FIRST CHOICE
CREDIT UNION LTD.

FOR SAVINGS, FOR LOANS, FOR YOU

Submission to the Central Bank of Ireland on CP109

June 2017

Introduction

First Choice Credit Union is a community based Credit Union, headquartered in Castlebar, Co. Mayo, managing over €190m in assets and serving 27,000 members through its 5 branch offices.

We make this submission to the Central Bank of Ireland to address many of the questions listed in Section 7 of CP109, and we also make a number of additional observations.

One such observation is that the income generated from investment of Credit Union member's surplus funds is currently an important contributor to the overall operating income in the sector. Particularly so since personal lending levels generally in the sector are not yet fully recovered. Any further downward pressure on this income stream may negatively impact surplus generation.

Views Requested by the Central Banks

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.*

It is interesting, but not surprising, to see the level of concentration of credit union investments in the financial sector, with 91% of all investments in financial institutions, and 70% in just five counterparties. This is an unhealthy level of risk concentration, and is inconsistent with good investment risk management. The potential impact of BRRD on bank bonds and deposits, as outlined in CP109, makes this level of risk concentration all the more inappropriate.

The only real alternative to financial institutions allowed under the current regulations is euro zone sovereign bonds, and with a very large proportion of those bonds trading at negative yields in recent times (or at best, at very low positive yields), it is not surprising that they account for such a low proportion of credit union investments.

Sovereign bonds undoubtedly offer a low-risk diversification option to credit unions, but while the current interest rate environment persists, and while earning sufficient income continues to be a major challenge for many credit unions, it would be unrealistic to expect any significant increase in sovereign bond investments on the part of credit unions.

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?*

CP109 has highlighted the unhealthy concentration of credit union investments in the financial sector, and so we welcome any proposals that would offer real diversification opportunities.

Of the proposed new investment classes, supranational bonds and corporate bonds are logical additions to the existing range of investment classes, as they have similar risk profiles while offering the potential for counterparty diversification.

For reasons that we explain below, we believe that supranational bonds are unlikely to become a significant investment class for credit unions. Investments in AHBs would clearly be a very new departure in many ways relatively to any investments that credit unions have made up to now, and it is difficult at this point to gauge how much appetite credit unions would have for such investments, or indeed how much interest AHBs would have in receiving investments from credit unions.

In our opinion, corporate bonds is the only proposed new investment class that has the potential to become a significant part of credit union investment portfolios, but as we discuss below, this cannot happen within the proposed concentration limits.

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.*

Given the understandable wish of the Central Bank for credit unions to only invest in low-risk, 100% capital-protected investments, the range of suitable investment classes for credit unions is very limited, and apart from the existing and proposed new investment classes there are no others that we can suggest at this point that would meet the required risk profile. However, we feel that if appropriate concentration limits were applied to the existing and proposed new investment classes, there would be reasonable scope for asset-class and counterparty diversification.

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?*

As stated above, we welcome any proposals that would offer new diversification opportunities for credit unions. However, for a number of reasons, we believe that bonds issued by supranational entities are unlikely to significantly broaden the range of investment options.

Firstly, the number of such entities that issue euro-denominated bonds in significant size is very limited. Secondly, the risk and return profile of such bonds is very similar to that of the bonds issued by the governments that form and support these supranational entities, and for the reasons outlined earlier, those sovereign bonds are not attractive options for credit unions in this investment environment.

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.*

We don't expect that these bonds will ever becoming a significant part of credit union investment portfolios, and so we don't believe that the proposed limit of 50% of a credit union's regulatory reserve would be restrictive.

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?*

We believe that corporate bonds would be a very welcome addition to the range of investments available to credit unions. As an investment class, corporate bonds are very similar in structure and risk profile to bank bonds, and in that regard they are a logical extension to the existing investment options. However, as corporate bonds are so similar to bank bonds, we see no reason why similar credit rating requirements and concentration limits should not apply to them. We expand on this point below.

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.*

While we welcome the addition of corporate bonds as an investment class, we believe that the proposed concentration limit of 25% of a credit union's regulatory reserve would render it almost meaningless in terms of allowing greater investment-class and counterparty diversification.

According to CP109, 25% of the regulatory reserve would on average equate to 4.2% of a credit union's investment portfolio. In our opinion, of the three proposed new investment classes, corporate bonds is the only one with the potential to offer significant risk diversification away from the financial sector, but a limit of around 4.2% would massively curtail that potential. To have any real impact on risk diversification, the limit would need to be far higher.

We do not understand the rationale of having an effective concentration limit on corporate bonds of 4.2%, with a minimum credit rating of A, while the concentration limit on bank bonds is 70%, with no minimum credit rating requirement. If security of investments is the most important issue, and if credit ratings are the best available measurement of investment security, we believe that consistent concentration limits and credit rating requirements should apply across the two investment classes.

In the investment world, bank bonds and corporate bonds are not generally seen as two separate investment classes. Bank bonds are considered a subset of corporate bonds. Our suggestion would be to have a concentration limit of 70% on all corporate bonds (including bank bonds), with a minimum requirement of an investment-grade credit rating.

