of Sovereign, Supranational and Corporate bonds as designated liquid assets. This exclusion is in direct conflict with the liquidity treatment of these assets in European and UK Banking regulation.

The omission from CP109 of the impact of credit unions' stringent liquidity requirements and the consideration of cash only products for liquidity purposes is surprising for two reasons:

1. the key role the requirements play in increasing reliance on, and exposure to, the Irish banking sector and
2. the fact that current liquidity requirements and a lack of flexibility to include other liquid assets such as bonds, are forcing credit unions to place funds on deposit with credit
3. institutions at capital losses.

Specific CP109 proposals regarding expansion of asset classes into Supranational and Corporate Bonds are welcome but proposed conditions are too restrictive to bring about much needed change.

Proposed changes to credit unions ability to invest in Bank Bonds, as a result of the BRRD (Bank Recovery and Resolutions Directive) are concerning as credit unions are already struggling to find a suitable and diverse mix of counterparties under the existing framework. Bank Bonds are a key asset class in the existing framework and currently account for 18% of portfolio holdings. CUMA does not see bond eligibility for MREL (Minimum Requirement for Own Funds and Eligible Liabilities) as the key risk factor in holding these assets as part of a balanced investment portfolio.

The key risk factors used in assessing Bank Bonds are their capital strength and probability of default and these have to be prioritised in assessing the appropriateness of Bank Bonds for inclusion in credit union investment portfolios.

CUMA welcomes the proposed allocation to social housing AHB's through an investment structure given the difficulties of lending directly or through syndication. The risks of investing in these structures are extensively documented in CP109. The most suitable structure agreeable to AHB's and local authorities would ensure cash flows are steady to repay funding and that the state underwrites these cash flows to a significant extent. This will allow the offering to be acceptable to credit unions from a risk perspective and competitive in terms of pricing from an AHB perspective. Legislative change, if necessitated, should be addressed forthwith, in line with proposals advanced in this area.

The Credit Unions Current Investment Framework – Implications and Insights

- Narrow asset class choice, set out in regulation, is based on traditional and dated attitudes to investment risk management and has led to a potentially calamitous concentration of credit union investment exposure to the Irish banking sector. This restriction in asset class ignores the long established, and empirically proven, value of asset class diversification in lowering overall investment portfolio risk. Given the differences in volatility between asset classes, be they equities, commodities of various types, bonds of various types, alternative investments or property, even a very small allocation to other non-bond or non-cash asset classes can reduce overall portfolio volatility and counterparty risk.

- The monetary policy led collapse in the "risk free" rate (*See page 8) has seen returns on all investment assets reduce similarly. While CP109 notes that the only way to increase investment returns is to journey further out the risk curve, this does not have to be a linear relationship. Investment risk management techniques have had to evolve given the interest rate environment, to help achieve acceptable returns while minimising risk. Furthermore, low risk investment returns will increase while maintaining risk levels as the interest rate environment normalises but CUMA does not see this as a strong possibility over the next 5 years. Therefore, the investment returns environment is low and the credit union movement together with the regulator needs to develop a framework that reduces concentration risk on the financial sector while maintaining the accepted low risk mandate to ensure security of members' funds. As the investment industry evolves to this new reality, greater diversification and sophisticated risk management techniques can help credit unions maintain low risk investment portfolios. As a secondary, yet important, consideration given the myriad of challenges credit unions face, embracing this more sophisticated approach may also increase investment returns slightly.

- Credit unions are finding it increasingly difficult to allocate funds to strong counterparties because of:

1. tight Asset Class restrictions;
2. provider inertia to vanilla low risk cash and CIS offerings etc. as the interest rate environment has continued to squeeze their margins and
3. provider withdrawal (ie Rabobank's withdrawal in June end 2017 will see a requirement for credit unions to find an alternative home for, it is estimated, circa €800m of on demand funds).

- CP109, by proposing to further reduce counterparty limits and further restrict bank bond access, will only make sourcing quality counterparties, from a decreasing pool, more difficult. This will not be matched by offering very limited access to Corporate Bond and Supranational Bond markets.

CP109's failure to address a 'cash only' focussed liquidity regime appears a regressive strategy when taken with the other proposals. Therefore, proposals as set out in CP109 cannot meaningfully address the investment management framework issues which have conspired to see 91% of the credit unions €11.5bn investment book exposed to the Irish banking sector.

CP 109 Proposed Changes - Merits & Consequences

The proposals set out in the consultation paper have been reviewed in detail and their effects assessed below.

Bank Bonds

Citing the pending BRRD aimed at minimising the extent to which bank failures into the future will result in taxpayer bail-outs, CP109 is proposing that MREL eligible issuances are not included in the list of assets in which credit unions can invest. CUMA make two key technical points in relations to this proposal:

1. The extent to which MREL eligible senior unsecured debt is subordinated to preferred senior debt is marginal relative to the full array of issuer capital. MREL eligible debt still ranks above equity, subordinated paper and tier 1 and 2 capital.

2. The MREL eligibility or otherwise ignores the probability of issuer default which is the key consideration when assessing a bonds risk. To fully base suitability for credit union investment on MREL eligibility without assessing the core issue of default probability is flawed investment risk analysis and will misrepresent the suitability of bank bond investment for credit unions. Credit Ratings are the universal, independent, timely and dynamic metric for an issuer or bond instrument credit default risk and this has to be the key consideration in evaluating the merits of a bond for investment purposes. To illustrate the point, an MREL eligible bank instrument with an AA rating is a better credit union investment from a risk perspective than a single B rated, junk senior preferred bond with all other things being equal such as maturity etc. Simply put, the MREL eligibility of a bank bond is irrelevant if the probability of the issuer falling into difficulty over the bonds lifetime is negligible.

As such, CUMA considers the proposal to further restrict investment in bank bonds based only on MREL eligibility to be simplistic, overly conservative and does not reflect the core default risk probability.

