# ILCU RESPONSE TO CP109

## CONSULTATION ON POTENTIAL CHANGES TO THE INVESTMENT FRAMEWORK FOR CREDIT UNIONS

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Irish League of Credit Unions

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# 1. Background

The Irish League of Credit Unions ("ILCU") is the largest credit union representative body on the island of Ireland. It was founded to provide representation, leadership, co-operation, support and development for credit unions in both the Republic of Ireland ("ROI") and Northern Ireland ("NI"). Credit unions affiliated to the ILCU elect the leaders of the ILCU and ultimately drive what the ILCU delivers. The ILCU responds directly to the needs of the affiliated credit unions. As an advocate of the credit union ethos of mutuality, volunteerism, self-help and not for profit philosophy the ILCU has a vision to influence and inspire the credit union movement to achieve all its goals – social, economic and cultural – while always respecting the individual's rights and dignity. The ILCU achieves its vision in the following ways:

- Providing leadership for the movement in philosophy and services;
- Fostering and maintaining unity and co-operation between credit unions;
- Developing and making available to credit unions and their members, a full range of highest quality financial products and services; and
- Recognising the value of volunteers, staff of the credit union movement, the dignity of credit union members and their value in the community by their contribution to the social development of communities in Ireland and other countries.

289 registered ROI credit unions (of a total of 302 in ROI) are affiliated to the ILCU[1].

[1] Registered credit unions as of 21 June 2017. The number of "active" credit unions is slightly lower due to approximately 20 registered credit unions in the process of mergers and transfers at time of writing.

## 2. Introduction

The ILCU welcomes the opportunity to respond to the Consultation on Potential Changes to the Investment Framework for Credit Unions ("CP 109") and to address within this document significant issues which arise from the proposed changes.

The ILCU does not want CP 109 to represent a missed opportunity. Instead of repositioning the existing investment framework for credit unions in the context of the unprecedented low/negative yield environment, CP 109 proposes to restrict investment in Bank Bonds for credit unions and puts forward as an alternative, low yield "A" rated Supranational and Corporate bonds at very limited concentration limits.

The investment framework being considered is wholly inconsistent. The Central Bank is proposing to apply credit ratings to Supranational Bonds and Corporate Bonds however, no credit rating has been applied in the 2016 Regulations to investments in Accounts in Authorised Credit Institutions, Irish and EEA State Securities or Bank Bonds. Moreover, it is suggested that concentration limits for investments in Supranational Bonds, Corporate Bonds and Approved Housing Bodies are to be based on a percentage of the regulatory reserve of the respective credit union while pre-existing investment asset classes concentration limits are generally based on a percentage of the investment portfolio. There is no rationale provided in CP 109 for these differing approaches.

CP 109 does not propose a framework of effective risk management and mitigation, instead the prime objective appears to be the elimination of investment returns for credit unions. The Investment Framework under the 2016 Regulations is already restrictive and we expect the proposals will further exacerbate the downward pressure on investment income. Investment losses have historically not represented a systemic risk for credit unions and the movement has not experienced significant investment losses. Annual investment losses from 2012 to 2016 have ranged from 0.01% to 0.12% of investments.

The Central Bank's own publication "Financial Conditions of Credit Unions 2011-2016" in February 2017 highlights the significant vulnerabilities of credit unions' return on assets to the current low interest rate investment environment given that investments represent the

largest asset on the balance sheet. It illustrates that 50% of credit unions would report a negative return on assets by 2018 based on a scenario estimating future rates of return on investments and projected dividends similar to those that were proposed at the time for the 2015 year-end. The proposed changes in CP 109 would potentially result in this scenario becoming a reality.

Section 84 of the Credit Union Act 1997 asserts that the function of the Central Bank is to administer the system of regulation and supervision of credit unions with a view to the maintenance, financial stability and well-being of credit unions. CP 109 does not improve the well-being of the financial model of credit unions or address the issues identified in the Central Bank's own publication.

In our discussions with credit unions[2], a recurring theme was the severe difficulty they are continuing to experience in making a return on investments. The investment yield for our ROI affiliated credit unions has declined from 3.6% in 2012 to only 1.4% in the six month period to March 2017.

We have performed a portfolio impact analysis of the proposed changes in CP 109 on our affiliated credit unions and we estimate that the current 1.4% annualised yield from Credit unions investments would decline to as low as 0.3% in the coming financial years, particularly as current fixed investments mature from higher rates and reinvestment options offer relatively lower rates. How can credit unions have a sustainable future business model in the context of these future projected investment yields?

Unlike the banks, credit unions do not have the opportunity to create vehicles for investment products to generate income. As a result of European Central Bank Quantitative Easing coupled with deposit takers pursuit of depressing the cost of funding, Credit Unions have borne the brunt of the implications of these policies in terms of ever declining rates of

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[2] We have surveyed ILCU ROI affiliated credit unions when compiling our response to gauge how these proposed changes will affect them. Respondents to the survey were representative of the entire credit union movement; including differing sizes, locations, and types (community and industrial). Where we have quoted results of this survey this is referenced within the enclosed document.

returns and under the existing and proposed investment framework there is little scope to obtain any reasonable investment return going forward. This interest rate environment has come at the worst possible time, as Credit Unions experience a substantial growth in the size of their investment portfolios.

Section 43 (5) of the Credit Union Act, 1997 states that the Central Bank shall have regard to the need to ensure that that the requirements imposed by the regulations made by it are effective and proportionate having regard to the nature, scale and complexity of credit unions, or the category or categories of credit unions, to which the regulations will apply. The Central Bank has continued to ignore this obligation and instead CP 109 continues the “one size fits all” approach and does not allow latitude for those credit unions that possess the skills and systems necessary to manage a more complex investment portfolio.

The “Guidance Note on Investments by Credit Unions” October 2006 and the “Application for Exemption” dated July 2007 issued by the Financial Regulator stated that credit unions could be granted an exemption from the investment limits if they could demonstrate that they possessed the skills and systems necessary to manage a more complex investment portfolio. We ask the Central Bank to reconsider the reintroduction of this concept. In addition, we would like to engage with the Central Bank to develop appropriate objective benchmarks that credit unions would be required to meet in order to be granted the exemption.

## 3. Bank Bonds

Bank Bonds are a significant investment asset class for our affiliated ROI credit unions with €1.86 billion (18%) of the investment portfolio invested in Bank Bonds as at 31 March 2017. Section 3.3 of CP 109 states that the Central Bank is proposing to amend the existing definition of Bank Bonds so that Bank Bonds that are subordinated to any Senior Bonds issued by a credit institution will no longer be eligible investments for credit unions. Page 8 of CP 109 states that bonds that are subordinated to any unsecured creditor of the credit institution should not be considered as a senior bond. Consequently, applying this logic we assume that Senior Unsecured debt issued by authorised credit institutions which would not

be subordinated to any unsecured creditor will continue to be permitted as an authorised investment.

The Central Bank is not seeking views on this proposed amendment to the definition of Bank Bonds in the feedback section 7 of CP 109. We urge the Central Bank to constructively engage with the credit union movement on this very important matter.

We understand that banks are under pressure to meet Minimum Requirement for own funds and Eligible Liabilities ("MREL") and consequently, their issuance focus in the future will be on MREL eligible bonds. As a result of CP 109's proposal to rule out such bonds and as existing bonds mature, the universe of authorised Bank Bonds may be severely curtailed. It is unlikely that Banks will issue any significant Senior Unsecured Bonds in the future given that they would not be MREL. We expect that credit unions will be broadly limited to investing in covered bonds which represents a far smaller population of bonds with a much lower yield than the existing Senior Unsecured Bonds.

