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Central Bank of Ireland

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27/June/2017

CREDIT UNION REGULATION
29 JUN 2017
RECEIVED

Dear Sirs,

The comments in this document are issued on behalf of the Board of Directors of Tullamore Credit Union Limited , in response to the recent Consultation paper on Potential Changes to the Investment Framework for Credit Unions (CP109) issued in May 2017.

Our Credit Union welcomes the proposal to review the investment framework, and to introduce additional asset classes. The introduction of corporate bonds and supranational bonds will assist in diversifying the counterparty risk away from financials. However it is our view that the implementation of the proposals as set out provides very little scope for diversification benefits given the proposed concentration limits which are based solely on regulatory reserves. In particular, the practical impact on credit unions of the restriction on future investment in bank bonds may have been underestimated in formulating the proposals, and needs urgent review.

Tullamore Credit Union Limited Observations on CP 109

POINT 1 "Section 43 (1) of the 1997 Act requires that a credit union shall manage its investments to ensure that those investments do not (taking account of the nature, scale, complexity and risk profile of the credit union) involve undue risk to members' savings and, for that purpose, before making an investment a credit union shall assess the potential impact on the credit union, including the impact on the liquidity and financial position of the credit union. Under section 43(2) of the 1997 Act, the Central Bank may prescribe investments in which a credit union may invest its surplus funds."

"Notwithstanding the current investment environment for credit unions including the current low level of interest rates, the Central Bank's overriding consideration, in considering changes to the investment framework for credit unions, remains our statutory mandate and the legislative requirement under section 43 of the 1997 Act for credit unions to ensure investments do not involve undue risk to members' savings."

TCU RESPONSE In our view, it is questionable whether the proposals are in accordance with Section 43 of the Act, as they do not appear to allow credit unions take into account their nature, scale, complexity and risk profile, as per the Act, in determining the nature of any possible investment options. This is also relevant in respect of the investment of a credit union's reserves, which we also comment on below. We would suggest that consideration be given to the development of a mechanism whereby the balance sheet strength of many credit unions, that are capitalised far beyond current regulatory requirements, could be harnessed to support and underpin a broader investment portfolio for applicable credit unions.

In its current form there is a danger that the proposals would be seen as micromanaging and could be interpreted as interfering in the legal responsibility of the boards of credit unions to determine the risk tolerance for the credit union.

POINT 2 **the power to make regulations in relation to investments in projects of a public nature is specifically referenced in the regulation making powers provided for under section 43 of the 1997 Act and that therefore such investments could be facilitated by future regulations**

The regulations state that investments in projects of a public nature include, but are not limited to, investments in social housing projects.

TCU RESPONSE Given the time intervals between reviews, and the urgent requirement to broaden the range of investments options for credit unions, and with the number of available counterparties reducing, would it not be appropriate to proactively consider what other opportunities may present themselves in this space over the coming years?

POINT 3 **The Central Bank is of the view that any changes to the investment framework for credit unions should reflect the fact that it is the savings of credit union members (which can be withdrawn on demand) that will be invested by credit unions and that the risk profile of credit union investment portfolios should reflect this.**

TCU RESPONSE We do not believe that this is entirely true. In many cases, such as TCU, a significant proportion of the invested funds reflect the retained earnings, or reserves, of the credit union. In our case this amounts to c€60million. If the logic of the proposals are to be accepted there should then be added scope for investment options for an amount equivalent to the additional reserves held, over and above the level required for the Regulatory Reserve.

History has also indicated that, while credit union savings have been nominally "on demand", they have remained particularly sticky on a longer term basis. Despite this, we, and many other credit unions are actively examining the possibilities in respect of Asset & Liability Management in putting in place a formal product offering to enhance the longevity of member savings.

POINT 4 **Irrespective of current yield levels, investment regulations must reflect appropriate levels of investment risk for credit unions consistent with the requirement under section 43 of the 1997 Act.**

TCU RESPONSE It can be reasonably argued that the current level of approved investment products does not adequately address the question of concentration risk. The old adage of "a balanced, diversified, portfolio is the safest portfolio" has been completely ignored, with credit union investments being "shoehorned" into two limited investment classes. The effect of the current proposals, rather than address this critical issue positively, will be to further limit credit union options almost exclusively into accounts in authorised credit institutions. In effect, credit unions will no longer be allowed invest in bank Bonds in the future should these proposals be implemented. This at a time where the number of institutions in the marketplace has reduced considerably, and those remaining, as competitors to credit unions, may well be using market conditions to penalise credit unions by way of negative interest rates.

The proposals fail completely to address the pressure on credit unions as a result of the level of liquidity imposed on credit unions by regulation, and the current negative returns available on short term deposits. Consideration of the reclassification of tradeable permitted securities as liquid, perhaps subject to a reasonable "haircut" by way of additional risk reserves, is required

The proposals focus entirely on risk, with no consideration of the increased risk to credit unions as a consequence of the loss of income arising from the implementation of the proposals. This renders the proposals dangerously flawed. Similarly there is little consideration of the increased concentration risk within credit union portfolios as a consequence of these proposals.

