LINK CREDIT UNION

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RESPONSE TO CONSULTATION PAPER 109

CONSULTATION ON POTENTIAL CHANGES TO THE INVESTMENT FRAMEWORK FOR CREDIT UNIONS

Contents

Overview:

Link Credit Union (LCU) Ltd welcomes the opportunity to make a submission on "CP109 Consultation on Potential Changes to the Investment Framework for Credit Unions".

LCU is a community Credit Union based across two counties, namely Cavan and Meath. We now serve over 17,000 members and have assets in excess of €95m, with an investment portfolio circa €77m.

LCU receive investment advice from Davy & have received assistance with the technical analysis, to support this submission.

Executive Summary:

- CP109 has not taken into account the liquidity pressures facing Credit Unions from an investment perspective and does not address this issue.
- The Central bank's proposed amendments to authorised bank bonds are a serious concern in light of changes occurring in bank funding and issuance trends. CP109 and the Regulatory Impact Analysis (RIA) overlook these developments and proposes to prohibit bonds which are likely to dominate senior bank bond issuance over the next five years.
- We recognise that risk management is a key regulatory priority for the Credit Union sector. At the same time, it must be acknowledged that Credit Unions are operating within an extremely limited investment universe. Any proposals which contract the investment universe further will increase pressure on a sector that remains vital to the Irish social and economic landscape.
- The potential addition of new investment classes is welcome, particularly in the case of supranational and corporate bonds. However, the proposed concentration limits are at odds with the intended diversification benefits. Testing shows that the maximum exposure to supranational and corporate bonds will average circa 8% and 4% of portfolio respectively.
- Within Section 4 of this submission, LCU put forward recommendations to address the challenges outlined above.
- In particular, LCU recommend that certain bonds should be interpreted as liquid for regulatory liquidity ratios. This is consistent with credit union regulations in other jurisdictions (Northern Ireland and the UK), as well as regulations governing liquidity in banking.
- Bank bond funding principles are changing within a market landscape that is subject to a high level of regulatory control and oversight. Stakeholders need to acknowledge this and credit unions should continue to be authorised to invest in senior unsecured bank bonds, regardless of whether they are subordinated within the senior space. Bonds which are MREL (See Appendix 1) eligible require an investment grade rating in order to be considered authorised. Credit unions should be able to conduct their own risk assessments in determining whether investments, including senior non-preferred bonds, are appropriate for their investment portfolios taking into account the nature, scale, complexity and risk profile of the credit union.
- Concentration limits on the proposed additional asset classes should be incorporated into existing limits which are based on a percentage of the investment portfolio rather than regulatory reserves.
- Counterparty limit of 25% should remain unchanged, given the counterparty pressures currently facing credit unions.
- Contracting the limited investment universe will not increase lending to members. Instead, it will increase pressure on a sector that remains vital to the Irish social and economic landscape.

Section 1: Key areas facing Credit Unions from an investment perspective

1. **Liquidity:** LCU is now entirely reliant on overnight deposits/demand accounts and accessible collective investments to meet our short-term liquidity requirements. We believe that this represents capital risk, which needs to be minimised, as it is contrary to the underlying principle of not taking undue risk with members' savings, as per Section 43(1) of the 1997 Act.
2. **Counterparty pressure**: Given the shortage of counterparty options and banks' lack of appetite for short-term funding, we anticipate that LCU, together with all other Credit Unions, will find it very difficult to source a home for funds which will allow them to observe regulatory counterparty and liquidity limits without incurring a capital loss on funds as a result of negative interest rates.
3. **Lack of investment choice and the challenge to generate income:** In the current investment environment, it has become increasingly difficult for LCU to source appropriate and suitable investments.

Section 2: General commentary and feedback on additional issues not incorporated into the Central Bank's questions

- **Liquidity:** CP109 has not taken into account the liquidity pressures facing Credit Unions from an investment perspective and does not address this issue, which is disappointing given the representations made to the RCU prior to the publication of the consultation paper.

