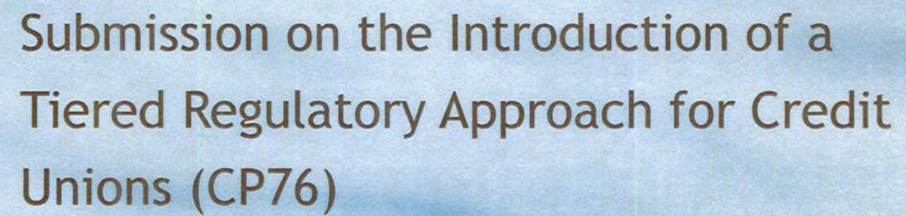


Submission on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP76)

March 2014

BDO Private Wealth Management Ltd

Private Wealth Management Limited

BDO PWM Response to the Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions. (Consultation Paper CP76)

As an Independent Investment Advisor to a significant number of Credit Unions throughout the country with combined assets of well over €1bn, we believe we are well positioned to comment constructively on the investment related proposals contained in CP76 and to highlight what we believe are some overly prescriptive changes to the current investment guidelines for Credit Unions. In light of this, we set out here in our views on the impact of proposed changes in the Consultation Paper CP76 which we believe will directly impact on member's savings.

4.8 (i) Do you agree with the proposed tiered regulatory approach for Credit Unions?

CP76 proposes a dramatic departure from the current Central Bank of Ireland (CBI) guidance note on investments. The proposals are extremely prescriptive. The main changes in CP76 are detailed in Table 1. In summary; Category 1 Credit Unions will be limited to sovereign bonds and deposits products to a maximum of five years and category 2 Credit Unions will have some additional latitude. The changes in counterparty limits and the minimisation of the investment universe will have a material impact on the investment returns available and a minimal impact on risk mitigation in a well-constructed investment portfolio under the current guidelines.

We estimate that currently under the Guidance note at today's available rates a Credit Union could achieve a return of 2.03% this would fall to 1.39% for an optimally invested Category 2 portfolio and 1.23% for an optimally invested Category 1 portfolio. This is would result in a c.31.5% fall in investment income for a Category 2 portfolio and a c.39.4% fall in investment income for a Category 1 investment portfolio. In our universe of Credit Unions investment income is c 50% of the total income for a Credit Union currently and we note that this is similar to the broader Credit Union movement. The impact of a c.15% to c.20% fall in income on a sustained basis will result in the need for further rationalisation in the movement at a time when it is already absorbing considerable additional costs to meet the new CBI regulatory requirements.

Table1: Summary of Changes

	2006 Guidance Note	Category 1	Category 2
Investments[1]			
Class 1			
Irish & EMU State Securities[2]	Max. 70% of Investments	Yes	Yes
Class 2			
Accounts in Authorised Credit Institution	Max. 100% of Investments	Yes	Yes
Class 3			
Bank Bonds	Max. 70% of Investments	No	50% of Regulatory Reserves
Class 4			
Investments in Equities	Max. 5% of Investments	No	No
Class 5			
Collective Investment Schemes	Yes	No	No
Counterparty Concentration	Max. 25% of Investments	100% of Regulatory Reserves	
Minimum Liquidity Requirement	20%	10% @ 7 days and 15% @ 30 day	
Maximum Maturity Requirements	10 years	5 Years Max. 50% over 3 years	7 years[3] Max. 50% over 5 years

Note 1: Only Euro denominated investments
Note 2: No minimum credit rating
Note 3: Government bonds will remain at a maximum of 10 years.

While we applaud the intention to simplify investments available to Credit Unions and we actively advise on effective risk mitigation and a reduction in Credit Union investment risk, we believe a by-product of CP76 as it stands, will be an over reliance by Credit Unions on structured deposits. These products often have embedded high fees and while the

principal is usually in a reasonably secure investment the return element of these products is often placed in a very high risk structure. This results in these products taking undue risks with member's investments to generate the return element of the investment while the fixed return of the principal often underperforms relative to a direct investments in a sovereign or bank bond.