Also, at present 18% of credit union investment portfolios are invested in bank bonds. This proposed adjustment would require credit unions to rotate out of such bonds on the open market, exposing them to duration risk and maybe losses at a time when many see a possible turn in the interest rate cycle. Furthermore, they would have to rotate into a lower yielding, shrinking preferred bond market as banks' focus will increasingly be in MREL eligible issuances given their regulatory obligations under BRRD. Therefore, this proposal will have the unintended consequence of significantly reducing holdings in bank bonds and reducing investment portfolio yields. Investments will likely rotate into Credit Institution Deposits with some allocation to close to zero-yielding Supranational Bonds and Corporate Bonds to the extent possible under tight proposed concentration limits.

The CP109 Regulatory Impact Analysis (RIA) assumption of static investment in bank bonds is therefore unlikely with allocation to new proposed asset classes coming from relatively higher yielding bank bonds rather than credit institution deposits. The overarching view on this proposal is that it will cause substantial yet needless disruption to credit union investment management, incurring trading costs, reducing yields and reducing bank bond holdings but with no meaningful risk or counterparty diversification benefit. Simply applying investment grade credit rating parameters around MREL eligible bank bonds ensures the key credit default risk metric is assessed as part of the investment suitability without fully restricting credit unions from investing in such assets.

Supranational & Corporate Bonds

CUMA welcomes the expansion of asset classes set out in CP109 but are surprised by three key aspects of the proposal:

1. The low concentration limits which reduce the impact to token changes
2. The basis of the limit as a percentage of Reserve Ratios
3. The Credit Ratings limit set at A and divestment terms should this be breached

While CUMA can appreciate a logic for the basis in that if a bond defaults, the loss given default is almost always significant, we see it as a very blunt way to manage bond risk. It would be more effective in managing risk to allow corporate and supranational bonds to be a much larger proportion of the investment book within the overall bond limits (70%) but to apply geographic, sector and counterparty limits within the specific subset to ensure diversification say, within the corporate bond element of investment book and to avoid concentration of exposure to individual entities, sectors and countries.

CUMA agrees that exposure to all bonds including sovereign, bank, corporate or supranational, should be subject to a certain level of credit rating but argue that this should be investment grade (Triple B grade) and not single A grade as suggested. Investment grade means the issuer is considered able to meet its financial obligations, exposing the bondholder to minimal default risk. CUMA believes it is inappropriate for Credit Unions to hold non-investment grade bonds and credit union investment portfolio detail suggests the broader credit union movement agree. The current investment framework around sovereign and bank bonds, is without grade restrictions. However, credit unions have avoided venturing into below investment grade bond exposure to seek higher yields, reflecting their fundamental prudence in managing risk and protecting members' funds.

Credit ratings

By agency

Highest — INVESTMENT GRADE ◄ | ► NON-INVESTMENT GRADE — Lowest

Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Ca	C	
S&P	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	C	D
Fitch	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC	CC	C	RD	D	

Source : The Economist

Importantly, the proposal as set out in CP109 around divesting "as soon as possible" in bonds that fall below the required credit rating may need a more nuanced approach. Simply insisting on divesting in bonds in event of a downgrade will lead to the realisation of capital losses. This will be undertaken without fully assessing the risk to the overall investment portfolio and the probability of the specific issuer default. On assessment, it may well be that divestment is the best course of action but CUMA would argue it is important that this assessment is allowed to take place to ensure needless capital loss does not arise. For instance, if a corporate bond issuer fell into non-investment grade status due to a deterioration in geo-political exposure and a credit unions exposure to that bond was maturing within 6 months, it may well be imprudent to sell the bond when full recovery can be achieved in the short term and the probability of default over that term is assessed as limited.

Counterparty Limits

CUMA strongly disagrees with the proposal to reduce counterparty limits from 25% to 20% in the current environment. The proposal shows a lack of understanding of the market faced by boards and managers in investing credit union funds. The counterparty concentration within credit union investment portfolios is not a function of limits set but the significant restriction in asset class categories available to them and the linked issue of “cash only” liquidity restrictions. Only by addressing these core issues meaningfully and in a risk conscious manner, can concentration risk across counterparties and the wider Irish banking sector, be resolved.

Should an external shock effect the vulnerable Irish banking sector into the future, the fact that the credit unions have exposure to 4 inherently linked Irish financial institutions at just under 25% each or 5 financial institutions at just under 20% will make marginal difference to the fallout across the sector.

Only genuine change through expanding asset class choice and accepting bond assets as liquid can resolve counterparty concentration sustainably to a point where diversification within investment portfolios is so strong that counterparty limits are no longer of systemic concern.

Secondly, the idea implied in CP109 that credit union investment managers are not using a supposed breadth of potential counterparties is to misunderstand the realities of the market they have had to face in recent years. Whilst there may be more possible counterparties available under existing restrictions, the risks involved in placing money with them is not equal and terms on offer also differ. Credit Union investments, constrained significantly by asset class choice and cash liquid requirements, have naturally concentrated exposure to the main local providers. The alternatives of, say, allocating to Portuguese, Spanish, Greek or Italian Sovereign or Bank Bonds do not offer the yield uplift to compensate for the greater risk given the economic stresses present in these jurisdictions and the difficulties their banking sectors face. Other more stable economies and their Bank Bonds offer zero or very close to zero return. To allocate to these supposed alternative counterparties would be irresponsible and not be in the best interest of protecting members’ funds.

Rabobank as a key deposit provider, leaving the market at June end 2017 is indicative of the narrowing options facing the sector under the existing framework. Reducing limits from 25% to 20% in this environment when there is also a proposal to restrict bank bonds and restrict significantly the extent to which funds can be moved into Corporate and almost zero-returning Supranational Bonds is not workable in the current environment. This will either result in credit unions breaching requirements in a rebalancing effort where options are insufficient or push credit unions to take risks they are not comfortable with in an attempt to meet such restrictions (E.g. pushing credit unions into fragile European Bank and Sovereign Bond markets).

CUMA proposes that this idea be withdrawn and that our alternative propositions on asset class expansion and liquidity adjustments are implemented.

This greater choice with neutral risk will result in significantly reduced counterparty concentration but can be reviewed in two years to ensure the desired counterparty diversification is well below the 20% level.

