Carrickmacross Credit Union's submission in relation to The Central Bank of Ireland's Consultation process on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76)

Executive Summary

Carrickmacross Credit Union is a well established (50 years) credit union serving a common bond area with a population of approximately 15,000 people. The assets of the Carrickmacross Credit Union at 30 September 2013 were almost €84m of which investments were €72m and loans were €11m net of provisions. With members' shares at €65m the Credit Union's reserves stand at over €18m (27%). Our Credit Union has weathered the storm since the eruption of the financial crisis in 2008 and continues to return a healthy surplus annually.

The Report of the Commission on Credit Unions recommended, among other things, that the regulatory framework should be strengthened for credit unions and that this framework should include a tiered structure. Our Credit Union supports the strengthening of the regulatory framework but is concerned that some of the proposals being mooted will have a detrimental effect on the ability of our Credit Union to generate income and will be damaging to the Credit Union movement in general.

In December 2013, the Central Bank published a consultation paper ('CP76') which is seeking input from the movement on proposed activities and services, including lending and investments that it proposes be undertaken within a tiered structure. Based on initial analysis, the proposals, if implemented, are likely to have far-reaching implications for the movement's savings, loans and investments.

The Investment income being generated by our Credit Union is already under pressure due to much lower returns on deposits available in the market place. It is our understanding that this is likely to be further impacted by the introduction of Basel III. The proposals contained in CP76 are likely to further adversely affect our Credit Union's ability to generate income and growth in general may be inhibited as a result. In addition and due to the introduction of reduced counterparty limits, there will be significant transfers of deposits from Irish to foreign banks.

Issues specific to our Credit Union

We have asked our investment advisor, Davy Stockbrokers, to provide us with an analysis of the effect that the new proposals would have on Carrickmacross Credit Union's investment portfolio and the results of this analysis is shown in the attached table:

Description	Current Allocation		% Portfolio
Investments which are not authorised under proposals	Government bonds (maturity > 5 years)	€3.5 million	4.89%
	Collective Investment Schemes	€3.8 million	5.20%
	Bank bonds	€4.2 million	5.77%
	Structured investments (bank bonds)	€3.08 million	4.19%
	Total	**€14.58 million will need to be allocated to cash deposits or short-term government bonds**	**20%**

	Counterparty	€ Exposure > 100% Regulatory Reserves	Current Exposure as a % Regulatory Reserves
Breaches of proposed counterparty limit of 100% regulatory reserves (€12.5 million which is approximately 17% of the investment portfolio)	BOI	€4.3 million	134% regulatory reserves
	PTSB	€4.9 million	140% regulatory reserves
	KBC Bank	€2.7 million	122% regulatory reserves
	Total	**€11.9 million will need to be allocated to alternative counterparties**	**16% of investment portfolio**

	Sources of liquidity	€ Amount	% Total Liquidity
Liquidity management: Credit unions will need to divert funds from collective investment schemes and access / step-up accounts to call accounts or alternative liquid investments	Call accounts	€2.1 million	10.58%
	Term investments nearing maturity	€3.1 million	16.02%
	Collective Investment Schemes	**€3.8 million**	19.26%
	Access/Step-up accounts	**€10.7 million**	54.14%
	Total	**€14.5 million will need to be allocated to call accounts or alternative liquid investments**	

	Limit	Current %	OK / Breach?
Maturity limit	No more than 50% of the portfolio may mature after 3 years	25% investment portfolio	OK
Short-term Liquidity Constraints	At least 10% of unattached shares must be available 0-7 days	19% unattached shares	OK
	At least 15% of unattached shares must be available up to 1 month	21.3% unattached shares	OK

i. **The impact on investment income**Our primary observation is that the proposed changes, as outlined, are likely to have an adverse impact on our credit unions investment income. This is at a time when it is already very difficult for credit unions to generate income. Our loan to asset ratio is 13% and the investment/asset ratio is 86%. We rely on investment returns to supplement the loan interest income in order to ensure sustainability in the current adverse economic environment. Investment income represents 66% of the total income generated by our credit union in the year ending 30th September 2013. According to the research prepared by Davy, investment income will be adversely affected by the proposed investment limits for the following reasons:

a) Increased reliance on call deposits: Credit unions are likely to become more reliant on call deposit accounts which are yielding minimal returns. The average call rate available to credit unions from Irish banks16 is 0.43% and we anticipate that this rate will drop further as the Irish banks fully implement Basel III liquidity ratios17. It is likely to move closer towards the average call rate of 0.14% that is currently available from non-Irish banks18, which in the main have been more progressive in implementing Basel III. We can anticipate an increased reliance on call deposits for the following reasons:

Collective investment schemes:

- *The proposed exclusion of collective investment schemes as authorised investments may push credit unions into lower yielding call deposits in order to meet their liquidity requirements.*
- *Class 5 collective investment schemes have served credit unions well as an effective means of managing liquidity, diversifying counterparty risk and ensuring that a meaningful return is achieved on liquid funds.*
- *175 credit unions are currently invested in and have balances greater than €100,000 in Class 5 collective investment schemes[19] which are 100% deposit based and currently yielding around 1% variable (net of fees), which is in marked contrast to the call deposit rates outlined above.*
- *As professionally managed funds which are subject to separate and rigorous independent regulation, the inclusion of unit trusts as an investment class brings an additional layer of regulatory supervision and therefore supports the objective of strengthening the investment framework.*
- *We view it as unlikely that the credit union movement will achieve a new classification under the Basel III ratios of LCR and the NSFR. Cash-based unit trusts may therefore be one investment which may assist participating unit holders in mitigating some of the negative impact of Basel III.*

