Goodbody Stockbrokers Response to the Consultation on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act

Consultation Paper CP 88 Submission

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Consultation Paper CP88

Further to our submission on CP76 and our observations therein, we welcome the majority of changes which have been made between CP76 and CP88. We believe that CP88 is more reflective of the current environment and largely allows Credit Unions to continue to invest members' funds in a prudent manner. We believe, that the removal of the tiered regulatory approach, as was proposed in CP76, serves the long term interests of the Credit Union movement as its introduction at this time, particularly given the current environment in lending and investments, would have damaged the movement as a whole.

In reviewing CP88 however, we believe that reverting to a one size fits all approach for regulation of investments and savings is not reflective of the fact that all Credit Unions are not the same. Nor does it take into account the 2012 Report of the Commission on Credit Unions whereby it suggested that "credit unions should not be regulated on a one-size fits all basis". The proposals in CP88 seem to disregard the Commission findings in relation to this.

Regulatory Impact Analysis

The Regulatory Impact Analysis does not appear to analyse the financial impact of regulatory changes on the investments of Credit Unions. It merely analyses the affected amounts as a proportion of the total pool of Credit Union assets as per the June 2014 prudential returns. In our opinion this approach does not quantify the actual impact of the proposed changes on the movement. We highlight what we would suggest are the key investment impacts below;

Section 6.4 (I)

Impact of 10 day liquidity requirement

The Regulatory Impact Analysis highlights from the June 2014 prudential return that 20% of the sector's investments have a maturity of less than 8 days and that 17% of these investments are on demand. We believe it is important to highlight that the Irish banking system is in the process of exiting the biggest financial crisis in the history of the state and the deposit options currently available do not reflect a normal environment.

CP88 is employing point-in-time data to analyse the impact of measures that may not be appropriate through the credit cycle. Currently Rabobank and Ulster Bank offer higher call deposit rates than those offered for term deposits placed in either of the two Irish pillar banks of AIB and BOI. This current situation distorts the data used in the Prudential Return analysis and could lead to an incorrect assumption that this is the long term situation. We have attempted below to analyse the financial impact on the Credit Union movement.

Central bank Credit, Money & Banking Statistics Table B.1.1 shows household overnight deposit rates and deposits redeemable at notice dating back to January 2003. If we assume the redeemable at notice as a suitable proxy for 3 month deposits the spread between these as shown in Figure 1, would reflect the spread cost.

The average spread over the period is 1.4% but if we assume the current low spread and the recent high spreads are exceptional (as the Irish covered banks had to pay very high levels for deposits during and immediately after the crisis). A more appropriate measure of the normalised spread is the pre-crisis spread without the current exceptional economic stress, (see the red line in Figure 1) the average return for this period from January 2003 to August 2006 is c. 1.1%.

Figure 1: Household Retail Interest Rates Spread Redeemable at notice to Overnight rates

Source: CBI; Goodbody Research

The cost to a Credit Union of carrying very short maturities is thus 1.1% on 10% of investments. As per the aggregate figures outlined in CP88 in Section 2 of the Impact Analysis – total assets of Credit Unions are €14.1bn of which €9.9bn relates to investments and €4.1bn represents loans to members. This if we conservatively assume unattached shares at €9.9bn, implementing a measure which requires Credit Unions to keep 10% of their funds under 8 days liquidity will, we estimate cost the Credit Union movement c. €10.98m per year.

To put this number in context the Report of the Commission on Credit Unions detailed that in the year to September 2010, 392 credit unions had interest income of €546.47m and total income of €772.42m. Therefore the introduction of this measure would cost the credit union sector c. 1.99% of interest income and 1.41% of total income. This proposal seems excessive and does not allow credit unions to seek alternatives even if they can demonstrate alternative liquidity solutions proportionate to potential requirements.

We would request that the Registrar reconsider this blanket imposition and allow for innovations that would satisfy any liquidity concerns by the Regulator, which would also allow for the prudent use of members funds.