Bank bonds are a key source of investment yield for credit unions. 77 % of the respondents to our survey confirmed that this revised definition would significantly reduce their investment yields.

There is an evident lack of a Regulatory Impact Analysis ("RIA") in respect of the impact of excluding investments in Bank Bonds that are subordinated to Senior Unsecured debt. A RIA is required "*to identify any possible side effects or hidden costs associated with regulation and to quantify the likely cost of compliance on the individual citizens or the business*"[3]. However, CP 109 contains no analysis of the serious side effects in respect of reduced investment yield that credit unions will suffer as a result of the proposed change.

The proposed changes represent a fundamental misunderstanding of the impact of the Bank Resolution & Recovery Directive ("BRRD") on credit risk. The credit risk no longer resides solely in the actual instrument. Instead, the credit risk of the issuer of the financial instrument is also very relevant.

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3 Page 3, Revised RIA Guidelines : How to Conduct a Regulatory Impact Analysis, Roinn an Taoiseach, June 2009

In order to reflect this change the eligibility for investment in Bank Bonds should be linked to the credit rating of the specific Bank Bonds (that have a defined maturity date or are not perpetual in nature) which will reflect not only the credit assessment of the issuer financial institution but also the degree of subordination of the financial instrument.

There is an obvious inconsistency in excluding many Bank Bonds which would have a far higher credit rating and would be considered far more secure than some compliant Bank Bonds. For example, a BNP Paribas senior unsecured non-preferred bond (BNP 1.125% 10.10.2023) which would not be permitted under the proposed regulations has a Baa2 credit rating with Moody's, an A+ credit rating with Fitch and an A- credit rating with S&P, whilst the senior unsecured debt issued by the Italian Bank Unicredit SPA (Unicredit SPA 4.35% 25.08.2022) which has Baa1 credit ratings with Moody's, BBB credit rating with Fitch and BBB- with S&P will still be permitted. The list of counterparty credit ratings is set out in Appendix A.

If security of investments is the primary concern, the best way to measure and apply this on a consistent basis is to set a minimum credit rating on all Bank Bonds. We recommend that this minimum credit rating should be Investment Grade and should be applied to Bank Bonds with a fixed maturity date i.e. Moody's Baa3, S&P/Fitch BBB-. A list of the credit ratings by the rating agencies is set out in Appendix A for information. We consider that a rating of Investment Grade is reasonable in the context of the highly regulated environment which the financial sector now operates in including the increased level of supervision and monitoring since the financial crisis. Please refer to Appendix B where we have identified that yields on a population of European Investment Grade Bank Bonds are circa 0.73% for 5 year maturity and circa 1.66% for 10 year maturity *(Source: Bloomberg 08.06.2017)*

It is also our view that credit unions should be permitted to invest in bonds issued from holding companies which is the structure that was announced by Bank of Ireland and AIB in February 2017 subject to the application of the Investment Grade rating noted above.

## 4. Liquidity Ratios

We are disappointed that the Central Bank has not put forward any proposals in respect of the revision of liquidity requirements for credit unions in the context of the negative interest rate environment. The minimum liquidity ratio which requires credit unions to maintain liquid assets of at least 20% of unattached savings and the minimum short term liquidity ratio which requires short term liquid assets of at least 5% of unattached savings are resulting in credit unions experiencing negative yields on these related short term investments.

The Central Bank has referred to the legislative requirement in section 43 of the 1997 Credit Union Act of no undue risk to members savings however, it must be highlighted that banks appear to have no appetite for short term deposits from credit unions and this is reflected in punitive negative deposit rates or short term deposit offerings being withdrawn from the market. We anticipate that these pressures will intensify as reflected by Rabobank's scheduled exit of the market at the end of June 2017. Consequently, the negative interest rates now being applied by financial institutions will continue to erode the capital of credit unions.

The current definition of liquid assets is restricted to the inclusion of cash, investments with a maturity of less than 3 months and investments with a maturity of 3 months or more, where a written guarantee exists to the effect that funds are available to the credit union in less than 3 months. Many banks will often not provide the written guarantee that longer term funds may be available less than 3 months. We consider that the definition should be changed to the effect that credit unions can report assets as liquid if the credit union is satisfied that they can access the funds, even if some portion of interest may be lost or a nominal charge is applied.

This in many cases seems to indicate that liquid assets are confined to Accounts in Authorised Credit Institutions. This implied restriction is inconsistent with the liquidity methodologies applied in a European perspective by the Basel Committee on Banking Supervision and also from a UK view by the Prudential Regulation Authority ("PRA").

Credit unions have historically adopted a prudent approach to liquidity and annual cash flow requirements are predictable due to the stability of retention of members' savings. As at 31 December 2016, the average short term liquidity ratio is 16% which is well in excess of the 5% required limit. In addition, the average liquidity ratio is 39% which is again well in excess of the requirement of 20%.

The liquidity requirements for ROI credit unions should be amended so that they are consistent with the approach used by the Basel Committee on Banking Supervision and the PRA whereby longer term investments such as Government Bonds, Bank Bonds, Corporate Bonds and Supranational Bonds are explicitly included in the definition of liquid assets. These bonds are in essence more liquid than deposits given that they are quoted on public markets and they can be converted into cash at their market value.

The Basel III Liquidity Coverage Ratio provides for the inclusion of these Bonds in the definition of highly liquid assets subject to credit ratings, haircuts being applied to market value and concentration limits. We would be happy to discuss similar appropriate measures being applied for the explicit inclusion of Bonds in the liquidity definitions for ROI credit unions.

The explicit inclusion of these further investment asset classes as liquid assets would provide some relief for credit unions from punitive negative interest rates, promote investment diversification and ultimately assist in protecting members' savings.

## 5. CP 109 – Comments, Observations and Responses

We have addressed below the request for feedback as per Section 4 of CP109 following your section headings:

### 5.1 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.***

69% of respondents to our survey stated that the restricted investment classes set out in the 2016 Regulations represented the greatest challenge to their investment strategy. In question 3 below we have proposed additional investment classes that should be considered.

We have identified in section 4 above that the current liquidity ratio requirements effectively restrict investment in Bonds. As at 31 March 2017 only 24% of investments in our affiliated credit unions are held in Government and Bank Bonds. Our recommendations in relation to expanding the definition of liquid assets would assist credit unions to diversify further and promote investments in Bonds

Only 2% of investments of our affiliated credit unions are held in Collective Investment Schemes primarily because such schemes are restricted to low yield Irish and EEA State Securities, Bank Bonds and Accounts in Authorised Credit Institutions. We are proposing that the allowable investment asset classes in such Collective Investment Schemes should be expanded. Please refer to our response to question 16 below for further details.

Furthermore, as noted in section 3 above, the proposed restriction of the Bank Bonds definition will further compress the investment universe for credit unions.

**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?***

The ILCU welcomes the introduction of additional investment classes for credit unions which will increase the current level of investment diversification. The proposals in respect of investments in Approved Housing Bodies are broadly in line with our expectations.

However, Supranational Bonds and Corporate Bonds will only have a very negligible impact on investment income, at a time when credit union loan books and loan income

are not increasing significantly. While credit unions are making every effort to turn this lending trend around, this will take some time, and credit unions remain wholly dependent on investment income.

The key vulnerability for the business model of credit unions is the ability to generate an adequate investment return on members' savings and these additional investment asset classes do very little to address this significant challenge.

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.***

The ILCU has serious concerns regarding the ability of credit unions to generate meaningful investment returns in the context of the current investment regulations and the proposed changes to the investment framework. Credit unions have developed their investment policies which are underpinned by improved risk management structures that are subject to a higher level of regulatory scrutiny. Credit unions should therefore have a certain level of scope and autonomy to select and approve appropriate individual asset classes, to assign suitable limits and to determine whether individual investments are consistent with the investment objectives and risk appetite of the credit union. Consequently, credit unions should be allowed to allocate appropriate proportions of their investment portfolio to higher yielding growth assets.

