DAVY CREDIT UNIONS

Kilmallock Credit Union Ltd

Assessing the Impact of Proposals within CP109 on the Investment Portfolio

June 2017

Introduction

This report is intended to assist Kilmallock Credit Union in establishing the impact of the proposals contained within CP109 on their 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 Kilmallock Credit Union's portfolio as at 16/05/17. The regulatory reserve figure used in the testing is €4,533,614.

Kilmallock 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

Kilmallock 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	906,000	70%	16,886,346	4%
	Accounts in Authorised Credit Institutions	13,637,169			57%
	Bank Bonds	2,500,000	70%	16,886,346	10%
	Collective Investment Schemes	7,080,183			29%
	Other	0			0%
	Total	24,123,352			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%	9.4%	2,266,807	
	Corporate bonds	25%	4.7%	1,133,404	
	Total (additional bonds)		14.1%		
	*Investments in AHB's 3 proposed options:				
	a) or	25%	4.7%	1,133,404	
	b) or	lesser of 25% or €3m for credit unions with assets less than €100m	4.7%	1,133,404	
	c)	50%	9.4%	2,266,807	

**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 Kilmallock Credit Union's investment portfolio:

Table: Counterparty Exposure

[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]	[redacted]	[redacted]
[redacted]		[redacted]	[redacted]		[redacted]

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, Kilmallock Credit Union will need to reallocate 8.3% of the investment portfolio or €2.0m to alternative counterparties. 10.9% of the portfolio or €2.6m 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, Kilmallock 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 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 Kilmallock 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, we have

1 The current yields available are based on yields as at 31'1 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 Kilmallock Credit Union's investment portfolio is 1.00%.

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		1.00%
Impact of senior non-preferred not being authorised	-23%	0.77%
Impact of senior non-preferred bonds not being authorised and supranational & corporate bonds added to the portfolio	-19%	0.81%
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		1.00%
Impact of senior non-preferred being authorised	9%	1.09%
Impact of senior non-preferred bonds being authorised and supranational & corporate bonds added to the portfolio	-2%	0.98%
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%	1.13%

Source: Davy w1th reference to Davy's Subm1ss1on 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. 0.77%.
- 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. 0.81%. 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 1.09%. 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 0.98%. 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 1.13%.

Liquidity

We understand that Davy have proposed that certain bonds should be treated as liquid for the purposes of regulatory liquidity ratios. We support this recommendation.

In the event, that this recommendation is implemented, Kilmallock Credit Union's has the following holdings which may be treated as liquid:

Table: Additional sources of liquidity in the event that Davy's proposal to treat certain bonds as liquid is implemented.

	Value 30/5/17	Potential contribution to liquidity based on a 5% haircut	Potential contribution to STLC*	Potential contribution to regulatory liquidity*
Government bonds €	906,000	860,700	614,934	860,700
% unattached shares			2.50%	3.50%

Source: Davy

* Davy have suggested that relevant bonds may contribute a maximum of 50% to the 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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Kilmallock Credit Union welcomes the opportunity to respond to Consultation Paper 109 issued by the Central Bank of Ireland. We agree that the topic of the certain investment classes that Credit Unions are allowed to invest in needs to be addressed for a number of reasons which we will outline in our response to the Consultation Paper. We attach as appendices both the Irish League of Credit Unions response to this Consultation Paper and also the Summary Document of Davy Submission on CP109. Davy assisted Kilmallock Credit Union in preparing a portfolio impact analysis should the recommendations contained within CP109 be implemented and we also include this document with our submission.

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.

In the current investment environment it is next to near impossible to reap any sort of return from the classes which we are allowed to invest in at the moment. The current classes are too concentrated and currently we are almost 85% invested in Bank/Cash Deposits/ Collective Investment Schemes with 10% of our portfolio in Bank Bonds and a further 4% in Irish and EEA State Securities. Within the current classes we have a weighted average income of circa 1% per annum.

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?

Kilmallock Credit Union welcomes the potential to introduce new classes of investments for Credit Unions, however we do feel that the proposed additional classes are not enough and the concentration limits mentioned in CP109 are very restrictive. Bonds issued by Supranational Entities and Corporate Bonds as mentioned by the ILCU in their response will have a negligible impact on investment income. Currently our investment income is on average 1% this investment class would not improve our investment income if we were to invest, please see document prepared by Davy to support this argument.

