St Francis Credit Union

Response to the Proposals in CP109

Registry Of Credit Unions,
Central Bank Of Ireland,
PO Box 559,
New Wapping Street,
North Wall Quay,
Dublin 1.

28th June 2017

Dear Sir/Madam,

St Francis Credit Union is a large community credit union based in Ennis Co. Clare and serves the areas of Mid, West & East Clare. Our credit union has assets of €190m, employs 37 staff and has 8 offices.

As a stakeholder in the sector we welcome the opportunity to make a submission to the Central Bank of Ireland (CBI) on consultation paper CP 109.

It is our opinion that the implementation of the provisions of this consultation paper will have a devastating effect on the ability of credit unions to remain viable and will almost certainly be a large contributory factor of the wind-up of a large number of credit unions in the future. The viability factor has to be viewed as the ability of the credit union to be financially sustainable in generating sufficient surplus to meet both its statutory obligations, its member's expectations and meet its growth ambitions.

St Francis Credit Union has had investment advisors in place since early 2010. This was well before this notion was fashionable or desirable and it was recognition by the Board of our credit union of the importance of having the requisite level of expertise involved in the decision making process for investments. That decision has proven to be a major cog in the success of our credit union and the ability of our board to understand the risks involved and the requirement to having expertise involved to mitigate the risk.

The investment classes of St Francis Credit Union has remained reasonably similar over the last number of years and would typically be that as set out in the March 2017 Prudential return:

Irish & EFA State Securities	€16.079m	10.70%
A/c in authorised Inst.	€64.045m	42.75%
Bank Bonds	€69.536m	46.55%

The expectation as a result of the introduction of the key proposals under CP 109 namely allow investment in supranational bonds, allow investment in corporate bonds, allow investment in Approved Housing Bodies, amend the definition of bank bonds to exclude any class of bond which would be subordinated in a bank resolution and reduce the counterparty limit from 25% to 20% would be a reduction in investment income to the tune of at least 30%. The effect of the measures outlined on out credit union on average investment returns, return on assets and surplus as % total assets can be seen on the tables below.

Pre CP 109

Year	2017	2018	2019	2020	2021
Inv Average Return	1.42%	1.13%	1.01%	0.92%	0.84%
As % total Income	34%	30%	27%	25%	23%

Total Income	€6,249,171	€5,706,689	€5,610,381	€5,558,483	€5,540,764
Surplus	€1,722,644	€1,181,031	€981,396	€834,429	€727,282
Return on Assets	0.88%	0.58%	0.46%	0.38%	0.32%
Surplus % Total Income	27.57%	20.70%	17.49%	15.01%	13.13%

Post CP 109

Inv Average Return	1.42%	1.11%	0.92%	0.78%	0.75%
As % total Income	34%	29%	25%	22%	21%

Total Income	€6,249,171	€5,665,689	€5,476,381	€5,346,483	€5,403,764
Surplus	€1,722,644	€1,140,031	€847,396	€622,429	€590,282
Return on Assets	0.88%	0.56%	0.40%	0.28%	0.26%
Surplus % Total Income	27.57%	20.12%	15.47%	11.64%	10.92%

1.1 Bank Bonds - Risk Profile

The Central Bank has not taken into account the nature, scale, and complexity and risk profiles of credit unions when drafting the consultation paper. In the case of St Francis Credit Union we have included a figure of almost €1m in our Operational Risk Reserve (ORR) that relates to default risk on bank bonds. This reserve has been in place since the commencement of our ORR. Below is an extract from our Reserve Policy setting out the calculation of the Investment ORR calculation. This calculation should give the Central Bank a degree of comfort that a Credit Union of our ilk understand the risks involved in investing in Bank Bonds and that a credit union who can show process, knowledge and mechanism should be allowed through a tiered system or otherwise to continue to be allowed to use Bank Bonds as a means of generating investment returns.

Description of method used by this credit union to calculate the “Investments ORR” element of its “Total ORR figure”:

The necessary workings are initially completed by the general manager and the risk management officer (RMO) who will follow the steps set out below:

- Review the credit union’s investment portfolio and identify all bank bonds and government bonds (i.e. Irish and EEA state securities).

- Separate out the bank and government bonds by issuer (i.e. governments and financial institutions).

- Analyse out the bonds of each issuer by the accounting year in which the bonds will mature (maturity years) – known as “tranches of bonds” for the purpose of this calculation.

- Obtain the “long term institutional credit rating” for each of the issuers.

- Assign a “default probability percentage” to each of the issuers based primarily (but not exclusively) on the issuers “long term institutional credit rating”. This is a subjective process based on the opinions of the general manager and the RMO (including any advice received from the credit union’s investment advisers). The following table can be used as a reference basis;
  Default Unlikely – 0% to 5%
  Default Possible – 6% to 15%
  Default Moderate – 16% to 30%
  Default Probable – 31% to 75% - Possibly Provision included in the F.S.’s instead.
  Default Definite – 75% to 100% - Possibly W/o or Provision included in the F.S.’s instead.
- Assign a “bond term score” to each of the maturity years. Again, this is a subjective process based on the opinions of the general manager and the RMO. The following table can be used as a reference basis;

  Current year to the end of the following two years (years 1-3) – 1
  Next three years (years 4-6) – 1.5
  Next three years (years 7-9) – 2
  Any further years (year 10 onwards) – 2.5

- Decide on an “estimated burden sharing percentage” to be applied to the portfolio of bank and government bonds. Again this is a subjective process based on the opinions of the general manager and the RMO following their consideration of all available information (including any advice received from the credit union’s investment advisers). Currently the percentage chosen involves a review of the average of the “Moody” historical default rates from 1920 to 2015.