Given that the CP 109 proposals would effectively eliminate investment returns it is essential that the investment rules are amended to allow for centralised lending of mortgages and SME's so that some of the c. €10 billion of surplus funds can be lent out.

In our survey of credit unions, the following additional investment asset classes have been highlighted:

### *(i) Investments in Credit Union Service Organisations*

Under the Credit Union Acts 1997 (as amended), credit unions are not permitted to hold shares in a company. This prevents credit unions from obtaining direct ownership of companies which may be established solely for the purpose of the provision of credit union services (Credit Union Service Organisations – "CUSOs"). This can lead to the establishment of entities, often with complex legal structures, without any direct reference to credit unions and without credit unions obtaining any shareholder rights including voting rights.

The World Council of Credit Unions ("WOCCU") has a Model Law for Credit Unions which includes a provision that would allow for investment in such entities. The relevant section 8.15(4) of the Model Law is set out below:

*8.15 Authorised Investments*

*Subject to the act and the regulations, credit union funds not used for loans to members, may be invested in:*

*4. Shares, stocks, deposits in, loans to or other obligations of any registered cooperative society, organization, company or association providing services associated with the general purposes of credit unions or engaging in activities related to the operations of a credit union. Such investments in the aggregate are not to exceed [insert number] percent of the credit union's capital and deposits.*

WOCCU's commentary on this provision explains that this would allow credit unions collectively to invest in finance service organisations furnishing essential services such as data processing, liquidity management and group purchasing. The commentary goes on to say that such investments are usually limited to 15% of capital.

We would support the application of WOCCU's Model Law in this regard. If, however, at this point in time, the Central Bank are unwilling to allow for a significant investment in company shares we believe a middle ground can be found. In that case we would suggest that the Regulations should permit credit unions to hold a nominal shareholding in such entities which would give rise to rights of membership. In this situation as the liability of members in companies is limited the risk to the financial position of the credit union is effectively non-existent.

### *(ii) Centralised Mortgage Lending*

65% of respondents to our survey identified the potential for investment in centralised mortgage lending. Home loans will bring longevity and growth to the credit unions loan book and will deliver additional income to credit unions which is vital for their future operating models. The ILCU Home Loan Working Group which was set up by the ILCU Board comprising representatives from the ILCU, supported by appropriate external expertise has recommended the implementation of a shared services model and central support mechanism so that credit unions can offer home loans in a prudent and compliant manner underpinned by a robust standardised process.

Phase 1 will see these mortgages reside on the Balance Sheets of individual credit unions. To achieve greater penetration of the mortgage market, phase 2 should be done centrally. This could be achieved through a central mortgage unit, authorised by the Central Bank as a Retail Credit Firm. Please refer to Appendix C for an Infographic of the proposed model for centralised mortgage lending. While the mortgage loans would be on the Balance Sheet of the Retail Credit Firm, the Individual credit unions could market the mortgage products, advise, provide customer assistance and act as loan officers/brokers, depending on the capability of the credit union to meet regulatory requirements, in particular the Consumer Protection Code, Minimum Competency requirements and the Mortgage Credit Directive.

The Retail Credit Firm would be funded by an authorised Investment Fund (owned by the movement), into which credit unions could place surplus investments. The business would be supported by a Services Company which would be non-regulated and would manage outsourced arrangements with third party companies for the provision of IT and operational services. Credit Unions would receive income from both their investment in the Investment Fund and from the Retail Credit Firm for mortgages business. This centralised model would effectively diversify mortgage risk across the movement.

We ask the Central Bank to consider including central mortgage lending as an additional investment class that may be used to achieve this home loan solution.

### *(iii) Centralised SME Lending*

40% of respondents have also indicated that SME lending using a centralised platform should be considered as a potential additional investment asset class. Credit unions worldwide perform a central role in supplying debt finance to the small firm sector, particularly mature movements such as Canada, the United States and Australia. AIB, Bank of Ireland and Ulster Bank control 93% of all new loans going to SME's. The credit union movement can enhance customer choice and diversity in the SME lending market.

Credit unions as community based lending organisations have a wider economic and social mission than solely providing financial services, and are therefore ideally positioned to extend loans to local enterprises, thereby contributing to generation of local employment with consequent benefits of economic development.

Irish credit unions could participate in a State backed vehicle that would:

- Enable Irish credit unions to act as an efficient distribution network to originate SME loan applications; and
- Enable Irish credit unions to invest in a funding facility that will lend to SMEs in Ireland.

Please refer to Appendix D for an infographic of the proposed model for SME lending.
The formation of a centralised vehicle to lend to the SME sector would enable a stronger centralised risk management capability whereby the vehicle, managed by an independent third party, would have dedicated and skilled resources to identify, assess, measure, and manage credit and operational risks. This would facilitate credit unions supporting the commercial loan market, but in a manner that would provide robust mitigants to manage risk, and above all, protect member funds. Consequently, we ask the Central Bank to consider the inclusion of centralised SME lending as an additional investment asset class.

### *(iv) Equities*

Whilst CP88 removed equities as a permitted investment class for Credit Unions surplus funds and the respective 2016 Regulations provided Credit Unions 2 years to dis-invest from such investments, we believe the need for such investments via Collective Investment Schemes, Investment Trusts or Exchange Traded Funds is even more pressing as the investment environment for existing permitted investments has deteriorated more than anticipated back in 2016.

We believe that those Credit Unions that can demonstrate robust controls and risk processes as well as clear understanding of allocating surplus funds to this asset class should be permitted to do so.

Credit Unions total investments have increased to €11.4bn at the end of 2016. Whilst Credit Unions are actively trying to address the Loan\Investment ratio, we believe it will take some time to address this balance. Hence, Credit Unions will remain "Long-Term" managers of member's funds. In this investment universe, even the most cautious investment mandate would have an allocation to equities. We refer you to charts in the Appendix E (2) which outline the benefits of been a long term investor (Robert Shiller – Total Market returns 1871 – 2012). It is this timeframe along with the necessary internal controls and processes that we deem this asset class to be suitable on a portion of Credit Unions surplus assets.

We recommend that the Central Bank should reintroduce the eligibility of 5% of the credit union's investment portfolio being allocated to equities as was originally set out in the "Guidance Note on Investments by Credit Unions" published in October 2006.

Please refer to Appendix E (1) where the MSCI Global Equity Index illustrates that equity valuations declined by circa 50% in the 18 months between 2007 to 2009. However, valuations recovered in the subsequent 4 years (after one of the worst financial crisis ever recorded) and investors continued to receive dividend income in the intervening period. This demonstrates that equities are an appropriate investment over the long term. It has been proven that equities outperform many investments types over the long term.

We also consider it would be sensible to include a specific counterparty limit for equities whereby exposure to any one individual equity would be limited. We would be happy to engage with the Central Bank to discuss a sensible equity counterparty limit which would promote equity diversification. In this context, an investment in euro denominated Passive Exchange Traded Funds which track recognised stock indices could also be considered as it would provide equity diversification across a wide range of equities tracking a recognised index.

We also suggest the definition of Collective Investment Schemes should be refined to include investment in equities subject to the 5% concentration limit.

***(v) State Sponsored Projects***

There have been for some time ongoing discussions around credit unions playing a significant role in various social and economic initiatives in the State. 45% of respondents to our survey have indicated a willingness to invest in such Irish Infrastructure State Projects. Credit unions consistent with their ethos are very keen to contribute actively to Ireland’s infrastructure and demonstrate clear social responsibility.

