MULLINGAR CREDIT UNION

Response to Consultation Paper CP109

Consultation on Potential Changes to the Investment Framework for Credit Unions

June 2017

This document contains the views of the Board and Management of Mullingar Credit Union on the proposals contained within Consultation Paper CP109

General Comment:

The existing investment framework for credit unions is already quite restrictive. The changes set out in the consultation paper CP109 seek to further limit the scope for credit union investments, which will inevitably lead to a greater concentration in low paying deposit accounts and a further reduction in investment income. Credit unions are in danger of becoming low-cost collection vehicles for bank deposits.

The consultation paper fails to recognise the unique composition of credit union balance sheets, and how credit unions require a return from their investment portfolios in order to remain viable. It does not recognise or appreciate the expertise that has been built up by credit unions and their investment advisors in the complex work of managing and administering their investment portfolios over many years.

Specifically in relation to investment returns: a projected analysis of MCU's investment portfolio predicts a reduction of approximately 19-23% in the weighted average return, if the proposed changes are implemented in full. One of the most significant impacting factors is the change to the definition of bank bonds, to exclude senior non-preferred bank bonds, and bank bonds not issued by the credit institutions. Investments in bank bonds should be limited to all such bonds at "investment grade", and to the same levels allowed under the current regulations.

The consultation paper fails to address the concerns of credit unions in relation to liquidity issues. Under the current regulations, credit unions are forced to hold a large proportion of their investments in low paying bank call or very short-term deposits; paying negligible returns. Many credit unions, MCU included, hold a significant tranche of their investment funds in government and bank bonds, which cannot be included in the liquid definition, but could be turned into cash in two to three days if necessary. This is particularly relevant in relation to government bonds, where there is a deep and liquid market, which should enable such bonds to be classed as "relevant liquid funds". Such a change in definition would offer the potential of increased returns while not impacting on the liquidity profile of the credit union.

Question 1:

Do you have any comments on the current level of diversification in credit union investment portfolios? Are there any barriers to the use of existing diversification options within the current investment framework? If so, please provide details and any suggestions to address these.

Response: There is currently a very low level of diversification in credit union investment portfolios – the vast majority (72%) of credit union investments were held in deposits at the end of September 2016. Why is this? The current liquidity ratio requirements and liquidity definitions, which exclude the use of government and bank bonds, are barriers to the use of existing diversification options within the current investment framework. The exclusion of bonds, particularly highly liquid government bonds, from the definition of "liquid assets", makes no sense.

In this regard, an expansion of the definition of liquid assets would assist in promoting additional investments in such bonds.

Question 2: Do you have any comments on the potential introduction of additional investment classes for credit unions and the appropriateness of the classes being considered by the Central Bank?

Response: MCU welcomes the addition of extra investment classes for credit unions, in principle. However, the proposed concentration limits, based on Regulatory Reserve, will have a negligible impact on the level of investment diversification. The maximum allowable in supranational bonds in MCU, for example, would be approx. 7% of total investments.

In relation to the proposed investments in Approved Housing Bodies, MCU would have to examine this model in more detail in order to decide whether to commit funds in this way. Such an investment will restrict liquidity and may carry a heightened level of risk.

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

Response: The original 2006 "Guidance Note on Investments" and the July 2007 "Application for Exemption" 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. MCU recommends the re-introduction of this concept, at least in a partial way, and allow certain larger credit unions to invest in a wider pool of investment classes, within the credit union's risk appetite and always having regard for the security of member funds.

Such additional asset classes could include, with appropriate limits in place:

- Senior bank bonds (not limited to those issued by a credit institution)
- Equities (either directly or through collective investment funds, and subject to certain minimum criteria for the type of entity being invested in)
- Investments in Credit Union Service Organisations (as detailed in the ILCU CP109 Submission)
- Investments in Irish infrastructure State projects
- Investments in Irish semi-state companies

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

Response: MCU welcomes the inclusion of supranational bonds in the list of authorised classes of investments and agrees with the proposed maturity limit of 10 years. However, in relation to the proposed minimum credit rating: this is inconsistent with the 2016 Regulations where no credit rating limit has been imposed on existing investment asset classes. MCU considers that a minimum credit rating of "Investment Grade" is more appropriate for the new asset class of supranational bonds.

It is also noted that, while the additional diversification option will be welcome, this asset class will not generate any significant return for credit unions in the foreseeable future.

Question 5: Do you have any comments on the suggested concentration limit for credit union investments in supranational bonds? If you have suggestions, please provide them along with supporting rationale.

Response: MCU fundamentally disagrees with the use of the Regulatory Reserve as a measurement tool for deciding concentration limits for any investment classes. Furthermore, credit unions should be allowed to decide upon their own concentration limits through their own investment policy (taking into account the umbrella limit on bonds, as set out in the 2016 Regulations).

