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Central Bank of Ireland Consultation (CP 76)
The Introduction of a Tiered Regulatory Approach for Credit Unions

Submission from Davy

31 March 2014

J&E Davy, trading as Davy, welcomes the opportunity to comment on the Central Bank's consultation paper related to the introduction of a tiered regulatory approach for credit unions. The purpose of this submission is threefold;

1. To give background to Davy's involvement in the consultation process to date.
2. To provide general commentary and impact analysis of the proposals on investments.
3. To highlight constructive alternatives and recommendations for the Central Bank to consider as part of the overall consultation process.

As this submission deals only with the proposed investment framework, it was not considered appropriate for Davy to answer questions within CP 76 that did not relate to investments. Therefore, we have deviated from the suggested format and instead have structured this submission in a layout which more effectively communicates our views and insights.

Section 1: Background

Davy is Ireland's leading provider of stockbroking, wealth management, asset management and financial advisory services. Davy acts as investment advisor to c. 140 of credit unions, has €2bn of assets under management on their behalf and has worked closely with our credit union clients for almost 18 years. Davy therefore has in depth knowledge of the sector and it is in this context that we are making a submission.

Upon reading the CP 76 publication earlier this year, Davy understood the importance of the proposals being put forward and recognised that the impact on the movement was likely to be very significant. As a result, and in an effort to assist credit unions in fully understanding the implications and to encourage their active participation in the consultative process, Davy undertook the following steps:

1. **Conducted Research**: We prepared two research papers which are attached to this document and which should be read in conjunction with this submission and treated as an integral part of it:

   - *The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76): Assessing the Impact on Credit Union Investments* ("Paper 1") outlines the main features of the proposed investment limits and highlights Davy's main observations regarding the potential impact that the proposals may have, particularly on investment income.

   - *Proposed Alternative Approach to Tiered Regulatory Framework for Credit Union Investments: A Follow-up to our Assessment of the Impact on Credit Union Investments* ("Paper 2") sets out Davy's recommendations on the introduction of a tiered regulatory approach and proposes an alternative framework ("the Davy proposal").

2. **Tested the impact of changes proposed in CP 76 on individual investment portfolios:** Davy has conducted testing of the impact of the proposals on 50 individual credit union portfolios and provided the results to the relevant credit unions. We understand that these results may be referred to in a number of individual submissions. The results are available upon request if the Central Bank requires further detail.

3. **Engaged with representative bodies:** Since January, Davy has engaged with representative bodies as well as with our credit union clients and we have actively encouraged all parties to participate in the consultation process. For the avoidance of doubt, this submission represents the views of Davy alone and may not represent the views of third parties with whom we have consulted.

Section 2: General Comments

Davy is in favour of tiered regulation as we believe that it overcomes the flaws inherent in a one size fits all approach and also facilitates the nature, scale and complexity of credit unions which are at varying stages of the growth cycle. However careful consideration must be given to ensure that the framework strikes the right balance between a supportive regulatory environment which promotes growth and a structure which, while preventing excessive risk taking, enables prudent risk management. In the event that this balance is not achieved, the new framework could pose a threat to the viability of a number of credit unions and rather than supporting development, it could result in a regression of the credit union movement.

On this basis, Davy has a number of observations in relation to the proposed framework within CP 76. Readers should only consider this submission in conjunction with the Paper 1 and Paper 2 which more comprehensively address the points summarised below.

A) Summary Observations

1. **Balance between risk management and threat to viability:** One of the key recommendations of the Commission Report was that "boards of directors [should] shape the strategic direction and performance of credit unions around the country". We believe that the proposed regulatory framework is unduly restrictive and would result in boards not having the appropriate scope and autonomy within the proposed framework to manage, develop and expand credit unions. We do not believe that the proposals in this regard in CP 76 strike the right balance between appropriate risk management and the provision of a platform for growth for credit unions. Therefore in our view the proposed framework falls short of this core recommendation from the Commission.

2. **Timing:** The timing is not right to introduce the scale of the changes proposed in CP 76**.** The regulatory framework has undergone significant transformation over the past 12 months; credit unions are undergoing momentous change as they adapt to increased governance requirements and a robust fitness and probity regime. Therefore at individual credit union level, risk management systems are being considerably strengthened and governance structures tightened. Credit unions should be given the opportunity to incorporate their enhanced risk management functions and until such time as these changes are fully embedded, in our view, it is not appropriate to implement a new regulatory framework.

3. **Testing:** Davy is not aware of any testing undertaken by the Central Bank to determine the shortcomings in the existing regulatory investment framework. As we are not aware of the perceived regulatory shortcomings and risks, particularly in relation to investments, it is difficult to make constructive recommendations on a tiered approach and to propose appropriate investment limits. In our opinion, the consultation process would be more constructive had such risks been presented at the outset.

4. **Transparency:** There is a lack of transparency around the rationale for the extent of the restrictions contained within the Central Bank proposals. Based on our discussions with both individual credit unions and the representative bodies, stakeholders are finding it difficult to understand the Central Bank's rationale for deviating from the structure outlined in the Commission Report. In addition, it would be helpful to understand the basis for restricting investment choices at this time and the rationale for excluding certain investment classes. A more constructive approach may be for the Central Bank to outline the supporting rationale for their proposed structure and restrictions contained therein, which would provide valuable insight and transparency and therefore aid a stronger and more collaborative consultation process.

5. **Adverse impact on investment portfolios:** Following extensive testing across 50 individual credit unions' investment portfolios; Davy has concluded that the proposals are likely to have adverse implications for investment returns, particularly with regards to income. We struggle to understand why a more restrictive investment framework is being proposed at a time when it is one of the most challenging periods in history to generate investment returns. Interest rates are at a record low and cash deposit rates are under significant pressure due to the banks' implementation of liquidity ratios under the Capital Requirements Directive IV (CRD IV). The need to generate income from their investment portfolios is a core requirement for credit unions. The proposals as outlined may pose a threat to the viability of certain credit unions.

6. **Use of regulatory reserves as investment limit:** From an investment perspective it is unusual to introduce limits that are related to regulatory reserves and therefore are unrelated to an investment thesis. The regulatory reserve figure is not directly correlated to the investment portfolio and its use in the manner proposed is likely to create complications in terms of management of counterparty risk and asset concentration limits. In addition it is likely to introduce inappropriate extremes for certain credit unions.

7. **Additional Unintended consequences:** As outlined in Paper 1, consideration should be given to additional unintended consequences. One such example is the exodus of cash deposits from Irish banks which is likely to result from the implementation of the proposal to introduce a counterparty limit of 100% of regulatory reserves. We estimate that in order to comply with the diversification requirements up to €2billion of cash deposits may be withdrawn from the Irish banks.

B) Key Recommendations

Following analysis of the framework contained within CP 76 and stress testing of the investment limits across individual credit union portfolios, Davy recognises that there are complexities involved in the development of a tiered regulatory approach. On this basis, we have a number of constructive recommendations in relation to i) the consultation process ii) the tiered structure and iii) the investment proposals. In Paper 2 we have incorporated our recommendations on investments into an alternative approach which is based on a three-tier structure.

Recommendations regarding the Consultation Process

a) *The risks and shortcomings of the current regulatory framework should be identified and outlined by the Central Bank:* We recommend that the results of the Central Bank's assessment of current regulatory framework should be disclosed, as giving this information to stakeholders would strengthen the consultation process and enhance feedback. In addition it may result in a more satisfactory outcome which not only effectively addresses deficiencies of the current framework, but also successfully meets the objectives of regulatory authorities in restructuring the framework.

b) *Commercial Impact Assessment / Testing:* We are unsure as to what level of testing will be in involved within the Regulatory Impact Assessment (referenced in the second stage of the consultation process) as little detail is provided. Davy views this stage as a critical part of the consultation process and it is paramount that in depth testing and viability analysis be conducted across all credit unions and at movement level. We recommend that an additional step should be incorporated into the consultation process which allows for the results of impact assessment to be circulated and an interactive workshop to take place which reviews findings.

Recommendations regarding the Tiered Structure:

a) *Three tier approach is preferable:* Davy favours the three tier approach advocated by the Commission Report rather than the two tier approach put forward in CP 76. We recommend that three categories of credit union be introduced as follows:

    - Category 1: Modifications can be made to the current investment framework for this category, which may include credit unions that are smaller in asset size, may be subject to mergers and may not have sufficient risk management structures in place.

- Category 2: The focus of revised proposals should be on this category which would include the vast majority of credit unions. Davy highly recommends that the status quo, with certain modifications, be maintained.

- Category 3: A wider range of lending and investment activities should be available to this category which will include larger credit unions that have more sophisticated risk management structures in place and will potentially become a hub credit unions of the future.

b) *The tiered approach should be based on nature, scale and complexity:* While asset size is the most logical determinant of categorisation, we recommend that the tiered structure should facilitate those credit unions who may not meet asset size requirements but whose business is of a nature and complexity which warrants a higher categorisation.

c) *Transparency around application process to a higher category:* While we accept that the consultation process is at a preliminary phase, we recommend that the requirements of higher categories should be outlined in detail. This is so that credit unions and their Boards have clarity and are fully aware of the prerequisites of various categories so that they can develop detailed strategic plans which direct them towards the necessary growth, expansion and development to suitably meet the relevant requirements. Following the initial transition period, we believe that there should be scope to make an application to be allocated to a higher category on a quarterly or semi-annual basis (rather than annually as proposed by the Central Bank). With regards to the application process, we recommend that credit unions should be given clear and detailed feedback as to why they may be unsuccessful in achieving a higher classification.

Recommendations specific to Investment Proposals:

a) *Status quo maintained:* In the main we recommend that the status quo should be maintained for credit unions with respect to the regulatory investment framework. We believe the Guidance Note has served credit unions well and that credit unions have managed investments in a prudent and conservative manner with asset allocations and investment below the maximums outlined in the Guidance Note. Consideration should be given to the operating environment which credit unions are facing; it is one of the most challenging periods in history to generate income with interest rates at historic lows, and the global search for yield has compressed the yields available on all asset classes. Furthermore, Irish banks still in the process of implementing liquidity ratios under CRD IV, so the effects of the ratios on credit unions have yet to be fully established. We believe that it would be ill advised to materially alter and restrict the investment framework at this time as it would pose a threat to the viability of certain credit unions.

b) *Wider range of investments and higher concentration limits:* In our view, credit unions should have the ability and autonomy to allocate surplus funds to a wider choice of asset classes which contribute different benefits to the investment portfolio. The regulatory framework should provide the appropriate scope and flexibility for individual credit unions and their Boards to manage investments in a manner conducive to achieving the credit union's investment objectives.

c) *Counterparty and concentration limits:* Davy recommends that counterparty limits and concentration limits should be calculated as a percentage of the total investment portfolio rather than as a percentage of Regulatory Reserves. From the perspective of effective portfolio management, it is unusual to introduce limits which are unrelated to an investment thesis. It is likely to introduce extremes for certain credit unions when the limit is translated to a percentage of the investment portfolio. Testing shows that the proposed counterparty limit may range from just 13% in certain cases and up to 52% in others, neither of which is ideal from a portfolio management perspective.