The 2016 Regulations state that the Central Bank may prescribe from time to time, in accordance with section 43 of the 1997 Credit Union Act, further classes of investments in which a credit union may invest its funds which may include investments in projects of a public nature. Investments in projects of a public nature include, but are not limited to, investments in social housing projects. Investment in Tier 3 Approved Housing Bodies has been proposed in CP 109 as a potential additional investment asset class however, we recommend that investments in public/state projects should also be considered.

## 5.2 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?***

The ILCU welcomes the potential addition of additional investment asset classes. As noted in the consultation paper these Supranational Bonds will provide credit unions with additional opportunities to diversify counterparty exposure.

The overwhelming feedback of our affiliated credit unions and independent investment advisors who we have discussed this matter with is that the new proposed asset classes for Supranational Bonds and Corporate Bonds will have very limited ability to generate any upside to existing investment returns.

However, we understand that the yields on these bonds (a sample of which are reproduced in the table below) are very low and are effectively similar to Government Bonds. The level of return on Supranational Bonds will provide no assistance to credit unions in trying to improve their investment returns which is critical to their future operating business model. The following table includes the yields on 3 Supranational Bonds:

| **Issuer** | **Maturity** | **Indicative Annualised Yield to Maturity** |
|---|---|---|
| European Investment Bank 0.375% | April 2027 | 0.55% |
| European Stability Mechanism 0.75% | February 2026 | 0.47% |
| European Financial Stability Facility 0.75% | May 2026 | 0.56% |

*Source: Bloomberg 09.06.2017*

In addition, we are not clear on why the Central Bank is proposing a minimum credit limit of no less than “A” with at least two recognised rating agencies. This is inconsistent with the existing 2016 Regulations where no credit rating limit has been imposed on existing investment asset classes including Accounts in Authorised Credit Institutions, Irish and EEA State Securities and Bank Bonds. In particular, we understand that the counterparty risk of Supranational and Government Bonds is similar and consequently, we are not clear as to the inconsistent credit rating methodology. CP 109 provides no

explanation of this differing approach and we ask the Central Bank to clarify their rationale.

68% of respondents to our survey have indicated that if the Central Bank insists on the application of credit ratings to Supranational Bonds that the minimum credit rating should be set at Investment Grade i.e. Moody's Baa3, S&P/Fitch BBB- by at least two recognised rating agencies (see Appendix A). Consequently, we ask the Central Bank to consider the application of Investment Grade as the minimum credit rating for Supranational Bonds.

We concur with the proposed maturity limit of 10 years to be applied in respect of the Supranational Bonds.

**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 do not believe that it is appropriate for the Central Bank to engage in the blanket application of investment concentration limits to every credit union irrespective of size or capacity to manage risk nor do we believe that the Central Bank has adequately explained its rationale for proposing to do so. Credit union boards and management are best placed to consider and agree on concentration limits (relative to factors in their own credit unions) as part of their overall Investment Policy.

No rationale for the use of the regulatory reserve as basis of the concentration limit for Supranational Bonds is provided in CP 109. The RIA highlights that the proposed limit of Supranational Bonds of 50% of regulatory reserves results in an average limit of 5.6% of total assets and 8.3% of total investments. The proposed concentration limits are simply too low for credit unions to have any meaningful investment in Supranational Bonds.

If the Central Bank is insistent on applying concentration limits then investment in the total bond universe (i.e. Irish and EEA State Securities, Bank Bonds, Supranational Bonds and Corporate Bonds) should be limited to 70% of the total credit union investments which is consistent with the 2016 Regulations.

## 5.3 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?***

The ILCU acknowledges that the potential addition of Corporate Bonds to the investment asset classes will provide credit unions with an opportunity to allocate a portion of investment portfolios to non- financial counterparties whose performance is not correlated to that of credit unions or the broader financial sector.

However, yields on “A” rated Corporate Bonds currently offer very low investment return upside to credit unions. As summarised in Appendix F the current yield on “A” rated European Corporate Bonds with a 10 year maturity is only c.1% which is actually lower than Bank Bonds.

We would ask the Central Bank to consider a minimum credit rating of Investment Grade being applied for Corporate Bonds invested in a Collective Investment Scheme overseen by an experienced investment manager which would contain a diversified population of such Bonds.

We concur with the proposed maturity limit of 10 years to be applied in respect of 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.***

Please see our response to question 5 above as our comments in respect of the use of blanket concentration limits and the regulatory reserve are equally applicable to question 7.

The proposed concentration limits for Corporate Bonds are even lower than those proposed for Supranational Bonds. The RIA estimates that the proposed limit of Corporate Bonds of 25% of regulatory reserves results in an average limit of 2.8% of

total assets and 4.2% of total investments. Although, in theory it is proposed that credit unions can invest in Supranational Bonds and Corporate Bonds any meaningful investment by credit unions is restricted by the extremely low proposed concentration limits and the “A” credit ratings.

We again recommend that a concentration limit of 70% of total credit union investments should be applied to the total bond universe (i.e. Irish and EEA State Securities, Bank Bonds, Supranational Bonds and Corporate Bonds).

## 5.4 Investments in Approved Housing Bodies (“AHBs”)

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

91% of respondents to our survey confirmed it is appropriate for credit unions to undertake investments in AHBs and we in the ILCU concur with this view. Serving a broader social agenda, is part of what credit unions were set up to do. We believe we can do so by using funds on deposit with credit unions more effectively. At present the credit union movement has c. €10 billion held in investment related products earning a low yield and put to an unproductive purpose. Under current regulations, there are limited options for the management and placement of these investments. We believe these investments could be better used to deliver key social goals, while also fully protecting those funds.

The Government Commission on Credit Unions recommended that methods for credit unions to invest in state projects be devised and this was reflected in the Credit Union and Co-operation with Overseas Regulators Act 2012. Section 43 (3) of the Credit Union Act 1997 states that the Central Bank may prescribe investments,… classes of investments, including where appropriate, any investment project of a public nature the credit union may invest in.

If the investment regulations were to be amended to facilitate investments by credit unions in AHBs, credit union funds currently deposited with banks, could contribute for

example to assist in the provision of social and affordable housing on a basis that assures both the protection of the fund and gives a modest return. This would be in line with the principle of existing legislation and the social ethos of credit unions.

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

91% of the respondents to our survey stated that a special purpose vehicle ("SPV") would be the most appropriate structure for investments in AHBs. Utilisation of an SPV would be in line with the Government's Social Housing Strategy 2020 and the Action Plan on Housing. In July 2016, Minister Simon Coveney launched the Government's Action Plan on Housing (please refer to- =http://rebuildingireland.ie/Rebuilding%20Ireland_Action%20Plan.pdf) which reiterated that the Government would welcome credit union funding for social housing and that support will be provided to the "Irish Council for Social Housing ("ICSH")/sector-led new special purpose vehicle, involving investors, including the Credit Union movement." It is imperative that this fund is set up so that credit unions can invest in AHBs .

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?***

The key risk for the SPV/Investment will be the ability of the AHBs' to repay the money borrowed. As part of our engagement with the Irish Council of Social Housing, we obtained an illustration of a proposed funding model for AHBs which is reproduced in Appendix G.

An important source of information on the AHB is the Regulation Office 2014 AnnualReport and Sectoral Analysis as issued by the Housing Agency Regulation. Please refer to link- https://www.housingagency.ie/Our-Publications/AHB-Regulation/HA-Regulation-Office-AR-2014-FINAL-WEB-pdf.pdf.