Omissions that limit the change required under CP109

CUMA believes the restrictive liquidity regime and the inclusion of other asset classes needs to be addressed along with those proposed in CP109 to ensure credit unions have a risk appropriate and effective framework to optimally manage members' funds. This is even more important now and over the next few years, as the majority of members' funds are managed through investments.

Liquidity Restrictions

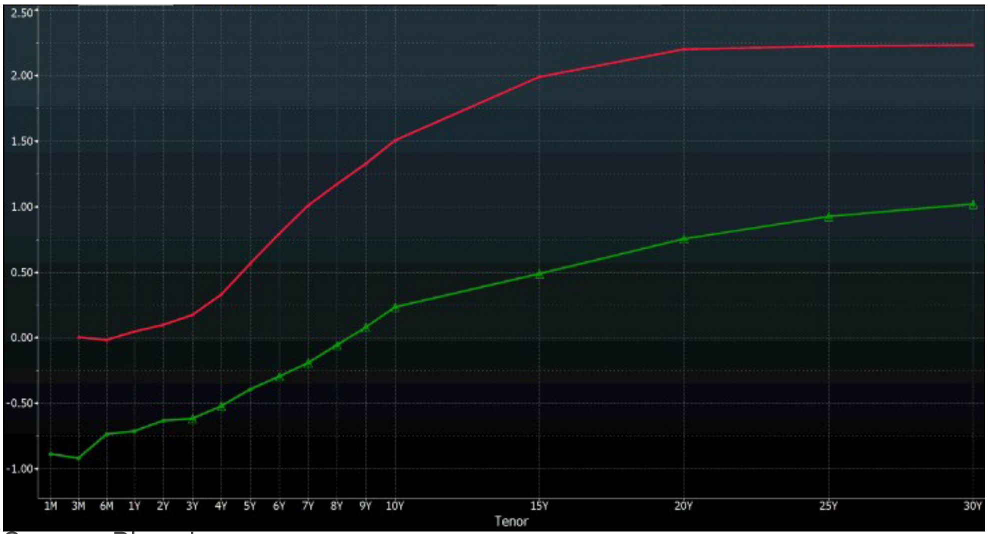
CP109's silence on the credit union liquidity framework is noteworthy given the current structure and ECB policy led negative interest rate environment, is forcing credit unions to endure capital losses to comply with their Short-Term Liquid Assets and Relevant Liquid Assets requirements. No impact analysis was ever evidenced in relation to the origination of the current regime. Nor was any consideration evidenced in relation to the "stickiness" of credit union savings, nor of the hold that life savings insurance exercises in savings retention. The credit union movement is highly liquid at close to twice their liquidity guidelines but the framework still forces individual credit unions to accept negative interest rates and guaranteed capital loss, albeit low losses, to adhere to liquidity guidelines. This is in direct conflict with its current stance on other highly regulated investments such as equities. Equities only have the possibility of losses from time to time given relatively high volatility but are fully restricted.

Furthermore, the exclusion of Sovereign and Corporate Bond assets for liquidity assessment purposes is impractical and contrary to their treatment for liquidity purposes in European and UK Banking regulation. Bond assets are traded on regulated exchanges and are considered a highly liquid investment product where European bonds can be sold on the market and cash settled in an owners account within a maximum of 3 days. The liquidity framework needs to reflect this which will aid in reducing significant balances held in credit institution deposits.

Sophisticated Investment Management Evolution

Stagnant economic growth across the western world and deflationary pressures have seen unprecedented levels of loose monetary policy stimulus from the worlds key central banks including the Federal Reserve, ECB, Bank of Japan and the Bank of England over the last 10 years. Unorthodox monetary policy stimulus (Quantitative Easing) has been coupled with unprecedented and prolonged zero interest rate environments in an attempt to increase money supply with the use of negative overnight base rates aimed at encouraging banks to inject funds into the constituent economies they service. This choreographed monetary policy initiative has seen a collapse in what in investment markets is known as the "risk free" or base rate. This is the rate on which all subsequent investment asset class returns are based with their yields dependent on their inherent investment risk. As a result, low risk investments, which are and should always be the mainstay of credit unions investment scope, have seen their yields collapse. Testament to this phenomenon is the fact that the bell-weather Euro based low risk instrument, the German Sovereign Bond, is yielding negative returns out its yield curve to 8.5 years.

German Sovereign Yield Curve June 2017 (Green) and the curve 5 years ago (Red)



Source : Bloomberg

Credit union investment portfolio returns will increase over time as the unprecedented monetary stimulus begins to stir economic activity, causing inflation to increase to the levels desired by Central Banks of 2% and the interest rate environment normalises. However, this is not likely to happen to any great extent in the next 5 years, especially in the Eurozone given the significant difference in economic health between northern and southern European national economies. However, the investment market's sophistication in offering low risk products that offer better returns than conventional low risk products (bonds) over time but without increasing risks significantly, has been a welcome development. Using unitised structures, providers can allow investors access to a range of underlying asset classes. The difference now is that the mix of these assets have been analysed regarding how they co-relate and co-vary and, using sophisticated mathematical modelling and simulation based risk techniques, providers rebalance regularly depending on various internal and external factors to ensure they smoothen these products volatility while offering greater returns. This sophistication has led to the growth of Absolute Return Funds. Standard Life's GARS (Global Absolute Returns Strategy) Fund is probably the best known with the longest history with which to illustrate its effective performance relative to equity and bond markets.

5-year Performance of Standard Life GARS Fund (Orange), EuroStoxx 50 (Blue) & Bloomberg Barclays 1 to 10-year Euro Corporate Bond Index (White)

Source : Bloomberg

Meaningful Asset Class Alternatives

CUMA's overarching view is that the investment framework afforded to credit unions in managing their investment portfolios needs meaningful change to ensure the chronic overreliance on the banking sector is significantly reduced in the short term.

This is paramount and in our view is in the interests of the Central Bank as regulator, who has the power to ensure it occurs in a meaningful way but through a controlled, risk conscious structure. With this in mind, CUMA has set out our views on the proposed allocation to Corporate and Supranational Bonds, AHB's and some other Asset Classes with the core aim of reducing risk through greater counterparty and asset class diversification with a neutral or marginally positive impact on investment portfolio returns. A high-level view of how a credit union investment portfolio might look like in September 2018 as a result of these changes is set out at the end of this section.