POINT 5 **Under Section 84 of the Credit Union Act 1997, (" the 1997 Act") the functions of the Central Bank are to administer the system of regulation and supervision of credit unions with a view to the:**

- **Protection by each credit union of the funds of its members; and**
- **Maintenance of the financial stability and well-being of credit unions generally.**

TCU RESPONSE We believe that, given the potential impact of these proposals on credit unions there is scope to challenge them on the basis of them not being consistent with the second function above. These proposals have the capacity to seriously undermine the long term financial stability and well being of credit unions generally, by limiting investment opportunities, creating an imbalance between Risk, particularly concentration Risk, and potential to make adequate returns.

POINT 6 **It is important that credit unions understand the risk implications arising from the BRRD for their investment options and ensure that the instruments they invest in continue to be within their risk appetite. The Central Bank is of the view that it is appropriate that credit unions would not be permitted to invest in subordinated debt instruments that are eligible for MREL, given their risk profile and the potential implications for credit unions should the institution that issued the instrument enter into resolution.**

TCU RESPONSE The above represents an overly restrictive response to BRRD that will, in effect deny credit unions the opportunity to invest in Bank Bonds in the future, as it is highly probable that future bond issues by credit institutions will fall chiefly, if not totally, into this category. Further consideration should be given as to the location of the bond within the capital structure of the credit institution and the relevant ratio of capital etc that is available prior to the bond being bailed in. Perhaps an agreed level of such prior capital could be set, thereby allowing investment in stronger, well capitalised entities. This could also be linked to the entities rating with the relevant agencies.

POINT 7 **The Central Bank commits to performing and publishing analysis of credit union sector investments two years post commencement of any amendments to the investment framework for credit unions to assess and analyse the actual impact which such amendments have had.**

TCU RESPONSE This should happen after 12 months and should include an undertaking to address any issues impacting in a seriously negative manner on credit unions. A review and analysis is not sufficient. There should also be a requirement to act earlier if crisis situation arises – preferably with actions outlined up front.

POINT 8 Potential Additional Investment Classes

TCU RESPONSE Our overall view that the proposals do not reflect any assessment of the requirements of section 43, in respect to scale and complexity of the business model of individual credit unions, as previously mentioned. Nor is there any acknowledgement or recognition that many credit unions have managed significant investment portfolios through extremely challenging times over the past 10 years.

Bonds issued by Supranational Entities

POINT 9 Minimum Credit Rating - A

TCU RESPONSE The implications of this restriction is that any qualifying bonds would provide a negligible return, at best, and probably a negative return.

POINT 10 Concentration Limit - did not exceed 50% of the credit union's regulatory reserve.

TCU RESPONSE For TCU this amounts to c€13.25 million or c5% of assets or 7.4% of current investment portfolio. This would appear extremely conservative given the nature of the investments and the fact that our credit union has total reserves of c€60million at April 30th 2017 to support investment risk.

The earlier point about the credit union investing its own funds rather than member savings applies.

This appears to be a blunt instrument that does not allow credit unions take into account the nature, scale, complexity and risk profile of their business. Nor does it meaningfully provide an alternative investment option. The proposals should also bear some reflection of the overall strength of the credit union to withstand any potential downside risk in respect of their investment portfolio. We would suggest therefore that consideration should therefore be given to a greater percentage based on overall reserves of the credit union. See comment on TCU impact analysis below.

Investments in Corporate Bonds

POINT 11 **Concentration Limit: - the investment did not exceed 25% of the credit union's regulatory reserve.**

TCU RESPONSE For TCU this amounts to c€6.12 million or c2.5% of assets or 3.7% of current investment portfolio. This would appear extremely conservative given the nature of the investments and the fact that our credit union has total reserves of c€60million at April 30th 2017.

My earlier point about the credit union investing its own funds rather than member savings applies.

Again a blunt instrument does not allow credit unions take into account the nature, scale, complexity and risk profile nor meaningfully provide an alternative investment option. There should be some reflection of the overall strength of the credit union to withstand any potential downside risk. Consideration should therefore be given to a greater percentage based on overall reserves of the credit union. See comment on TCU impact in POINT 12 analysis below.

POINT 11 **Investments in Approved Housing Bodies**

Concentration Limit:

Three illustrative concentration limits have been considered in this RIA as follows:
(a) Maximum investment by a credit union limited to 12.5% of regulatory reserves;
(b) Maximum investment by a credit union limited to:
i.25% of regulatory reserves, for credit unions with total assets of at least €100million; or
ii.the lesser of 25% of regulatory reserves or €3 million, for credit unions withtotal assets of less than €100 million; and
(c) Maximum investment by a credit union limited to 50% of regulatory reserves.