Section 3: Conclusion

Davy appreciates the approach being adopted by the Central Bank whereby interested parties are being afforded a chance to provide feedback on the development of a tiered regulatory approach. We would welcome the opportunity to meet with the Central Bank to further discuss the content of this submission and the attached research papers as given our experience in the sector we are uniquely placed to assess the significance of the proposals for credit unions and the movement in general.

While we accept that a tiered regulatory approach is the best roadmap for the development of the regulatory framework, we would caution that a great deal of groundwork is required to select and implement the most effective structure. It is necessary to conduct detailed impact analysis and to determine the most appropriate timing to ensure that it represents a progressive step forward for the movement. We think that the consultation process would be well served by engagement with investment experts and Davy is keen and willing to play an active role in this regard.

Attachments to this Submission:

1. Davy Research Paper I: *The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76): Assessing the Impact on Credit Union Investments*
2. Davy Research Paper II: *Proposed Alternative Approach to Tiered Regulatory Framework for Credit Union Investments: A Follow-up to our Assessment of the Impact on Credit Union Investments*

DAVY

The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76)

Assessing the Impact on Credit Union Investments

MARCH 2014

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This paper is intended to provide a summary of the potential impact of certain proposals contained within the Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions ('Consultation Paper 76' or 'CP76' or 'Consultation' or the 'Paper'). It is provided for information and discussion purposes only and is not intended to be comprehensive. It focuses on the investment aspects of the Consultation Paper exclusively. Readers should supplement the content by reading the consultation paper and form their own view in relation to the investment aspects and any other points that may be relevant to their Credit Union. Statements and other assumptions contained in this paper are based on the current expectations, opinions and/or beliefs of Davy at the time of publishing. These assumptions and statements may or may not prove to be correct and actual outcomes may differ.

Executive Summary

- The Report of the Commission on Credit Unions (2012) recommended, among other things, that the regulatory framework should be strengthened for credit unions and that this framework should include a tiered structure.
- In 2013, the Central Bank of Ireland (the 'Central Bank') began the process of implementing a new framework which features enhanced governance, risk management systems and a fitness and probity regime for credit unions.

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- In December 2013, the Central Bank published a consultation paper ('CP76') which is seeking input from the movement and its stakeholders on proposed activities and services, including lending and investments that it proposes be undertaken within a tiered structure. Based on initial analysis, the proposals, if implemented, are likely to have far-reaching implications for the movement's savings, loans and investments. This paper focuses almost exclusively on the implications for investments.
- Investment income is likely to be adversely affected and growth in general may be inhibited as a result. In addition and due to the introduction of reduced counterparty limits, there is potential for significant deposit outflows from the Irish banking system.
- Davy has conducted preliminary testing of the proposals across a number of investment portfolios from a sample of 83 individual credit union balance sheets incorporating a sample size of approximately 39% of total movement assets (€5.4 billion) and approximately 38% of surplus funds (€3.7 billion)[1]. Davy intends to use the results of this analysis as the basis for a submission to the Central Bank which will feature constructive recommendations.
- We urge every credit union to review the proposals contained within the consultation and to give due consideration to making individual submissions to the Central Bank before the closing date of 31st March 2014.

PLEASE NOTE: Until the consultation process concludes and a new investment framework is fully implemented, there is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ.

1 Please refer to Appendix 1 for additional details on the sample of credit unions used by Davy.

Section 1: Introduction & Background

Introduction

The Central Bank of Ireland (the 'Central Bank') published a consultation paper on the introduction of a tiered regulatory approach for credit unions ('CP76') in December 2013. As outlined, the proposals are likely to have far-reaching implications for the movement's savings, loans and investments. Therefore, Davy highly recommends that your credit union reviews and gives consideration to the proposals contained within the consultation.

In particular, if the proposals in relation to investments are implemented in their current form, they are likely to have considerable implications for investment portfolios and their management henceforth. The purpose of this paper is to raise awareness of the main features of the proposed investment limits and to highlight the significant impact that the proposals are likely to have if implemented on, among other things, investment income.

Background

This consultation process is the first step[2] towards adopting a tiered regulatory approach for credit unions as recommended by the Report of the Commission on Credit Unions (2012)[3]. The Central Bank has taken account of certain recommendations of the Commission's report, made modifications where it deemed appropriate and proposed a new tiered regulatory framework within the consultation paper. A two-category approach is suggested[4], which is in contrast to the three-tier structure as advocated by the Commission. The intention is that Category 1 credit unions would offer services comparable to those currently being offered. Credit unions that are capable of and wish to undertake a wider range of activities and services could apply to become a Category 2 credit union. Category 2 credit unions may invest in a wider range of assets and longer dated investments than Category 1 credit unions.

In reviewing the proposed approach adopted by the Central Bank, due consideration should be given to factors such as the timing of the proposals and the current landscape within which credit unions are operating. Credit unions in Ireland are facing the most challenging environment in their history:

- arrears remain elevated;
- loans continue to decline having fallen by 11% from September 2012 resulting in an average loan to asset ratio of just 33%[5];
- it is extremely difficult for credit unions to generate investment income in the current record low interest rate environment and as the effects of banks' classification of credit unions under Basel III[6] depress cash deposit rates; and
- credit unions are undergoing huge change as the regulatory framework transforms to include a robust fitness and probity regime, strengthened governance and heightened supervision.

Consideration should also be given to appropriate diligence to assess the impact of the proposed approach on credit unions. We are not aware of any testing of the existing regulatory investment framework nor were we able to source models of the proposals. However, we note that the second stage of the consultation process involves a Regulatory Impact Analysis. This analysis should include testing of the current framework so that any shortcomings and potential risks are clearly identified. Furthermore, it is imperative that the analysis evaluates the commercial impact of the proposed changes on credit unions and their viability. If the framework is overly restrictive or sufficient impact analysis is not conducted, we believe that it could pose a threat to the viability of certain credit unions.

[2] Please refer to Appendix 2 for more detail on the consultation process and the timetable.
[3] https://www.rebo.ie/images/documents/creditunionrepmar2012.pdf
[4] Please refer to Appendix 3 for further detail.
[5] http://www.centralbank.ie/press-area/speeches/Pages/AddressbyRegistrarofCreditUnionsSharonDonneryCUDAAGM.aspx
[6] Basel III introduces new liquidity ratios called the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratios (NSFR). These ratios are being implemented in the EU via the Capital Requirements Directive IV. Essentially, the ratios force banks to classify deposits according to their perceived stability. Credit union deposits are currently classified in the most penal category which means that they are no longer as attractive to banks, and this is reflected in reduced deposit rates available to credit union funds.

Section 2: Main Features of the Proposals on Investments[7]

i. **A more limited subset of authorised investment classes:** Currently, credit unions may invest in securities as authorised under the Trustee (Authorised Investments) Order 1998. In addition, credit unions must adhere to the authorised classes and limits as prescribed by the Central Bank. The Central Bank's Guidance Note on Investments by Credit Unions (2006)[8] (the 'GN') authorises credit unions to invest in five separate investment classes. Under the proposed measures the investment classes will be reduced to just three for the majority of credit unions, who are likely to be classified as Category 1:

   - All credit unions (i.e. both Category 1 and 2) may invest in certain bank deposits[9], government bonds[10], and shares/deposits of other credit unions.
   - Category 2 credit unions may also invest in certain senior unsecured bank bonds[11] and corporate bonds[12].
   - Investments in equities (Class 4 of the GN) are no longer proposed as an authorised investment class.
   - Collective investment schemes (Class 5 of the GN) are no longer proposed as an authorised investment class.

ii. **Counterparty limits relate to regulatory reserves rather than a percentage of the investment portfolio:**

   - It is proposed that investments in a single counterparty other than a credit union (i.e. bank or EEA state) can be up to 100% of a credit union's Regulatory Reserves.
   - This is likely to reduce counterparty exposure to well below the current limit of 25% of the investment portfolio.

iii. **The introduction of short-term liquidity constraints:** In addition to the minimum liquidity ratio of 20%, short-term liquidity requirements will apply:

   - At least 10% of unattached savings must be available in up to seven days; and
   - Up to 15% of unattached savings must be available within one month.

iv. **No minimum credit ratings:** No minimum credit ratings are proposed in relation to government bonds, cash deposits or senior unsecured bank bonds.

v. **Maximum maturity limits:** Maturity limits of investments are reduced from 10 years currently to 5 years for Category 1 credit unions. For Category 2 credit unions, maturity limits of cash deposits and senior bank bonds / corporate bonds are reduced from 10 years currently to 7 years, and the maturity limit of 10 years for government bonds is maintained.

vi. **Maturity exposures limits are at portfolio level rather than asset class level:** Under the original GN, there are exposure limits to longer dated maturities at asset class level. For example, credit unions may not hold more than 30% of government bonds which are maturing after 7 years. The consultation proposes limits at portfolio level. Category 1 credit unions cannot hold more than 50% of the portfolio maturing after 3 years while Category 2 credit unions cannot hold more than 50% of the portfolio in investments maturing after 5 years.

vii. **Asset class concentration limits are related to reserves:** Asset class concentration limits are no longer expressed as a percentage of the investment portfolio but rather of Regulatory Reserves. Category 2 credit unions may invest up to 50% of their Regulatory Reserves in bank bonds, and up to 50% of their Regulatory Reserves in certain corporate bonds. Based on initial analysis, we estimate that 50% of Regulatory Reserves translates to approximately 9% of the total investment portfolio, which is a restrictive limit for senior bank bond investments and in stark contrast to the limit under the GN, under which up to 70% of the investment portfolio may be allocated to bank bonds.