Access accounts are unlikely to be available in a Basel III investment world:

- *We estimate that credit unions are achieving approximately 50% of their required liquidity from access accounts, step up deposits or term deposits with one-off access features.*
- *Such deposits offer attractive rates which mean that they generate attractive income while making an important contribution to credit union liquidity requirements.*
- *Once banks have fully implemented Basel III liquidity ratios, access accounts will no longer be an attractive means of raising funding for banks and are highly unlikely to be available any longer. Therefore, credit unions will be more reliant on call deposit accounts in order to meet their liquidity requirements.*
- *It should be stated that we anticipate that this trend will adversely affect credit unions' investment income regardless of any changes to the investment framework. However, the absence of collective investment schemes and the introduction of short-term liquidity constraints against this backdrop may exacerbate the negative impact on credit unions.*

b) Lower yielding universe of authorised asset classes and investments: We expect that the vast majority of credit unions would be classified as Category 1 credit unions due to the indicative asset size threshold of €100 million for Category 2 credit unions. Therefore, in the main, credit unions will be restricted to a lower yielding universe of authorised asset classes and investments:

Category 1 credit unions will no longer be able to invest in collective investment schemes, bank bonds and longer term government bonds.

This may force some credit unions to increase their allocation to cash deposits which are a lower yielding asset class.

The yield differential between a 5-year senior bank bond with Bank of Ireland and a 5-year cash deposit rate is currently 0.93%[20].

Category 1 credit unions will not be able to purchase government bonds with more than 5 years term to maturity; this limits them to a lower yielding universe of government bonds.

The 10-year Irish government bond is yielding 3.26% in contrast to the 5-year government bond which is yielding 1.93%[21].

c) Counterparty limits:

The consultation proposes a counterparty limit of 100% of Regulatory Reserves.

Based on our analysis, we estimate that this limit, on average, translates to approximately 18% of the investment portfolio. However, some credit unions' Regulatory Reserves represent just 13% of the investment portfolio, while a smaller number's Reserves represent as much as 52% of the investment portfolio.

This means that certain credit unions may need to introduce or increase exposure to three to four additional counterparties, while others could potentially limit their exposure to just two counterparties. Therefore, the proposed measures do not provide for such extremes which have no real basis in an appropriate investment thesis.

Whilst the diversification of counterparty risk to a wider range of counterparties is a sensible and prudent investment strategy in theory, based on our sampling, the dilution may be excessive. It is also likely that such counterparties may offer lower yielding cash deposits and therefore this proposal is likely to adversely impact investment income.

In certain instances, deposit products available are limited to overnight deposits only (Rabobank) while other institutions offer few deposit alternatives beyond 12 months. Furthermore, in an environment where international banks are closing their deposit taking facilities in Ireland, we believe that some credit unions may struggle to source an appropriate number of suitable deposit-taking counterparties.

Such credit unions may be forced to allocate to government bonds which may introduce unnecessary volatility to the investment portfolio.

It is noteworthy that senior bank bonds are not included as an authorised investment class for Category 1, and therefore such credit unions will not be able to use senior bonds as a means of diversifying counterparty risk.

ii. More Complex Investment Framework. The proposed framework is more complex in nature and may require additional management:

Credit unions will be required to manage investments with regard to at least three different reference points. For example, the proposed counterparty limit and asset concentration limits are referenced off regulatory reserves, liquidity is referenced off unattached shares, and maturity limits are laid out as a percentage of the investment portfolio.

A lower counterparty limit means that additional counterparties may need to be added to the investment portfolio, which may be more onerous in terms of management.

Liquidity will be more difficult to manage. The introduction of short-term liquidity constraints means that liquidity will require additional attention and management. We believe that the majority of credit unions would currently meet the proposed limits.

However, we expect that it may be more difficult to meet the constraints in the future as access accounts become less prevalent and if collective investment schemes are excluded as proposed, attractive liquid investments or term investments with access will be more difficult to source.

It may be harder to manage excess liquidity in the absence of authorised collective investment schemes which have been the foundation of a number of credit unions' investment portfolios heretofore.

Finally, the proposed exclusion of bank bonds and longer term government bonds for Category 1 reduces the potential for exposure to liquid marketable securities which play an important function in investment portfolios and contingency funding plans. In the event of an unforeseen liquidity event, they often represent a critical source of additional liquidity.

iii. Cap on Savings of €100,000. We note that there is a proposed cap on savings of €100,000 for both Category 1 and 2 credit unions. In our view, this is penal and potentially obstructive to growth, especially for those core credit unions which are candidates to become the hub of mergers and acquisitions in the years to come. This cap may act as a hindrance to the growth of credit unions' savings, and by consequence, the expansion of loan books and investment portfolios. Our Credit Union currently has imposed its own cap on savings as a specific measure to protect existing members when there is limited lending and investment returns are poor. However, as lending increases we may wish to attract further members savings to meet demand.

iv. Additional Unintended Consequences. The proposed counterparty limit is likely to result in an exodus of cash from the Irish banking system.