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Registry of Credit Unions
Central Bank of Ireland
PO Box 559
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Dublin 1

Dear Madam or Sir,

On behalf of the credit union I would like to thank you for the opportunity to provide our views on the Central Bank's proposals for Potential Changes to the Investment Framework for Credit Unions (CP109).

The Board have authorised the Investment Committee to respond on behalf of the Credit Union. I am pleased to provide our response.

In order to facilitate your review of the numerous responses you may receive, we have set out our views on a question-by-question basis in an appendix to this letter.

Raymond Joyce

Raymond Joyce
Chief Financial Officer and Deputy CEO
Secretary to the Investment Committee

# Appendix 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.**

In the case of certain investment classes, they are in effect not viable options so we cannot diversify because there are no available assets in those categories. A good example is **shares of and deposits with other credit unions**. Credit unions needing investment have had a period recently where Rebo could have addressed any need for investment. In addition, it is hard to see how any credit union would invest in another credit union if that CU had recourse to the Savings Protection Scheme of the Irish League of Credit Unions. There is also a natural and well-placed reluctance to engage in any such investment, which would in effect import the risk of another credit union into our own. It is hard to imagine any credit union doing so.

Another example is **shares of a society registered under the Industrial and Provident Societies Act 1893 to 1978.** This is a very limited investment class; in truth, it would more accurate to describe such investments as quasi-charitable donations of credit union reserves, but without an explicit write-off.

Also, the proposed amendment to the definition of a senior **bank bond** will likely restrict our investment options and reduce the overall average return on the investment portfolio.

There are also invisible barriers in terms of what people in the credit union movement think as regards investing in certain counterparties. For example, a desire to express solidarity with the wider community through supporting Irish banks; a perception that any future investment loss in Irish banks would be more easily understood and forgiven by our members and our regulator than an investment in a foreign bank; an inherent distrust of new counterparties and so on. The combined effect of all of these influences is to tend to concentrate investments with a small group of Irish banks.

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 widening of the potential choices for credit unions is welcomed.

We have made comments about the appropriateness of the classes being considered under individual investment classes.

It would be useful to consider a further investment class of investments in the interest-bearing shares or bonds of building societies. This is on the basis that building societies, like credit unions, are based on the mutual model of ownership. The absence of any building society based on Ireland may render this a moot point for the time being but it would be useful to get the Central Bank's initial view of whether this might be permitted in a later version of the 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.**

There is an argument to be made for allowing credit unions to invest a certain small proportion of their reserves in index trackers, exchange traded funds or well-diversified equity funds. The logic for this is that there is a base level of reserves that credit unions could be expected to retain even in a very long period of adverse operating conditions. On that basis, there exists an appetite and a capacity for the kind of long term investment horizon in which equities have outperformed all other investment classes.

Obviously, there would have to be outright bans on direct ownership of shares as well as a ban on speculative buying and selling of permitted investments of this type. There would also have to be strict concentration limits, similar to the level for investment in other credit unions, which is a form of equity investment and would carry similar or higher levels of risk.

## 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 proposal to include supranational bonds is warmly welcomed. This class of investments is relatively safe and tends to be priced more favourably than individual government bonds. It would be highly attractive because of its combination of top credit ratings and price stability.

In the long term, the market for these bonds may recede as countries supported by the supranational entities will become more financially independent.

The proposed minimum credit rating requirement and maturity limit would be in line with our expectations.

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.**

The concentration limit is proposed at a very low level. If we take a rough average of credit union reserves of say 12% of assets, the 50% restriction would be 6% of assets. It is hard to see why the limit would need to be set so low when there is also a proposed minimum credit rating of A by two recognised ratings agencies.

A more appropriate limit would be 25% of total investments, in our view.

## 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?**

Inclusion of corporate bonds amongst allowable investments will further assist in portfolio diversification. There is a little more risk associated with corporate bonds compared to government bonds or other types of bonds, but that also should mean there would be the opportunity for a greater return. If corporate bonds for reputable companies (A rated bonds) are invested in then even if interest rates fall, bonds can be sold for a profit on a secondary market. Therefore overall risk in investing in corporate bonds is relatively low.

