# Response of

# St Anthony's & Claddagh Credit Union

# To

# Consultation paper CP109

# "Potential Changes to the Investment Framework for Credit Unions"

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**General Comments**

St Anthony's & Claddagh Credit Union (SACU) welcome the opportunity to contribute to the debate on "Potential Changes to the Investment Framework for Credit Union".

Since 2007 the investment environment for Credit Unions has changed dramatically. We have seen:

- The financial crisis which led Ireland seeking assistance from the Internationally Monetary Fund.

- Changes in regulations with regard to the ratings of Investments arising from the downgrade of Ireland during the aforementioned crisis.

- The enactment of the EU Bank Recovery and Resolution Directive.

The impact on our Investment Strategy of this environmental change has been to narrow our investment options and indeed our market risk appetite. Our portfolio in 2017 is significantly more concentrated in terms of asset class and counterparties then it was in 2007. Furthermore the lack of return, indeed at times the negative return, of investments is a real threat to the business model of the Credit Union.

The continuing growth of the savings book is a practical demonstration of the confidence of the membership and of a real need for an alternative to the current offering of the retail banks. To meet this need we must in the long term engage in more advanced Asset Liability Management. This should be appropriate to the nature, scale and complexity of our Business Model and more critically that of our Balance Sheet. It is our hope that the Investment Regulations would be supportive of such an activity.

Diversification is a basic risk management tool and the opportunities offered by this framework provide a starting point. The investment products included in the proposed framework are narrow and tightly ring-fenced and are not sufficient to radically change the current Investment Strategy.

Investment options are limited because of the

- Difficult investment environment particularly the impact of low interest rates

- Inclusion of the limits based on the regulatory reserve rather than the Investment Portfolio

- Changes in the definition of allowable bank bonds

This means that there is a real risk that a change of the counterparty limit from 25% to 20% would put such downward pressure on income so as to actually increase the risk profile of the credit union.

Example of behaviour which would increase risk includes:

- A conservative investment strategy is followed and the income and at times capital lose from low interest rates investments means the current business model is not viable - Interest Rate Risk

- A more aggressive investment strategy is followed seeking greater returns from investments which results in longer investments in more risky counterparties - Market Risk & Liquidity

This is a real threat based on our current investment portfolio and amount of €4m would have to be reinvested. Currently these funds are earning 0.35% for a 12 month term. The rates offered by other counterparties for a similar term range from a negative of 0.30% to a positive of .01%. This would mean a loss of income of at least €13,600 and a possible capital loss of up to €12,000 in a year. This is the equivalent of the average industrial wages for 9 months. This interest rate risk is a real threat to the Credit Union sector. The investment options included in this proposal would impose a longer term and increase liquidity risk.

This drive to diversify is further limited if traditional Senior Bank Bonds are no longer available.  CP109 proposes that new types of bonds issued (senior none preferred) will be prohibited. If this proposal is implemented it will further reduce the Bank Bond Investment opportunities available to Credit Unions. Credit Unions should be allowed to invest in Senior Bank Bonds- both senior preferred and senior non preferred.

Credit Unions after conducting their own risk assessment should be allowed to determine whether investments in senior non preferred bonds are appropriate for their investment portfolios taking into account the nature, scale, complexity and risk profile of the Credit Union.

At a minimum individual Credit Unions should have a mechanism available to them whereby they could demonstrate their ability and suitable sophistication to continue to invest in Bank Bonds to current levels of concentration

It is our view that the reduction in a possible market risk, already managed by counterparty selection criteria, is not sufficient to counteract the real liquidity and interest rate risk posed by the alternatives, allowed by this paper.

Furthermore the framework does not consider other opportunities that may be available to Credit Unions.

- **Investment in Public or Community Projects beyond those related to Social Housing.**

Following discussion with Galway City Council in May 2016 it is clear that there is a lack of availability of suitable land for the development of Social Housing and any project will be small scale and very limited in number. However there are opportunities for investment in infrastructure associated with the Galway 2020 European City of Culture project. Under this framework such an investment would not be facilitated.

We recognise the challenge such an investment poses in terms of counterparty risk. However the community basis of the credit union does mean that it holds a unique place in Irish Society, it has the trust of the membership and consequently the savings while technically on demand has a low turnover rate.

Based on our own analysis of the share book, 34% of shares deposited in 2002 have not been withdrawn by 2017. Such a deposit term of 15 years is beyond any term deposit available in the Retail Banks and is clear evidence of the “stickiness” of the Credit Union shares. This would suggest that there is potential to develop long term products which have a “look through” from the member savings to Community Projects.

While the economic risk of such projects may be higher the political risk is significantly lower. From a members perspective a loss resulting from the failure of a local project or institution is more palatable than that of a foreign institution. The economic risk of such projects could be managed by an agreement with the Department of Finance of a list of public, state and semi state bodies which would be supported. Examples of such bodies in our common bond include – Galway City Council, NUI Galway and its associated research companies, Udaras na Gaeltachta and  University Hospital Galway.

There is a history of investment in Community Development and Enterprise Centres by Credit Unions, these investments have proven successful in both financial and social terms. Such investments are not considered in this paper.