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.

We agree that under no circumstances should member funds be put at risk. However there are certain other low risk categories that Credit Unions should be allowed to invest in. We agree with the ILCU in that Credit Unions should be allowed to invest in equities. We also support Davy's view that certain Credit Unions should be allowed to invest in senior Bank Bonds.

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?

We welcome the proposed addition of supranational bonds. However we feel that it will not have a positive impact on investment income for Kilmallock Credit Union as the yield on these types of bonds are so low similar to state securities. See Davy Portfolio analysis to see the effect of investment in Supranational Bonds on our portfolio and decline in income as a result of same.

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 feel that concentration limit should be based on asset size as opposed to 50% of our regulatory reserve. This currently limits Kilmallock Credit Union to circa €2.2 million available for investment in supranational bonds. We feel this is too restrictive and has no positive impact on our portfolio other than providing a new counterparty with a low yield. We support Davys view that the concentration of supranational bonds should be included in the current asset class level of 70%.

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?

Kilmallock Credit Union welcomes this proposal. However we agree with the ILCUs point of view that yields on "A" rated corporate bonds offer very low investment returns. We also query where a bond no longer meets the minimum rating requirement. The Credit Union would be required to divest of the bond as soon as possible. How long is as soon as possible?

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 feel that the 25% Regulatory Reserve concentration limit is too restrictive. We support the ILCU and Davys view of adhering to the 2016 regulations and incorporating this into the current 70% class limit of bank bonds. For Kilmallock credit Union it limits us to a total possible investment of circa €1.1million.

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

We feel this is a natural extension to the ethos of the Credit union movement if there was a correct investment vehicle in place.

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

We support the ILCU and Davys views that a special purpose vehicle would be the most appropriate structure for investment in AHB's.

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?

Ability of the AHB to repay the money invested. Also we support Davys point that correct Business Model Analysis of the AHB would have to be undertaken. Many of the current housing bodies have very limited public financial information available to review. We also feel that there may be a liquidity risk for an investment term of up to 25 years.

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

We support Davys view that the most realistic way to provide access to this type of investment via a collective investment which is large and accessible to all Credit Unions.

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?

Given the extended maturity limit for AHB type of investments we agree that reduced concentration limits should be applied to this class of investment. We accept the ILCU's view that the concentration limit should lie somewhere in between 10% and 20% of the investment portfolio.

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?

We welcome the proposal to include these investment types as they are subject to more oversight, we believe it reduces overall risk exposure.

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 support the ILCU and Davys comments on counterparty exposure. We also feel that reducing counterparty limits from 25% to 20% places additional pressure on Credit unions as there aren't enough of counterparties available at this present time to warrant such a reduction. If this is implemented it means Kilmallock Credit Union will have to move 8.3% of our portfolio to other counterparties, at a time when investment yields are so low it puts even more pressure on our portfolio and investment income. Please see Davy portfolio impact analysis document attached.

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

As stated above we do not understand the rationale for reducing counterparty exposure limits at this time when here are so few options available to us and we also are of the opinion that a 12 month transitional arrangement post commencement is too short.

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

We support the use of collective investment schemes. We agree with the ILCUs opinion that the definition of Collective Investment Schemes could be expanded to include Supranational Bonds , Corporate Bonds, Social Housing/AHB's , State sponsored Projects and Equities which would increase the return generated by Collective Investment Schemes.

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

Currently one of the main barriers for us as a Credit Union is the declining return being generated by Collective Investment Schemes. If other classes of investments were to be included as outlined above in our previous point it may overcome this barrier.

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 rational.

We would like to see revised feedback from the Central Bank in light of the submissions received before we could comment on whether we agree with the proposed timelines. We also support Davys point that liquidity has not been addressed in this consultation paper. We support the view that certain bonds should be treated as liquid for the purposes of regulatory liquidity. Please see our impact analysis paper supplied by Davy.

DAVY CREDIT UNIONS

SUMMARY DOCUMENT OF DAVY SUBMISSION ON CP109:

CONSULTATION ON POTENTIAL CHANGES TO THE INVESTMENT FRAMEWORK FOR CREDIT UNIONS

JUNE 2017

OVERVIEW

Davy welcomes the opportunity to make a submission on CP109. This document is a summary of a more detailed submission which will be made to the RCU before the deadline of 28th June 2017. The summary does not contain the level of detailed analysis and commentary from the full report but summarises the findings from it. This document is designed to help credit unions to interpret CP109 and can be used for reference purposes when making individual submissions to the Central Bank.