1. **Nature, scale, complexity and risk profiles of Credit Unions:** The Central Bank does not appear to have taken into account the nature, scale, complexity and risk profiles of Credit Unions.
2. **Risk v return:** The Central Bank has focused purely on risk and assessed the potential impact of the proposed changes on asset allocation. As a result of this, LCU believe that the RIA requires further analysis.
3. **Credit v duration risk:** LCU are concerned that duration risk is not addressed in CP109 and Credit Unions may look to "move out the curve" in order to secure valuable yield in the government, corporate or bank bond universe.
4. **Bank Bonds – implications for Credit Unions as a result of the Central Bank's proposal to amend the definition of bank bonds:** Traditional senior bank bonds may no longer be available, while CP109 proposes that new types of bond issues (senior non-preferred) will be prohibited. If the Central Bank's proposal is implemented, the measures will effectively close off an authorised investment class which historically has represented an important investment option for LCU and indeed Credit Unions generally. LCU, together with every other Credit Union in the country, are likely to face additional pressure on income as traditional senior unsecured bonds mature in their investment portfolio and new bond opportunities are sought out. It is extremely unlikely that Credit Unions will maintain 18% of investment portfolios in bank bonds as assumed by the RIA. LCU firmly believe this figure will be materially lower, as a result of this proposed.

Section 3: Impact on Link Credit Union

In order to assess the impact of the proposals, analysis was carried out on our investment portfolio as at 30/04/2017. The regulatory reserve figure used in the testing is €9,879,156.

LCU's investment portfolio is likely to be impacted in three main ways if the proposals outlined in CP 109 are implemented:

1. Asset Allocation

LCU 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%	54,065,926	0%
	Accounts in Authorised Credit Institutions	60,166,827			78%
	Bank Bonds	16,028,108	70%	54,065,926	21%
	Collective Investment Schemes	714,314			1%
	Other	327,788			0%
	Total	77,237,036			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%	6.4%	4,939,578	
	Corporate bonds	25%	3.2%	2,469,789	
	Total (additional bonds)		9.6%		
	*Investments in AHB's 3 proposed options:				
	a) or	25%	3.2%	2,469,789	
	b) or	lesser of 25% or €3m for credit unions with assets less than €100m	3.2%	2,469,789	
	c)	50%	6.4%	4,939,578	

**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 LCU's investment portfolio:

Table: Counterparty Exposure

	Moody's				
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, LCU will not need to reallocate any of its investment portfolio as it currently stands. However, the portfolio is presented at 30th April 2017 and there have been occasions when the counterparty limit would exceed the proposed 20% limit.
- 7% of the portfolio or €5.4m must also be reallocated from [redacted] 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, LCU'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 LCU's individual investment portfolio, we have applied the percentage changes derived from the above model to the portfolio and assessed the impact on our 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

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

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 LCU's investment portfolio is 1.0%.

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		1.0%
Impact of senior non-preferred not being authorised	-23%	0.77%
Impact of senior non-preferred bonds not being authorised and supranational & corporate bonds added to the portfolio	-19%	0.81%
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		1.0%
Impact of senior non-preferred being authorised	9%	1.09%
Impact of senior non-preferred bonds being authorised and supranational & corporate bonds added to the portfolio	-2%	0.98%
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%	1.14%

Source: Davy with reference to Davy's Submission to CP109

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 our credit union's weighted average investment income, our income is expected to decline to c. 0.77%.
- 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 LCU's weighted average investment income, our income is projected to decline to c. 0.81%. 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 LCU's weighted average investment income, our income is projected to increase to 1.09%. 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 our weighted average income to 0.98%. 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 LCU would result in an increase your weighted average income to 1.14%.

Section 4: Recommendations

1. Liquidity

LCU firmly believe that certain bonds should be considered liquid for both the purposes of the short-term liquidity constraint and regulatory liquidity. This would be comparable with credit union regulations in the UK and Northern Ireland.