Section 8.4 (I)

Impact of removal of Equities as an Investment Class

Some credit unions feel that equities provide an important element of generating returns for members over the investment cycle. While we would agree with the restriction of equities as a general asset class we would argue that a credit union that can demonstrate the correct controls and risk process should not be precluded from equity investing. Equity investments have significant volatility in the returns over the cycle but can form an important element of return as a small proportion of an overall managed portfolio.

A well-managed basket of equity investments has the potential to provide a real rate of return of c. 5% per annum over the medium to longer term. Thus as a vehicle to provide a diversification of returns, equities would potentially have a role to play for some credit unions. This is particularly so at the moment given the low level of return likely on "safer" assets over the next few years.

Currently, Irish government bonds yield just 0.4% per annum for 5 years and 1.10% for 10 years while deposit rates continue to fall towards those being paid in other Eurozone countries. A relatively modest weighting in equities of c. 5% of a portfolio seems reasonable for those credit unions who can show they understand the risks involved and have the appropriate systems in place to manage their exposure.

Section 9.4 (I)

Savings Limit

The application of a limit of member savings to €100k and the requirement of credit unions to return excess funds above this amount does not make sense to us. If the CBI has any concerns regarding the capital or loan book of a specific credit union, the Registrar has the ability to introduce arbitrary savings and lending restrictions on any specific credit union.

It is generally considered that the credit union movement as a whole has a strong balance sheet and does not use gearing. As per their regulatory requirements, Credit Unions are invested in predetermined and largely defensive investments to specific tolerances and are required to demonstrate and operate high liquidity levels. We fail to understand why members of such an organisation should be precluded from holding amounts on deposit to a specific level determined by regulation. Such a restriction does not apply in the banking sector. We believe it would be fairer to allow credit unions themselves to decide on savings limits whilst reminding members that, only the first €100k of their investments would be covered under the deposit guarantee scheme?

It is unclear to us why the Registrar has a concern about the 0.11% of credit union members that currently prefer to keep funds with their local credit union as opposed to their local bank. The credit union movement has a significantly lower loan to deposit ratio than the banks and therefore has lower liquidity risks. We would again point out that unlike a bank, Credit Unions do not use leverage. At a 10% reserve Credit Unions can demonstrate higher capital balances than most traditional banks. We fail to see the rationale for implementing this measure. Furthermore asking a credit union to return deposits of over €100k to members could be misconstrued as reflecting regulators' concerns in relation to the specific credit union.

Section 15 (IV/VIII)

Investment Innovation

Since the banking crisis first emerged, amendments to the 2006 Guidance Notes have been necessitated by rapid and unexpected changes in market conditions. This has led to unintended consequences, and it is important that the new regulatory provisions should not give rise to similar problems. We have pointed out above how the proposed requirement to maintain a very short duration on liquidity could cost the sector an additional €100million without any meaningful benefit in liquidity. The 2006 Guidance Note allowed for "credit unions that can demonstrate to the Registrar of Credit Unions that they possess the skills and systems necessary to manage a more complex investment portfolio." We would suggest that the new Guidance Note retain this element of flexibility, so that further unforeseen market movements do not require either further regulatory change or precipitate action by credit unions which could ultimately prove destabilising.

Government bonds have always been an approved component of credit unions' portfolios, and the new Guidance Notes state that this should continue to be the case. In order to broaden the investment universe, we propose that investment in the bonds of state-owned companies should also be permitted. This would have the beneficial effect of enabling credit unions to invest to support employment-creating infrastructure without the addition of significant risk to their portfolios.

Engagement

The Registrar previously stated in the June 2014 Feedback statement on CP 76 that they would have on-going engagement and consultation with credit unions and other sector stakeholders on the prudent development of the credit union sector and the regulatory framework for credit unions. We would strongly wish for, encourage and provide supportive inputs into a framework for consultation on investments.

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