EXECUTIVE SUMMARY

- CP109 does not factor in the liquidity pressures facing credit unions from an investment perspective. This is somewhat disappointing given the representations made to the RCU prior to the publication of the consultation while the reality of capital losses are being experienced as a result of negative interest rates.
- The Central Bank's proposed amendments to authorised bank bonds (see Appendix) are a serious concern in light of changes occurring in bank funding and issuance trends. CP109 and the Regulatory Impact Assessment (RIA) overlook these developments and proposes to prohibit bonds which are likely to dominate senior bank bond issuance over the next five years.
- We recognise that risk management is a key regulatory priority for the credit union sector. At the same time, it must be acknowledged that credit unions are operating within an extremely limited investment universe. Any proposals which contract the investment universe further will increase pressure on a sector that remains vital to the Irish social and economic landscape.
- The potential addition of new investment classes is welcome, particularly in the case of supranational and corporate bonds. However the proposed concentration limits are at odds with the intended diversification benefits. Testing shows that the maximum exposure to supranational and corporate bonds will average circa 8% and 4% of portfolios respectively.
- Within Section 4 of this submission, Davy has put forward constructive recommendations to address the challenges outlined above.
- In particular, Davy recommends that certain bonds should be interpreted as liquid for regulatory liquidity ratios. This is consistent with credit union regulations in other jurisdictions (Northern Ireland and the UK) as well as regulations governing liquidity in banks.
- Bank bond funding principles are changing within a market landscape that is subject to higher levels of regulatory control and oversight. Stakeholders need to acknowledge this and credit unions should continue to be authorised to invest in senior unsecured bank bonds, regardless of whether they are subordinated within the senior space. Bonds which are MREL (see Appendix) eligible should require an investment grade rating in order to be considered authorised. Credit unions should be able to conduct their own risk assessments in determining whether investments, including senior non-preferred bonds, are appropriate for their investment portfolios taking into account the nature, scale, complexity and risk profile of the credit union.
- Concentration limits on the proposed additional asset classes should be incorporated into existing limits which are based on a percentage of the investment portfolio rather than regulatory reserves.
- The counterparty limit should remain unchanged at 25% given the counterparty pressures facing credit unions.
- Contracting the limited investment universe will not increase lending to members. Instead, it will increase pressure on a sector that remains vital to the Irish social and economic landscape.

SECTION 1:
KEY ISSUES FACING CREDIT UNIONS FROM AN INVESTMENT PERSPECTIVE

1 **Lack of investment choices and the challenge to generate income:** In the current investment environment, it has become increasingly difficult for credit unions to source appropriate and suitable investments.

2 **Counterparty pressures:** Given the shortage of counterparty options and banks' lack of appetite for short-term funding, we anticipate that credit unions will find it very difficult to source a home for funds which will allow them to observe regulatory counterparty and liquidity limits without inflicting a capital loss on funds as a result of negative interest rates.

3 **Liquidity:** Credit unions are now entirely reliant on overnight deposits/demand accounts and accessible collective investment schemes to meet their short-term liquidity requirements. We contend that this represents capital risk which needs to be minimised as it is contrary to the underlying principle of not taking undue risk with members' savings.

SECTION 2:
GENERAL COMMENTARY AND FEEDBACK ON ADDITIONAL ISSUES NOT INCORPORATED INTO THE CENTRAL BANK'S QUESTIONS

1 **Nature, scale, complexity and risk profiles of credit unions:** The Central Bank appears to have neglected to take account of the nature, scale, complexity and risk profiles of credit unions.

2 **Risk versus return:** The Central Bank has focused purely on risk and assessed the potential impact of the proposed changes on asset allocation. By consequence, the regulatory impact analysis (RIA) requires further analysis.

3 **Credit versus duration risk:** We are concerned that duration risk is not addressed in CP109 and credit unions may look to "move out the curve" in order to secure valuable yield in the government, corporate or bank bond universe. In our view, this is potentially the worst point in the interest rate cycle for credit unions to be securing long-term investments.