Absolute Return Funds

Absolute Return Funds are typically provided by leading investment and insurance firms and have an inherent low risk due to their clearly defined volatility mandate, sophisticated asset class diversification and actively managed risk functionality. This coupled with their proven unitised structure, which allows individual investment ring fencing, and top-quality custodianship makes them very suitable for credit unions. Also, in the current environment, they may also afford credit unions the prospect of greater returns while maintaining their low risk focus.

CUMA proposes that a concentration level of 7.5% of the total investment portfolio is set on such investments and that this would be reviewed in two years. Furthermore, Absolute Return Funds are fundamentally different to simple insured diversified funds and are subject to greater risk and volatility management parameters. Therefore, only Absolute Return Funds should be allowed in this category and we propose that these funds should have a rating of 4 or less on the universal ESMA (European Securities and Markets Authority) Fund Volatility Scale. This scale runs from 1 to 7 and has been universally adopted by European investment fund providers in recent years.

Inflation – linked Bonds

Inflation linked Sovereign Bonds and Inflation linked Sovereign Bond ETFs (Exchange Traded Funds) offer exposure to sovereign debt but with its capital linked in a formulaic manner to the daily inflation index in its jurisdiction, thus hedging against the inflation risk inherent in all bonds. Given where we are in the current interest rate cycle with fledging growth being witnessed in US and Eurozone economies such instruments may form part of a balanced credit union investment portfolio. These bonds are exposed to sovereign risk but ultimately offer the prospect of greater returns should inflationary pressures increase in the coming years as recovery takes hold. The current investment framework for credit unions is not explicit in including these bonds but may not restrict their use given ultimately their sovereign exposure. The main issuers of such bonds in the Eurozone are the German, French and Italian Governments. CUMA proposes that concentration levels should be incorporated in existing overall sovereign bond levels (70% of the investment book).

Equities

2016 regulations allowed credit unions with equity exposure, 2 years to divest these investments following CP88 deciding equities were unsuitable investments for credit unions. CUMA disagrees with this assessment and believes, similar to any normal low risk investment management mandate that a small portion of equity exposure is of benefit in credit union investment portfolios. An allocation to equities adds diversification and due of equities inverse historical correlation with bonds, they can offer a stabilising influence in times of bond market weakness and a hedge against duration risk on bond holdings. Furthermore, while their short term volatility and negative performance can be striking relative to bonds periodically, over time they have recovered to deliver considerable investment value over time.

In terms of instruments used to gain exposure to equity markets, CUMA believes that individual equity holdings or stock picking is wholly inappropriate for credit unions and exposure should only be gained through passively managed, index tracking euro denominated ETF’s such as the Luxor DAX ETF, the SPDR EuroStoxx 50 ETF or dividend prioritising, lower volatility ETF’s such as the iShares EuroStoxx Select Dividend 30 ETF.

CUMA sees a 5% allocation limit on equities relative to the total investment portfolio as reasonable given the benefits they can offer the overall portfolio and believes this should be reviewed in two years as proposed in CP109.

Commodities

Similarly, exposure to commodities of different types is of significant benefit to investment portfolios in terms of diversification and inverse correlation as they have fundamentally different drivers. For example, increased geo-political tensions in the Middle East tend to cause equity and currency market weakness due to uncertainty and bond market contagion but energy prices tend to increase as supply concerns hit WTI and Brent Crude markets. Therefore, CUMA believes commodities have a role to play in credit unions investment portfolio management but at a small level.

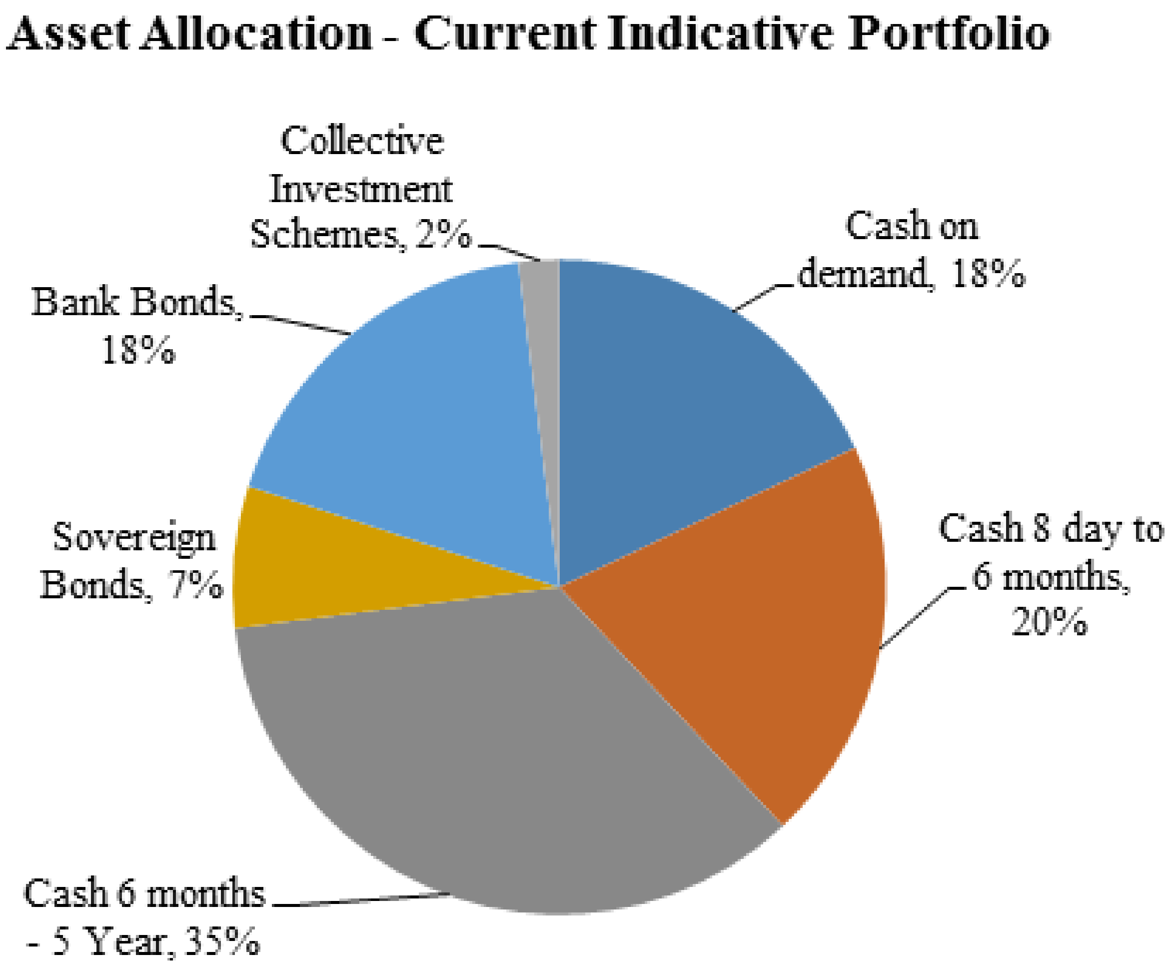
Commodity investment in modern investment portfolio management is typically split between Energy (Oil & Gas), Gold, Industrial Metals and Agricultural Commodities. Exposure to these assets is most appropriately through ETF’s such as the ETFS Agriculture ETF, the SPDR Gold ETF, the SPDR Oil and Gas ETF and the SPDR Metals and Mining ETF. Commodities and their ETF’s are typically denominated in US Dollars but again such small exposure to non-Euro denominated assets will add diversification to a credit union portfolio and minimal risk.