5.12 (i) Do you agree with the proposals for the operation of the two category approach for Credit Unions set out in sections 5.1 - 5.11?

Categorisation Levels

We do not agree with the current proposal and believe that the gap in categorisations is far too broad. The difference in the structures, management and investments between a Credit Union of €10m and €100m are very different. At the upper end the proposals in CP76 are too prescriptive for a Credit Union of sufficient scale and resources. The proposals do not mitigate risk but curtail returns.

We note that all Credit Unions will initially be designated as a Category 1 Credit Union. It is expected that in general CU's that apply to become Category 2 CU's will have assets close to or above €100m. In our experience there are many professionally run Credit Unions of a smaller size very capable of managing a diversified investment portfolio and would disagree with this broad categorisation.

Chart 1: European Bond Yield since the Crisis

Source: Bloomberg, BDO Research

Due to the limited options available it is clear that Credit Unions will need to invest in Irish and EEA state securities. With counterparties limited to reserves in our example of a typical Credit Union which is 25% lent, with 10% reserves, the resulting counterparty limit would be c. 13%. This would require the Credit Union to invest with approximately eight counterparties as opposed to the current four. This is an extremely difficult challenge at a time of major consolidation in the Irish banking market. Appendix 4 shows the consolidation of the 14 banking options available pre-crisis to the current 7 options and this assumes no further consolidation. We would refer to the volatility in Sovereign bonds in recent years (Chart 1) and highlight that it is the quality and understanding of the specific investment and counterparty that is most crucial when managing investment risk and not the volume of counterparties.

In the absence of clarification on credit ratings it is not clear as to whether CP76 would in fact lead to excessive risk taking through structured products and certain EEA sovereign bonds as Credit Unions may attempt to shore up the business plan targets submitted to the central bank that support the viability of individual Credit Unions.

Reserves as a basis for Counterparty Limits

While we can appreciate the theoretical attractiveness for relating an institutions ability to absorb losses to the amount of capital/ reserves available to that institution, we consider this an unnecessary layer of complexity due to the prescriptive low risk investments allowed. As CP76 does not allow for risky investments the more straight forward percentage of investment calculation minimises the risk of a falling reserve level impacting the investment portfolio. We would favour maintaining static counterparty limits. A dynamic risk allocation as is proposed is not in the best interest of the Credit Unions from a governance perspective. An investment committee could at the time of an investment, lock in a term deposit that is fully compliant with CP76 that maximises their maximum allowable counterparty exposure at that time with a particular institution. . In the ongoing operation of Credit Union activities, the reserve levels may decline due to a number of factors. This could result in an unintentional breach for the Credit Union on an ongoing basis of its counterparty limits.

We believe the complexity of calculating counterparty exposures with impact on the Credit Unions normal Irish banks activity would in turn be seriously curtailed affecting the efficient running of the Credit Union.

We would question the merit of the addition of extra counterparties; the focus should be on the quality of counterparties and the analysis around a decision to include a particular counterparty as suitable. The process should not look for an abstract diversification benefit from an increased number of counterparties. The first bank to fail in the Eurozone crisis was IKB a German bank and the largest bank to fail in the crisis was Hypo Real Estate (parent of Depfa Bank) a bank that has never been rated below A by the rating agencies during the crisis, due to the intervention and nationalisation by the German government.

Under current guidelines and the Credit Union Act 2012 *'a Credit Union shall manage its investments to ensure that those investments do not involve undue risk to members savings'* so what we propose is already a legislative requirement for all Credit Unions and does not require further prescriptive counterparty restrictions. At BDO we carefully assess each Irish banking institution on behalf of the respective Credit Union boards and investment committees particularly as all the Irish banks are currently sub-investment grade institutions and it is necessary to demonstrate the suitability of counterparties as the guidelines currently stands.