Stability of the issuing company is important therefore both the proposed minimum credit rating requirement and maturity limit would be in line with our expectations.

**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.**

Our concerns would be similar to those expressed under question 5: The concentration limit is proposed at a very low level. If we take a rough average of credit union regulatory reserves of say 12% of assets, the 25% restriction would be just 3% of assets. It is hard to see why the limit would need to set so low when there is also a proposed minimum credit rating of A by two recognised ratings agencies.

A more appropriate limit would be 10% of total investments, in our view.

## Investments in AHBs

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

Credit unions are financial organisations serving their members and wider local communities. From that perspective, this initiative would be closely linked to the credit union movement ethos and operating principles. In particular, providing funding for social housing schemes (so helping to address the wider issue of homelessness) would increase the contribution of credit unions to society.

In addition, Irish credit unions are currently challenged due to low lending demand. Significant portion of members' funds is invested (with at least 20% of investment portfolio held in short term investments earning no return) and investment income yields are under huge pressure due to ultra low interest rates. Investing in AHBs would be a way of using members' funds in a more productive way, even if the returns were modest.

It is worth bearing in mind that the Housing Finance Agency plc (HFA) has at 31/12/2015 an outstanding balance of €67m due from AHBs of which roughly half was in respect of loans issued in 2015. The HFA is, in light of its experience of funding housing projects in Ireland for 35 years, in a much better position to assess the risks involved in an AHB investment than any individual credit union would be. Furthermore, it is amply funded with excellent access to long term low interest loans; for example, it has a facility for €150m over 25 years at 3.25%.

Would credit unions be funding the HFA on the same basis? If so, the returns would perhaps be acceptable. However, credit unions would only substitute its funding for that available elsewhere. Would we instead compete with the HFA for investment opportunities? The returns are not attractive, given the direct risk involved. If we were to operate alongside the HFA in funding AHBs, would credit unions only want to fund projects at a higher return? If that were true would these only be the riskier projects?

Any investment would require a great deal of consideration. However, the investment class is appropriate for credit unions. It may well be that in practice, the level of due diligence that would properly be required for such an investment might create a strong sense of inertia against investing in the class.

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

Most straight forward would appear to be investment in bonds. Collective investment schemes (CIS) could also be considered. Given that currently only 3% of the total credit union investment portfolio is invested in CIS, it would raise the profile of this class of investment.

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

The obvious one would be the liquidity risk. Investing in AHB would mean that credit unions' funds will be tied up for say 25 years so liquidity levels in the credit unions would be impacted. However, taking into account the current credit unions' current liquidity levels which are at their historic highs, this initiative could actually help rather than expose credit union to undue risk.

There is also the risk of the AHB defaulting on paying the capital back. However, taking into account government support in the form of regular availability payments and an unsecured bullet loan to part fund the initial investment alongside the debt funding provided by the HFA, there is a basis for managing the credit risk. We would suggest that the government loan be formally subordinated to the credit union investment. In any case, by being repayable at maturity it is subordinated in terms of the sequence of repayment in the normal course of events; that is to say that the credit union investment should have been repaid in full before the government funding falls due for payment.

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

There is no such thing as an optimal liquidity level for all credit unions. One size doesn't fit all. It would be fair to say that optimal level would be different for each credit union as it ultimately depends on the pattern of its members' savings movements in and out. Looking at the aggregate figures for the last few years, the level of members' funds has remained relatively stable, even during the economic crisis. But it is not possible to predict future patterns and therefore each credit union must monitor the funds base very closely and must not place too much reliance on long term investing.

There should also be rigorous reporting in place and investments in AHB should be properly regulated.

**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?**

The limit of at least 25%, but perhaps best 50% of regulatory reserve would be appropriate. From the perspective of our credit union, the limit of 12.5% would be too low to enter into AHB investments.

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

Given the long-term nature of social housing project, the proposed 25-year maturity limit appears to be sensible.

