CP 109– Consultation on Potential Changes to the Investment Framework for Credit Unions

Response to CP 109– from

Ballinasloe Credit Union (Our Lady of Lourdes) Limited

23rd June 2017

changes to the bank's approach herein. It would be beneficial if the credit union was aware of the Bank's rationale or thought processes in the compilation of the consultation paper.

Section 2

Purpose of this consultation

2.1 The Board of BCU notes that the Bank's reference point is the Bank's review of investment regulations introduced on 01.Jan 2016 and that the CP 109 addresses these matters.

2.2

The Board notes that the bank has performed a Risk Impact Analysis that assesses the likely impact of the proposed changes. BCU has also, with the assistance of its Investment Advisors (Davy) performed such an analysis. The results of same are included within this response to the CP 109.

Section 4

Potential Additional Investment Classes

The CB proposes to allow credit unions to invest in an additional limited number of investment classes:

- Bonds issued by Supranational Entities;
- Corporate Bonds
- Investments in Tier 3 Approved Housing Bodies (AHBs).

All of the investments are tied to being a % the credit unions reserves and as such the value of the investments allowed due to the restriction based on capital reserves would probably leave the new investments proposed unworthy of consideration.

Restricting investments in housing bodies to Approve Housing Bodies (AHBs) with more than 300 units implies that credit unions will be unable to invest in new housing bodies being developed – when there is an absolute need for social housing. Restricting the investment to established AHBs with more than 300 units is counterproductive.

In reply to questions

1) the restricted investment classes set out in the 2016 Regulations represented the greatest challenge to BCU's investment strategy.

Irish and EEA State Securities, Bank Bonds, Supranational Bonds and Corporate Bonds) should be related by % of the total credit union investments which is consistent with the 2016 Regulations.

4.2 Corporate Bonds

The restoration of corporate bonds is welcome. They were available as an investment possibility in the past (pre 2016). BCU notes that the Bank refers to an absence of expertise within credit unions for such investments. This begs the question of course how do you get informed or become expert except by participating in the activities of a bond portfolio. In addition it should be possible to charge an investment manager with managing a Corporate Portfolio in a centralised fund for credit unions.

In reply to questions

7) Including corporate bonds in the investment portfolio at this time is of little value due to the poor returns (currently) on "A" rated bonds. However this may change.
8) Again tying the % of such investments to the reserves is regressive.

4.3 Investments in Approved Housing Bodies

The inclusion of investments in social infrastructure is a welcomed development for credit unions which seek to use the savings of their members for social good. However what the CB gives with one hand it takes back with the other. Limiting such investments in AHBs with > 300 units effectively excludes a great portion of the housing bodies – which could probably use credit unions funds were they available.

In reply to questions

9) This type of investment is most appropriate for credit unions.
10) The most appropriate structure is a Special Purpose Vehicle (SPV).
11) Due to the State's involvement this type of investment would be more secure than current bank bonds. In addition the private provider of the funds (70%) has a charge on the properties.

Section 6 Next Steps

This response is in reply to the Banks invitation to make comment on CP109.

Section 7 Summary

In reply to questions

19) The Bank needs to publish its response to the representations it receives and engage in face to face interaction with credit union representative bodies and credit union investment advisors before this consultation is concluded.

Conclusion

BCU having considered the proposals as outlined in CP 109 finds that the level of direction and restriction within the proposals will inhibit the development of credit union into the future. There is a complete absence of any strategic developmental thinking within the document about the future of credit unions and the credit unions ability to service its members in any meaningful way with financial services. Instead there appears to be a conscious determination to force credit unions to cap the inflow of funds to members' accounts – which is the complete antithesis of the credit unions determination to be the preferred financial service supplier to its members.

DAVY CREDIT UNIONS

Ballinasloe Credit Union Ltd

Assessing the Impact of Proposals within CP109 on the Investment Portfolio

June 2017

- When converted to a percentage of the investment portfolio, the proposed concentration limits on the additional asset classes are extremely low and are unlikely to make a material difference to the portfolio.
- The introduction of concentration limits linked to regulatory reserves will introduce additional complexity and may be cumbersome from an investment management perspective.