Liquidity

In addition to the existing minimum liquidity ratio of 20% additional short term liquidity requirements will apply. Assets required being in liquid form of 10% of unattached savings available up to 7 days and up to 15% available in 1 month. Again domestic and international banking institutions will only pay EURIBOR rates of c. 23bps as opposed to the

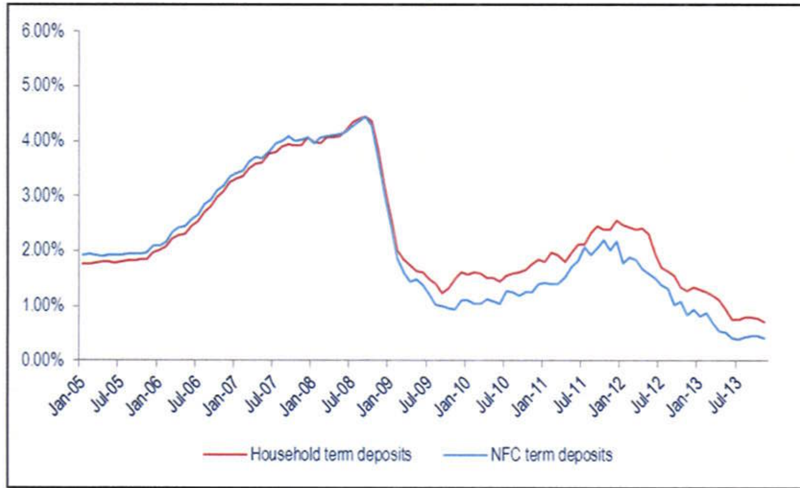
current short term rates of 50bps to 1.25% currently available on 1-3 month deposits. This is a portfolio impact of 4.6bps to 20.4bps on the entire portfolio and again is overly perspective and implies that Credit Unions have to date been incapable of managing short term cash requirements. This is not the case in our experience.

There is no rational provided for the inclusion of additional liquidity requirements but when the financial impact is considered it seems to be a disproportional cost impact relative to any effective incremental liquidity risk mitigation. For a €50m Category 1investment portfolio we estimate this will cost c. €50k per annum and for a €100m Category 2 portfolio this measure will cost €130k per annum with no obvious risk mitigation benefit over the existing guidelines.

Lending as an alternative to Investments

The Credit Unions in our universe are typically 25% lent. This is reflective of the movement as a whole. It is also the case that currently investments generate as much income for the Credit Unions as lending. This is expected to fall in the coming years as the domestic banks see a normalisation in their balance sheets and deposit margins continue to fall Chart 2 below shows the dramatic deterioration in rates currently available from the Irish covered banks (BOI; AIB; PTSB) for Credit Union deposits. We expect the downward pressure on deposit rates to continue as the Irish banks recover the confidence of international markets and normalise the funding arrangements.

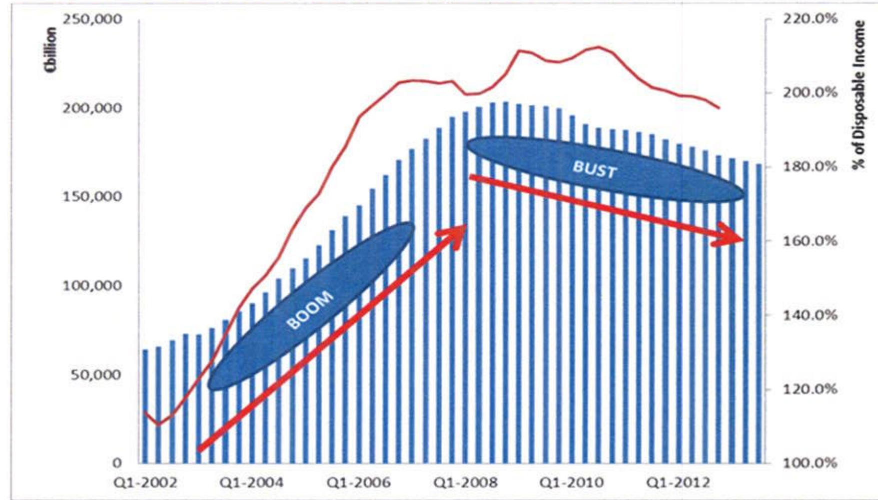
Chart 2: Irish banks short term deposit rates



Source: CBI, BDO Research

The Irish covered banks remain very reliant on ECB funding at this time so while we are comfortable with their capital positions on a funding basis we expect Irish banks will continue to pay a premium to their European peers for the medium term due to the size of the domestic banking balance sheet.