- Calculate the required ORR figure for each individual “tranche of bonds” using the following formula;

Total value of that “tranche of bonds” X “estimated burden sharing percentage” X “default probability percentage” X “bond term score”

- Total the ORR figures for each of the individual “tranche of bonds”.

1.2 Bank Recovery & Resolution Directive (BRRD) in operation

Banco Popular recently went through the BRRD process which provides for the orderly resolution of failing European Banks. This process has resulted in the protection of all senior obligations of Banco Popular, but a total loss for equity and subordinated bond holders. This resolution imposes a total loss on holders of the bank’s capital instruments, with full protection on holders of senior obligations. This is the most recent result implication of the Bail-In tool, under which the Single Resolution Board may impose losses on senior unsecured bonds, but the resolution outlined above highlights the options available without getting to this point, and also highlights the significant difference between a bank’s capital and senior obligations.

2. Supranational Institution Bonds

The inclusion of Supranational Bonds as an new investment class is unlikely to open a wide range of new investment opportunity as in the case of St Francis CU the maximum investment would be €10.5m or 7% of our investment book. While strong credit ratings in these products would be welcome from a risk perspective the return would be reflective in exceptionally low or negative yields

3. Corporate Bonds

The introduction of Corporate Bonds is not a new concept as it was proposed under CP 76 but did not materialise. The inclusion of Corporate Bonds is to be welcomed but the restriction of 25% of Regulatory reserves is limiting and in the case of St Francis equates to €5.25m or 3.5% of the investment book which will not provide sufficient return to make up for any reduction of income relating to bank bonds.

The other areas of concern in relation to Corporate bonds is the lack of liquidity the product would provide in a liquidity crisis and the increased risk levels with this class of investment given that Credit Unions will be “rate chasing” due to income requirements. The default rates relating to 5 year Corporate Bonds is 2% & 10 year bonds are 5.26% which are very much higher than the near zero default rates attributed to historic senior bank bonds.

4. Approved Housing Bodies

   We are puzzled by the inclusion of AHB’s as an additional investment class given this proposal is completely at odds with other aspects of CP 109. The investment term of 25 years will exacerbate any liquidity concerns the Central Bank may have with the credit union movement. Given the lack of a model for such an investment or a tried and trusted income stream model it is our belief is that the inclusion of AHB’s an as additional class is a “red herring” aided by political pressure and has no place in an investment framework in its current proposal.

The Central Bank is seeking views on the following:

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 current level of diversification in CU’s investment portfolio is more of a factor of credit institutions discouraging the placement of funds due to lack of liquidity requirements. The returns being achieved in the current environment are satisfactory and continue to allow our credit union to generate sufficient surplus to cover regulatory requirements and develop our business model.

   There is no mention of investment returns and their importance to credit union in CP 109. It would appear to our credit union that there are other agendas afoot in the drafting of this consultation paper. The inclusion of Corporate Bonds which are proven riskier investments, the inclusion of AHB’s where there is no proven structure with maturity dates that provide no liquidity and no proven income stream and the inclusion of supranational bonds where current returns are at best zero but likely negative and the exclusion of senior bank bonds from allowable investment will create an almost impossible situation for credit unions to derive sufficient return on assets.

   Credit unions will potentially become more vulnerable though these proposals, to increasingly risky counterparties in an effort to secure minimum required returns in the current environment.

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 inclusion of Corporate Bonds which are non-regulated products and AHB’s which provide no liquidity or current structure and the removal of senior non-preference bank bonds within a highly regulated sector defies logic particularly from a risk standpoint.

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.*

No

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?*

   By their very nature these bonds are backed by more than one European Sovereign which will imply high credit ratings and low returns. Also by limiting the level allowable to 50% of Regulatory reserve will do little to add a further counterparty.

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.*

   Concentration limits should be based on total reserves and the maximum term of 10 years

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 a non-regulated at the expense and the exclusion of senior non-preference bank bonds within a highly regulated sector will push credit unions in search for higher returns in less desirable “A” rated corporate bonds and which will lead to lead to a higher concentration of risk and booking of losses in the event of failures.

   Default rates on 10 year “A” rated corporate bonds are over 5% and will likely lead to losses in the CU sector.

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.*

   We fundamentality disagree with the inclusion of Corporate bonds in the list of approved investments.

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

   There is currently no structure in place for this type of investment and CP 109 does not shed any light on the matter. The term of 25 years is not appropriate to credit unions and will likely lead to liquidity problems. There is also no revenue model for this type of investment.

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

   Our Credit Union does not have appropriate level of expertise in this area to comment.

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?*

    It is not possible for St Francis Credit Union to comment on this investment class when so little detail has been provided.

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

    It is not possible for St Francis Credit Union to comment on this investment class when so little detail has been provided.

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?*

    It is not possible for St Francis Credit Union to comment on this investment class when so little detail has been provided.

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?*

    While it may be positive that AHB's are being considered as a new assets class we are of the opinion that the term of 25 years is too long for credit unions and is likely to provide liquidity problems. The revenue model needs inclusion in any proposals.

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 do not support the proposed reduction in counter party limits at a time when the number of counter parties is contracting. There is a danger in credit unions placing investments in dubious counter parties thereby greatly increasing the counter party risk profile of investment portfolios.
    We have three pillar banks in Ireland and the proposals of reducing credit unions counter party exposure from current level of 75% to 60% does not send out the correct message about the Irish economy.

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

    We disagree with the introduction of this changed limit at this time.

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

    Given the current poor rates of return a fund of this nature is not a workable alternative at this time.

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

    The current costs associated with Collective investment schemes preclude this investment class as returns are too low.

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.*

    There needs to be more discussions on the proposals with all stakeholders and this cannot be achieved in the timelines suggested.