7 Please refer to Appendix 4 for a summary of the main features of the proposals on investments.

8 http://www.centralbank.ie/regulation/industry-sectors/credit-unions/Documents/200610%20-%20Guidance%20Note%20on%20Investments%20(amended%20for%20website).pdf

9 Bank deposits in an authorised credit institutions.

10 Irish and EEA State Securities.

11 Senior unsecured bonds issued by credit institutions authorised by the Central Bank or in any other EEA State.

12 Corporate bonds that are listed on a recognised exchange with a rating that is not lower than 'A' or its equivalent.

TABLE 1: Concentration limits

	Current Guidance	Proposed Limit
Investments in the shares and deposits of a single credit union (Category 1 and 2)	n/a	12.5% Regulatory Reserves
Total investments in bank bonds (Category 2)	70% of the investment portfolio	50% Regulatory Reserves *This translates to approximately 9% of the investment portfolio of the average credit union based on our sample*
Total investments in corporate bonds (Category 2)	n/a	50% Regulatory Reserves *This translates to approximately 9% of the investment portfolio of the average credit union based on our sample*

Source: Davy with reference to the Central Bank of Ireland's website

Section 3: Impact Analysis of the Proposals

In order to assess the impact of the proposals on credit union investments, we are in the midst of testing across a number of individual investment portfolios. For the purposes of illustration, we have identified a specific credit union portfolio[13] which we believe is a good representation of the average portfolio advised by Davy. We have tested the potential impact of the proposals on the credit union and our findings are significant. It should be noted that the implications for your credit union may differ considerably from those outlined below.

TABLE 2: Impact analysis on a sample credit union's investment portfolio

As all credit unions will be classified as Category 1 credit union at the outset, the following analysis is based on the assumption that the sample credit union will be a Category 1 credit union. Certain credit unions may apply to transfer to Category 2; it is proposed that such credit unions will have asset sizes close to or above €100 million with other qualifying criteria yet to be outlined.

	Description	**Current Allocation**	**% Portfolio**
Investments which are not authorised under proposals	Government bonds (maturity > 5 years)	€3.5 million	4.89%
	Collective Investment Schemes	€3.8 million	5.20%
	Bank bonds	€4.2 million	5.77%
	Structured investments (bank bonds)	€3.08 million	4.19%
	Total	**€14.58 million will need to be allocated to cash deposits or short-term government bonds**	**20%**
	Counterparty	**€ Exposure > 100% Regulatory Reserves**	**Current Exposure as a % Regulatory Reserves**
Breaches of proposed counterparty limit of 100% regulatory reserves (€12.5 million which is approximately 17% of the investment portfolio)	BOI	€4.3 million	134% regulatory reserves
	PTSB	€4.9 million	140% regulatory reserves
	KBC Bank	€2.7 million	122% regulatory reserves
	Total	**€11.9 million will need to be allocated to alternative counterparties**	**16% of investment portfolio**
	Sources of liquidity	**€ Amount**	**% Total Liquidity**
Liquidity management: Credit unions will need to divert funds from collective investment schemes and access / step-up accounts[14] to call accounts or alternative liquid investments	Call accounts	€2.1 million	10.58%
	Term investments nearing maturity	€3.1 million	16.02%
	Collective Investment Schemes	**€3.8 million**	19.26%
	Access/Step-up accounts	**€10.7 million**	54.14%
	Total	**€14.5 million will need to be allocated to call accounts or alternative liquid investments**	
	Limit	**Current %**	**OK / Breach?**
Maturity limit	No more than 50% of the portfolio may mature after 3 years	25% investment portfolio	OK
Short-term Liquidity Constraints	At least 10% of unattached shares must be available 0-7 days	19% unattached shares	OK
	At least 15% of unattached shares must be available up to 1 month	21.3% unattached shares	OK

Source: Davy

Please note that there is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ materially.

13 Please see Appendix 5 for background information on the sample credit union and their investment portfolio.

14 Please note that the requirement to divert funds from access accounts is likely to occur even in the absence of any changes to the investment framework.

Following on from the above analysis, we have identified a number of concerns with regards to the potential impact of the proposals:

i. The Impact on Investment Income

Our primary observation is that the proposed changes, as outlined, are likely to have an adverse impact on credit unions' investment income. This is at a time when it is already very difficult for credit unions to generate income. We believe that a number of credit unions may be relying on their investment returns in order to ensure sustainability in the current adverse economic environment. Investment income represented 41% of the total income generated by our sample of credit unions in the year ending 30th September 2013[15]. Davy anticipates that investment income will be adversely affected by the proposed investment limits for the following reasons:

a) Increased reliance on call deposits: Credit unions are likely to become more reliant on call deposit accounts which are yielding minimal returns. The average call rate available to credit unions from Irish banks[16] is 0.43% and we anticipate that this rate will drop further as the Irish banks fully implement Basel III liquidity ratios[17]. It is likely to move closer towards the average call rate of 0.14% that is currently available from non-Irish banks[18], which in the main have been more progressive in implementing Basel III. We can anticipate an increased reliance on call deposits for the following reasons:

- **Collective investment schemes:**
  - *The proposed exclusion of collective investment schemes as authorised investments may push credit unions into lower yielding call deposits in order to meet their liquidity requirements.*
  - *Class 5 collective investment schemes have served credit unions well as an effective means of managing liquidity, diversifying counterparty risk and ensuring that a meaningful return is achieved on liquid funds.*
  - *175 credit unions are currently invested in and have balances greater than €100,000 in Class 5 collective investment schemes[19] which are 100% deposit based and currently yielding around 1% variable (net of fees), which is in marked contrast to the call deposit rates outlined above.*
  - *As professionally managed funds which are subject to separate and rigorous independent regulation, the inclusion of unit trusts as an investment class brings an additional layer of regulatory supervision and therefore supports the objective of strengthening the investment framework.*
  - *We view it as unlikely that the credit union movement will achieve a new classification under the Basel III ratios of LCR and the NSFR. Cash-based unit trusts may therefore be one investment which may assist participating unit holders in mitigating some of the negative impact of Basel III.*
- **Access accounts are unlikely to be available in a Basel III investment world:**
  - *We estimate that credit unions are achieving approximately 50% of their required liquidity from access accounts, step up deposits or term deposits with one-off access features.*
  - *Such deposits offer attractive rates which mean that they generate attractive income while making an important contribution to credit union liquidity requirements.*
  - *Once banks have fully implemented Basel III liquidity ratios, access accounts will no longer be an attractive means of raising funding for banks and are highly unlikely to be available any longer. Therefore, credit unions will be more reliant on call deposit accounts in order to meet their liquidity requirements.*
  - *It should be stated that we anticipate that this trend will adversely affect credit unions' investment income regardless of any changes to the investment framework. However, the absence of collective investment schemes and the introduction of short-term liquidity constraints against this backdrop may exacerbate the negative impact on credit unions.*

15 Source: Davy
16 AIB, Bank of Ireland, EBS and Permanent TSB. Rates as at 6th February 2014.
17 Please refer to our paper Basel III Liquidity Standards: The Implications for Credit Union Investments http://www.davy.ie/binaries/content/assets/davypublic/credit-unions/davycreditunions_basel-iiiliquiditystandards_may13_final.pdf
18 KBC Group, Danske Bank and Ulster Bank. Rates as at 6th February 2014.
19 Source: Davy, Prescient

b) **Lower yielding universe of authorised asset classes and investments:** We expect that the vast majority of credit unions would be classified as Category 1 credit unions due to the indicative asset size threshold of €100 million for Category 2 credit unions. Therefore, in the main, credit unions will be restricted to a lower yielding universe of authorised asset classes and investments:

- Category 1 credit unions will no longer be able to invest in collective investment schemes, bank bonds and longer term government bonds.
- This may force some credit unions to increase their allocation to cash deposits which are a lower yielding asset class.
- The yield differential between a 5-year senior bank bond with Bank of Ireland and a 5-year cash deposit rate is currently 0.93%[20].
- Category 1 credit unions will not be able to purchase government bonds with more than 5 years term to maturity; this limits them to a lower yielding universe of government bonds.
- The 10-year Irish government bond is yielding 3.26% in contrast to the 5-year government bond which is yielding 1.93%[21].

WARNING: Past performance is no indication of future performance. The value of investments can fall as well as rise.

c) **Counterparty limits:**

- The consultation proposes a counterparty limit of 100% of Regulatory Reserves.
- Based on our analysis, we estimate that this limit, on average, translates to approximately 18% of the investment portfolio. However, some credit unions' Regulatory Reserves represent just 13% of the investment portfolio, while a smaller number's Reserves represent as much as 52% of the investment portfolio.
- This means that certain credit unions may need to introduce or increase exposure to three to four additional counterparties, while others could potentially limit their exposure to just two counterparties. Therefore, the proposed measures do not provide for such extremes which have no real basis in an appropriate investment thesis.
- Whilst the diversification of counterparty risk to a wider range of counterparties is a sensible and prudent investment strategy in theory, based on our sampling, the dilution may be excessive. It is also likely that such counterparties may offer lower yielding cash deposits and therefore this proposal is likely to adversely impact investment income.
- In certain instances, deposit products available are limited to overnight deposits only (Rabobank) while other institutions offer few deposit alternatives beyond 12 months. Furthermore, in an environment where international banks are closing their deposit taking facilities in Ireland, we believe that some credit unions may struggle to source an appropriate number of suitable deposit-taking counterparties.
- Such credit unions may be forced to allocate to government bonds which may introduce unnecessary volatility to the investment portfolio.
- It is noteworthy that senior bank bonds are not included as an authorised investment class for Category 1, and therefore such credit unions will not be able to use senior bonds as a means of diversifying counterparty risk.

ii. More Complex Investment Framework

The proposed framework is more complex in nature and may require additional management:

- Credit unions will be required to manage investments with regard to at least three different reference points. For example, the proposed counterparty limit and asset concentration limits are referenced off regulatory reserves, liquidity is referenced off unattached shares, and maturity limits are laid out as a percentage of the investment portfolio.
- A lower counterparty limit means that additional counterparties may need to be added to the investment portfolio, which may be more onerous in terms of management.

[20] The yield on the BOI 3.25% 2019 Senior Unsecured Bond is 2.92%. The 5-year cash deposit rate is 1.99%. Both rates as at 10th February 2014.

[21] The yields are sourced from Bloomberg as at 10th February 2014.