These include:

- Irish & EEA securities;
- Supranational bonds; and
- Corporate bonds, all of the above with associated haircuts applied.

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

Asset	Qualifications	Haircut for the purposes of liquidity (% of Market value)
Irish & EEA securities	Investment grade	5%
Supranational bonds	Minimum rating of 'A'	5%
Corporate bonds	Minimum rating of 'A'	30%

LCU recommend that transferrable securities may contribute up to a maximum of 50% of the regulatory liquidity ratios, as we recognise the need for us to maintain access to cash deposits as working capital.

2. Counterparty Limits

LCU firmly believe that the counterparty limit should remain unchanged. Diversification proposals in CP109 are insufficient to warrant any contraction in current limits.

3. Bank Bonds

LCU firmly believe that credit unions should be authorised to invest in senior bank bonds (both senior preferred and senior non-preferred).

4. Concentration Limits

LCU firmly believe that the concentration limits of additional asset classes (supranational and corporate bonds) should be incorporated into existing concentration limits.

Section 5: Responses to the Central Bank's 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.

LCU agree with the Central Bank that Credit Union investment portfolios are too concentrated. This has been caused by factors outside the control of LCU, by financial market conditions and investment regulations.

At present, Credit Unions have little choice other than to consider cash deposits or bank bonds.

2. Do you have any comments on the potential introduction of additional investment classes for Credit Unions and the appropriateness of the classes being considered by the Central Bank?

LCU agree with the proposal to include supranational bonds and corporate bonds. However, the proposed concentration limits by reference to a percentage of regulatory reserves is almost non material and we propose to switch any change to concentration limits to asset level, which we feel is more appropriate, as it is consistent with current investment regulations.

3. Taking account of the appropriate risk profile for Credit Union investments, are there any additional investment classes that the Central Bank should consider? If so, please outline the investment classes and why such investment classes are considered appropriate for Credit Unions.

Yes. Certain Credit Unions should be allowed to invest in senior bank bonds. The RCU should allow Credit Unions to assess investments (which are within the prescribed classes authorised by the Central Bank) and decide if they are suitable and based on their own investment objectives.

4. Do you have any comments on the potential to include supranational bonds in the list of authorised classes of investments set out in Credit Union investment regulations with a minimum credit rating requirement and maturity limit?

LCU agree with this proposal, together with proposed minimum credit rating and maturity limit. This asset class will provide diversification benefits and allow Credit Unions to access a wider range of counterparties.

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.

LCU oppose the introduction of regulatory reserves as a concentration limit. We propose that the concentration limits on supranational bonds is incorporated into the current asset class level of 70%.

6. Do you have any comments on the potential to include corporate bonds in the list of authorised classes of investments set out in Credit Union investment regulations with a minimum credit rating requirement and maturity limit?

LCU agree with this proposal, together with proposed minimum credit rating and maturity limit.

7. Do you have any comments on the suggested concentration limit for Credit Union investments in corporate bonds? If you have suggestions, please provide them along with supporting rationale.

Please refer to point 5 above. LCU propose that the concentration limit of corporate bonds is incorporated into the current 70% asset class limit of bank bonds.

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

Credit Unions are a natural investor in social housing.

Appropriate vehicles must be put in place to make Credit Unions' investment in social housing meaningful, affordable to Credit Unions and affordable by housing applicants.

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

We feel that special purpose vehicles (SPV's) or collective investment schemes are potentially the most appropriate structures for investments in AHB's. We recommend that the Central Bank opens an application process that accepts proposals with assessments conducted on a case by case basis.

10. What do you consider to be the risks associated with this type of investment and what mitigants do you feel are available to manage these risks?

Risks associated with investing in this sector may be summarised as:

- liquidity risk;
- investment risk;
- regulatory risk;
- financial risk: and
- business model risk.

