Health Services Staffs
Credit Union

Submission on CP109

Consultation on Potential Changes to the Investment Framework for Credit Unions

June 2017

Overview

Health Services Staffs Credit Union (HSSCU) is an industrial credit union providing services to 37,000 members across our nationwide common bond. With our head office at High Street Dublin 8 we operate 3 branches in Dublin, Cork & Galway. HSSCU has undertaken 7 transfers of engagement since 2010. At the end of May 2017, the assets of the credit union amounted to € 253M including an investment portfolio of € 118M. HSSCU 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'.

HSSCU engage Davy as its investment advisor and have requested Davy to carry out an impact analysis on our current portfolio. This impact analysis is included at appendix 1 and forms the basis for this document. In its 2016 report 0n the viability of Credit Unions the Credit Union Advisory Committee highlights investment income as one of the main areas of income generation for credit unions. In the past two years investment income at HSSCU has accounted for 12% (2016) and 16.7% (2015) of our total income. However, in the findings of the Davy analysis the proposed changes under CP109 will reduce our investment income by c.23%. We believe this consultation process comes at an appropriate and vital time for credit unions and we welcome the opportunity to make a submission.

Liquidity

HSSCU is concerned that CP109 does not deal with the liquidity issues facing credit unions. We are aware that these matters were brought to the attention of the registry in advance of the issuing of the paper. In an investment climate of reducing returns, a shrinking number of counterparties, and a credit union dependency on overnight deposit rates to meet short term liquidity requirements no attempt has been made to alleviate these pressures. We believe that the proposal to reduce the counterparty limits from 25% to 20% would only further exacerbate these problems. In the case of HSSCU this proposal will require a reallocation of 11.6% of our existing portfolio into a reduced number of counterparties. This in our view makes no sense in the current banking environment. We would recommend that certain bonds should be considered as liquid instruments as is the norm in the financial sector and in other jurisdictioons.

Bank Bonds

HSSCU would have major concerns at the proposed amendments to the definitions of bank bonds in CP109. In effect, these changes would prohibit credit unions from investing in the new senior non-preferred bonds. These changes do not appear to have formed part of the regulatory impact analysis in CP109. As outlined in the Davy analysis a move from traditional bank bonds to corporate and supranational bonds will reduce the average credit union income by as much as 19%.

HSSCU would fully agree with the Davy proposal to allow senior non-preferred bonds which would have a positive impact on our investment return. We believe that a credit union of our scale is capable of monitoring and mitigating any additional credit risk these products may bring. We also believe that certain bonds must be treated as liquid investments, as is the case in other financial institutions. This would allow us to possibly reduce the proportion of funds held in short term, negative yielding deposits.

New Investment Classes

HSSCU welcomes the introduction of new investment classes such as supranational and corporate bonds. However, we feel that the addition of new investment classes is negated by the proposed concentration limits.

Concentration Limits

HSSCU can see no rationale in CP109 for the proposal to base concentration levels restrictions on regulatory capital as opposed to the current percentage of total investments. The Davy analysis of the HSSCU portfolio clearly shows that the proposed concentration rates of additional asset classes are extremely low and are unlikely to make a material difference to the income generating ability of our portfolio.

Social Housing

HSSCU welcomes the proposed allocation to social housing AHB's (Approved Housing Bodies) through an investment structure, given the difficulties of lending directly or through syndication. We believe that investment through special purpose vehicles or collective investment schemes are potentially the most appropriate structure. 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.

CP109 - Responses to specific CP109 questions

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 that credit union investment portfolios are too concentrated and are the main challenge to our investment strategy. The range of authorised investments in the current regulations is very restrictive and has over years deteriorated to the point where no growth assets are allowed.

   Collective Investment schemes have returned historically low returns as they are restricted to low yield Irish and EEA State Securities, Bank Bonds, and accounts in Authorised Credit Institutions.

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?**

   HSSCU agrees with the proposal to include supranational and corporate bonds. However, the proposal to limit concentration levels to a percentage of regulatory capital severely limits any positive impact the introduction of these classes of investment may have on diversification or income generation. We would propose that any change to concentration levels to the level of assets is far more appropriate.

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, HSSCU believes that credit unions of our scale should be allowed invest in senior bank bonds regardless of subordination. We would be totally opposed to the proposal in CP109 to restrict the type of senior bond authorised and cannot understand why such a restriction would apply while allowing credit unions to invest in social housing. We believe that credit unions and the financial sector in general is now in a far better position than we were during the financial collapse.

We would also ask that the bank consider the following products,

- Investments in Credit Union Service Organisations particularly in the area of centralised lending for mortgages and SME's.
- Investment in State Sponsored projects

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?**

HSSCU would agree with this proposal and the proposed minimum credit rating and maturity limit. We note however the current low level of returns on these bonds which will not address our income generation concerns in any meaningful way.