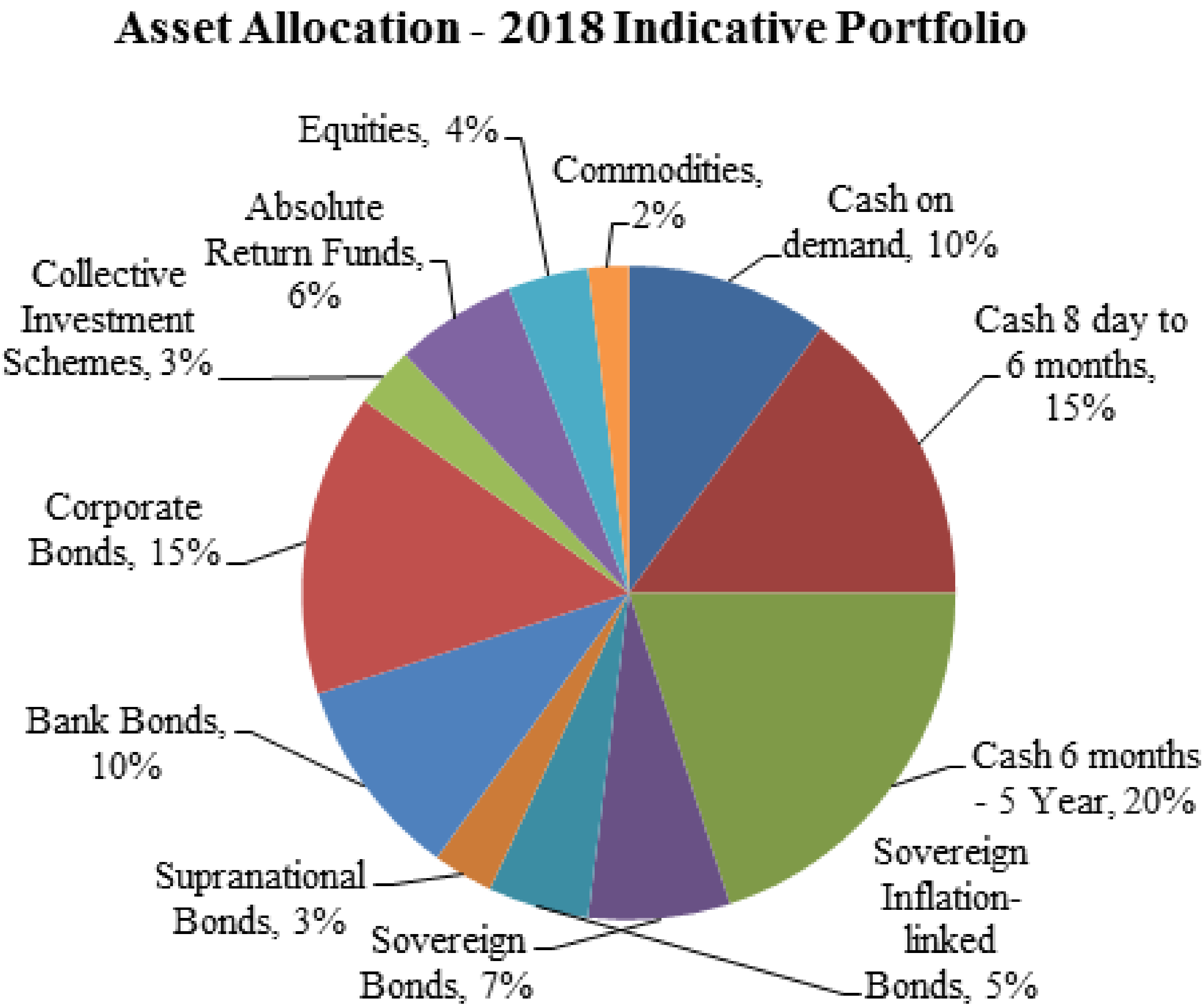
CUMA sees a 2.5% allocation limit on commodities relative to the total investment portfolio as reasonable given the benefits they can offer the overall portfolio and again believes this should be reviewed in two years as proposed.