- Liquidity will be more difficult to manage. The introduction of short-term liquidity constraints means that liquidity will require additional attention and management. We believe that the majority of credit unions would currently meet the proposed limits.
- However, we expect that it may be more difficult to meet the constraints in the future as access accounts become less prevalent and if collective investment schemes are excluded as proposed, attractive liquid investments or term investments with access will be more difficult to source.
- It may be harder to manage excess liquidity in the absence of authorised collective investment schemes which have been the foundation of a number of credit unions' investment portfolios heretofore.
- Finally, the proposed exclusion of bank bonds and longer term government bonds for Category 1 reduces the potential for exposure to liquid marketable securities which play an important function in investment portfolios and contingency funding plans. In the event of an unforeseen liquidity event, they often represent a critical source of additional liquidity.

iii. Cap on Savings of €100,000

We note that there is a proposed cap on savings of €100,000 for both Category 1 and 2 credit unions. In our view, this is penal and potentially obstructive to growth, especially for those core credit unions which are candidates to become the hub of mergers and acquisitions in the years to come. This cap may act as a hindrance to the growth of credit unions' savings, and by consequence, the expansion of loan books and investment portfolios.

iv. Additional Unintended Consequences

The proposed counterparty limit is likely to result in an exodus of cash from the Irish banking system:

- Based on the assumption that credit unions have between 20% and 25% of their investment portfolios with the Irish banks (AIB, BOI and Permanent TSB), the proposed counterparty limit will reduce the majority of credit unions' exposure to approximately 18% of the investment portfolio.
- Based on our estimation that the movement has over €9 billion in investments[22], we believe that up to €2 billion may be withdrawn from the Irish banking system and invested with alternative counterparties.
- The potential for this deposit flight and the adverse impact on the Irish banks should be given careful consideration by the appropriate authorities.

Please note: Until the consultation process concludes, there is no assurance that the proposals will be implemented, and therefore the impact on investment portfolios could be materially different.

[22] The Registrar of Credit Unions (25th January 2014) stated that the total assets of the sector were just below €14 billion and loans to members currently stand at €4.5 billion. Therefore, we believe that €9 billion is a good estimation for the total size of investments. Please see http://www.centralbank.ie/press-area/speeches/Pages/AddressbyRegistrarofCreditUnionsSharonDonneryCUDAAGM.aspx for more information.

Section 4: Summary

At this stage it is clear that the proposed approach is likely to have a serious impact on investments and investment income, and it is regrettably being put forward at a time when income is already under significant pressure due to record low interest rates, the effects of Basel III and more broadly when loan demand is at historically low levels. We are concerned that the proposals, if implemented, may act as further headwind to the sustainability of a number of credit unions and we struggle to understand the rationale for introducing the proposed measures at this time.

This paper looked at just one aspect of a credit union's business (i.e. investments), yet we understand that there are also likely to be far-reaching implications for credit unions' loan books which have not been covered by this paper. Therefore, it is imperative that individual credit unions digest the content of the consultation paper and assess the potential implications for the future of their overall business.

As outlined, Davy is in the midst of ongoing testing and analysis of the consultation paper proposals and we will use the results as the basis for a submission to the Central Bank which will feature constructive recommendations.

Individual Submissions

We understand that it is the intention of a number of stakeholders to make submissions to the Central Bank but, in addition, Davy is urging credit unions to give consideration to making individual submissions to the Central Bank before the closing date of 31st March. These sentiments were echoed by the Registrar for Credit Unions, Ms. Sharon Donnery, who *"strongly encourage(s) you to review the paper and to submit any views or suggestions that you may have. While we are confident that representative bodies will make submissions to the consultation, we also welcome submissions from individual credit unions."*[23] If a large number of credit unions partake in the consultation, it will strengthen the process and is more likely to deliver an outcome that is agreeable for all parties involved.

Conflicts of Interest

As Davy offers a wide range of financial services, it is inevitable that a number of potential or actual conflicts exist. This means that from time to time Davy may have interests which conflict with our clients' interests or with duties that we owe our clients. This includes conflicts arising between the interests of Davy, other entities within the Davy Group and employees on the one hand and the interests of our clients on the other and also conflicts between clients themselves. As well as providing investment management and stockbroking services to credit union clients, Davy may also provide investment services to some companies referred to directly or indirectly in this paper. This includes, but is not limited to, the production and distribution of investment research, the provision of corporate broking services, the provision of corporate finance advice and acting as sponsor. Further information is available on request. Our Conflicts of Interest policy is available at www.davy.ie.

J&E Davy, trading as Davy, is regulated by the Central Bank of Ireland. Davy is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext.

[23] http://www.centralbank.ie/press-area/speeches/Pages/AddressbyRegistrarofCreditUnionsSharonDonneryCUDAAGM.aspx

Section 5: Appendices

Appendix 1: Information on the sample of credit unions used by Davy to conduct initial impact analysis

TABLE 3: Davy collated a sample of credit union annual accounts as of 30th September 2013. Information on the sample size:

Number of credit unions: 83		
	Total Sample	**Average Credit Union**
Total Assets	€5.4 billion	€66 million
Total Investments	€3.7 billion	€44 million
Investment income (2013)	€119 million	€1.4 million
Regulatory Reserves	€636 million	€7.7 million
Regulatory Reserves / Total Assets		11.68%
Regulatory Reserves / Investments		18.02%
Regulatory Reserves / Investments - range		13.04% to 51.86%

Appendix 2: Timetable of the consultation process

The Section on Investments of the Credit Union and Co-operation with Overseas Regulators Act 2012 is currently scheduled to be commenced in Q2 2014. Upon commencement, the section of the Credit Union Act 1997 which requires credit unions to manage investments in accordance with the Trustee (Authorised Investments) Order 1998 (as amended in 2002) will be removed and substituted with text which gives the Central Bank regulatory powers with regards to credit union investments. This means that the Central Bank can effectively replace the GN with alternative guidance which will have a legislative basis. It is within this context that the Central Bank intends to introduce a tiered regulatory approach for credit unions.

TABLE 4: Timetable of the Consultation Process

Date	Process
31st March 2014*	Consultation closes - deadline for submissions from credit unions and relevant stakeholders
March 2014 to June 2014	Section 12 (Investments) of the Credit Union and Co-operation with Overseas Regulators Act 2012 is scheduled to be commenced. This will amend the Credit Union Act 1997 to provide the Central Bank with regulation making powers in a number of areas including investments.
May 2014	Central Bank issues feedback and a second consultation paper which includes regulations to implement the tiered regulatory approach.
July 2014	Second consultation closes
October 2014	Central Bank issues feedback and publishes regulations and updated CU Handbook
October 2014 to March 2015	Application period to become Category 2
April 2015	Regulations come into force

**Please note that this has been extended from 28th February 2014. This could have a knock-on impact on the rest of the deadlines.*
Source: Davy with reference to the Central Bank's consultation paper

Appendix 3: The Central Bank's tiered approach to credit unions

	Category 1	Category 2
Description	▶ All credit unions will initially be designated Category 1 credit unions. They will be able to offer a comparable range of services to those that credit unions are currently offering.	▶ Credit unions wishing to undertake a wider range of activities including more sophisticated lending and investment activities will be permitted to apply to the Central Bank to be categorised as Category 2 credit union. ▶ Additional regulatory requirements will apply. ▶ Credit union must have the ability to meet the proposed regulatory requirements including a sound and robust strategic plan, adequate financial and other resources and appropriate governance arrangements. ▶ It is expected that Category 2 will have assets close to or above €100 million.

Source: Davy with reference to the Central Bank's consultation

Appendix 4: Summary of Proposed Changes to Investment Limits

<table>
<tr><th></th><th>Current Guidance</th><th>Category 1</th><th>Category 2</th></tr>
<tr><td rowspan="5">Authorised Classes Under the GN</td><td>Irish and EMU State Securities
a) Maturity date shall not exceed 10 years
b) Not more than 30% of holding shall be held in bonds maturing after 7 years
c) Holding shall not exceed 70% of the total value of the credit union's investment portfolio</td><td>✓
Maturity date shall not exceed 5 years</td><td>✓
Maturity date shall not exceed 10 years</td></tr>
<tr><td>Accounts in Authorised Credit Institutions
a) Maturity date shall not exceed 10 years
b) Not more than 50% of deposits shall be held in deposits maturing after 5 years
c) Not more than 20% of deposits shall be held in deposits maturing after 7 years</td><td>✓
Maximum maturity of 5 years</td><td>✓
Maximum maturity of 7 years</td></tr>
<tr><td>Bank Bonds
a) Maturity date shall not exceed 10 years
b) Not more than 30% of bank bonds shall be held in bank bonds maturing after 7 years
c) Holding in bank bonds shall not exceed 70% of the credit unions investment portfolio</td><td>✗</td><td>✓
Senior unsecured Bank Bonds | Corporate Bonds that are listed with a rating of 'A'
a) Maximum maturity of 7 years
b) Total investments in bank bonds can be up to 50% of a credit union's regulatory reserves.
c) Total investments in corporate bonds can be up to 50% of regulatory reserves</td></tr>
<tr><td>Investment in Equities</td><td>✗</td><td>✗</td></tr>
<tr><td>Collective Investment Schemes</td><td>✗</td><td>✗</td></tr>
<tr><td>New Class</td><td>Shares and Deposits of other Credit Unions</td><td colspan="2">✓ ✓
Investments in shares & deposits of a single credit union can have a maximum maturity of 5 years and can be up to 12.5% of the Regulatory Reserves</td></tr>
<tr><td rowspan="3">Additional Limits</td><td>Counterparty Limits
a) Investments in a single institution shall not exceed 25% of the total value of the investment portfolio</td><td colspan="2">Investments in a single counterparty other than a credit union can be up to 100% of a credit union's Regulatory Reserves</td></tr>
<tr><td>Maturity Limits
As outlined under individual asset classes above</td><td>Up to 50% of the total value of the portfolio can be in investments maturing after 3 years</td><td>Up to 50% of the total value of the portfolio can be in investments maturing after 5 years</td></tr>
<tr><td>Liquidity
a) 20% of unattached savings (up to 30% if applicable)</td><td colspan="2">20% of unattached savings (up to 30% if applicable)
10% unattached savings available up to 7 days
15% unattached savings available up to 1 month</td></tr>
<tr><td></td><td></td><td></td><td>Liquidity stress tests required</td></tr>
</table>

Source: Davy with reference to the Central Bank Consultation Paper

Please note the above information is not exhaustive. It is intended for summary purposes only.