It makes sense that Tier 1 and Tier 2 AHBs are ruled out as a potential investment class.

It may be appropriate to delay the implementation of this investment class until the governance for the sector has moved from a Voluntary Regulation Code to a mandatory statutory basis.

## 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.**

The dwindling pool of credit institution counterparties has led to this situation and with Bank of Ireland's recent interest rate decisions there are now only a handful of counterparties offering positive rates for deposits of any term length. The proposal is necessary but not particularly timely; as a general rule the regulations in force should be based on sufficient foresight to cater for situations that might develop not just those that are present or clearly imminent. 20% would appear to be a proper limit provided that the new classes of investments are approved and a sufficient transitional period is given to the credit unions to reconfigure their investment portfolio accordingly.

It is also worth bearing in mind that there is, in the sector generally, a very noticeable increase in concentration on fixed term investments with long maturity dates; this could be very inflexible in the event of the emergence of a continual long term trend towards higher borrowing or falling savings balances. It might be useful to consider a minimum level of investment of 5% or 10% in Irish and EEA State Securities as a supplement to liquidity levels, or to allow the value of Irish and EEA State Securities to count to a maximum of 5% of the overall liquidity limit of 20%. Another solution would be to introduce a maturity ladder of caps in the overall level of investments that could be held for various terms. The existing maximum limits of 50% over 5 years and 30% over 7 years would be supplemented by the addition of other limits at 3 years, 4 years and 6 years for example.

In addition of the maximum maturity limits; it would be very worthwhile to consider a cap on the overall level of deposits that could be held with credit institutions, even if this was as high as say 80%. This would have the effect of obliging credit unions to consider other investment options e.g. Government and Corporate Bonds, CIS etc.

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

In an environment where a very large proportion of credit union investments consists of fixed term deposit accounts with long maturities and no possibility of access in the interim, the introduction of a transitional arrangement is certainly necessary and to be welcomed. We would suggest that in at least some cases there will be credit unions whose term deposits with at least one entity (PTSB in particular) of longer than 12 months are significant enough to require a longer introductory period or a general waiver for any arrangements which existed at the time of the commencement of the new regulations. If a general waiver for existing arrangements was to be granted, then the 12-month transitional period should be sufficient.

## Collective Investment Schemes

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

We are obliged to re-examine the option of using CIS as a potential investment and have enquired of several investment advisers as to the possibility of doing so. The feedback to date is that there would need to be a critical mass of credit unions interested in the concept to make it work.

It appears to be correct to count the market value of any CIS investment towards liquidity and short-term liquidity, provided there is an option to sell units within a period of less than 8 days. This has the potential to make CIS a viable alternative to a call or short-term deposit account, which might attract a negative rate. A CIS can of course only perform as well as the underlying assets and at present it can only achieve a positive return by investing in longer term deposits or government or bank bonds with long maturities or with ratings at the lower end of the range of permitted ratings.

To avoid unnecessary transaction costs, there would also need to be a mutually understood expectation that credit unions only invested funds which they could reasonably be expected not to withdraw at short notice. It is generally our experience that there are significant elements of both liquidity (less than 90 days maturity) and short-term liquidity (less than 8 days maturity) that can remain in call accounts untouched over an extended period.

The participation of large number of credit unions should mean that the short term demands of any one credit union would not adversely affect the liquidity of overall fund.

An appropriately run CIS would allow credit unions to access a positive return by transforming the short maturity of our individual investments into longer term investments in bonds and term deposits.

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

There has been limited use of CIS to date for credit union investments, primarily because of the very limited availability of CIS that comply with the Credit Union Act 1997 (Regulatory Requirements) Regulations 2016, that is to say that are composed entirely of Irish & EEA state securities, accounts in credit institutions and bank bonds.

However, the current very poor returns from permitted investments may provide an opportunity for an investment provider to devise a CIS along the lines above to address a need in the credit union market for liquid investments with a positive yield.

## 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.**

We would suggest that there should be an interim period the publication of the statement feedback and the publication of the final regulations.

We agree with the timeline of the end of 2017, subject to a general waiver for all existing investments.