TCU RESPONSE for TCU options (a) amounts to c€3 million or c1.2% of assets or 1.8% of current investment portfolio. This would appear extremely conservative given the fact that our credit union has total reserves of c€60million at April 30th 2017. Option (b) amounts to c€6 million or c2.4% of assets or 3.6% of current investment portfolio, again appears conservative. Option (c) allows c€13.25 million or c5% of assets or 7.4% of current investment portfolio, which may be more appropriate, in the context of the overall portfolio and level of reserves.

Our earlier point about the credit union investing its own funds rather than member savings applies.

Again a blunt instrument does not allow credit unions take into account the nature, scale, complexity and risk profile or meaningfully provide an alternative investment option. There should be some reflection of the overall strength of the credit union to withstand any potential downside risk. Consideration should therefore be given to a greater percentage based on overall reserves of the credit union. See comment on TCU impact analysis below.

POINT 12 **Summary of Impact on TCU investment Options**

	As at April 30th 2017
Total Investments:	€179m
Invest in Bank Bonds :	€ 42m (23.5% of overall)
Regulatory Reserve:	€ 26.5m (10.95%)
Impact of Loss of Bank Bond Option	Reduction of €42 million
Max additional Supranational Entity Bonds	€13.25 million
Max additional Corporate Bonds	€6.12 million
Max AHB	€3 million (€6m) (€13.25m)

The net impact of the above proposals would be to force our credit union to divert up to €20 million additional into bank deposits, attracting no return and more than likely having negative returns for the a number of years. This figure is based on the current portfolio level, and does not take into account any likely increase in the level of investments in future years.

<u>POINT 13</u> **Counterparty Limit - to amend the existing 25% counterparty limit set out in the 2016 Regulations to 20%.**

<u>TCU RESPONSE</u> This should be viewed in the context of the overall impact of the proposals on credit unions as per our example above, and the fact that the number of counterparties available in the marketplace continues to shrink. While it is prudent to widen the spread of investment, this would be better achieved by broadening the number of counterparties, offering a reasonable balance between risk and return, available to credit unions.

We are extremely disappointed that the Central Bank has not put forward any proposals in respect of the revision of liquidity requirements for credit unions, particularly in light of the current negative interest rate environment. With Banks having little or no appetite for short term deposits from credit unions this has resulted in negative deposit rates or alternatively short term deposit offerings being withdrawn from the market. We support the proposals of Davy in this regard.

We trust that you find this a worthwhile contribution to the dialogue. We would be available to meet should you require clarification of any of the points made in this document.

Yours Sincerely

Patrick Doheny

Patrick Doheny

Chairperson

27/06/2017

Breda Flynn

Breda Flynn

Hon. Secretary

27/06/2017

DAVY CREDIT UNIONS

Tullamore Credit Union Ltd

Assessing the Impact of Proposals within CP109 on the Investment Portfolio

June 2017

Introduction

This report is intended to assist Tullamore 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 Tullamore Credit Union's portfolio as at 31/05/17. The regulatory reserve figure used in the testing is €26,538,725.

Tullamore 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

Tullamore 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	6,807,678	70%	125,239,537	4%
	Accounts in Authorised Credit Institutions	133,862,299			75%
	Bank Bonds	35,093,858	70%	125,239,537	20%
	Collective Investment Schemes	3,143,314			2%
	Other	6,475			0%
	Total	178,913,624			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%	7.4%	13,269,363	
	Corporate bonds	25%	3.7%	6,634,681	
	Total (additional bonds)		11.1%		
	*Investments in AHB's 3 proposed options:				
	a) or	25%	3.7%	6,634,681	
	b) or	lesser of 25% or €3m for credit unions with assets less than €100m	N/A	N/A	
	c)	50%	7.4%	13,269,363	

**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 Tullamore 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]	[redacted]	[redacted]
[redacted]		[redacted]	[redacted]		[redacted]

- In the event that the counterparty limit is amended to 20% as proposed by the Central Bank, Tullamore Credit Union will need to reallocate 0.5% of the investment portfolio or €1m to alternative counterparties. 4.3% of the portfolio or €7 .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, Tullamore 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 Tullamore 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

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

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 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 Tullamore Credit Union's investment portfolio is 1.53%.

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		1.53%
Impact of senior non-preferred not being authorised	-23%	1.18%
Impact of senior non-preferred bonds not being authorised and supranational & corporate bonds added to the portfolio	-19%	1.24%
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		1.53%
Impact of senior non-preferred being authorised	9%	1.67%
Impact of senior non-preferred bonds being authorised and supranational & corporate bonds added to the portfolio	-2%	1.50%
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%	1.73%

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. 1.18%.
- 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. 1.24%. 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 1.67%. 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 1.50%. 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 1.73%.

Liquidity

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

In the event, that this recommendation is implemented, Tullamore 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.

LIQUIDITY	Gov bonds	Subject to 5% haircut	Potential contribution to STLC	Potential contribution to regulatory liquidity
Government bonds	6,807,678	6,467,294	4,140,019	6,467,294
% unattached			2.50%	3.91%

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 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.

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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