- **Investment in shared service entities for Credit Unions to include vehicles for**

    - The provision of outsourced services for Credit Unions

    - The management of members' savings, particularly by offering long term investment and protection products

If the Credit Union Sector is to develop in a real and meaningful way it must invest in collaboration, research and development. To do this effectively seed capital is required. Such capital should be recognised as the investment which it is.

**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.**

The overall poor level of diversification emerged during and after the financial crisis and can attributed to

- Reduction in availability of suitable counterparties, willing to make economic offerings to the CU sector
- Lack of risk appetite to assume political risk and look beyond Irish institutions i.e. local brands
- Restrictions of liquidity as loan book rising

The greatest barrier is the lack of appetite in the market place for credit union funds meaning that there is no competition which had led to an effective oligopoly in the Sector.

A creative solution must be sought, there is a real need for investment in the public sector and there is clear availability of funds in the Credit Union sector. The inherent risk of term mismatch can be managed by more proactive asset liability management and recognition of the real nature of credit union savings. This will require work by all stakeholders including credit unions, regulators and advisors.

We recognise that such an investment proposal is a new departure for the sector. We are confident that the changes in governance arrangements introduced during and after the financial crisis are sufficient to manage such a proposal. These governance arrangements include up skilling and the attainment of minimum competency qualifications by staff and volunteers and the introduction of formal risk management processes.

**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 funds suggested are in line with current regulatory risk appetite and while likely to be effective in managing the market risk they do not consider the strategic risk of limiting the business model development. This point is developed in 3 below.

**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.**

If the business model is to develop we must look beyond the traditional investment options and include

- Investment in Public and Community projects which may include the development of savings products linked to such projects
- Investment in entities providing shared services to Credit Unions

**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?**

Investment in such bonds may expose the Credit Union to political risk (discussed in General Comments section), given the risk appetite of SACU to date it is likely that we would limit such investments to well established Irish companies.

**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.**

In absolute terms the limit suggested is appropriate to manage Market Risk but at a portfolio level it is inadequate to provide real diversification, consideration should be given to using the asset or portfolio size as a limiting factor rather than the regulatory reserve

**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 inclusion of Corporate Bonds will aid diversification but as in point 5 above in absolute terms the limit suggested is appropriate to manage Market Risk but at a portfolio level it is inadequate to provide real diversification. Consideration should be given to a higher limit for the Asset Class and a lower limit for the counterparty.

**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.**

See 6 above.

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

Investments in AHB are appropriate for Credit Unions as it:

- Aids diversification of investment portfolio mitigating market risk
- Provides additional source of income mitigating strategy risk
- Supports community development mitigating reputational risk

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

There would appear to be 2 distinct possibilities each with defining properties which bring a different risk profile

- Small scale direct investments in local area – while economic risk may be higher strategy and political risk would be lower
- Collective Investment Schemes at a National Level – while strategy and political risk would be higher economic risk would be lower

**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?**

See above.

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

We have just commenced an Asset Liability Modelling Project; there are a number of aspects to this project each with different time lines

- Short term – quarterly review of loan book and biannual review of savings book and reserves leading to changes of risk limits to deal with immediate issues

- Medium term – detailed data analytic exercise to establish turnover of loan book and savings book with view to developing additional products and services

- Long Term - project leader in Solution Centre, under the auspices of CUDA, looking at ALM modelling and long term strategy development

**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?**

While we recognise the need to have risk limits they are a crude tool and may have unintended consequences.

As an organisation we are moving from using limits in the short term to developing a more sophisticated ALM approach. Based on the very early work completed the "stickiness" of share is clear. In 2017 we have retained 32% of shares invested in 2007.

Furthermore we have seen continuing growth in savings during the greatest financial crisis of our time when our returns to members reduced.

While the data is not yet available to show conclusively the impact of this, the observed trends suggest that lower level of liquidity and return to members could be tolerated as value is placed on the intangibles such as ethical behaviour and community support.

The medium term project detailed above i.e. the analysis of the turnover of the loan book and the savings book will provide statistical support for this view.

**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 welcome the opportunity to diversify our investment portfolio and view this as an initial step to real community and public investment.

**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.**

We recognise the concern regarding the narrowing of the Investment Portfolios of Credit Unions and the consequent increase in market risk. While the change in counterparty limit would address this issue it does not deal with the greater strategy risk.

Without a real alternative the movement of funds from current counterparties will further reduce the income of Credit Unions. The alternatives provided by this framework are not sufficient to allow for the reduction in current counterparties in the time proposed.

We would have a real concern that this proposal would exacerbate the pressure on income and actually increase substantially the strategy risk of the credit union if implemented as proposed. This point is elaborated on in the general comments section

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

Refer to section 14 above.

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

Collective Investment Schemes have been part of the Credit Union landscape for many years; the benefits they bring include economies of scale allowing investment in products which may otherwise not be economical. However the management charges are significant and in recent years the low interest rate environment has made them less attractive. To date such schemes have been managed by third party providers who will also seek a profit margin. There is significant opportunity if Credit Union were allowed to invest in shared service entities which could manage such scheme.

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

The main barrier is the economic viability of such schemes

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

We would be particularly concerned about the implementation of a reduction in the counterparty limit to 20% within the proposed timeframe.