We consider that this counterparty risk in relation to the AHB is manageable and does not present undue risk to credit union members' funds for the following reasons:

- **Up to 30% of the initial project cost** is funded by the Department of the Environment, Community and Local Government via a **Capital Advance Leasing Facility** ("CALF").
- **The remaining portion of the project typically 70% is secured by private debt**. This is the element of finance that the ICSH SPV involving investors including the credit union movement would be looking to provide. The private lender has a first charge on the property. In the unlikely event of a collapse in the AHB mid-build, the lender has a first charge, and, the CALF lender (the State) does not.
- **The primary source of income for the AHB to fund repayment of this loan is the rent it receives for the provision of social housing.** There are two rental payments, the principal one being from the Local Authority (i.e. the State) under what is called a Payment and Availability Agreement. This is the core source of funds to repay the AHB loan. There is a second rental income stream from the social housing tenant.
- **The Payment and Availability Agreement** is the agreement between the Local Authority and the AHB whereby the Local Authority agrees to pay the AHB for the provision of social housing which is generally 92% of market rent and is indexed linked. The core purpose of this rent is to fund the debt repayment.
- The rental income stream from the social housing tenant is means tested and would range between 11% to 16% of income of the social housing recipient. On average this works out at €47 per week. In general, this is utilised by the AHB to cover running costs.
- The agreement also includes a provision whereby the Local Authority acknowledges what is called a **Continuation Agreement**. This is a separate agreement, between the AHB, the Local Authority and the lender (this would be the ICSH SPV). This agreement provides a safeguard for the lender to the AHB in the event of default. In this case, the Local Authority "steps in" and continues the Payment and Availability Agreement payments, and actively assists the lender in finding an alternative AHB. This is built on the principle that in the unlikely event of a collapse of an AHB, the State, acting through the Local

Authority, has an interest in ensuring continuity of the provision of social housing.

- While the de-jure counterparty to a loan to an AHB, is the AHB, the repayment capacity is built on the rental payments made by the Local Authority (i.e. the State) to the AHB. In this regard, the de-facto counter-party to a loan to an AHB is the State, as State funds ultimately repay the loan.
- For further details of the various agreements please refer to- https://www.icsh.ie/sites/default/files/attach/icsh news/1035/calf_guidance_april_2016.pdf.

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

As part of the central management of the SPV, the mix of projects would be designed to ensure a balance in the portfolio in terms of length of term and a mix between acquisition and construction projects to ensure appropriate liquidity and keep risks within stated appetites.

While investments in an SPV for social housing would by their very nature be longer-term investments we believe credit unions can easily meet their liquidity requirements across the rest of their investment portfolio i.e. currently credit unions have an average liquidity of 39% (liquidity being defined as cash and investments less than 3 months to maturity as a percentage of unattached savings).

***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?***

Consistent with the existing Investment Framework we consider that concentration limits should be based on a proportion of investments with an acceptable range being

between 10% to 20% which was the view of 71% of respondents to our survey. Credit union boards and management are best placed to consider and agree the specific concentration limits for AHBs (relative to factors in their own credit unions) as part of their overall Investment Policy.

We believe credit unions can easily meet their liquidity requirements as noted above.

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 concur with the 25 year maturity limit and the investment in Tier 3 AHBs as proposed in CP 109.

## 5.5 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.***

In the current investment environment it is a significant challenge for credit unions to identify counterparties who can provide a reasonable investment yield. The proposed reduction in the counterparty limit would place additional counterparty strain on credit union investment portfolios.

In addition, the proposed reduction in the counterparty limit to 20% may well force credit unions to invest much more significant funds in institutions outside of the State which is not something they would wish to do. Consequently, it is our strong view at this time that the counterparty limit should be retained at 25%. This is the limit that has been in place since 2006 and there have been no issues or risks arising from this counterparty limit even though we have had the biggest global financial crisis in the meanwhile.

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

Notwithstanding our view above, the proposed transitional period of 12 months post commencement of the amended investment regulations is insufficient. Investment pressures will intensify over the coming months with the exit of Rabobank from the deposit market and the need to reallocate c. €600m of deposits the majority of which are on call and constitute a significant portion of the short term liquidity requirement.

Instead investments with fixed maturity dates should be held to maturity which is consistent with the 2016 Regulations transitional arrangements and the views of 85% of respondents to our survey. This is particularly critical given the significant re-investment risk arising from the low interest rate environment.

## 5.6 Collective Investment Schemes

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

Collective Investment Schemes provide a mechanism for credit unions to invest in a range of asset classes, across a mix of maturities in a well regulated manner and with the advice of regulated investment advisors.

However, as at 31 March 2017, only 2% of investments comprise Collective Investment Schemes. Investments in such schemes are effectively restricted per the 2016 regulations to low yield investments in Irish and EEA State Securities, Bank Bonds and Accounts in Authorised Credit Institutions. We recommend that the definition of Collective Investment Schemes should be expanded to incorporate investments in Supranational Bonds, Corporate bonds, Social housing/AHBs, State Sponsored Projects and Equities.

We would only advocate investing in those Collective Investment Schemes\Investment Trusts\Exchange Traded Funds that are listed with a daily price and have no "No-Lock" in periods. The concentration limits we would propose would be as follows:

| **Category of Investment** | **maximum % of total credit union portfolio** |
|---|---|
| Bonds | 70% |
| Equities | 5% |
| Social Housing/AHBs | 10% to 20% |
| State Sponsored Projects | 10% to 20% |

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

The majority of respondents to our survey cited the low yield on the investment asset classes within the existing definition of Collective Investment Schemes as being the key barrier to credit unions using these schemes. As noted in question 16 above, we consider that expanding the definition of the investment asset classes included in these schemes will promote their use by credit unions and will assist with investment diversification.

In addition, 48% of respondents referred to a lack of knowledge in relation to Collective Investment Schemes. We are willing to engage in a series of training presentations with credit unions to assist in their knowledge of collective investment schemes particularly, if the constituent assets in such schemes are expanded to increase their relevance as a viable investment opportunity.

## 5.7 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.***

It will be necessary to see the Central Bank's responses to the significant issues raised in this submission (and those from all other contributors) before we can reasonably be expected to provide a view as to whether we agree with the proposed timelines.

We look forward to the publication of all submissions received and the Central Bank's feedback on same which we will consider and analyse carefully.

It is imperative that the Central Bank meets with the ILCU to discuss the matters raised in this submission.

## 6. Conclusions & Next Steps

The ILCU has highlighted in the sections above the significant issues which arise from the proposed changes to the investment framework as set out in CP 109. We ask the Central Bank to consider the following:

(i) Active and constructive engagement with the credit union movement in respect of any proposed amendment to the definition of Bank Bonds. Consider using a minimum credit rating of investment grade as a benchmark as it is a more appropriate reflection of counterparty risk.

(ii) Review of liquidity requirements for credit unions in particular the explicit inclusion of additional investment asset classes within the definition of liquid assets subject to sensible credit ratings, haircuts being applied to market value and concentration limits.

(iii) Consider inclusion of additional investment classes:

- Investments in Credit Union Service Organisations;
- Centralised Mortgage Lending;
- Centralised SME Lending;
- Equities; and

- State Sponsored Projects;

(iv) Concentration limits for the bond investment universe (Supranational Bonds, Corporate Bonds, Bank Bonds and Irish and EEA State Securities) to be set at 70% of the entire credit union investment portfolio.

(v) Minimum credit rating of Investment Grade to be applied to Supranational Bonds. In addition we also recommend a minimum credit rating of Investment Grade for Corporate Bonds which are managed in a Collective Investment Scheme overseen by an experienced investment manager which would contain a diversified population of such Bonds.

(vi) Counterparty limit should be maintained as it is has for the past 11 years at 25% in recognition of the very challenging investment environment and the difficulty in identifying counterparties who can provide a reasonable investment return.