(2) Counterparty Exposure

The following table assesses how the Central Bank's proposed counterparty limit of 20% would impact Ballinasloe Credit Union's investment portfolio:

Table: Counterparty Exposure

[redacted]

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, Ballinasloe Credit Union will need to reallocate 6.5% of the investment portfolio or €4.26m to alternative counterparties. 2.6% of the portfolio or €1.7m must also be reallocated from [redacted] to an alternative counterparty by the end of June 2017.
- We believe that there is no rationale to implement limits by reference to regulatory reserves and now is the wrong time to be placing unnecessary pressure on credit unions from a counterparty perspective.

(3) Income

Based on analysis conducted by Davy within an income impact model outlined in the submission from Davy, Ballinasloe Credit Union's income is likely to be impacted by the proposals contained within CP109.

Based on the modelling included in theDavy submission, if a credit union were to fully invest their portfolio based on the average asset allocation of the sector (as outlined in the Central Bank's RIA) and current yields available, the weighted average return on the portfolio is approximately0.31%[1]. As portfolio performance differs from one credit union to another, longer term investments such as government bonds that make a significant contribution to current returns could not be included in testing. This finding indicates the important contribution of residual investments with higher yields in bolstering investment income in the current environment.

In order to examine the potential impact of the CP109 proposals and the additional recommendations made by Davy on Ballinasloe Credit Union's individual investment portfolio, we have applied the percentage changes derived from the above model to the portfolio and assessed the impact on your credit union's weighted average income. It is important to understand that the changes outlined in the table below are an approximation only and based on a number of crucial assumptions underlying the analysis which should be noted in Appendix 1. Perhaps most importantly, for ease of analysis,

[1]The current yields available are based on yields as at 31st May 2017

Findings:

- For the purpose of this analysis and to maintain consistency with the testing performed at sector level,income forecasting analysis completed earlier this year has been excluded from the testing model above.
- The figures in the table above outline that if the Central Bank proceeds with the proposed changes to bank bonds, we project that the average credit union's investment will decline by c. 23%. Applying this projection to your credit union's weighted average investment income, your income is expected to decline toc. 0.73%.
- In the event that the Central Bank proceeds with the proposed changes to bank bonds and a credit union allocates to the proposed additional asset classes of supranational and corporate bonds,we project that the average credit union's investment income may decline by up to 19%. Applying this projection to credit union's weighted average investment income, your income is projected to decline to c. 0.77%. It should be noted however that the yields on the additional asset classes of supranational and corporate bonds are at extremely low levels and are likely to normalise in the future; in addition they may contribute diversification benefits to the portfolio.
- If senior non-preferred bonds are authorised, we project that the average credit union's investment income will be positively affected and may rise by up to 9%. Applying this to your credit union's weighted average investment income, your income is projected to increase to 1.04%. It should be noted however that this allocation will introduce additional credit risk into an investment portfolio which will require ongoing assessment by credit unions and investment adviser to monitor that it is in line with your investment policy.
- We project that income may fall by up to 2%for the average credit union in the event that senior non-preferred bonds are added and a credit union allocates to supranational and corporate bonds. This would reduce your weighted average income to 0.93%.Based on current pricing, the allocation to supranational and corporate bonds is likely to reduce average income in the portfolio due to the exceptionally low yields on these bonds at this time.
- In the event that certain bonds may be treated as liquid in line with proposals outlined in the Davy submission, certain credit unions may be able to reduce the proportion of funds placed in short term deposits which may be attracting negative yields and this may result in an improvement of investment income by up to c. 13% for the average credit union.Applying this forecast to your credit union would increase your weighted average income to 1.08%.

(4) Participation in the Consultation Process

Davy is making a submission to the RCU regarding CP109. A summary of this submission will be circulated to our clients ahead of the deadline for submissions which is on Wednesday 28th June 2017. Individual credit unions have also been invited to make submissions and it is imperative that you do so ahead of the deadline in order to influence the outcome of these proposals in an effort to minimise the impact on future investment income.

Warning:This report is summary in nature. It does not constitute investment advice and is provided for information and discussion purposes only and is not intended to be comprehensive. Readers should supplement the content by reading the consultation paper and form their own view.

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