Chart 3: Private Sector Debt to disposable income



Source: BDO Research

Chart 3 above clearly shows how the Irish household remains too heavily indebted at this time for a change to a lending based income model in the short to medium term. Such a change needs to be implemented over a much longer time frame than that which is currently proposed.

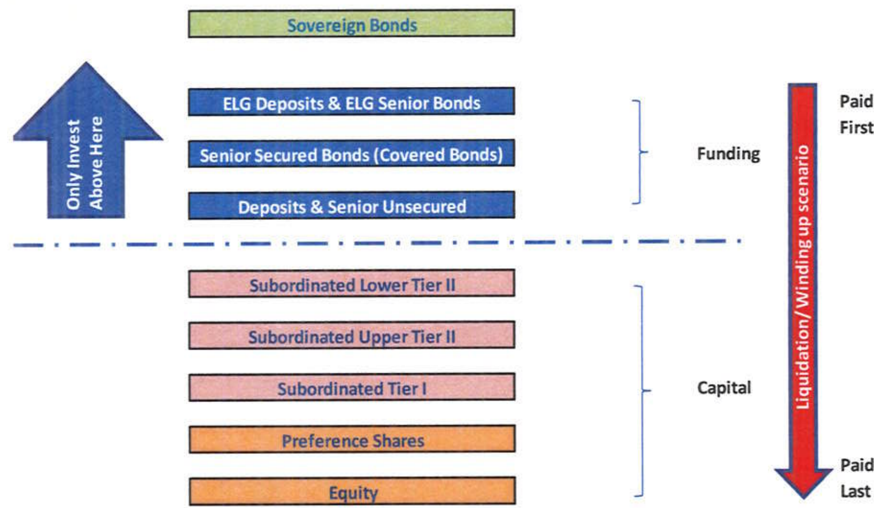
The proposals in CP76 would push the Credit Union movement to move away from investments and focus on lending which is of course the core business of Credit Unions. If there was reasonable quality lending to be carried out which is clearly not the case at this time, we would agree with this approach. We believe and are supported by publically available research, that this is the wrong moment in the credit cycle to encourage

Credit Unions away from reasonable investments that are a prudent use of members' funds.

Bank Bonds Allocation is Prohibitively Small

Under current legislation senior bank bonds and uninsured deposits rank pari passu. It is possible that this ranking may be subject to change under the European Central Bank (ECB) when it takes over the supervision of the European banks later this year following a rigorous balance sheet assessment process. We believe that Senior Bank Bonds in appropriate institutions should be included as an allowable investment vehicle for both categories of Credit Unions and investments in these instruments are in the best interests of suitably advised Credit Unions. Leaving money in uninsured deposits while preventing investment in suitable Senior Bank Bonds significantly reduces the returns available to Credit Unions while not mitigating the risks and perversely reducing risk adjusted returns available to the movement.

Chart 4: Counterparty Hierarchy



Source: BDO Research **Note:** Deposits refer to Uninsured Deposits.

We agree with CP76 in that no Credit Union investment should have the potential to be loss absorbing. In the chart opposite we would not consider any investment below the broken line where there is a risk to the principal in the normal course of the investment as an appropriate investment. Category 1 Credit Unions will not be allowed to invest in bank bonds currently covered under class 3 of the guidance note, a reduction from the current 70% of investment allowed. Category 2 Credit Unions will be allowed to invest 50% of reserves in bank bonds under CP76. This will materially curtail the investment returns available to Credit Unions going forward while having no impact on risk mitigation. This proposal will most likely result in higher risks in Credit Union investment portfolios as Credit Unions will be limited to structured deposits with a high risk return element.