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 are totally opposed to the introduction of regulatory reserves as a measure of concentration limit. No rationale has been offered for a change which will have is put forward in the document given the major effect such a change would have on investment portfolios. We would suggest that the concentration limit should be linked to the total investment portfolio and that supranational bonds be incorporated into the existing asset class limit 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?**

HSSCU welcomes the proposal to include corporate bonds as an authorised asset class which will allow more diversification. We also agree with the 10-year maturity limit on Corporate Bonds.

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.**

As in question 5 above, HSSCU believes that the proposed restriction as a percentage of Regulatory Reserve as a concentration limit is too small a concentration to make any meaningful allocation to the new asset class that is intended 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.

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

   We believe that it is appropriate and in keeping with our community ethos for credit unions to invest in AHB's. We feel that this proposal deserves further investigation on how an appropriate vehicle can be put in place

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.

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 many risks associated with AHB investments, these include,

    - Investment risk – the risk of underperformance of the asset
    - Governance Risk – The risk around the governance of individual AHB, s
    - Financial Risk – inappropriate/insufficient funding
    - Business Model Risk – Viability risk due to funding issues

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

We believe that the only realistic way to deal with the ALM issues is to offer the investment through a collective investment vehicle. We would however need to be cognisant of the illiquid and longer-term features of such investments. HSSCU believes that the 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.

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?**

HSSCU accepts that a 25-year term for an investment in social housing will be required. This proposed longer term would need to be considered in light of liquidity, tenor of investment, and pricing in the cost of the risks being undertaken. HSSCU would therefore suggest a concentration limit of 5% of total investments.

13. **Do you have any comments on the proposal to include investments in Tier 3 AHBs in the list of authorised classes of investments set out in credit union investment regulations with a 25-year maturity limit?**

We would agree with the 25-year maturity limit and the inclusion of Tier 3 AHB's but would again point to the considerations outlined in point 11 above.

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.**

HSSCU strongly disagrees with this proposal at this time and recommend that it is withdrawn. We believe that the limited diversification in CP109 doesn't warrant such restrictions.

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

The matter of a transitional period should not arise unless the Central Bank presents a solid rationale for the proposed amendment.

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

HSSCU advocate the use of collective investment schemes for credit unions. We believe that credit unions can benefit from the active management of such funds.

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

We believe that the issue with collective investment schemes is that the products allowed currently are low yield products and it is therefore difficult to build scale in the funds. The accounting treatment of the funds on a mark to market basis which introduces volatility to the portfolio.

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.

DAVY CREDIT UNIONS

Appendix 1

HSSCU Credit Union Ltd

Assessing the Impact of Proposals within CP109 on the Investment Portfolio

June 2017

Introduction

This report is intended to assist HSSCU Credit Union in establishing the impact of the proposals contained within CP109 on the investment portfolio. It is important to note that this analysis should not be regarded as comprehensive; in particular, the projected impact on income is based on a broader impact analysis conducted by Davy. This modelling was subject to a number of assumptions which are outlined in more detail in the submission from Davy.

Please note that all analysis is based on HSSCU Credit Union's portfolio as at 31/05/17. The regulatory reserve figure used in the testing is €26,272,710.

HSSCU Credit Union's investment portfolio is likely to be impacted in four main ways if the proposals outlined in CP 109 are implemented:

(1) Asset Allocation

HSSCU Credit Union will have the opportunity to invest in additional asset classes. The Central Bank has proposed concentration limits on the new asset classes as a percentage of regulatory reserves. The table below is intended to illustrate the proposed limits as a percentage of the investment portfolio and in euro terms:

	Asset Class	Current Allocation €	Concentration Limit (% Investment Portfolio)	Concentration Limit (as € Amount)	Current Weight
Current Portfolio & regulatory limits	Irish and EEA State Securities	0	70%	82,961,882	0%
	Accounts in Authorised Credit Institutions	89,603,061			76%
	Bank Bonds	13,033,633	70%	82,961,882	11%
	Collective Investment Schemes	15,880,280			13%
	Other	0			0%
	Total	118,516,975			100%

		Central Bank's Proposed Concentration Limit (% Reg Reserves)	**Proposed Limit calculated as a % of the Investment Portfolio**	**Proposed Limit (€ amount)**	
Proposed Additional Asset Classes (Central Bank)	Supranational bonds	50%	11.1%	13,136,355	
	Corporate bonds	25%	5.5%	6,568,178	
	Total (additional bonds)		16.6%		
	*Investments in AHB's 3 proposed options:				
	a) or	25%	5.5%	6,568,177	
	b) or	lesser of 25% or €3m for credit unions with assets less than €100m	N/A	N/A	
	c)	50%	11.1%	13,136,355	

**AHB's are included for illustrative purposes only. There is no social housing vehicle available for investment at present which means that AHB's cannot realistically be included within an asset allocation at this time.*

- When converted to a percentage of the investment portfolio, the proposed concentration limits on the additional asset classes are extremely low and are unlikely to make a material difference to the portfolio.
- The introduction of concentration limits linked to regulatory reserves will introduce additional complexity and may be cumbersome from an investment management perspective.