Appendix 5: Background information on the sample credit union used to illustrate the potential impact of the proposals on investments

	€ Amount (million)	% of Portfolio
Regulatory Reserves (30th September 2013)	€12.5	
Total Assets (30th September 2013)	€83.7	
Size of Investment Portfolio (31st January 2014)	€73.5	
Unattached shares (31st January 2014)	€62	
Asset Allocation		
Government Bonds (>5 years)	€3.6	4.89%
Cash Deposits	€51.2	69.59%
Bank Bonds	€4.2	5.77%
Collective Investment Schemes	€3.8	5.2%
Structured Investments (Bank Bonds)	€3.08	4.19%
Structured Investments (Cash Deposits)	€7.6	10.36%
Total	**€73.5**	**100%**
Counterparty Risk		
AIB	€8.5	11.49%
BOI	€16.8	22.85%
PTSB	€17.4	23.76%
KBC Bank	€15.2	20.73%
Ulster Bank	€7.05	9.58%
Rabobank	€1.1	1.5%
Irish Government	€3.6	5.2%
Total	**€73.5**	**100%**
Liquidity	€19.8	31.9% unattached shares

Source: Davy

Appendix 6: Performance Data

	2009	2010	2011	2012	2013	10th February 2014
Irish 5-year Government Bond Yield	3.25	3.14	7.62	3.32	2.18	1.93
Irish 10-year Government Bond Yield	4.84	9.06	8.21	4.52	3.51	3.26
Bank of Ireland Senior Unsecured Bond Yield*	5.01	12.74	15.74	3.41	4.42	2.92

**The yield is based on the Bank of Ireland 4.625% 2013 Senior Unsecured Bond from 2009 to 2013. The yield as at 10th February 2014 is based on the Bank of Ireland 3.25% 2019 Senior Unsecured Bond.*

All data is sourced from Bloomberg as at market close 10th February 2014

WARNING: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up.

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DAVY

CP76 - Paper II

Proposed Alternative Approach to Tiered Regulatory Framework for Credit Union Investments

A Follow-up to our Assessment of the Impact on Credit Union Investments

MARCH 2014

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This document is intended for information and discussion purposes only and is not intended to be comprehensive. It does not constitute investment advice. It focuses on the investment aspects of the Consultation Paper exclusively. Readers should supplement the content by reading our March 2014 paper, "The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76): Assessing the Impact on Credit Union Investments". In addition, readers should consult the Consultation Paper and form their own view in relation to the investment aspects and any other points that may be relevant to their credit union. Statements and other assumptions contained in this document are based on the current expectations, opinions and/or beliefs of Davy at the time of publishing. These assumptions and statements may or may not prove to be correct and actual outcomes may differ.

Until the consultation process concludes and a new investment framework is fully implemented, there is no certainty that the proposals set out in the Consultation Paper will materialise.

Executive Summary

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- In December 2013, the Central Bank of Ireland (the 'Central Bank') published a consultation paper (CP76) which is seeking input from the movement and its stakeholders on proposed activities and services, including lending and investments that it proposes be undertaken within a tiered structure.
- In early March, Davy published a paper "The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76): Assessing the Impact on Credit Union Investments" ('Paper I') which highlighted Davy's concerns regarding the impact that the proposals are likely to have if implemented, on credit union investment portfolios.
- Results of analysis by Davy on individual credit union portfolios indicate that the Central Bank proposals are likely to have adverse implications for investment portfolios, particularly with regards to investment income.
- Davy has a number of core recommendations regarding the introduction of a tiered investment framework. Although Davy has concerns over the timing of implementation, Davy is in favour of a tiered approach and advocates the three tier approach outlined in the Report of the Commission on Credit Unions 2012 (the 'Commission Report') rather than the two tier approach put forward in CP 76.
- Davy proposes an alternative investment framework (the 'Davy proposal'), which incorporates our core recommendations. It is intended that this approach will provide a platform for growth which we believe is in line with the spirit of the Commission Report.
- Boards would have the appropriate scope and autonomy to direct the credit union towards the financial forecasts (including investment returns) as outlined in their strategic plans and their chosen business model, and to develop their governance, prudential and operational standards to reflect the complexity of their chosen model.
- Davy reiterates the message from Paper I that it is imperative for individual credit unions and their representative bodies to engage in the consultation process so that the requirements and views of the movement are given due consideration by the Central Bank.

PLEASE NOTE: Until the consultation process concludes and a new investment framework is fully implemented, there is no certainty that the proposals set out in the Consultation Paper will materialise. Actual outcomes may differ.

Section 1. Introduction & Background

In early March, Davy published a paper "The Central Bank of Ireland's Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions (CP 76): Assessing the Impact on Credit Union Investments". The paper looked at the main features of the Central Bank's proposed investments limits (the 'Central Bank proposals')[1] and highlighted Davy's concerns regarding the significant impact that the proposals are likely to have if implemented on, among other things, investment income.

Davy is in the midst of testing the Central Bank proposals across a broad sample of individual credit union portfolios. The results of this analysis to date[2] indicates that the Central Bank proposals are likely to have adverse implications for investment portfolios, particularly with regards to investment income. The purpose of this paper is to make constructive recommendations on the introduction of an alternative tiered investment framework (the 'Davy proposal') which we believe is within the spirit of the Commission Report. Our proposals encompass some of the main recommendations laid out by the Commission and we believe that they strike the right balance between appropriate risk management and a framework which allows viable credit unions to grow.

It should be noted that the content of this paper focuses exclusively on investments. However, the proposed structure may also be an appropriate framework for a tiered regulatory approach to credit unions' savings and loan books.

[1] Please refer to Appendix 1 for a summary of the Central Bank's proposed changes to investment limits

[2] Please refer to Appendix 2 for details on the testing completed by Davy and the main findings of this analysis.

Section 2: Core Recommendations

A. The timing is not right to introduce the scale of the changes proposed in the Consultation Paper (CP 76): If implemented as outlined, the commercial viability of the sector may be compromised. Therefore, Davy highly recommends that the status quo be maintained, with certain modifications, or alternatively that consideration is given to an extended consultation period to allow for further stress testing of the model. Our rationale is as follows:

- The regulatory framework has gone through significant transformation over the past 12 months; credit unions are undergoing momentous change as they adapt to increased governance requirements and a robust fitness and probity regime. This has placed substantial additional responsibilities on credit unions' management and their respective boards to ensure that the appropriate risk management systems and compliance programmes are in place, including appointing officers specifically tasked with these functions. Therefore, at individual credit union level or at micro level, credit union risk management systems are being considerably strengthened and governance structures tightened.
- Credit unions should be given the opportunity to develop and incorporate their enhanced risk management functions to review and strengthen policies around investments, liquidity and asset liability management and be in a position to build on the opportunities that are likely to emerge as the domestic and global economies begin to recover. This will ensure that the credit union sector is operating within an appropriate investment framework which reflects the revised regulatory backdrop and yet is tailored to their individual risk appetite and investment objectives.
- Until such time as these changes are fully embedded, in our view, it is not necessary to implement a new regulatory framework.

B. Davy is in favour of a tiered regulatory approach outlined in the Credit Union Commission Report: While we have concerns regarding the timing, we are in favour of a tiered approach as we believe that it overcomes the flaws of a one size fits all approach to regulation and also facilitates credit unions which are at varying stages of the growth cycle.

TABLE 1: Three-tier approach advocated by the Commission

Category 1	Category 2	Category 3
Assets < €10 million	€10 million < Assets < €100 million	Assets > €100 million

Source: Davy with reference to the Report of the Commission on Credit Unions

Davy favours the three-tier approach outlined in Commission Report rather than the two-tier approach put forward in CP 76. While we accept that there are certain merits in proposing a two-tier structure which include a more simplified model and potentially greater ease of implementation, we believe that three tiers is preferable for the following reasons:

- In rationalising the three-tier approach to two, some of the Commission's recommendations may have been inadvertently lost in the process and the structure does not serve small or medium–to-larger sized credit unions particularly well.
- In contrast, the three-tier approach would facilitate the following:
  - ***Category 1:*** Modifications can be made to the current investment framework for this category, which is likely to include credit unions that are smaller in asset size, may be subject to mergers and may not have sufficient risk management structures in place. As the Commission proposed, it will serve "*those smaller credit unions that want to operate a simpler business model…under a simpler regulatory regime*".
  - ***Category 2:*** The focus of revised proposals should be on this category, which would apply to the vast majority of credit unions. Davy highly recommends that the status quo, with certain modifications, be maintained (please refer to Section 3 for further detail).
  - ***Category 3:*** A wider range of lending and investment activities should be made available to this category which are larger, likely to have more sophisticated risk management structures in place and will potentially become a hub credit union of the future. As put by the Commission, it will accommodate "*larger credit unions that are capable of operating on a more sophisticated basis [and which] should be allowed to offer a wider range of products and services and engage in a broader range of lending and investment activities*".

C. The tiered approach should be based on nature, scale and complexity: We support the Commission's recommendation that the "new tiered approach to regulation should be based on nature, scale and complexity of the credit union concerned". Asset size is the primary basis of categorisation of credit unions in the proposed structures from the Commission and the Central Bank. While we agree that asset size or scale is the most logical determinant for classification, we believe that the structure should facilitate those credit unions that may not meet asset size requirements but whose business is of a nature and complexity which warrants a higher categorisation.

D. Counterparty limit and concentration limits: Davy recommends that counterparty limits and concentration limits should be represented as a percentage of the total investment portfolio rather than as a percentage of Regulatory Reserves. From the perspective of effective portfolio management, it is unusual to introduce limits which are unrelated to an investment thesis. The Regulatory Reserve figure is a very separate unrelated aspect of the business to the investment portfolio, and therefore by introducing it as a measure to limit counterparty risk, it presents complications in terms of management. In addition, the counterparty limit of 100% Regulatory Reserves is likely to introduce extremes for certain credit unions when the limit is translated to a percentage of the investment portfolio. Testing shows that counterparty limits may range from just 13% in certain cases and up to 52% in others. The proposals outlined do not accommodate outliers of this type and is therefore far from ideal from a portfolio management perspective.

E. Wider range of investments and higher concentration limits: Our key thesis is that the regulatory framework should provide the appropriate scope and flexibility for individual credit unions and their Boards to manage investments in a manner conducive to achieving the credit union's investment objectives. In our view, credit unions should have the ability and autonomy to allocate surplus funds to asset classes which contribute different benefits to the investment portfolio. Table 2 illustrates the range of benefits that our proposed asset classes are likely to contribute to a portfolio under five key theses: income, liquidity, diversification of counterparty risk, growth and stabilisation.

TABLE 2: Recommended asset classes and their contribution to credit unions' investment portfolios

Asset Class	Subtype	Income	Liquidity	Diversification of counterparty risk	Growth	Stabilisation
Government Bonds*		✓		✓		
Accounts in Authorised Credit Institutions	*Term accounts*	✓				
	Call accounts		✓			
	Capital protected structured investments				✓	
Bank Bonds*	*Bonds*	✓		✓		
	Capital protected structured investments				✓	
Corporate Bonds*		✓		✓		
Equities					✓	
Collective Investment Schemes		✓	✓	✓		
Shares and deposits of other credit unions						✓

Source: Davy

**While the above assets may not be treated as liquid for the purposes of regulatory liquidity requirements, they play an important function as contingent liquidity sources.*

WARNING: Table 2 is for illustrative purposes only and does not suggest that all asset classes are suitable for all credit unions. It does not constitute investment advice.