In our example included in Appendix 1 we assume our Credit Union has reserves of 10% as proposed under CP76. In reality most Credit Unions would have reserves above this level but we are using the most conservative scenario in terms of reserves. We assume the Credit Union modelled is 25% lent and has investments of 75%. This would imply 100% reserves as a percentage of investment as c.13%. This in turn would only allow 6.5% of the investment portfolio of a Category 2 Credit Union to be invested in senior unsecured bonds that rank pari passu in the capital structure to uninsured deposits.

A Credit Union will be allowed to invest 100% in accounts in authorised credit institutions and this will include structured deposits that have their own specific risks relative to senior unsecured bonds. During the recent crisis it was structured deposits in IBRC that caused financial loss to Credit Unions. It is of note that not a single uninsured deposit or senior bank bond caused financial loss to a Credit Union. As the ECB takes over the supervision of the majority of the European banking system in late 2014, they will require all supervised banks to hold increasing levels of capital and to de-risk their balance sheets. Senior unsecured funding in banks and covered bonds should form a core element of a Credit Unions investment portfolio. These investments allow a Credit Union to optimise the fixed returns available at that time without undertaking unnecessary risks to generate the return element.

Even though CP76 is intended as a model for through the cycle it is clear that Ireland is in an unprecedented position in terms of our domestic banking landscape and sovereign credit position. To propose a model that disregards the current landscape is wholly unrealistic.

Impact on a Category 1 Credit Union

A Category 1 Credit Union will only be able to invest in bank deposits, Irish and EEA State securities (no mention of credit rating at this point) with a maximum duration of 5 years.

- This will result in a significant loss to CU's as they will no longer be able to invest in bank bonds. Bank bonds currently rank pari passu with deposits and allow Credit Unions to add additional investment income into their portfolio with the same counterparty risk. Even for Category 2 Credit Unions investment in Bank bonds will be limited to 50% of reserves which is penal.
- Ireland has had very limited issuance of Sovereign debt since the beginning of the bailout. Irish Sovereign bonds with a duration of less than 5 years currently trade at a significant premium to par. Many Credit Unions, as part of their accounting requirements, have to write-down such an investment to par at the time of purchase. In this case, investment in such Sovereign debt is prohibitive as such an investment with have a significantly negative impact on the Credit Union income. These means that although allowable, such short term Sovereign debt will not provide a Credit Union with any alternative to deposits because of the restrictive costs of investment.
- The NTMA currently has cash of c€30bn and we do not expect much short dated (less than 5 years) issuance in the coming 12 to 24 months, it will be several years before Ireland has a normal issuance programme for less than 5 year issuance that CU's could participate in.

Concentration and counterparty limits will be related to reserves.

- Up to 100% of a Category 1 CU's regulatory reserve. We estimate (simplistically; 10% regulatory reserve and 75% in investments) that this would be c. 13% of investments from the current 25%.
- Foreign banks such as BNP and KBC NV who do not have the Irish country risk premium pay c. 15 – 25bps for short term deposits. In the case of PTSB deposits this would cost €12k per million that had to be reinvested away from PTSB, and c. €11.5k for BOI deposits and c.€5.5k per million for AIB short term deposits.
- The introduction of this measure will result in a significant outflow from the Irish domestic banking sector. At a time when the ECB is looking to reduce its funding commitments to peripheral banks this seems to disadvantage both domestic banks and the Credit Unions that have supported the domestic banks through the crisis.

Lending volumes in all credit institutions including the domestic banks and Credit Unions have been anaemic during the crisis. The Irish consumer has continued to deleverage during the crisis and the savings ratio remains high reflecting the continued lack of confidence and elevated unemployment. Ireland's household debt to disposable income according to Central Bank data still remains one of the most elevated in Europe.