If including bank bonds and corporate bonds in the one investment class is not an option, we would suggest that the concentration limit on corporate bonds is set at level that would allow meaningful diversification into that class. In our opinion, that would require a limit of no less than 100% of the regulatory reserve, or an equivalent figure – e.g. 20% of the investment portfolio or 15% of total assets.

Investment in Approved Housing Bodies (AHB's)

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

The proposal to allow investments in AHB's is potentially the most radical. Investments of up to 25 years would be a major departure for credit unions from anything done to date in terms of either lending or investment and would have significant implications for asset / liability management.

While we welcome the opportunity, in principle, for credit unions to invest in AHB's, in the absence of any specific details regarding returns, risk or underlying exposures it is difficult to comment any further.

Counterparty Exposure Limits

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 believe that credit unions should diversify their investments as much as reasonably possible, and we have always believed that in an ideal world a credit union's maximum exposure should be well below 25%. In reality, in the current environment, with a lot of financial institutions effectively withdrawing from the deposit market, achieving that level of diversification can be difficult.

We acknowledge that one of the aims of the proposed changes to the list of investment classes is to offer greater diversification options, allowing credit unions to have less concentration in a small number of counterparties. However, as we have explained, we don't believe those proposals, as they stand, will make a major difference in that regard.

So, while in principle, we are in favour of the proposal to reduce the counterparty limit, we believe that without any further real diversification options available to make it easier to stay within that limit we believe that reducing the counterparty exposure to 20% at this time will simply make planning short term deposits much more difficult without making any real difference to reducing risk.

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

Our only comment in relation to the transitional arrangements is that there may be instances where a credit union has more than 20% exposure to a counterparty at the beginning of the transitional period, and it may not have sufficient maturities during the transitional period to reduce exposure below 20%. We would suggest that in this situation a credit union should not be forced to sell an investment before maturity, as this could involve a significant cost.

Collective Investment Schemes

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

Collective investment schemes have the potential to offer very good, well-manged, low-risk diversification options for credit unions. Unfortunately, due to a combination of regulatory restrictions and the current interest rate environment, that potential isn't being realised at present, and the amount invested by credit unions in collective investment schemes is currently very low.

The requirement that credit unions only invest in collective investment schemes where the underlying instruments are comprised only of sovereign bonds, bank deposits and bank bonds greatly limits the number of compliant schemes. The overwhelming majority of collective investment schemes do not meet those requirements. The introduction of corporate bonds as an investment class may open up a wider range of schemes to credit union investments, or may make it more viable for investment managers to structure collective investment schemes aimed at the credit union market.

With yields on sovereign bonds, bank bonds and bank deposits at current levels, it is extremely difficult for any credit union-compliant collective investment scheme to generate a positive return net of fees. That is why any such schemes are not attractive to credit unions at the moment.

While credit unions are not investing in collective investment schemes to any significant degree at present, that could change whenever interest rates recover, and we believe that they have the potential to become a valuable asset class for credit unions again in the future.

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

See comments in 16 above.

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 are happy with the proposed timelines.

Other Comments

Bank Bond Definition

CP109 states that the Central Bank proposes to amend the definition of bank bonds to exclude bonds which in any scenario would be subordinated to any other unsecured liabilities or creditors of a credit institution or which are issued by a holding company. Many banks (including the Irish banks) will in future issue their senior debt via holding companies. Others will have a number of tiers of senior debt, making all but the "senior-senior" non-compliant. This has the potential to drastically reduce the range of bank bonds on offer to credit unions, and all but eliminate bank bonds as an investment class. At a time when many banks have effectively withdrawn from the deposit market, bank bonds are the only alternative for finding counterparty diversification within the financial sector.

The reality is that many "non-preferred" or "junior-senior" bonds which will be excluded under this proposed new definition will have stronger credit ratings than "senior-senior" debt in other institutions which will still be permitted, by virtue of the fact that the debt is being issued by far more secure institutions.

We stated earlier that if security is the most important issue in relation to credit union investments, and if credit ratings are the best available measurement of investment security, we believe that consistent credit rating requirements should apply across different investment classes. We believe that this should also apply within investment classes, and so we suggest that the requirement for a bank bond, regardless of its status, should be that it has an investment-grade credit rating.

Conclusion

We welcome any proposals to address the over-concentration of credit union investments in financial institutions, and in particular we believe that the introduction of corporate bonds as an investment class has the potential to go some way towards achieving this. However, we also believe that the concentration limit for corporate bonds as currently proposed will greatly restrict the extent to which it will allow credit unions to diversify their investments, and that the limit on these bonds should be significantly increased.

The revised definition of bank bonds which will exclude all senior debt except "senior-senior" debt issued by operating companies is likely over time to virtually eliminate bank bonds as an investment class, leading to a greater concentration of investments into deposits at an ever-decreasing number of financial institutions. We would propose that in order to have consistency in terms of the security of investments, the compliance or otherwise of a bank bond should be based on its credit rating rather than its ranking within the capital structure of the bank. In that regard, we would suggest that the minimum credit rating for a bank bond, and indeed for any bond, should be investment grade.