4 **Bank bonds – Implications for credit unions as a result of the Central Bank's proposal to amend the definition of bank bonds:** Traditional senior bank bonds may no longer be available while CP109 proposes that new types of bond issues (senior non-preferred) will be prohibited. If the Central Bank's proposal is implemented, the measures will effectively close off an authorised investment class (see Appendix) which historically has represented an important investment option for credit unions. Credit unions are likely to face additional pressure on income as traditional senior unsecured bonds mature in their portfolios and they seek out new bond opportunities. Credit unions are highly unlikely to maintain 18% of investment portfolios in bank bonds as supposed by the RIA – it is more likely to be materially lower.

5 **Liquidity:** CP109 does not factor in the liquidity pressures facing credit unions from an investment perspective which is somewhat disappointing given the representations made to the RCU prior to the publication of the consultation.

SECTION 3:
INCOME ANALYSIS

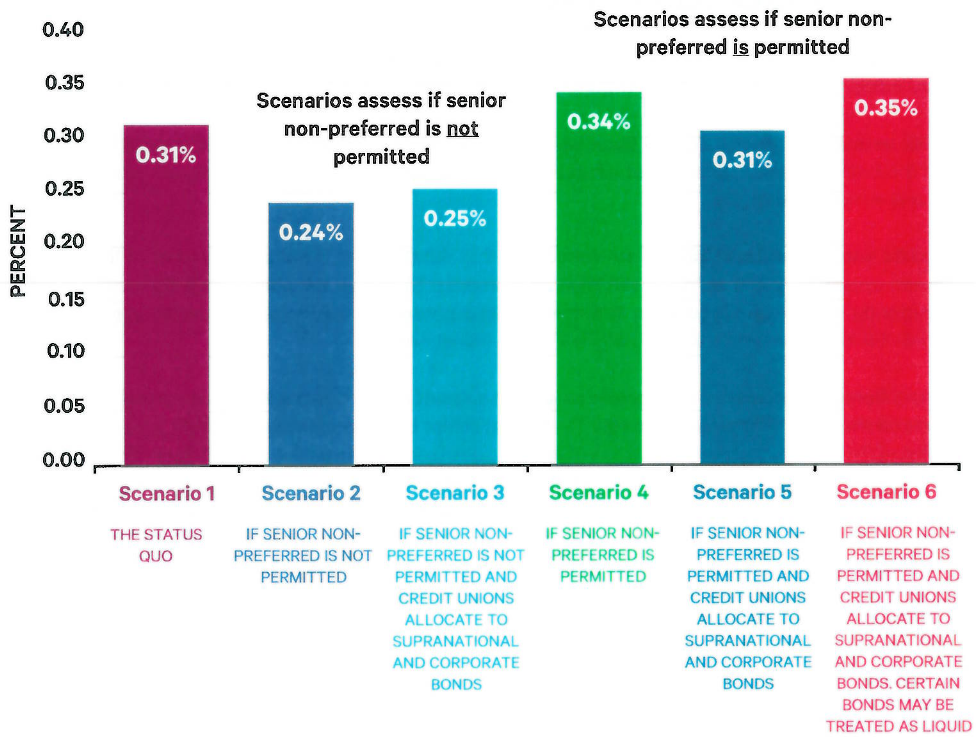
SUMMARY OF INCOME ANALYSIS

In order to assess the impact of the proposals, we have conducted testing on the average investment portfolio based on the asset allocation of the average credit union. We have used current returns on each asset class as our starting point in Scenario 1 using appropriate benchmarks for each asset category. Returns have been kept constant in each scenario to isolate the impact of asset allocation difference 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. We then conducted a scenario analysis with varying asset weightings reflecting six different scenarios which are summarised in Table 1. (Full details of this analysis are available in our CP109 submission document).

Table 1: Scenario analysis assumed returns

ASSET CLASS	ASSUMED RETURNS
Senior secured (covered) bank bonds	0.01%
Senior unsecured bank bonds	0.49%
Senior non-preferred bank bonds	0.78%
Term deposits (cash)	0.43%
Short-term cash	-0.38%
Government bonds	-0.15%
Supranational bonds	0.01%
Corporate bonds	0.37%

Figure 1: Scenario analysis and the impact on income



Source: Davy with reference to Bloomberg

SUMMARY OF FINDINGS FROM INCOME ANALYSIS

- **Scenario 1**
  Status quo, existing portfolio return based on current yields in each asset category.