Credit unions should be able to select and approve appropriate asset classes, determine an asset allocation with relevant limits, and establish investment constraints on matters such as maturity profile and counterparty exposure, all of which should be formally laid out in their investment policy. Regulatory limits should not be overly restrictive and should be regarded as limits rather than targets. Credit unions should reduce those limits if and as appropriate within their investment policy.

F. **Transparency around application process to a higher category:** We note that the Central Bank expects that in general, "credit unions that apply to become Category 2 credit unions will have assets close to or above €100 million". They further state that applications to Category 2 will "be assessed based on criteria that demonstrate that the credit union has the ability to meet the proposed regulatory requirements of a Category 2 credit union including having a sound and robust strategic plan, adequate financial and other resources and appropriate governance arrangements". It is critical that additional detail is provided on such requirements in advance of the completion of the consultation period. Credit unions and their Boards must have clarity and be fully aware of the prerequisites of various categories so that they can develop detailed strategic plans which direct them towards the necessary growth, expansion and development to suitably meet the relevant requirements.

Section 3: Davy Proposal

Table 3 outlines Davy's proposed authorised investment classes and associated limits based on a three-tier approach. Please refer to Appendices 3, 4 and 5 for illustrative tables which contrast the proposed investment framework for Categories 1, 2 and 3 against the current guidance under the Guidance Note on Investments by Credit Unions, October 2006 (the 'GN').

Please note this is a draft framework which was developed in consultation with certain stakeholders and credit unions.

TABLE 3: The Davy Proposal: Investment Classes & Limits

			Category 1 Assets < €10 million	Category 2 €10 million < Assets < €100 million	Category 3 Assets > €100 million
Authorised Classes	**Irish and EEA State Securities[A]**	Investments in transferable securities issued by the Irish State and other EEA States which are rated investment grade (minimum Baa3) by at least one recognised rating agency.	✓ Maturity date shall not exceed 5 years	✓ Maturity date shall not exceed 10 years	✓ Maturity date shall not exceed 10 years
Authorised Classes	**Accounts in Authorised Credit Institutions[B]**	Investments in interest bearing deposit accounts in credit institutions authorised by the Central Bank or by the competent authority of another EEA State[C].	✓ Maturity date shall not exceed 5 years	✓ Maturity date shall not exceed 7 years	✓ Maturity date shall not exceed 10 years
Authorised Classes	**Bank Bonds[D]**	Investments in bonds issued by credit institutions[3].	✗	✓ Maturity date shall not exceed 7 years Total investments in bank bonds shall not exceed 20% of the investment portfolio[C]	✓ Maturity date shall not exceed 10 years Total investments in bank bonds shall not exceed 20% of the investment portfolio[C]
Authorised Classes	**Corporate Bonds[E]**	Corporate bonds that are listed on a registered exchange with a rating that is not lower than A or its equivalent	✗	✓ Maturity date shall not exceed 7 years Total investments in corporate bonds shall not exceed 20% of the investment portfolio	✓ Maturity date shall not exceed 10 years Total investments in corporate bonds shall not exceed 20% of the investment portfolio
Authorised Classes	**Investments in Equities[F]**	Euro-denominated equities or exchange traded funds ('ETFs') which track stock indices, traded on a regulated market within the EU. The issuing corporate or Fund shall have a minimum market capitalisation of €1.5 billion.	✗	✓ Total investment in equities shall not exceed 5% of the investment portfolio	✓ Total investments in equities shall not exceed 10% of the investment portfolio
Authorised Classes	**Collective Investment Schemes[G]**	Collective investment schemes which are 100% invested in accounts in authorised credit institutions	✓	✓	✓
Additional Limits	**Maturity Limits[H]**		Up to 30% of the total value of the portfolio can be in investments maturing after 3 years	Up to 30% of the total value of the portfolio can be in investments maturing after 5 years	Up to 50% of the total value of the portfolio can be in investments maturing after 5 years
Additional Limits	**Counterparty Limits[I]**		Investments in a single institution shall not exceed 25% of the total value of the investment portfolio		
Additional Limits	**Liquidity[J]**		20% of unattached savings (up to 30% if applicable) At least 10% unattached savings available up to 7 days At least 15% unattached savings available up to 1 month		
Additional Limits	**Currency**		Only investments in euro-denominated investments permitted		
Other	**Shares and Deposits of other Credit Unions (New Class)[K]**		✓ Investments in shares & deposits of a single credit union can have a maximum maturity of 5 years and can be up to 12.5% of the Regulatory Reserves	✓	✓

WARNING: Past performance is no indication of future performance. The value of investments can fall as well as rise.

Section 4: Explanatory Notes on the Davy Proposal

(A) Irish and EEA States (government bonds):

- Credit unions should only be able to purchase government bonds which are of investment grade quality. Please refer to Appendix 6 for relevant ratings of Irish and EEA States.
- Investments in Irish and EEA State securities may represent up to 100% of the portfolios of Category 1, 2 and 3 credit unions.
- The counterparty limit of 25% of the investment portfolio should not be applicable to investments in Irish and EEA State securities. This is in contrast to the Central Bank's proposal. We believe that a credit union should be permitted to place 100% of their portfolio with an investment grade government if deemed appropriate. For example, at the peak of the European debt crisis, certain risk adverse investment portfolios allocated 100% to short-term German government bonds, and we believe that this option should be available to credit unions albeit that an investment strategy such as this is unlikely to be required.
- We recommend that Category 1 credit unions should be restricted to government bonds with a maximum maturity of 5 years, while both Category 2 and 3 credit unions should be able to purchase government bonds with a maturity of up to 10 years.

(B) Accounts in Authorised Credit Institutions (cash deposits):

- Category 2 and Category 3 credit unions should have the flexibility to place deposits up to 7 and 10 years respectively.
- Due consideration should be given to the fact that the interest rate environment is likely to alter materially from the current environment (within which, in Davy's view it is not prudent to be placing a significant proportion of funds beyond 3 years at present). However and as an example, during 2003-2005, credit unions secured extremely attractive deposit rates for terms between 5 and 10 years which served portfolios very effectively.

(C) Structured Investments

- It is important that credit unions should be in a position to participate in the performance of growth assets such as equities through structured investments where the capital protection is provided by either a cash deposit or alternatively by bank bonds.

(D) Bank Bonds:

- Category 2 and 3 credit unions should be able to purchase bank bonds. Within an appropriate allocation in a portfolio, they can provide important benefits of income, counterparty diversification and a contingency funding source in the event of an unforeseen liquidity event.
- This asset class and associated limits should be reviewed in approximately 12 months' time in order to review the parameters with a potential view to introducing minimum credit ratings.
- We believe that 20% of the investment portfolio is an appropriate limit for bank bonds.

(E) Corporate Bonds:

- Davy welcomes the introduction of corporate bonds as a proposed investment class. It provides an opportunity to diversify investments outside of banks and other credit institutions whose performance may be highly correlated to that of credit unions.
- We believe that 20% of the investment portfolio is an appropriate limit for corporate bonds which have a rating not less than 'A'.

(F) Equities:

- Equities should be included as an authorised investment for Category 2 and 3 credit unions. In the investment universe, the most cautious portfolio mandates often include an element of equity exposure; structured investments and investments in equities provide the only means of accessing real growth assets for credit unions. Category 2 and 3 should have the potential to invest a small portion of their portfolio directly in equity markets if they deem this to be appropriate and consistent with the investment objectives, constraints and risk appetite as laid out in their investment policy. The category should be broadened to encompass exchange traded funds ('ETFs') which track stock indices for the following reasons:
  - Credit unions can mitigate stock specific risk by investing in ETFs
  - They would provide a means of diversifying the portfolio exposure beyond companies that are primarily euro-based to include international companies and stock indices.
  - ETFs are highly cost effective and an efficient way of achieving access to equity markets.

(G) Collective Investment Schemes:

- Collective investment schemes which are 100% cash deposit based should continue to be an authorised investment class for credit unions.
- They have served credit unions well as an effective means of managing liquidity, diversifying counterparty risk and ensuring that a meaningful return is achieved on liquid funds.
- The benefits are particularly pronounced for smaller credit unions which may not have sufficient risk management systems or sophisticated investment policies in place. In addition, they can play an important role as a liquid and diversified short-term holding place for investments of credit unions which are in the midst of mergers and acquisitions.
- As professionally managed funds which are subject to separate and rigorous independent regulation, the inclusion of unit trusts as an investment class brings an additional layer of regulatory supervision and therefore supports the objective of strengthening the investment framework.
- We view it as unlikely that the credit union movement will achieve a new classification under the Basel III ratios of LCR and the NSFR[3]. Cash-based unit trusts may therefore be one investment which may assist participating unit holders in mitigating some of the negative impact of Basel III particularly in view of the fact that they are 100% deposit based.

(H) Maturity Limits:

- We agree that the maturity limits should be represented at portfolio level rather than at asset class level.
- We have suggested a sliding scale of maturity limits based on the categorisation of credit unions.

(I) Counterparty Limit:

- The counterparty limit should continue to be 25% of investments.
- This is a prudent and sensible limit within the investment universe and, for example, lies between the specified counterparty limits for UCITS[4] (20%) and non-UCITs funds (30%). In the event that a credit union wishes to diversify counterparty exposure further and reduce its limit below 25%, this may be implemented through their investment policy.

[3] Basel III introduces new liquidity ratios called the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratios (NSFR). These ratios are being implemented in the EU via the Capital Requirements Directive IV. Essentially, the ratios force banks to classify deposits according to their perceived stability. Credit union deposits are currently classified in the most penal category which means that they are no longer as attractive to banks, and this is reflected in reduced deposit rates available to credit union funds

[4] UCITS refers to Undertakings for Collective Investment in Transferable Securities. Non-UCITS refers to collective investment schemes other than UCITS.

(J) Liquidity:

- We support the Central Bank's proposal to extend the definition of liquid assets to include investments with more than three months to maturity that have an explicit guarantee that the funds can be accessed by the credit union in less than three months, excluding penalties on interest or income.
- We support the introduction of short-term liquidity constraints as it is a prudent policy.
- Credit unions are likely to find it more challenging to source liquid attractive investments in the future as banks withdraw access accounts due to the implementation of Basel III liquidity rules. Therefore the reliance on cash based collective investment schemes is likely to increase and it is essential that they are included as an authorised investment as a result.