Indicative Credit Union Investment Portfolio – Current vs CUMA Proposed

Asset Classes	Weighting Sept 2016	Weighting Sept 2018	Return Sept 2016	Return Sept 2018	ESMA based Risk Scale Sept 2016	ESMA based Risk Scale Sept 2018
Cash on demand	18%	10%	-0.10%	-0.10%	1	1
Cash 8 day to 6 months	20%	15%	0.00%	0.00%	1	1
Cash 6 months - 5 Year	35%	20%	0.30%	0.30%	1	1
Sovereign Bonds	7%	7%	0.10%	0.10%	2	2
Sovereign Inflation-linked Bonds		5%	0.30%	0.30%	2	2
Supranational Bonds		3%	0.15%	0.15%	2	2
Bank Bonds	18%	10%	0.80%	0.80%	3	3
Corporate Bonds		15%	0.45%	0.45%	3	3
Collective Investment Schemes	2%	3%	0.20%	0.25%	3	3
Absolute Return Funds		6%	1%	1%	3	3
Equities		4%	4%	4%	5	5
Commodities		2%	4%	4%	6	6
Weighted Average Totals	100%	100%	0.24%	0.53%	1.47	2.09

** AHB and Public Infrastructure Project Investment exposure excluded in Sept 2018 indicative portfolio given likely structural and legislative adjustments required*





Asset Allocation - 2018 Indicative Portfolio
Equities, 4%
Commodities, 2%
Cash on demand, 10%
Cash 8 day to 6 months, 15%
Cash 6 months - 5 Year, 20%
Sovereign Inflation-linked Bonds, 5%
Sovereign Bonds, 7%
Supranational Bonds, 3%
Bank Bonds, 10%
Corporate Bonds, 15%
Collective Investment Schemes, 3%
Absolute Return Funds, 6%

Summary of areas where the Central Bank is seeking views

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.

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?

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.

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?

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.

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?

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.

Investments in AHBs:

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

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

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

Summary of areas where the Central Bank is seeking views

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 Consultation on Potential Changes to the Investment Framework for Credit Unions 22 view that the concentration limit would need to be set at a level that reflects this12. 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?

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?

Counterparty Exposure Limit:

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.

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

Collective Investment Schemes:

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

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

Timelines:

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.

CUMA Responses to specific CP109 questions

Potential Additional Investment Classes

Question 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.

- As articulated above, diversification in credit union investment portfolios is poor across many different metrics including:

  - Asset Classes
  - Counterparty
  - Sector

  The concentration has come at a time when lending assets have contracted considerably relative to investment assets as a proportion of total assets, heightening the risk to the wider movement to this striking lack of diversification.

- In a time of contraction and consolidation within the already small Irish banking market, the lack of array of asset classes allowed within the credit union investment framework has been the main contributor in counterparty and asset class concentration leading to the current situation where:
  - Over 70% of the €11.5bn investment book is placed with 5 counterparties and
  - 91% of investment book assets are exposed to the Irish Banking Sector.

- Barriers to diversification cannot be assessed or indeed tackled in an integrated and meaningful way without looking at the credit unions liquidity framework. The narrow and simplistic, “cash only” view of liquidity has seen a concentration of investment funds in Credit Institutions. Given the small and contracting market and lack of quality counterparties, has inevitably led to counterparty concentration.

CUMA Responses to specific CP109 questions

Potential Additional Investment Classes

Question 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?

- As outlined earlier in this document, proposals in CP109 cannot address in any meaningful way the risky banking sector and counterparty concentrations. The practical reality of the proposals will at best, see maybe 10% of investment portfolios move from banking sector exposure to Corporate and Supranational Bonds with maximum limits not reached for Supranational Bond allocations given their almost zero returns profile. Therefore, banking sector concentration may decrease from 91% to closer to 80% and counterparty concentrations move from just under 25% to just under 20%. In this scenario, credit unions' health remains fundamentally linked to that of the Irish banking sector and from a regulatory perspective, these marginal concentration improvements, given the size, vulnerability and integrated nature of the Irish banking sector, have to be unsatisfactory.

CUMA Recommendations

- We propose widening significantly but in a controlled and risk neutral manner the asset classes available to the credit union movement. These include:

  - Euro denominated Corporate Bonds within concentration limits that are part of the overall existing bond limit of 70% of the investment book. Also, limits on geography, sector and counterparty exposure will ensure strong and appropriate diversification across the Corporate Bond book.

  - Euro denominated Supranational Bonds within concentration limits that are part of the overall existing bond limit of 70% of the investment book.

Potential Additional Investment Classes

Question 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.

CUMA fundamentally agrees that credit unions investment portfolios need to be very low risk in focus to ensure security of members' funds. However, the traditional view that therefore, asset classes such as equities and commodities have no role to play is contrary to the experience of a sophisticated and risk/volatility focused investment market. Higher risk assets in small concentrations do add stability and diversification due to their inverse correlation and how they co-vary with other lower risk asset classes. Expanding asset classes within bonds but also beyond bonds and cash adds diversification across portfolios and will also reduce counterparty exposure. Given the sophistication of investment risk management this asset class expansion can be achieved in a risk neutral manner.

CUMA Recommendations

- Absolute Return Funds with concentration limits of 7.5% of the overall investment book. Concentration limits to be reviewed in 2 years.
- Euro denominated Sovereign Inflation-linked Bonds within concentration limits as part of the overall existing bond limit of 70% of the investment book.
- Euro denominated, passive index tracking Equity ETFs – concentration limit of 5% of the total investment book.
- US Dollar denominated, Commodity ETFs – concentration limit of 2.5% of the total investment book.
- Euro denominated Bank Bonds – react to the BRRD changes by not excluding MREL eligible instruments but rather by assessing the probability of default and capital strength as the core indicator of future bond losses. This means incorporating credit rating controls around Bank Bond exposures to ensure implications of BRRD are appropriately considered within the credit union investment framework.
- Allowing Corporate, Supranational and Sovereign Bonds form part of the liquidity framework which will give greater geographic, sector and counterparty choice while ensuring the liquidity requirements are met and managed. This liquidity framework may include valuation haircuts dependent on the specific bond markets liquidity, (be that sovereign, supranational or corporate), and the size of credit unions exposure within that particular issuance.