It is an impossible time in the credit cycle to prevent CU's from generating prudent investment income to ensure sustainability and to look for CU's to replace investment income with interest income in a short space of time. Everyone wants Credit Unions to return to lending but this will inevitably be a gradual process that will reflect a broader economic recovery in coming years.

These proposals will force CU's into deposit type structured products that contain extremely high fee structures relative to deposits and senior unsecured bonds. It is common that structured products while protecting the initial investment amount rely on highly speculative and at times, inappropriate investments, to generate the return element of the structured deposit relative to the needs of a Credit Union and its members. Credit Unions will be required to spend vast sums on sub-optimal deposit type investments that disadvantage the members relative to a direct investment in bank bonds.

Impact on a Category 2 Credit Union

A Category 2 Credit Union will be impacted by all of the key elements to impact on Category 1 with the exception that a Category 2 Credit Unions will be allowed to partially invest in bank bonds to 50% of reserves and a Category 2 Credit Union will be allowed to invest in Sovereign bonds out to 10 years. This should give Category 2 Credit Unions marginally more options when structuring an investment portfolio.

On the basis of our analysis contained in Appendix 1 below the introduction of the measure in CP76 will result in the loss of €631k or 31% of investment income in a €100m Category 2 Credit Union. The reduction is primarily driven by 1) lack of access to bank bonds and 2) lower access to the Irish covered banks and the requirement to diversify to

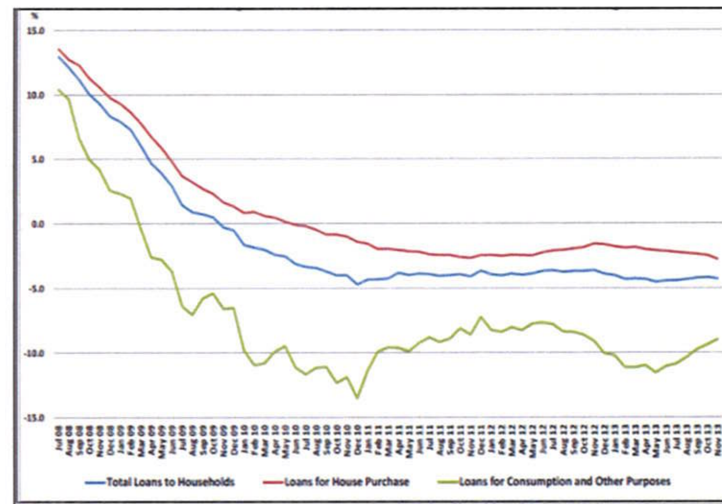
counterparties outside of Ireland and 3) higher liquidity requirements in lower interest earning deposits.

7.2 (i) Do you agree that the tiered regulatory approach should be introduced at this time?

(ii) If it is considered that the tiered regulatory approach should be introduced at this time, do you agree with the proposed timelines for the introduction of the tiered regulatory approach as set out in section 7.1, in particular the transitional period proposed between the publication and commencement of the regulations?

As stated previously in the submission we feel the proposals contained in CP76 are overly prescriptive, reduce investment returns without mitigating risks and could only be introduced very gradually over a long time period in line with the recovery in credit demand in the real economy. It is clear from the chart below that domestic credit in Ireland continues to contract at c. 10% year on year.

Chart 5: Irish Domestic Loan Growth



Source: CBI; BDO Research

We fundamentally believe that this is not the correct moment in the credit cycle to move aggressively to an increased dependence on interest income while the domestic consumer continues to deleverage the household balance sheet.

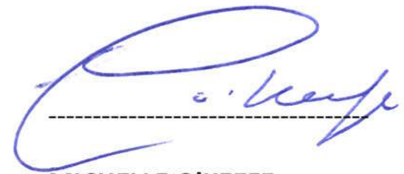
While appreciating that CP76 is a prescriptive set of guidelines for a through the cycle environment, the sudden implementation of CP76 will undermine the viability of many Credit Unions and cause unnecessary rationalisations in most. We would propose a far more gradual introduction at a minimum and we would strongly oppose changes in relation to counterparty limits and restrictions on investments in instruments such as bank bonds as a percentage of investments.