(2) Counterparty Exposure

The following table assesses how the Central Bank's proposed counterparty limit of 20% would impact HSSCU Credit Union's investment portfolio:

Table: Counterparty Exposure

	Moody's				
Counterparty	Rating	€ Amount	%	Breach?	Reallocation
AIB	Baa1	15,280,200	12.9%	OK	0.0%
BOI	A3	24,613,398	20.8%	Breach	0.8%
PTSB	Ba3	25,077,647	21.2%	Breach	1.2%
KBC Bank Ireland Plc	Ba1	22,971,967	19.4%	OK	0.0%
Ulster Bank Ireland	Baa3	5,016,894	4.2%	OK	0.0%
Rabobank	Aa2	11,471,686	9.7%	OK	9.7%
Investec Bank Plc	A2	5,125,710	4.3%	OK	0.0%
Deutsche Bank plc	A3	3,050,708	2.6%	OK	0.0%
Irish Gov	A3	0	0.0%	OK	0.0%
Other	n/a	5,908,764	5.0%	OK	0.0%
Total		118,516,975	100.0%		11.6%

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, HSSCU Credit Union will need to reallocate 2% of the investment portfolio or €2.4m to alternative counterparties. 9.7% of the portfolio or €11.5m must also be reallocated from Rabobank to an alternative counterparty by the end of June 2017.
- We believe that there is no rationale to implement limits by reference to regulatory reserves and now is the wrong time to be placing unnecessary pressure on credit unions from a counterparty perspective.

(3) Income

Based on analysis conducted by Davy within an income impact model outlined in the submission from Davy, HSSCU Credit Union's income is likely to be impacted by the proposals contained within CP109.

Based on the modelling included in the Davy submission, if a credit union were to fully invest their portfolio based on the average asset allocation of the sector (as outlined in the Central Bank's RIA) and current yields available, the weighted average return on the portfolio is approximately 0.31%[1]. As portfolio performance differs from one credit union to another, longer term investments such as government bonds and longer dated deposits that make a significant contribution to current returns could not be included in testing. This finding indicates the important contribution of residual investments with higher yields in bolstering investment income in the current environment.

In order to examine the potential impact of the CP109 proposals and the additional recommendations made by Davy on HSSCU Credit Union's individual investment portfolio, we have applied the percentage changes derived from the above model to the portfolio and assessed the impact on your credit union's weighted average income. It is important to understand that the changes outlined in the table below are an approximation only and based on a number of crucial assumptions underlying the analysis which are noted in Appendix 1. Perhaps most importantly, for ease of analysis, we have assumed that the investment portfolio moves from the current asset allocation to revised allocations (which are shaped by the scenario assumptions) with immediate and total effect and that yields on the various asset classes remain constant. In reality:

- The projected changes in allocations and associated changes in income are more likely to occur on a phased basis.
- Yields on the various asset classes will change.

Income will be influenced by a broader range of factors primarily which are not included in this analysis such as the run-off of residual investments and tapering of ECB's quantitative easing purchases. The current weighted average return on HSSCU Credit Union's investment portfolio is 0.81%.

[1] The current yields available are based on yields as at 31st May 2017

Table: Assessing the impact of CP109 proposals on your credit union's investment income

	Projected impact on the average credit union's investment income	Projected weighted average return of your credit union
Current weighted average return		0.81%
Impact of senior non-preferred not being authorised	-23%	0.62%
Impact of senior non-preferred bonds not being authorised and supranational & corporate bonds added to the portfolio	-19%	0.65%
Impact of investments in social housing (AHB's)	There are no schemes currently available to assess the potential income so this has not been included in our testing	

Table: Assessing the impact of Davy's recommendations on your credit union's investment income

	Projected impact on the average credit union's investment income	Projected weighted average return of your credit union
Current weighted average return		0.81%
Impact of senior non-preferred being authorised	9%	0.88%
Impact of senior non-preferred bonds being authorised and supranational & corporate bonds added to the portfolio	-2%	0.79%
Impact of senior non-preferred bonds being authorised. Credit unions allocate to supranational and corporate bonds. Certain bonds may be treated as liquid for liquidity purposes.	13%	0.91%

Warning: Please note there is no assurance that the assumptions which our model and scenario analysis is based on will materialise. Our model is based on the average credit union's asset allocation and your credit union's portfolio may be materially different. Actual outcomes may differ significantly from the projections outlined above.