- **Scenario 2**
  If the proposal by the Central Bank to prohibit credit unions from investing in any subordinated senior bonds proceeds, the proportional change is likely to reduce the weighted average income by circa -23% from current levels.

- **Scenario 3**
  If senior non-preferred bonds are not authorised and credit unions allocate to supranational and corporate bonds the proportional change is likely to reduce the weighted average income by -19%.

- **Scenario 4**
  If the Central Bank authorises senior non-preferred bonds, and assuming that credit unions do not increase their bond weighting above 18% of the investment portfolio, we anticipate that the weighted average income of portfolios could increase by 13%.

- **Scenario 5**
  If senior non-preferred bonds are permitted and credit unions allocate to new asset classes of supranationals and corporate bonds. At current yields, the proposed introduction of supranational bonds and corporate bonds are unlikely to contribute to the weighted average yield on portfolios and in fact may detract from portfolio performance. This may be attributed to two main factors: Firstly, the yields on supranational bonds are effectively zero. Secondly, the concentration limit on corporate bonds is so low that the asset class is unlikely to make a material difference to portfolios from either an income assessment or potentially from a diversification perspective.

- **Scenario 6**
  In the event that government, supranational and corporate bonds may be treated as liquid for regulatory liquidity, credit unions may reduce the extent of cash held in deposits which are accessible or have less than eight days to maturity. This development is likely to contribute a 13% gain versus current weighted average income.

Please note: AHB scenario excluded as no vehicle for investment currently exists.

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 model may be materially different. Actual outcomes may differ significantly from the projections outlined above.

SECTION 4: RECOMMENDATIONS

1 Liquidity: Davy strongly believes that certain bonds should be considered liquid for both the purposes of the short-term liquidity constraint and regulatory liquidity. These include: Irish and EEA securities, supranational bonds, and corporate bonds – all with associated haircuts applied.

Table 2: Proposed expansion of the regulatory definition of 'liquid assets' and associated haircuts

ASSET	QUALIFICATIONS	HAIRCUT FOR THE PURPOSES OF LIQUIDITY (% OF MARKET VALUE)
Irish and EEA securities	Investment grade	5%
Supranational bonds	Minimum rating of 'A'	5%
Corporate bonds	Minimum rating of 'A'	30%

Davy recommends that transferable securities may contribute up to a maximum of 50% of the regulatory liquidity ratios as we recognise the need for credit unions to maintain access to cash deposits as working capital.

2 The counterparty limit of 25% should remain unchanged. Diversification proposals in CP109 are insufficient to warrant any contraction in current limits.

3 Bank bonds: We recommend that credit unions should be authorised to invest in senior bank bonds, both senior preferred and senior non-preferred.

4 The concentration limits of additional asset classes (supranational and corporate bonds) should be incorporated into existing concentration limits.

Table 3: Proposed concentration limits

REVISED CLASSES OF INVESTMENT	REVISED CONCENTRATION LIMITS (% INVESTMENT PORTFOLIO)
Irish, EEA state securities and supranational bonds	70%
Accounts in credit institutions	100% (unchanged)
Senior bank bonds (which do not qualify as MREL) MREL eligible senior bank bonds (investment grade) Corporate bonds ('A' rated)	70%
Collective investment schemes (deposits)	No limit (unchanged)
Collective investment schemes (non-deposits)	Concentration limit of underlying asset class should apply
Social housing: Investments in Tier 3 AHBs	5%

SECTION 5:
RESPONSES TO THE CENTRAL BANK'S QUESTIONS

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.

We agree with the Central Bank that credit union investment portfolios are too concentrated. At present, credit unions have little choice other than to consider cash deposits or bank bonds.

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?

We agree with the proposal to include supranational bonds and corporate bonds. However the proposed concentration limits by reference to a percentage of regulatory reserves is almost non material and we propose to switch any change to concentration limits to asset level.

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.

Yes. Certain credit unions should be allowed to invest in senior bank bonds. The RCU should allow credit unions to assess investments (which are within the prescribed classes authorised by the Central Bank) and decide if they are suitable and based on their own investment objectives.