The effect of these changes may be seen from the indicative investment portfolio where concentration to the Irish banking sector reduces from 91% to 55% by September 2018 and counterparty diversification is driven by the expansion of asset class choice and not by reducing concentration limits from 25% to 20%. Indeed, this metric could be reviewed in 2 years and in all likelihood would not be an issue as greater counterparty choice will see it automatically reduce. Furthermore, this indicative portfolio does not include the effect of the last bullet point above where the liquidity instruments are expanded to include sovereign, supranational and corporate bonds. This may likely further reduce banking sector reliance below 55% and spread counterparty risk while being liquidity neutral given these assets cash equivalent quality (…proven ability to be encashed on the open market within 3 working days) but with appropriate cash weightings maintained. The levels of diversification outlined in this scenario contrast significantly with those outlined in responses to CP109 Question 1 above where meagre diversification benefits are foreseen.

CUMA Responses to specific CP109 questions

Supranational Bonds

Question 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?

- The European Supranational Bond market dominates the global Supranational Bond market given the significant requirement for capital to deal with the financial crisis and bail-outs that occurred over recent years' period. A Nord LB Fixed Income Research document itemised 8 European Supranational Organisations guaranteed by different European member states. These were;

  - European Financial Stability Facility EFSF – a bailout fund
  - European Stability Mechanism (ESM) – a bailout fund
  - European Union (EU) – a bailout fund
  - European Investment Bank (EIB) – a promotional bank
  - European Bank of Reconstruction and Development (EBRD) - a promotional bank
  - Nordic Investment Bank (NIB) - a promotional bank
  - Council of Europe Development Bank (CEB) - a promotional bank
  - European Company for the financing of Railroad Rolling Stock – (EUROFIMA) - a promotional bank

While the market is substantial and liquid, their state guarantees mean the issuances are in line with core European Sovereign Bond markets such as Germany and France and offer close to zero returns out to the 10 year maturity limit. As such, the expansion of asset classes to this bond market subsection is welcome but unlikely to see significant allocation of assets even up to the proposed tight concentration limits of 50% of regulatory reserves given their poor return profile. They offer similar return profiles to sovereign bonds and without such tight concentration or rating limits, these only account for 7% of investment portfolios currently given their poor risk/reward profile.

- CUMA agree with the 10 year maturity limit on Supranational Bonds.

CUMA Responses to specific CP109 questions

Supranational Bonds

Question 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.

- Notwithstanding the above return observations, should Supranational Bond yields improve, 50% of Regulatory Reserve as a concentration limit is too small to make any meaningful allocation to the new asset class. In reality the maximum allocation is around 8% for credit unions and adds another reserve ratio metric to investment risk daily management, which is unnecessary.

- Supranational bond risk and exposure is similar to that of sovereign bonds in terms of yield and credit risk. Therefore, their exposure should be subsumed into the existing bond exposure limit of 70% of the overall investment portfolio.

- The rating minimum of “Single A” is too restrictive in general for bonds when investment grade by its very definition is appropriate for such low risk investment. It may be prudent initially to minimise the amount of overall bonds rated in the “Triple B” within the overall portfolio initially and review in two years. For example, if a limit of 70% of total portfolio assets was maintained for all bonds but opened up to sovereign, sovereign-inflation linked, supranational, bank and corporate bonds, then a limit of 25% of the bond element of the portfolio being held in “Triple B” may ensure prudent transition to this new investment framework.

- CUMA notes the problem with divesting of bonds that fall out of certain grades from time to time and the resultant crystallisation of losses. A more nuanced approach may allow a credit union investment committee make the call on divestment or not if the bond holding is under a certain proportion of the overall investment portfolio, say 5%.

CUMA Responses to specific CP109 questions

Corporate Bonds

Question 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?

- The proposal to include corporate bonds as an authorised asset class is very welcome given the scale and diversity of the Euro denominated market and the genuine potential of it to add much needed diversification. However, the proposed restrictions placed upon the authorisation will minimise its potential to the point of irrelevance.

- The rating minimum of "Single A" is too restrictive in general for bonds when investment grade by its very definition is appropriate for such low risk investment. As mentioned in the Supranational Bond section, if the Central Bank wished to manage transition to a new investment framework that genuinely looks to solve concentration risks within the sector, then authorising all investment grade bonds but limiting the proportion of all bonds held in the "Triple B" category is more appropriate.

- CUMA again references the divestment terms proposed should bonds fall below the authorised credit grade. The more nuanced approach outlined under Question 5 is recommended to avoid unnecessary capital losses.

- CUMA agrees with the 10 year maturity limit on Corporate Bonds.

Question 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.

- 25% of Regulatory Reserve as a concentration limit is too small a concentration to make any meaningful allocation to the new asset class that works to solve concentration risks. In reality the maximum allocation is around 4% for credit unions and adds the regulatory reserve metric to investment risk daily management, which is unnecessary.

- Corporate bond risk and exposure is marginally higher than that of sovereign bonds in terms of yield and credit risk. Modern investment risk management uses diversification across sectors, geography and counterparty to ensure appropriate risk within Corporate Bond exposure. Therefore, their exposure should be subsumed in to the existing bond exposure limit of 70% of the overall investment portfolio and limits applied across these areas to ensure diversification and low risk suitability.

- These limits might include;
  - Corporate Bonds holdings are limited to 30% of the overall bond book
  - Within the Corporate Bond book;
    - Individual Sector Exposure Limit is 30%
    - Counterparty Exposure Limit is 30%
    - Geography Exposure is 30%
    - "Triple B" Credit Rating limits would be across the total bond book

CUMA Responses to specific CP109 questions

AHB's

Question 8:

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

- CUMA believes it is appropriate to invest in AHB's from a risk perspective and that such investment is fully aligned with the movement's community and societal ethos.

Question 9:

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

- A unitised investment structure appears the most logical structure where funds from individual credit unions can be separated yet pooled and used to invest in AHB's on a national basis where risk to specific AHB's and geographic areas can be balanced. This structure is suitable for all credit unions.

- The availability of a unitised structure would not exclude credit unions with the sophistication to assess risks specific to individual tier 3 AHB's, to also avail of this investment through specific SPV structures. These structures should be backed by agreements that guarantee state underwriting of at least a significant portion of the investment.