11. How can the ALM issues associated with such investments be addressed by Credit Unions?

LCU believe that the only realistic way of dealing with the ALM issues arising from investments in AHB's is to provide the investment through a collective investment vehicle which is large and accessible to all Credit Unions.

12. Given the existing mismatch between the maturity profile of the sector's funding and assets and the likely maturity profile of such investments, the Central Bank is of the view that the concentration limit would need to be set at a level that reflects this. Do you have any views on what an appropriate concentration limit would be for such an investment? What liquidity and ALM requirements could be introduced to mitigate these risks and potentially facilitate a larger concentration limit?

LCU recommend a concentration limit of 5% initially to be reviewed for potential upward revision as the sector develops over the next few years. Creating an explicit ALM match for Credit Unions is problematic. We see the duration of AHB investments as remaining an outlier in ALM terms as it is not possible in our view to duration match AHB investments and the loan book of Credit Unions. Rather, investment in AHB's needs to be looked at on a portfolio basis and in this context, a 5% weighting will not pose a significant risk in ALM terms, as the overall investment portfolio duration remains relatively short.

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

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

We believe that there may be other options worthy of consideration such as;

A joint development between Credit Unions and NTMA of a department with expertise in this area

Examination of the market models used in other countries

14. Do you have any comments on the proposal to amend the existing counterparty limit for Credit Union investments? If you have suggestions, please provide them along with supporting rationale.

LCU does not feel it is appropriate to reduce the counterparty limit for Credit Union investments at this time.

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

LCU would propose a 24 month transitional period but believe that the matter of a transitional period should not arise, as we do not feel it is appropriate to reduce the counterparty limit.

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

LCU advocates the use of collective investment schemes for Credit Unions.

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

LCU believe that the barriers are predominantly on the supply side and emanate from the investment environment. Under FRS 102, collective investment schemes are regarded as complex investments and as such, must be valued at fair value. Many Credit Unions hold a preference for valuing investments on an amortised cost basis and are therefore reluctant to absorb the mark to market volatility of collective investment schemes.

It is difficult for advisers to build critical mass to cover and sufficiently dilute the costs involved in setting up a collective investment schemes.

Authorisation process in the central bank may represent a barrier for advisers.

18. Do you agree with the proposed timelines for the introduction of potential changes to the investment framework set out in this consultation paper? If you have other suggestions please provide them, along with the supporting rationale.

LCU agree with the proposed timelines for the introduction of potential changes to the investment framework set out in this consultation paper.

However we would argue that changes are required which are not set out in this consultation paper (please refer to Section 2), particularly in respect of liquidity, and we would urge the RCU to give consideration to implementing these changes ahead of the proposed timeline.

Appendix 1 – Definitions

Bank Bonds: Globally, banks must meet onerous regulatory requirements for loss-absorbing bonds. This is to ensure that in the future, banks have sufficient capital and loss-absorbing instruments to ensure that equity holders and bond holders pay for future bank bailouts rather than tax payers. In the EU, the requirement for loss-absorbing bonds is referred to as minimum requirements for own funds and eligible liabilities (MREL) and is being introduced on a phased basis from 2019 to 2022. Although difference countries are approaching the MREL shortfall in different ways, all banks are issuing a new type of senior bond which qualifies as MREL and may be subjected to losses or bail-in in the event that the bank goes into resolution. These bonds may be referred to as "senior non-preferred", "junior senior", "tier 3", or "holding company debt (or holdco)". They will rank below traditional senior unsecured debt (which may now be referred to as "senior preferred", "senior senior", or operating company debt (opco)".

MREL: The minimum requirement for own funds and eligible liabilities (MREL) laid down in the EU's Bank Recovery and Resolution Directive (BRRD). They clarify how institution's capital requirements should be linked to the amount of MREL needed to absorb losses and, where necessary, recapitalise a firm after resolution.

Bank Recovery and Resolution Directive: An EU directive introduced to deal with "resolution" of European banks after the financial crisis. Resolution means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings.

Appendix 2 - 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