We would propose that the current 25% counterparty exposure, at worst be reduced to 20% but be maintained as a percentage of investments. While appreciating the rationale for relating investment risk to the capital

available, a Credit Union is an ungeared institution unlike a bank and has a very restricted universe of reasonably low risk investments as it stands. Further restrictions and complexities are unnecessary and unlikely to have any material impact from a risk mitigation perspective.

We would strongly argue that bank bonds should form a core element of an investment portfolio and we would maintain the current guidance note criteria for the investment in bank bonds. Prohibiting investment in bank bonds has a disproportionate impact on investment returns available. Credit Unions have institutional size investment pools and should not be disadvantaged from being able to access returns for a similar risk profile for their members.

This submission is made on behalf of BDO Private Wealth Management Limited by the following:



MICHELLE O'KEEFE
Managing Director

KARL GOGGIN
Investment Director

BDO Private Wealth Management Limited is regulated by the Central Bank of Ireland under the European Communities (Markets in Financial Instruments) Regulations 2007 as an Investment Firm.

Appendix 1: Model for CP76 Impact

	Return	Allocation %			€50mn Investment Return in €		€100mn Investment Return in €		
Class 1 (Irish & EMU State Securities)		Current	CP76 Category 1	CP76 Category 2	Current	CP76	Current	CP76 Cat. 1	CP76 Cat. 2
Irish State Securities (5 Year)	1.43%	0%	13%	5%	-	93,210	-	186,420	71,700
EMU AA Rated State Securities (5 Year)	0.92%	0%	20%	25%	-	91,725	-	183,450	229,313
EMU sub-AA Rated State Securities (5 Year)	2.04%	0%	0%	0%	-	-	-	-	-
Irish State Securities (10-Year)	3.06%	10%	0%	8%	152,750	-	305,500	-	244,400
EMU AA Rated State Securities (10-Year)	2.05%	0%	0%	10%	-	-	-	-	205,425
EMU sub-AA Rated State Securities (10-Year)	3.35%	0%	0%	0%	-	-	-	-	-
Total		10.0%	33.0%	48.0%	152,750	184,935	305,500	369,870	750,838
Class 2 (Deposits)									
≤ 7 Day									
Euribor	0.19%	0%	10%	10%	-	9,550	-	19,100	19,100
≤ 30 Day									
Euribor	0.23%	0%	5%	5%	-	5,725	-	11,450	11,450
≤ 90 Day									
Irish Covered Banks Deposits	1.60%	15%	10%	5%	120,000	80,000	240,000	160,000	80,000
Non-covered Irish deposits	1.10%	5%	0%	5%	27,500	-	55,000	-	55,000
Euribor	0.30%	0%	0%	0%	-	-	-	-	-
≥ 90 Day ≤ 1 Year									
Irish Covered Banks Deposits	1.50%	10%	10%	10%	75,000	75,000	150,000	150,000	150,000
Non-covered Irish deposits	1.05%	10%	0%	5%	52,500	-	105,000	-	52,500
Euribor	0.57%	0%	0%	0%	-	-	-	-	-
≥ 1 Year ≤ 3 Years									
Irish Covered Banks Deposits	2.05%	15%	20%	5%	153,750	205,000	307,500	410,000	102,500
Non-covered Irish deposits	1.00%	0%	10%	0%	-	50,000	-	100,000	-
Euribor	0.62%	0%	2%	0%	-	6,220	-	12,440	-
Total		55.0%	67.0%	45.0%	428,750	431,495	857,500	862,990	470,550
Class 3 (Bank Bonds)									
Irish Covered Banks bonds ≤ 3 Years	2.25%	25%	0%	3.0%	281,250	-	562,500	-	67,500
Irish Covered Banks bonds ≤ 5 Years	3.00%	10%	0%	3.5%	150,000	-	300,000	-	105,000
Total		35.0%	0.0%	6.5%	431,250	-	862,500	-	172,500
Total		**100%**	**100%**	**100%**	**1,012,750**	**616,430**	**2,025,500**	**1,232,860**	**1,393,888**
Weighted Average Return		2.03%	1.23%	1.39%	2.03%	1.23%	2.03%	1.23%	1.39%
Irish Covered Banks Exposure		75%	50%	37%	75%	50%	75%	50%	37%
Irish Sovereign Exposure		10%	13%	13%	10%	13%	10%	13%	13%
Liquidity		20%	25%	32%	20%	25%	20%	25%	32%
Change			(0.79%)	(0.63%)		(396,320)		(792,640)	(631,613)