Question 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 a myriad of risks associated with AHB investments but credit unions are undoubtedly able to assess these risks in order to make informed and risk conscious decisions regarding the appropriateness of such investments in managing their members' funds. These risks include:

- Structure Risk incorporating:
    - Investment Risk
    - Repayment/Rental Risk
    - Guarantor Risk
    - Collateral Risk

Development Risk incorporating:
    - Planning Risk
    - Development Contract Risk
    - Regulatory Risk

- Financial Risk: -
    - Asset & Liability Risk
    - Liquidity Risk

CUMA Responses to specific CP109 questions

AHB's

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

- Within a unitised collective structure, exposure across AHB's, project types (development or acquired etc.) and maturities could be diversified to ensure blended exposure, reducing somewhat the severity of mismatch between funding and housing investment.

- In general, the credit union movements ALM sophistication will need to develop in order to offer longer term lending over time and this sophistication may also help in terms of allowing greater concentration levels apply to AHB investment.

- Such ALM sophistication may include term deposit offerings or groups of likeminded credit unions offering fixed income bond issuances.

Question 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?

- CUMA believes, once legislative and vehicle structure development has been agreed as necessary, that a limit of 10% should be initially introduced with this being reviewed for expansion after two years once the process and structure has been embedded and all stakeholders are comfortable with its workings.

Question 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?

- CUMA agrees with the inclusion of Tier 3 AHB's initially and this can be reviewed after two years as the structure and market evolves.

- CUMA believes that the maturity limit should be 35 years.

CUMA Responses to specific CP109 questions

Counterparty Exposure Limits

Question 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.

- CUMA strongly disagrees with this proposal and our views are set out clearly in the Counterparty Limits section on page 8 and 9 of this document.

- CUMA recommends that this proposal is withdrawn and that our proposals on asset class expansion and liquidity adjustments are implemented. This greater choice, while risk neutral, will result in significantly reduced counterparty concentration. This should be reviewed in two years to ensure the desired counterparty diversification is well below the 20% level.

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

- CUMA believes that this transition period is not workable given the current investment environment and under the minor asset class expansions proposed while significantly restriction existing bank bond access.

CUMA Responses to specific CP109 questions

Collective Investment Schemes

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

- On the surface and in a normal investment and interest rate environment, these vehicles would form a natural proportion of a credit unions investment portfolio given the inherent diversification offered across maturities, geographies and asset classes and their controlled, regulated and professional offering. However, demand for such offers is stifled by;

  - Restrictive asset classes permitted to be held in CIS for CU investment purposes

  - Consequently, poor returns are less than holding the underlying assets directly as the CIS provider needs to make a margin, diluting already close to zero returns on the narrow list of allowable asset classes.

  - Providers know demand is weak and profitability from the structure low given trade/rebalancing costs etc. are typically borne by the CIS provider. As a result, supply of such products is practically non-existent.

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

- Under current restrictions, no meaningful market of value will exist for CIS's that will attract credit union funds. Why?

  - In low return environment, Credit Unions can get marginally better returns with more control from holding the underlying asset.

  - Providers can't make meaningful margin given the low return environment and holding restriction to only very low risk assets.

- Should the asset classes allowed to be incorporated in CIS's expand to the breadth recommended above, then a meaningful market may arise to the benefit of all participants. The creation of a meaningful CIS market would further diversify counterparty and asset class exposures for credit union investment books.

- Until a broader range of asset classes are allowable, profitability cannot increase and supply of such products to the movement by providers will remain severely limited.

CUMA Responses to specific CP109 questions

Timelines

Question 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.

- CUMA, while welcoming the opportunity to outline views on CP109, is concerned that the obvious consequences of some of the detail being proposed and the less than substantial widening of asset class availability to compensate for further restrictions that show a lack of understanding for the nature of investment management and probability of adverse outcomes based on inherent asset class volatility, correlation, co-variance between these asset classes and credit default probability.

- Further intense engagement on any such changes would be welcomed by CUMA. Our aim is to ensure changes;

  - are not needlessly restrictive from a risk perspective,

  - do not put in danger the financial well-being of individual credit unions and the wider sector and

  - are practically meaningful in significantly reducing concentrations and risks brought about by the current investment framework and related liquidity framework

Conclusion

CUMA while welcoming the Central Banks commitment to review the credit union investment framework and its proposal to expand asset class choice, see the changes as only making marginal adjustments to the framework that cannot work practically to alleviate the significant concentration within portfolios. As seen from recent episodes in Spain and Italy, European banks are far from stable. Different political realities have seen bond holders bailed in and out in 2017 in resolution scenarios and the extent to which credit unions growing investment portfolios are concentrated on the Irish banking sector and its larger, constituent counterparties must be meaningfully dealt with in the short term. To that end, CUMA propose the following:

- Expand Asset Class Choice to the following areas:

  - Supranational Bonds
  - Corporate Bonds
  - Absolute Return Funds
  - Sovereign Inflation Linked Bonds
  - Passive Equity Index Tracking Exchange Traded Funds
  - Exchange Traded Commodity Funds
  - AHB's and other Public Infrastructure Funding subject to structural and legislative agreement

- The asset class additions to the investment framework can be completed in a risk neutral manner given the highly sophisticated risk management techniques used by some of these asset classes and by setting appropriate concentration limits within portfolios to ensure exposure to these higher volatility assets add stability and diversification to portfolios without adding to overall portfolio risk. These limit recommendation are detailed throughout this document.

- The linked issue of the credit unions liquidity framework also needs addressing in order to improve concentration risk within investment portfolios and to provide fair treatment relative to the banking sector. Sovereign, Supranational and Corporate Bonds need to be accounted for in the framework given their inherent liquidity. It may be prudent to apply valuation haircuts in line with the European banking framework. Therefore, a haircut of 5% may apply to investment grade Sovereign and Supranational Bonds and 10% to investment grade Corporate Bonds.

- The proposal to reduce counterparty limits should be withdrawn but reviewed in 2 years to ensure genuine asset class choice has driven counterparty diversification well below 20%.

- Bank Bond restriction proposal should be withdrawn with changes to the investment framework from BRRD implemented through limiting bank bond investment to investment grade issuances only.

- AHB and other Public Infrastructure investments to be available under concentration limit of 10% initially and to be reviewed after 2 years.

CUMA

Credit Union Managers Association