(K) Shares and Deposits of other Credit Unions (New Class):

- There is unlikely to be an investment thesis behind investing in the shares and deposits of other credit unions. It is more likely to be a stabilisation measure. Therefore, it should feature as guidance from the Central Bank which is separate to the guidance on investments.
- As we do not believe it should feature within guidance on investments, it is reasonable for the concentration limit to be represented as a percentage of Regulatory Reserves or alternatively of Total Assets rather than as a percentage of the total investment portfolio.

Section 5: Risks of the Davy Proposal

In certain cases, Davy is recommending a wider range of asset classes, longer maturity limits and higher concentration limits than those outlined in the Central Bank proposal. This could potentially allow for increased risk exposure within portfolios. However, it is important to note that the Davy proposal is very closely correlated with the current investment framework and we believe it should be assessed in this context. As the tables in Appendices 3, 4 and 5 illustrate, certain aspects of the Davy proposal are less restrictive than the current limits under the GN while other recommendations advocate more restrictive measures than the current guidance.

Section 6: Conclusion

Davy welcomes the consultation process by the Central Bank in relation to introducing a tiered regulatory approach and developing the investment framework for credit unions. As set out in Paper I on CP 76, we have a number of reservations about the proposals set out by the Central Bank; we do not believe that they strike the right balance between risk management and viability.

Our approach, as set out in this paper, is to propose a platform for growth which we believe is in line with the spirit of the Commission Report. Within our proposed framework, Boards would have the appropriate scope and autonomy to direct the credit union towards the financial forecasts (including investment returns) as outlined in their strategic plans and their chosen business model, and to develop their governance, prudential and operational standards to reflect the complexity of their chosen model.

Davy reiterates the message from our first paper that it is imperative for individual credit unions and their representative bodies to engage in the consultation process so that the requirements and views of the movement are given due consideration by the Central Bank.

PLEASE NOTE: Until the consultation process concludes, there is no assurance that the proposals will be implemented, and therefore the impact on investment portfolios could be materially different.

Section 7: Appendices

Appendix 1: Summary of Proposed Changes to Investment Limits

	Current Guidance	Category 1	Category 2
Authorised Classes Under the GN	**Irish and EMU State Securities** a) Maturity date shall not exceed 10 years b) Not more than 30% of holding shall be held in bonds maturing after 7 years c) Holding shall not exceed 70% of the total value of the credit union's investment portfolio	✓ Maturity date shall not exceed 5 years	✓ Maturity date shall not exceed 10 years
	Accounts in Authorised Credit Institutions a) Maturity date shall not exceed 10 years b) Not more than 50% of deposits shall be held in deposits maturing after 5 years c) Not more than 20% of deposits shall be held in deposits maturing after 7 years	✓ Maximum maturity of 5 years	✓ Maximum maturity of 7 years
	Bank Bonds a) Maturity date shall not exceed 10 years b) Not more than 30% of bank bonds shall be held in bank bonds maturing after 7 years c) Holding in bank bonds shall not exceed 70% of the credit unions investment portfolio	✗	✓ Senior unsecured Bank Bonds | Corporate Bonds that are listed with a rating of 'A' a) Maximum maturity of 7 years b) Total investments in bank bonds can be up to 50% of a credit union's regulatory reserves. c) Total investments in corporate bonds can be up to 50% of regulatory reserves
	Investment in Equities	✗	✗
	Collective Investment Schemes	✗	✗
New Class	**Shares and Deposits of other Credit Unions**	✓ Investments in shares & deposits of a single credit union can have a maximum maturity of 5 years and can be up to 12.5% of the Regulatory Reserves	✓
Additional Limits	**Counterparty Limits** a) Investments in a single institution shall not exceed 25% of the total value of the investment portfolio	Investments in a single counterparty other than a credit union can be up to 100% of a credit union's Regulatory Reserves	
	Maturity Limits As outlined under individual asset classes above	Up to 50% of the total value of the portfolio can be in investments maturing after 3 years	Up to 50% of the total value of the portfolio can be in investments maturing after 5 years
	Liquidity a) 20% of unattached savings (up to 30% if applicable)	20% of unattached savings (up to 30% if applicable) 10% unattached savings available up to 7 days 15% unattached savings available up to 1 month	Liquidity stress tests required

Source: Davy with reference to the Central Bank Consultation Paper

Please note the above information is not exhaustive. It is intended for summary purposes only.

Appendix 2: Impact Analysis of the Proposals

Davy has conducted testing of the Central Bank proposal across 35 individual credit union's investment portfolios. The testing is ongoing and the results are available upon request. To date the impact across individual investment portfolios is broadly consistent and is effectively illustrated by a sample credit union's investment portfolio. We believe this portfolio is a good representation of the average portfolio advised by Davy.

TABLE 4: Impact analysis on a sample credit union's investment portfolio

As all credit unions will be classified as Category 1 credit unions at the outset, the following analysis is based on the assumption that the sample credit union will be a Category 1 credit union. Certain credit unions may apply to transfer to Category 2; it is proposed that such credit unions will have asset sizes close to or above €100 million with other qualifying criteria yet to be outlined.

	Description	Current Allocation	% Portfolio
Investments which are not authorised under proposals	Government bonds (maturity > 5 years)	€3.5 million	4.89%
	Collective Investment Schemes	€3.8 million	5.20%
	Bank bonds	€4.2 million	5.77%
	Structured investments (bank bonds)	€3.08 million	4.19%
	Total	**€14.58 million will need to be allocated to cash deposits or short-term government bonds**	**20%**
	Counterparty	**€ Exposure > 100% Regulatory Reserves**	**Current Exposure as a % Regulatory Reserves**
Breaches of proposed counterparty limit of 100% regulatory reserves (€12.5 million which is approximately 17% of the investment portfolio)	BOI	€4.3 million	134% regulatory reserves
	PTSB	€4.9 million	140% regulatory reserves
	KBC Bank	€2.7 million	122% regulatory reserves
	Total	**€11.9 million will need to be allocated to alternative counterparties**	**16% of investment portfolio**
	Sources of liquidity	**€ Amount**	**% Total Liquidity**
Liquidity management: Credit unions will need to divert funds from collective investment schemes and access / step-up accounts[5] to call accounts or alternative liquid investments	Call accounts	€2.1 million	10.58%
	Term investments nearing maturity	€3.1 million	16.02%
	Collective Investment Schemes	**€3.8 million**	19.26%
	Access/Step-up accounts	**€10.7 million**	54.14%
	Total	**€14.5 million will need to be allocated to call accounts or alternative liquid investments**	
	Limit	**Current %**	**OK / Breach?**
Maturity limit	No more than 50% of the portfolio may mature after 3 years	25% investment portfolio	OK
Short-term Liquidity Constraints	At least 10% of unattached shares must be available 0-7 days	19% unattached shares	OK
	At least 15% of unattached shares must be available up to 1 month	21.3% unattached shares	OK

Source: Davy

Please note that there is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ materially.

5 Please note that the requirement to divert funds from access accounts is likely to occur even in the absence of any changes to the investment framework.

The main impact of the Central Bank proposal on credit union's investment portfolios is that investment income is likely to be adversely affected for the following reasons:

a. **Lower yielding universe of authorised asset classes and investments:** The sample credit union will need to reallocate €14.58 million or 20% of the investment portfolio from government bonds (with maturity greater than 5 years), collective investment schemes, bank bonds and structured investments (bank bonds) to lower yielding assets such as cash deposits or short-term government bonds.

b. **Increased reliance on call deposits:** The sample credit union will need to reallocate €14.5 million from access accounts (unlikely to be available in a Basel III investment world) and collective investment schemes (not authorised under the Central Bank proposal) to alternative investments which may be treated as liquid funds. In our view this will result in an increased reliance on call deposits in order to preserve liquidity requirements. The average call deposit rate available from the Irish banks[6] is 0.43% and the average call deposit rate available from non-Irish banks[7] is 0.14% - both rates are considerably lower than the current rate available from collective investment schemes which is approximately 0.90%.

c. **Additional counterparties will need to be added to the portfolio in order to comply with the proposed counterparty limit of 100% Regulatory Reserves:** The sample credit union will need to reallocate €11.9 million or 16% of the investment portfolio to alternative counterparties. While such alternative counterparties may have stronger credit ratings, and there may be a positive impact on investment portfolios from a counterparty risk management perspective, in the main, the average deposit rates available from such institutions are likely to be considerably lower than those available from existing counterparties.

6 The average of AIB, BOI and PTSB rates as at 13th March 2014.

7 The average of KBC Group, Danske Bank and Ulster Bank rates at 13th March 2014.

Note on Appendices 3, 4 and 5

The purpose of Appendices 3, 4 and 5 is to contrast the authorised classes and limits as proposed by Davy against the current guidance under the Guidance Note on Credit Union Investments. The tables are colour coded with the colours representing the following:

Grey cells show where there is little or no material change proposed regarding:

- The inclusion of an asset class as an authorised investment;
- The definition of the asset class;
- The limits proposed around the asset class.

Red cells highlight:

- The exclusion of certain asset classes which are currently authorised;
- A more restrictive definition of the authorised asset class;
- More restrictive limits or parameters around the asset class.

Green cells highlight:

- The inclusion of certain asset classes which are not currently authorised;
- A wider definition of the authorised asset class;
- More expansive limits or parameters around the asset class.