Findings:

- For the purpose of this analysis and to maintain consistency with the testing performed at sector level, income forecasting analysis completed earlier this year has been excluded from the testing model above.
- The figures in the table above outline that if the Central Bank proceeds with the proposed changes to bank bonds, we project that the average credit union's investment will decline by c. 23%. Applying this projection to your credit union's weighted average investment income, your income is expected to decline to c. 0.62%.
- In the event that the Central Bank proceeds with the proposed changes to bank bonds and a credit union allocates to the proposed additional asset classes of supranational and corporate bonds, we project that the average credit union's investment income may decline by up to 19%. Applying this projection to credit union's weighted average investment income, your income is projected to decline to c. 0.65%. It should be noted however that the yields on the additional asset classes of supranational and corporate bonds are at extremely low levels and are likely to normalise in the future; in addition they may contribute diversification benefits to the portfolio.
- If senior non-preferred bonds are authorised, we project that the average credit union's investment income will be positively affected and may rise by up to 9%. Applying this to your credit union's weighted average investment income, your income is projected to increase to 0.88%. It should be noted however that this allocation will introduce additional credit risk into an investment portfolio which will require ongoing assessment by credit unions and investment adviser to monitor that it is in line with your investment policy.
- We project that income may fall by up to 2% for the average credit union in the event that senior non-preferred bonds are added and a credit union allocates to supranational and corporate bonds. This would reduce your weighted average income to 0.79%. Based on current pricing, the allocation to supranational and corporate bonds is likely to reduce average income in the portfolio due to the exceptionally low yields on these bonds at this time.
- In the event that certain bonds may be treated as liquid in line with proposals outlined in the Davy submission, certain credit unions may be able to reduce the proportion of funds placed in short term deposits which may be attracting negative yields and this may result in an improvement of investment income by up to c. 13% for the average credit union. Applying this forecast to your credit union would increase your weighted average income to 0.91%.

Liquidity

Davy has proposed that certain bonds should be treated as liquid for the purposes of regulatory liquidity ratios.

(4) Participation in the Consultation Process

Davy is making a submission to the RCU regarding CP109. A summary of this submission will be circulated to our clients ahead of the deadline for submissions which is on Wednesday 28th June 2017. Individual credit unions have also been invited to make submissions and it is imperative that you do so ahead of the deadline in order to influence the outcome of these proposals in an effort to minimise the impact on future investment income.

Warning: This report is summary in nature. It does not constitute investment advice and is provided for information and discussion purposes only and is not intended to be comprehensive. Readers should supplement the content by reading the consultation paper and form their own view.

Appendix 1

Overview of the assumptions of the model contained in Davy's submission:

(1) The average asset allocation of a credit union has been sourced from the Central Bank's RIA within CP109. Non-material asset classes have been excluded for ease of analysis. We have assumed the following average asset allocation:

Asset Class	**% Portfolio**
Irish and EEA State Securities	7%
Accounts in Authorised Credit Institutions	75%
Bank Bonds	18%

(2) We have assumed that credit unions allocate their portfolios to investments at certain yields which are outlined in detail in Davy's submission. Please note we have kept these returns constant in each scenario to isolate the impact of asset allocation differences rather than asset return changes. In reality credit unions have legacy investments rolling off at superior yields but as these differ from one portfolio to another and for ease of analysis we have assumed that a credit union is investing their full portfolio at the yields outlined below. Note that yields available on asset classes are at unusually low levels due to the ECB's quantitative easing programme.

(3) Where possible, the yields on the various asset classes have been sourced from Bank of America Merrill Lynch bond indices. In the main, we have selected 3-5year terms. In the case of Irish and EEA State Securities, we have adopted the yield on the Irish 5 year government bond. In the case of cash deposits, we have used the average rate available from a selection of counterparties.

(4) In assessing the impact on income of the proposals, it is assumed that credit unions' allocation to Irish and EEA State Securities does not change as they are broadly unaffected by the proposals. Collective investment schemes and other investments are not included as allocations in the portfolio as the average credit unions portfolio does not have material exposure to either asset class.

(5) In order to analyse the impact of the proposals on income, we have made assumptions regarding how credit unions will allocate portfolios based on the various scenarios outlined. This allocation is based on a look forward basis and is intended to reflect how credit unions might allocate to various asset classes (and bonds in particular) once banks have met their

MREL requirements in 2022. For ease of illustration, we have assumed that yields do not change during this period.

(6) We have assumed that credit unions will allocate up to the proposed maximum limit on supranational and corporate bonds (i.e. 8% and 4% of the investment portfolio respectively) based on the average credit union portfolio.

(7) We have not included social housing in the impact analysis on income as we do not feel that the concept has been sufficiently well developed at this stage for it to be incorporated into the income analysis.

Please Note:

There is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ.

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