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?

Davy agrees with this proposal, together with proposed minimum credit rating and maturity limit.

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 oppose the introduction of regulatory reserves as a concentration limit. Davy proposes that the concentration limits on supranational bonds is incorporated into the current asset class level of 70%.

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?

Davy agrees with this proposal, together with proposed minimum credit rating and maturity limit.

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.

Please refer to question 5 above. Davy proposes that the concentration limit of corporate bonds is incorporated into the current 70% asset class limit of bank bonds.

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

Credit unions are a natural investor in social housing.

Appropriate vehicles must be put in place to make credit unions' investment in social housing meaningful, affordable to credit unions and affordable by housing applicants.

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

We feel that special purpose vehicles (SPVs) or collective investment schemes are potentially the most appropriate structures for investments in AHBs. We recommend that the Central Bank opens an application process that accepts proposals with assessments conducted on a case by case basis.

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?

Risks associated with investing in this sector may be summarised as, liquidity risk, investment risk, regulatory risk, financial risk and business model risk.

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

Davy believes that the only realistic way of dealing with the ALM issues arising from investments in AHBs is to provide the investment through a collective investment vehicle which is large and accessible to all credit unions.

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?

We recommend a concentration limit of 5% initially to be reviewed for potential upward revision as the sector develops over the next few years. Creating an explicit ALM match for credit unions is problematic. We see the duration of AHB investments as remaining an outlier in ALM terms as it is not possible in our view to duration match AHB investments and the loan book of credit unions. Rather, investment in AHBs needs to be looked at on a portfolio basis and in this context, a 5% weighting will not pose a significant risk in ALM terms, as the overall investment portfolio duration remains relatively short.

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?

For an investment in social housing to be tenable we accept that a term of up to 25 years will be required.

We believe that there may be other options worthy of consideration such as a development between credit unions and the NTMA of a department with expertise in this area and examination of the market models used in other countries.

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 feel it is appropriate to reduce the counterparty limit for credit union investments at this time. Diversification proposals in CP109 are insufficient to warrant any contraction in current limits.

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

We would propose a 24-month transitional period but believe that the matter of a transitional period should not arise.

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

Davy advocates the use of collective investment schemes for credit unions.

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

We believe that the barriers are predominantly on the supply side and emanate from the investment environment. Under FRS 102, collective investment schemes must be valued at fair value. Many credit unions hold a preference for valuing investments on an amortised cost basis and are therefore reluctant to absorb the mark to market volatility of collective investment schemes.

It is difficult for advisers to build critical mass to cover and sufficiently dilute the costs involved in setting up collective investment schemes.

Authorisation process in the Central Bank may represent a barrier for advisers.

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 agree with the proposed timelines for the introduction of potential changes to the investment framework set out in this consultation paper. However, we would argue that changes are required which are not set out in this consultation paper (please refer to Section 2), particularly in respect of liquidity, and we would urge the RCU to give consideration to implementing these changes ahead of the proposed timeline.

APPENDIX

Bank bonds: Globally, banks must meet onerous regulatory requirements for loss-absorbing bonds. This is to ensure that in the future, banks have sufficient capital and loss-absorbing instruments to ensure that equity holders and bond holders pay for future bank bailouts rather than tax payers. In the EU, the requirement for loss-absorbing bonds is referred to as minimum requirement for own funds and eligible liabilities (MREL) and is being introduced on a phased basis from 2019 to 2022. Although different EU countries are approaching the MREL shortfall in different ways, all banks are issuing a new type of senior bond which qualifies as MREL and may be subjected to losses or bail-in in the event that the bank goes into resolution. These bonds may be referred to as 'senior non-preferred', 'junior senior', 'tier 3', or 'holding company debt (or holdco)'. They will rank below traditional senior unsecured debt (which now may be referred to as 'senior preferred', 'senior senior', or 'operating company debt (opco)'.

MREL: The minimum requirement for own funds and eligible liabilities (MREL) laid down in the EU's Bank Recovery and Resolution Directive (BRRD). They clarify how the institution's capital requirements should be linked to the amount of MREL needed to absorb losses and, where necessary, recapitalise a firm after resolution.

Bank recovery and resolution directive: An EU directive introduced to deal with 'resolution' of European banks after the financial crash. Resolution means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings.

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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