Appendix 3: Contrasting the investment limits proposed by Davy for Category 1 against current guidance

		Guidance Note	Davy Proposed Approach - Category 1
Irish and EMU State Securities	Authorised?	✓	✓
	Definition	Transferable securities issued by the Irish State and other EMU States and traded on a regulated exchange	Investments in transferable securities issued by the Irish State and other EEA States which are rated investment grade (minimum Baa3) by at least one recognised rating agency
	Maturity Limit	Maturity date shall not exceed 10 years	Maturity date shall not exceed 5 years
		Not more than 30% of holding shall be held in bonds maturing after 7 years	Refer to portfolio maturity limits
	Concentration Limit	Holding shall not exceed 70% of the total value of the credit union's investment portfolio	No maximum limit on holdings in government bonds
Accounts in Authorised Credit Institutions	Authorised?	✓	✓
	Definition	Interest bearing deposit accounts (or instruments with similar characteristics) in credit institutions authorised by the Financial Regulator or by the competent authority of another EEA State which has fulfilled the appropriate notification procedures to the Financial Regulator	Investments in interest bearing deposit accounts in credit institutions authorised by the Central Bank or by the competent authority of another EEA State
	Maturity Limit	Maturity date shall not exceed 10 years	Maturity date shall not exceed 5 years
		Not more than 50% of deposits shall be held in deposits maturing after 5 years	Refer to portfolio maturity limits
		Not more than 20% of deposits shall be held in deposits maturing after 7 years	Refer to portfolio maturity limits
Bank Bonds	Authorised?	✓	✗
Corporate Bonds	Authorised?	✗	✗
Equities	Authorised?	✓	✗
Collective Investment Schemes	Authorised?	✓	✓
		A credit union may invest in a collective investment scheme if the underlying investments of the scheme are composed entirely of instruments falling within the definitions and limits of classes 1 to 4 above	Collective investment schemes which are 100% invested in accounts in authorised credit institutions
Shares & Deposits of other Credit Unions	Authorised?	✗	✓
Other Limits	Portfolio Maturity Limits		Up to 30% of the total value of the portfolio can be in investments maturing after 3 years
	Counterparty Limits	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio
	Liquidity	20% of unattached savings (up to 30% if applicable)	20% of unattached savings (up to 30% if applicable)
			At least 10% unattached savings available up to 7 days
			At least 15% unattached savings available up to 1 month
	Currency	Euro-denominated investments	Euro-denominated investments

Source: Davy with reference to the RCU's Guidance Note on Investments by Credit Unions, October 2006

Appendix 4: Contrasting the investment limits proposed by Davy for Category 2 against current guidance

		Current Guidance under GN	Davy Proposed Approach - Category 2
Irish and EMU State Securities	Authorised?	✓	✓
	Definition	Transferable securities issued by the Irish State and other EMU States and traded on a regulated exchange	Investments in transferable securities issued by the Irish State and other EEA States which are rated investment grade (minimum Baa3) by at least one recognised rating agency
	Maturity Limit	Maturity date shall not exceed 10 years	Maturity date shall not exceed 10 years
		Not more than 30% of holding shall be held in bonds maturing after 7 years	Refer to portfolio maturity limits
	Concentration Limit	Holding shall not exceed 70% of the total value of the credit union's investment portfolio	No maximum limit on holdings in government bonds
Accounts in Authorised Credit Institutions	Authorised?	✓	✓
	Definition	Interest bearing deposit accounts (or instruments with similar characteristics) in credit institutions authorised by the Financial Regulator or by the competent authority of another EEA State which has fulfilled the appropriate notification procedures to the Financial Regulator	Investments in interest bearing deposit accounts in credit institutions authorised by the Central Bank or by the competent authority of another EEA State
	Maturity Limit	Maturity date shall not exceed 10 years	Maturity date shall not exceed 7 years
		Not more than 50% of deposits shall be held in deposits maturing after 5 years	Refer to portfolio maturity limits
		Not more than 20% of deposits shall be held in deposits maturing after 7 years	Refer to portfolio maturity limits
Bank Bonds	Authorised?	✓	✓
	Definition	Bonds issued by Irish or non-Irish credit institutions as described in Class 2 and traded on a regulated market	Bonds issued by Irish or non-Irish credit institutions as described in Class 2 and traded on a regulated market
	Maturity Limits	Maturity date shall not exceed 10 years	Maturity date shall not exceed 7 years
		Not more than 30% of bank bonds shall be held in bank bonds maturing after 7 years	Refer to portfolio maturity limits
	Concentration Limit	Holding in bank bonds shall not exceed 70% of the credit unions investment portfolio.	Holding in bank bonds shall not exceed 20% of the credit unions investment portfolio
Corporate Bonds	Authorised?	✗	✓
	Definition		Corporate bonds that are listed on a registered exchange with a rating that is not lower than A or its equivalent
	Maturity Limit		Maturity date shall not exceed 7 years
			Holding in corporate bonds shall not exceed 20% of the credit unions investment portfolio
Investments in Equities	Authorised?	✓	✓
	Definition	Euro-denominated equities traded on a regulated market within the EU. The issuing corporate shall have a minimum market capitalisation of €1.5 billion	Euro-denominated equities or exchange traded funds ('ETFs') which track stock indices, traded on a regulated market within the EU. The issuing corporate or Fund shall have a minimum market capitalisation of €1.5 billion
	Limits	Investment in equities shall not exceed 5% of the total value of the credit union's investment portfolio	Investment in equities shall not exceed 5% of the total value of the credit union's investment portfolio
		Investment in a single equity shall not exceed 1% of the total value of the credit union's investment portfolio	
Collective Investment Schemes	Authorised?	✓	✓
		A credit union may invest in a collective investment scheme if the underlying investments of the scheme are composed entirely of instruments falling within the definitions and limits of classes 1 to 4 above.	Collective investment schemes which are 100% invested in accounts in authorised credit institutions
Shares & Deposits of other Credit Unions	Shares and Deposits of other Credit Unions	✗	✓
Other Limits	Portfolio Maturity Limits		Up to 30% of the total value of the portfolio can be in investments maturing after 5 years
	Counterparty Limits	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio
	Liquidity	20% of unattached savings (up to 30% if applicable)	20% of unattached savings (up to 30% if applicable)
			At least 10% unattached savings available up to 7 days
			At least 15% unattached savings available up to 1 month
	Currency	Euro-denominated investments	Euro-denominated investments

Source: Davy with reference to the RCU's Guidance Note on Investments by Credit Unions, October 2006

Appendix 5: Contrasting the investment limits proposed by Davy for Category 3 against current guidance

		Current Guidance under GN	Davy Proposed Approach - Category 3
Irish and EMU State Securities	Authorised?	✓	✓
	Definition	Transferable securities issued by the Irish State and other EMU States and traded on a regulated exchange	Investments in transferable securities issued by the Irish State and other EEA States which are rated investment grade (minimum Baa3) by at least one recognised rating agency
	Maturity Limit	Maturity date shall not exceed 10 years	Maturity date shall not exceed 10 years
		Not more than 30% of holding shall be held in bonds maturing after 7 years	Refer to portfolio maturity limits
	Concentration Limit	Holding shall not exceed 70% of the total value of the credit union's investment portfolio	No limit on holdings in government bonds
Accounts in Authorised Credit Institutions	Authorised?	✓	✓
	Definition	Interest bearing deposit accounts (or instruments with similar characteristics) in credit institutions authorised by the Financial Regulator or by the competent authority of another EEA State which has fulfilled the appropriate notification procedures to the Financial Regulator	Investments in interest bearing deposit accounts in credit institutions authorised by the Central Bank or by the competent authority of another EEA State
	Maturity Limits	Maturity date shall not exceed 10 years	Maturity date shall not exceed 10 years
		Not more than 50% of deposits shall be held in deposits maturing after 5 years	Refer to portfolio maturity limits
		Not more than 20% of deposits shall be held in deposits maturing after 7 years	Refer to portfolio maturity limits
Bank Bonds	Authorised?	✓	✓
	Definition	Bonds issued by Irish or non-Irish credit institutions as described in Class 2 and traded on a regulated market	Bonds issued by Irish or non-Irish credit institutions as described in Class 2 and traded on a regulated market
	Maturity Limits	Maturity date shall not exceed 10 years	Maturity date shall not exceed 10 years
		Not more than 30% of bank bonds shall be held in bank bonds maturing after 7 years	Refer to portfolio maturity limits
	Concentration Limit	Holding in bank bonds shall not exceed 70% of the credit unions investment portfolio	Holding in bank bonds shall not exceed 20% of the credit unions investment portfolio
Corporate Bonds	Authorised?	✗	✓
	Definition		Corporate bonds that are listed on a registered exchange with a rating that is not lower than A or its equivalent
	Maturity Limit		Maturity date shall not exceed 7 years
			Holding in corporate bonds shall not exceed 20% of the credit unions investment portfolio
Investments in Equities	Authorised?	✓	✓
	Definition	Euro-denominated equities traded on a regulated market within the EU. The issuing corporate shall have a minimum market capitalisation of €1.5 billion	Euro-denominated equities or exchange traded funds ('ETFs') which track stock indices, traded on a regulated market within the EU. The issuing corporate or Fund shall have a minimum market capitalisation of €1.5 billion
	Limits	Investment in equities shall not exceed 5% of the total value of the credit union's investment portfolio	Investment in equities shall not exceed 10% of the total value of the credit union's investment portfolio
		Investment in a single equity shall not exceed 1% of the total value of the credit union's investment portfolio	
Collective Investment Schemes	Authorised?	✓	✓
	Definition	A credit union may invest in a collective investment scheme if the underlying investments of the scheme are composed entirely of instruments falling within the definitions and limits of classes 1 to 4 above	Collective investment schemes which are 100% invested in accounts in authorised credit institutions
Shares and Deposits of other Credit Unions	Authorised?	✗	✓
Other Limits	Portfolio Maturity Limits		Up to 50% of the total value of the portfolio can be in investments maturing after 5 years
	Counterparty Limits	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio	Investments in a single institution shall not exceed 25% of the total value of the investment portfolio
	Liquidity	20% of unattached savings (up to 30% if applicable)	20% of unattached savings (up to 30% if applicable)
			At least 10% unattached savings available up to 7 days
			At least 15% unattached savings available up to 1 month
	Currency	Euro-denominated investments	Euro-denominated investments

Source: Davy with reference to the RCU's Guidance Note on Investments by Credit Unions, October 2006

Appendix 6: Credit Ratings of EEA States

The following table shows the Moody's and S&P ratings of the states in the EEA as at 13th February 2014, with Euro area member states highlighted in blue. Credit unions are limited to euro-denominated investments. Credit ratings which are investment grade are in black and non-investment grade in red.

	Moody's	S&P
Austria	Aaa	AA+
Belgium	Aa3	AAu
Bulgaria	Baa2	BBB
Croatia	Ba1	BB
Cyprus	Caa3	B-
Czech Republic	A1	AA-
Denmark	AAA	AAA
Estonia	A1	AA-
Finland	Aaa	AAA
France	AA1	AAu
Germany	AAA	AAAu
Greece	Caa3	B-
Hungary	Ba1	BB
Iceland	Baa3	BBB-
Ireland	Baa3	BBB+
Italy	Baa2	BBBu
Latvia	Baa2	BBB+
Liechtenstein	NR	AAA
Lithuania	Baa1	BBB
Luxembourg	Aaa	AAA
Malta	A3	BBB+
Netherlands	Aaa	AA+u
Norway	Aaa	AAA
Poland	A2	A-
Portugal	Ba3	BBu
Romania	Baa3	BB+
Slovakia	A2	A
Slovenia	Ba1	A-
Spain	Baa3	BBB-
Sweden	Aaa	AAAu
United Kingdom	Aaa	AAAu

Source: Davy with reference to Bloomberg

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