Appendix 2: Changes proposed in CP76 from existing CBI Guidance note

	2006 Guidance Note	Category 1	Category 2
Investments[1]			
Class 1			
Irish & EMU State Securities[2]	Max. 70% of Investments	Yes	Yes
Class 2			
Accounts in Authorised Credit Institutions	Max. 100% of Investments	Yes	Yes
Class 3			
Bank Bonds	Max. 70% of Investments	No	50% of Regulatory Reserves
Class 4			
Investments in Equities	Max. 5% of Investments	No	No
Class 5			
Collective Investment Schemes	Yes	No	No
Counterparty Concentration	Max. 25% of Investments	100% of Regulatory Reserves	
Minimum Liquidity Requirement	20%	10% @ 7 days and 15% @ 30 day	
Maximum Maturity Requirements	10 years	5 Years Max. 50% over 3 years	7 years[3] Max. 50% over 5 years

Note 1: Only Euro denominated investments

Note 2: No minimum credit rating

Note 3: Government bonds will remain at a maximum of 10 years.

Appendix 4: Pre and Post crisis Irish Banking Landscape

Irish Covered Banks deposit Rates	BOI	AIB	PTSB	**Average**
Call	0.30%	0.30%	0.60%	**0.40%**
1 Month	0.30%	0.45%	0.75%	**0.50%**
90 Day	1.40%	0.75%	1.60%	**1.25%**
1 Year	1.50%	1.10%	1.90%	**1.50%**
3 Year	1.65%	2.00%	2.50%	**2.05%**

Non Covered Banks Irish deposit rates	Ulster Bank	KBC	Rabobank	**Average**
Call	0.75%	0.75%	1.00%	**0.83%**
1 Month	1.13%	1.00%	1.00%	**1.04%**
90 Day	1.30%	1.00%	1.00%	**1.10%**
1 Year	1.15%	1.00%	1.00%	**1.05%**
3 Year	-	1.00%	1.00%	**1.00%**

Euribor Deposit Rates	
7 day	0.191%
30 day	0.229%
90 day	0.299%
1 Year	0.567%
3 Year	0.622%
5 Year	1.012%

Bank Bonds	BOI	AIB	**Average**
≥ 2 Years ≤ 3 Years[1]	2.000%	2.500%	**2.25%**
≥ 3 Years ≤ 5 Years[1]	3.000%	-	**3.00%**
≥ 5 Years ≤ 10 Years[2]	2.000%	2.000%	**2.00%**

Note 1: Senior Unsecured

Note 2: Covered Bond

Sovereign Bonds	**Ireland**	**France**	**Belgium**	**Netherlands**	**Austria**	**AA Rated**	**Italy**	**Spain**	**Non AA Rated**
5 Year Benchmark	**1.434%**	1.028%	1.006%	0.847%	0.788%	**0.917%**	2.079%	2.005%	**2.042%**
10 Year Banchmark	**3.055%**	2.183%	2.308%	1.833%	1.893%	**2.054%**	3.377%	3.313%	**3.345%**

Appendix 4: Pre and Post crisis Irish Banking Landscape