(vii) We have set out significant detail in our response in respect of the investment in AHBs. We would welcome the opportunity to discuss this at further length with the Central Bank.

(viii) The definition of Collective Investment Schemes should be expanded to incorporate investments in Supranational Bonds, Corporate Bonds, Social Housing/AHBs, State Sponsored Projects and Equities within defined concentration limits.

(ix) Re-introduction of the concept in “Guidance Note on Investments by Credit Unions” October 2006 and the “Application for Exemption” dated July 2007 issued by the Financial Regulator which stated that credit unions should be granted an exemption for investment limits if those credit unions can demonstrate that they possess the skills and systems necessary to manage a more complex investment portfolio.

The ILCU looks forward to engaging constructively with the Central Bank in respect of our feedback on CP 109. It is imperative that the revised investment regulations take account of

the current investment environment in conjunction with the continued evolution of credit union business models.

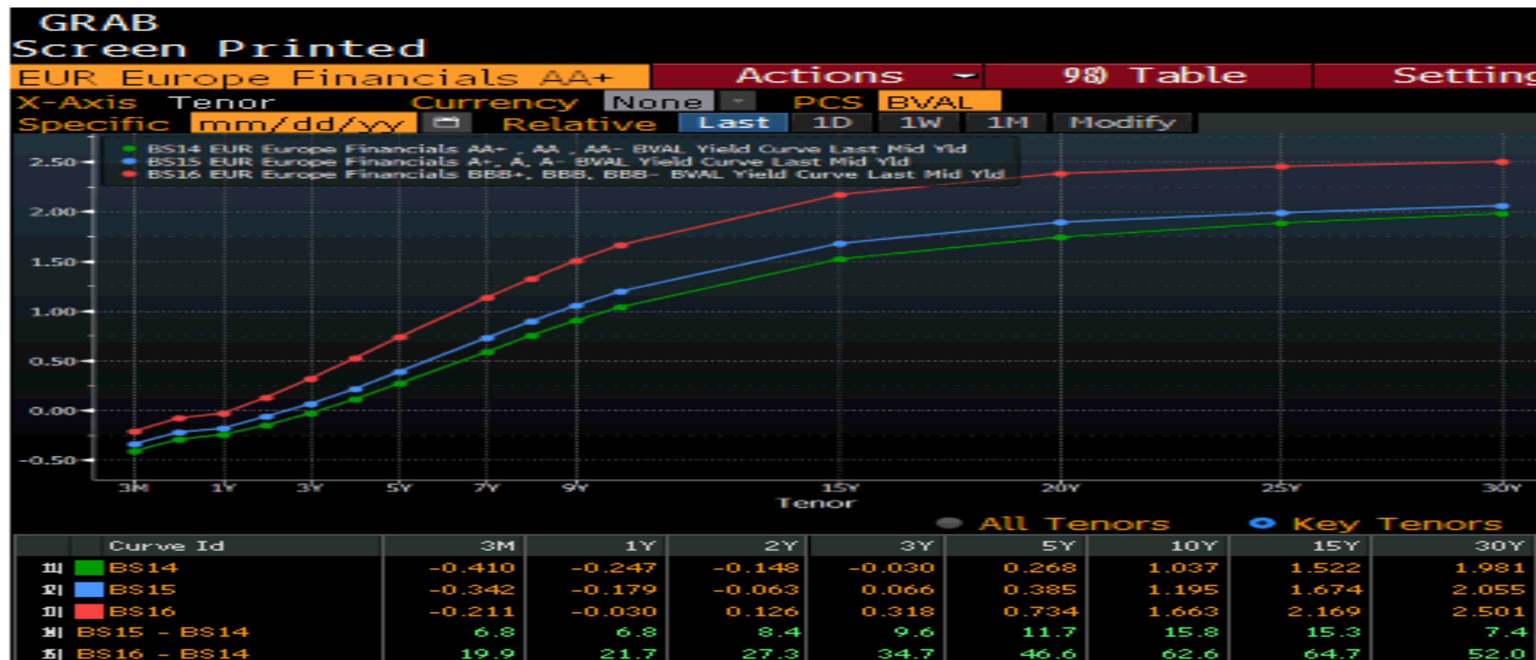
In the interests of credit unions continuing to play a significant and worthwhile role, we urge the Central Bank to consider our feedback in respect of CP109 and make the appropriate amendments to the Investment Framework.

# APPENDIX

## APPENDIX A- INVESTMENT GRADE CREDIT RATING

| | Moody's | S&P | Fitch | Meaning |
|---|---|---|---|---|
| Investment Grade | Aaa | AAA | AAA | Prime |
| | Aa1 | AA+ | AA+ | High Grade |
| | Aa2 | AA | AA | |
| | Aa3 | AA- | AA- | |
| | A1 | A+ | A+ | Upper Medium Grade |
| | A2 | A | A | |
| | A3 | A- | A- | |
| | Baa1 | BBB+ | BBB+ | Lower Medium Grade |
| | Baa2 | BBB | BBB | |
| | Baa3 | BBB- | BBB- | |
| Junk | Ba1 | BB+ | BB+ | Non Investment Grade Speculative |
| | Ba2 | BB | BB | |
| | Ba3 | BB- | BB- | |
| | B1 | B+ | B+ | Highly Speculative |
| | B2 | B | B | |
| | B3 | B- | B- | |
| | Caa1 | CCC+ | CCC+ | Substantial Risks |
| | Caa2 | CCC | CCC | Extremely Speculative |
| | Caa3 | CCC- | CCC- | In Default w/ Little Prospect for Recovery |
| | Ca | CC | CC+ | |
| | | C | CC | In Default |
| | | | CC- | |
| | D | D | DDD | |

## APPENDIX B- YIELDS ON BANK BONDS A GRADE & INVESTMENT GRADE

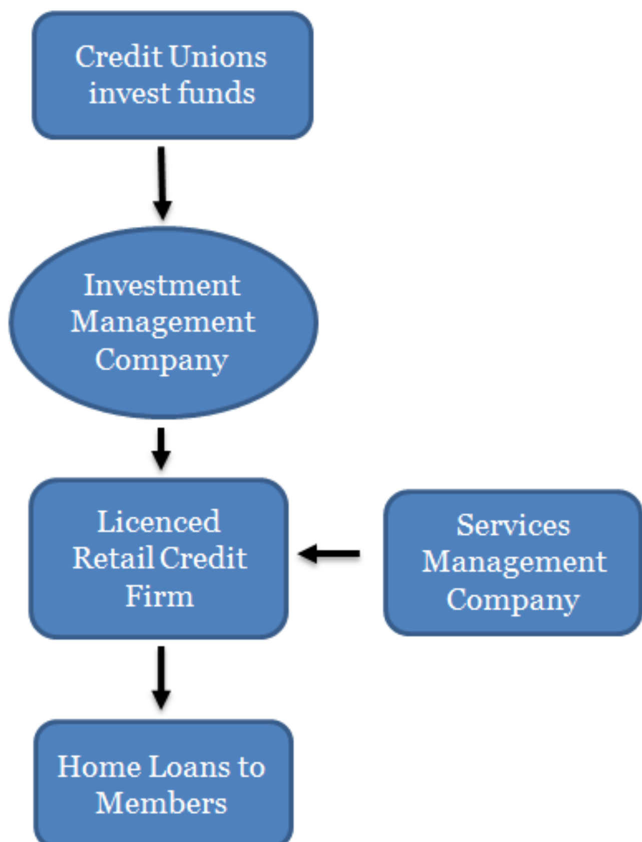



| Curve Id | 3M | 1Y | 2Y | 3Y | 5Y | 10Y | 15Y | 30Y |
|---|---|---|---|---|---|---|---|---|
| BS14 | -0.410 | -0.247 | -0.148 | -0.030 | 0.268 | 1.037 | 1.522 | 1.981 |
| BS15 | -0.342 | -0.179 | -0.063 | 0.066 | 0.385 | 1.195 | 1.674 | 2.055 |
| BS16 | -0.211 | -0.030 | 0.126 | 0.318 | 0.734 | 1.663 | 2.169 | 2.501 |
| BS15 - BS14 | 6.8 | 6.8 | 8.4 | 9.6 | 11.7 | 15.8 | 15.3 | 7.4 |
| BS16 - BS14 | 19.9 | 21.7 | 27.3 | 34.7 | 46.6 | 62.6 | 64.7 | 52.0 |

