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Castlecomer Credit Union

50th Celebrating Anniversary

Castlecomer Credit Union Ltd

Assessing the Impact of Proposals within CP109 on the Investment Portfolio

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Introduction

This report is intended to assist Castlecomer Credit Union in establishing the impact of the proposals contained within CP109 on the investment portfolio. It is important to note that this analysis should not be regarded as comprehensive; in particular, the projected impact on income is based on a broader impact analysis conducted by Davy. This modelling was subject to a number of assumptions which are outlined in more detail in the submission from Davy.

Please note that all analysis is based on Castlecomer Credit Union's portfolio as at 30th April 2017. The regulatory reserve figure used in the testing is €4,815,766.

Castlecomer Credit Union's investment portfolio is likely to be impacted in four main ways if the proposals outlined in CP 109 are implemented:

(1) Asset Allocation

Castlecomer Credit Union will have the opportunity to invest in additional asset classes. The Central Bank has proposed concentration limits on the new asset classes as a percentage of regulatory reserves. The table below is intended to illustrate the proposed limits as a percentage of the investment portfolio and in euro terms:

	Asset Class	Current Allocation €	Concentration Limit (% Investment Portfolio)	Concentration Limit (as € Amount)	Current Weight
Current Portfolio & regulatory limits	Irish and EEA State Securities	0	70%	23,899,015	0%
	Accounts in Authorised Credit Institutions	30,227,500			89%
	Bank Bonds	2,214,472	70%	23,899,015	6%
	Collective Investment Schemes	1,699,479			5%
	Other	0			0%
	Total	34,141,451			100%
		Central Bank's Proposed Concentration Limit (% Reg Reserves)	Proposed Limit calculated as a % of the Investment Portfolio	Proposed Limit (€ amount)	
Proposed Additional Asset Classes (Central Bank)	Supranational bonds	50%	7.1%	2,407,883	
	Corporate bonds	25%	3.5%	1,203,942	
	Total (additional bonds)		10.6%		
	*Investments in AHB's 3 proposed options:				
	a) or	25%	3.5%	€1,203,942	
	b) or	lesser of 25% or €3m for credit unions with assets less than €100m	3.5%	1203941.5	
	c)	50%	7.1%	€2,407,883	

**AHB's are included for illustrative purposes only. There is no social housing vehicle available for investment at present which means that AHB's cannot realistically be included within an asset allocation at this time.*

- 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 Castlecomer Credit Union's investment portfolio:

Table: Counterparty Exposure

Counterparty	Moody's Rating	€Amount	Direct Exposure (%of portfolio)	Breach?	%to be Reallocated
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]		[redacted]	[redacted]		[redacted]

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, Castlecomer Credit Union will need to reallocate 8.3% of the investment portfolio or €2.8m to alternative counterparties. 1.3% of the portfolio or 450k 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, Castlecomer Credit Union's income is likely to be impacted by the proposals contained within CP109.

Based on the modelling included in the Davy 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 approximately 0.31%[1]. As portfolio performance differs from one credit union to another, longer term investments such as government bonds and longer term deposits 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 Castlecomer 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 are noted in Appendix 1. Perhaps most importantly, for ease of analysis, we have

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

assumed that the investment portfolio moves from the current asset allocation to revised allocations (which are shaped by the scenario assumptions) with immediate and total effect and that yields on the various asset classes remain constant. In reality:

- The projected changes in allocations and associated changes in income are more likely to occur on a phased basis.
- Yields on the various asset classes will change.

Income will be influenced by a broader range of factors primarily which are not included in this analysis such as the run-off of residual investments and tapering of ECB's quantitative easing purchases. The current weighted average return on Castlecomer Credit Union's investment portfolio is 1.50%.

Table: Assessing the impact of CP109 proposals on your credit union's investment income

	Projected impact on the average credit union's investment income	**Projected weighted average return of your credit union**
Current weighted average return		1.50%
Impact of senior non-preferred not being authorised	-23%	1.15%
Impact of senior non-preferred bonds not being authorised and supranational & corporate bonds added to the portfolio	-19%	1.21%
Impact of investments in social housing (AHB's)	There are no schemes currently available to assess the potential income so this has not been included in our testing	

Table: Assessing the impact of Davy's recommendations on your credit union's investment income

	Projected impact on the average credit union's investment income	**Projected weighted average return of your credit union**
Current weighted average return		1.50%
Impact of senior non-preferred being authorised	9%	1.63%
Impact of senior non-preferred bonds being authorised and supranational & corporate bonds added to the portfolio	-2%	1.47%
Impact of senior non-preferred bonds being authorised. Credit unions allocate to supranational and corporate bonds. Certain bonds may be treated as liquid for liquidity purposes.	13%	1.69%

Source: Davy with reference to Davy's Submission to CP109

Warning: Please note there is no assurance that the assumptions which our model and scenario analysis is based on will materialise. Our model is based on the average credit union's asset allocation and your credit union's portfolio may be materially different. Actual outcomes may differ significantly from the projections outlined above.

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 to c. 1.15%.
- 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. 1.21%. 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 1.63%. 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 1.47%. 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 1.69%.

Liquidity

Davy has proposed that certain bonds should be treated as liquid for the purposes of regulatory liquidity ratios.

(4) Participation in the Consultation Process

Davy are 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.

Appendix 1

Overview of the assumptions of the model contained in Davy's submission:

(1) The average asset allocation of a credit union has been sourced from the Central Bank's RIA within CP109. Non-material asset classes have been excluded for ease of analysis. We have assumed the following average asset allocation:

Asset Class	% Portfolio
Irish and EEA State Securities	7%
Accounts in Authorised Credit Institutions	75%
Bank Bonds	18%

(2) We have assumed that credit unions allocate their portfolios to investments at certain yields which are outlined in detail in Davy's submission. Please note we have kept these returns constant in each scenario to isolate the impact of asset allocation differences rather than asset return changes. In reality credit unions have legacy investments rolling off at superior yields but as these differ from one portfolio to another and for ease of analysis we have assumed that a credit union is investing their full portfolio at the yields outlined below. Note that yields available on asset classes are at unusually low levels due to the ECB's quantitative easing programme.

(3) Where possible, the yields on the various asset classes have been sourced from Bank of America Merrill Lynch bond indices. In the main, we have selected 3-5year terms. In the case of Irish and EEA State Securities, we have adopted the yield on the Irish 5 year government bond. In the case of cash deposits, we have used the average rate available from a selection of counterparties.

(4) In assessing the impact on income of the proposals, it is assumed that credit unions' allocation to Irish and EEA State Securities does not change as they are broadly unaffected by the proposals. Collective investment schemes and other investments are not included as allocations in the portfolio as the average credit unions portfolio does not have material exposure to either asset class.

(5) In order to analyse the impact of the proposals on income, we have made assumptions regarding how credit unions will allocate portfolios based on the various scenarios outlined. This allocation is based on a look forward basis and is intended to reflect how credit unions might allocate to various asset classes (and bonds in particular) once banks have met their MREL requirements in 2022. For ease of illustration, we have assumed that yields do not change during this period.

(6) We have assumed that credit unions will allocate up to the proposed maximum limit on supranational and corporate bonds (i.e. 8% and 4% of the investment portfolio respectively) based on the average credit union portfolio.

(7) We have not included social housing in the impact analysis on income as we do not feel that the concept has been sufficiently well developed at this stage for it to be incorporated into the income analysis.

Please Note:

There is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ.

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