Notwithstanding this, the proposed concentration limit of 50% of Regulatory Reserve is too low for credit unions to make any meaningful investment in Supranational Bonds. For MCU, this would only allow for an investment of approx. 7% of total investments, generating a negligible income stream (for a relatively large credit union). If a certain limit must be set, it should be based on a percentage of total investments, not on a percentage of Regulatory Reserve.

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

Response: MCU welcomes the inclusion of corporate bonds in the list of authorised classes of investments and agrees with the proposed maturity limit of 10 years. However, in relation to the proposed minimum credit rating: such "A" rated corporate bonds currently offer very low investment returns.

MCU considers that a minimum credit rating of "Investment Grade" is more appropriate for the asset class of Corporate Bonds; invested through a Collective Investment Scheme overseen by a professional investment manager which would contain a diversified population of such bonds. This would help mitigate the potential risk of reducing the minimum credit rating to Investment Grade.

Question 7: Do you have any comments on the suggested concentration limit for credit union investment in corporate bonds? If you have suggestions, please provide them along with supporting rationale.

Response: As in question 5 above, MCU fundamentally disagrees with the use of the Regulatory Reserve as a measurement tool for deciding concentration limits for any investment classes. Furthermore, credit unions should be allowed to decide upon their own concentration limits through their own investment policy (taking into account the umbrella limit on bonds, as set out in the 2016 Regulations).

Notwithstanding this, the proposed concentration limit of 25% of Regulatory Reserve is too low for credit unions to make any meaningful investment in Corporate Bonds. For MCU, this would only allow for an investment of approx. 3.5% of total investments. If a certain limit must be set, it should be based on a percentage of total investments, not on a percentage of Regulatory Reserve.

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

Response: MCU is not certain of the appropriateness of credit unions undertaking investments in AHBs, given the fragmented, individually managed nature of such entities. In addition, there is very little information available in relation to the risk / quality of such investments, and the potential return available. We would require further information / clarity / assurance before being satisfied to undertake such investments.

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

Response: Given our limited knowledge of this sector, it would appear that some form of collective investment scheme would be most appropriate.

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

Response:

Risks: Counterparty risk – risks associated with the reliability of the relevant AHB.

Credit Risk – risk that the money borrowed will not be paid back.

Term Risk – risk that the 25 year maturity timeframe is not appropriate for credit union investments – no liquidity available / limited ability to exit product.

Mitigants:

- Obtain government guarantees/local authority guarantees
- Central investment vehicle for credit unions.

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

Response: The level of reserves already held by credit unions is an existing in built ALM buffer to deal with any potential issues. In addition, the current minimum liquidity requirement of 20% of unattached savings is also an effective ALM tool.

Credit unions can examine the possibility of introducing longer term savings products, as was the case when the SSIA product was being offered.

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

Response: Any concentration limit should be based on a proportion/set percentage of Investments (rather than Regulatory Reserve). Such a limit should be fairly low at the initial introductory stage in order to (1) gauge the market and product, and (2) spread the maturity of such investments.

If the limit remains relatively low, the existing liquidity requirements should be more than sufficient to manage the ALM requirements successfully.

If the limit is raised, then the maturity of such investments may need to be adjusted in order to manage the ALM issues.

See also the answer to (11) above in relation to the ALM requirements.

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

Response: MCU agrees with the proposal to include investments in Tier 3 AHBs in the list of authorised classes of investments, with a 25 year maturity limit.

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

Response: MCU does not agree with the proposal to amend the counterparty limits. There does not appear to be any specific or sound reason for doing so.

The number of potential counterparties operating in the Irish market is limited. Irish credit union members are more comfortable with their credit unions having investments in institutions that they are more familiar with.

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

Response: Notwithstanding the view expressed in (14) above, the proposed transition period of 12 months is not sufficient. All investments held at the date of the commencement of the amended investment regulations should be allowed to be held to maturity. The revised threshold could be arrived at through the passage of time without the need to break existing investment contracts, which could involve sustaining unnecessary losses.

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

Response: MCU agrees with the use of collective investment schemes for credit union investments, but it should be noted that, the low take up of such investment schemes is due to the fact that the schemes are subject to the same limited investment classes as individual credit union investments. This therefore lessens the attractiveness of such investments. An expanded definition of allowable investments available to collective investment schemes would make such schemes more attractive to credit unions and would assist in investment diversification and possibly income. The current regulations limit the income available to such collective investment schemes, and therefore limit their attractiveness to credit unions.

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

Response: Refer to the answer to (16) above. In addition, the level of investments (of any kind) in the collective investment scheme, being taken into account when calculating the levels of concentration in the investment portfolio, act as a significant barrier to undertaking such investments. Collective investment schemes need to be a standalone investment class. There should be no “look through”.

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

Response: The timeline proposed in the Consultation Paper is very tight, given the level of detail and the number of issues raised. There does not appear to be sufficient time for the Central Bank to consider the individual responses and take these into account in any revisions to the investment regulations before the commencement of same. In addition, the commencement of new investment regulations in Q4 of 2017 is not ideal timing from a credit union perspective, given that all credit unions are dealing with year end and Annual General Meetings at this time of year.