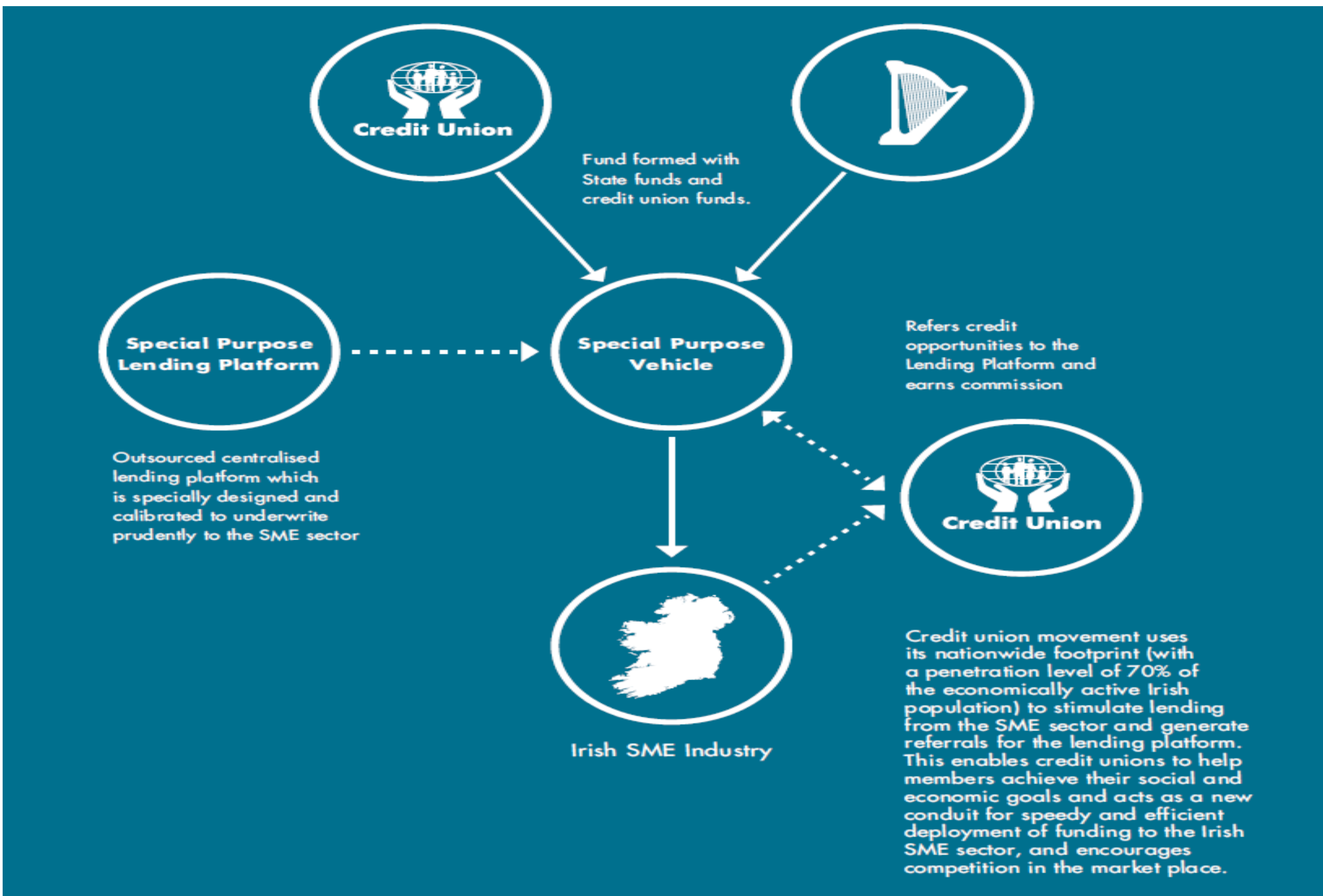
- The red line relates to yields on Bank Bonds that are investment Grade.
- The blue and green lines relates to yields on Bank Bonds that have a range of different “A “credit ratings attached to them.
- The table outlines the annualised yields to maturity from 3 months out to 30 years as well as the yield spread between each line for the period in question (e.g. Investment Grade Financial Debt has annualised yield to maturity of 1.66% for 10 years, whilst the A rated equivalent has annualised yield to maturity of 1.037% or 1.195% (i.e. BS 14 and BS15 respectively)

Source: Bloomberg 09.06.2017

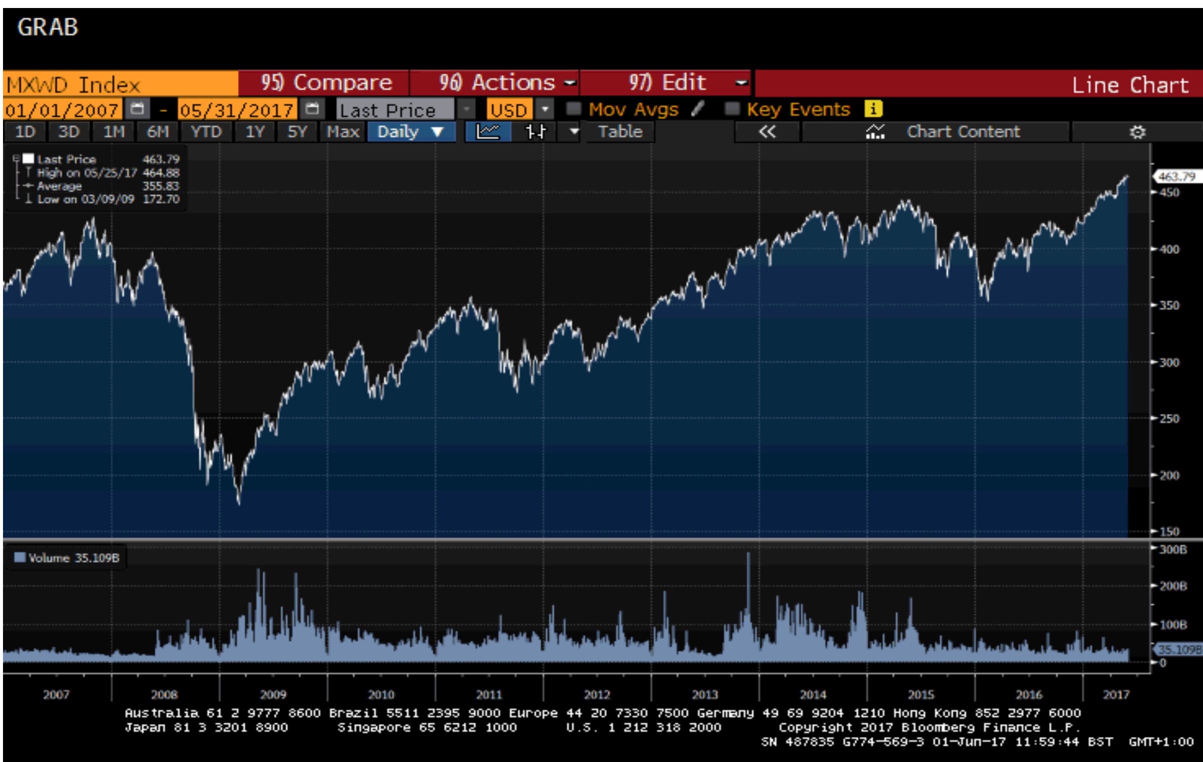
## APPENDIX C- INFOGRAPHIC OF CENTRALISED MORTGAGE LENDING PROPOSAL



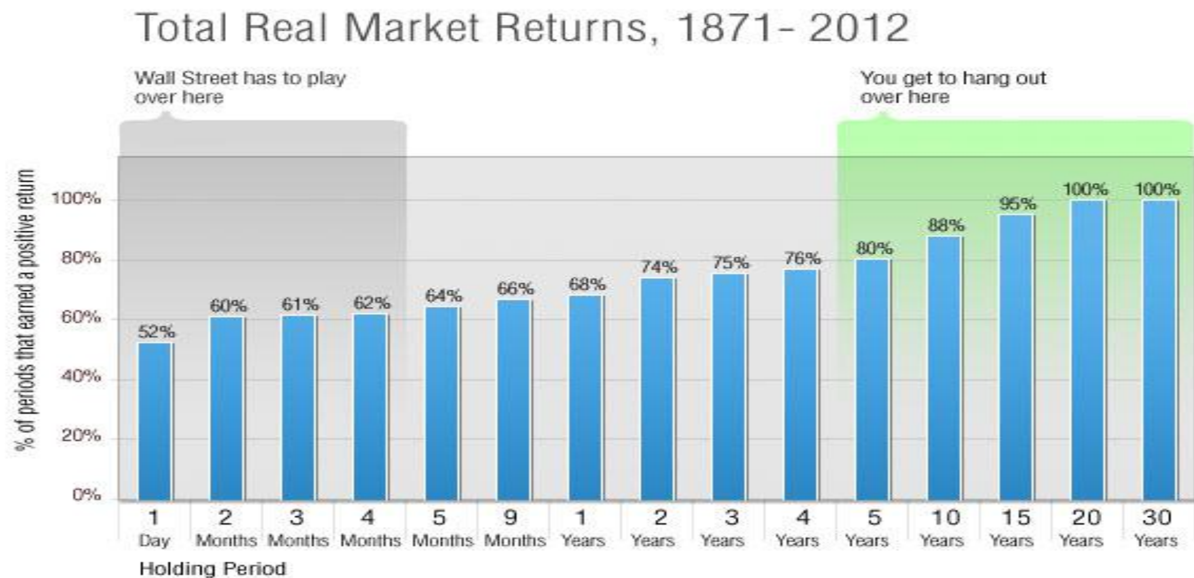
## APPENDIX D- INFOGRAPHIC OF SME CENTRALISED LENDING PROPOSAL



## APPENDIX E (1)- MCSI GLOBAL EQUITY INDEX PRICE MOVEMENT 2008 TO 2017



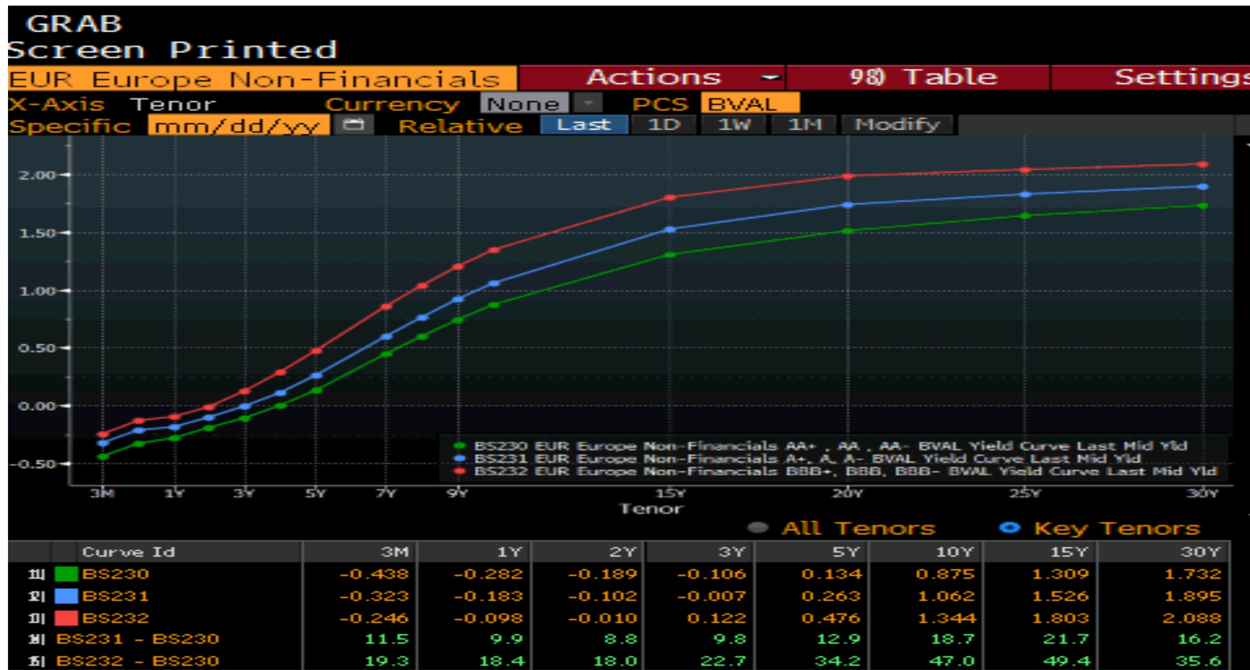
## APPENDIX E (2)- Robert Shiller – Total Real Market Returns 1871 – 2012




Source: Robert Shiller, author's calculations. 1-day returns since 1930, via S&P Capital IQ.

- History shows that those investors that can remain invested over the longer term have a higher probability of a positive return after inflation

## APPENDIX F - YIELDS ON CORPORATE BONDS A GRADE & INVESTMENT GRADE




| | Curve Id | 3M | 1Y | 2Y | 3Y | 5Y | 10Y | 15Y | 30Y |
|---|---|---|---|---|---|---|---|---|---|
| 11) | BS230 | -0.438 | -0.282 | -0.189 | -0.106 | 0.134 | 0.875 | 1.309 | 1.732 |
| 12) | BS231 | -0.323 | -0.183 | -0.102 | -0.007 | 0.263 | 1.062 | 1.526 | 1.895 |
| 13) | BS232 | -0.246 | -0.098 | -0.010 | 0.122 | 0.476 | 1.344 | 1.803 | 2.088 |
| 14) | BS231 - BS230 | 11.5 | 9.9 | 8.8 | 9.8 | 12.9 | 18.7 | 21.7 | 16.2 |
| 15) | BS232 - BS230 | 19.3 | 18.4 | 18.0 | 22.7 | 34.2 | 47.0 | 49.4 | 35.6 |

- The red line relates to yields on Corporate Bonds that are investment Grade.
- The blue and green lines relates to yields on Corporate Bonds that have a range of different “A “ credit ratings attached to them.
- The table outlines the annualised yields to maturity from 3 months out to 30 years as well as the yield spread between each line for the period in question (e.g. Investment Grade Corporate Debt has annualised yield to maturity of 1.34% for 10 years, whilst the A rated equivalent has annualised yield to maturity of 0.88% or 1.06% (i.e. BS 14 and BS15 respectively)

Source: Bloomberg 09.06.2017

## APPENDIX G- IRISH COUNCIL OF SOCIAL HOUSING ILLUSTRATIVE PROPOSED FUNIDNG MODEL FOR AHB's