DAVY

Central Bank of Ireland Consultation (CP 88)

J&E Davy, trading as Davy, welcomes the opportunity to participate in the Consultation on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act ("CP88"). The purpose of this submission is to comment on the sections relevant to investments, namely Section 6, Liquidity and Section 8, Investments.

Background

In response to the initial CP76 consultation, our submission presented an impact analysis which identified the adverse implications that the Central Bank proposals on investments would have for investment portfolios and for the broader credit union business model. Extensive testing revealed a number of important factors including quantification of adverse investment returns that would have resulted if the proposals were implemented as outlined.

In relation to CP88, Davy commends the Central Bank for making marked revisions to the original proposals on investments, thereby recognising the significant feedback received from the movement. The Central Bank is now proposing a framework which is largely based on the existing 2006 Guidance Note. This is an approach which Davy advocates, as outlined in our research paper "Davy Research Paper II: Proposed Alternative Approach to Tiered Regulatory Framework for Credit Union Investments".

In Davy's view, the proposals within CP88 are unlikely to prompt a significant change to the current composition of investment portfolios. As a result, the necessity to carry out extensive testing was not required. We have however carefully considered CP88 proposals and their potential impact in the current investment environment and set out below are a number of constructive observations and recommendations that are aimed at enhancing the framework for the future.

Section 6: Liquidity

Do you have any comments on the draft liquidity regulations? If you have suggestions please provide them along with the supporting rationale.

Expansion of the definition of liquid assets: Davy welcomes the Central Bank proposal to expand the definition of assets that qualify as liquid to include, any investments with more than three months to maturity where the credit union has an explicit written guarantee that the funds can be accessed by the credit union in less than three months, excluding penalties on interest or income.

The introduction of a short term liquidity ratio which requires that 10% of unattached savings must be held in investments with a maturity of less than eight days.

Davy is broadly in favour of the introduction of a short-term liquidity ratio. However, we have concerns with regard to implementing an additional liquidity requirement at this point in time. We note the Regulatory Impact Analysis ("RIA") which states that 20% of the sector's total investments have a maturity of less than eight days, whilst 17% are held on demand. The RIA findings broadly reflect the composition of our credit union client's investment portfolios which gives rise to question the necessity to introduce this ratio when there appears to be no direct requirement to do so. However irrespective of whether this short term liquidity constraint is implemented or not, Davy recommends that a mechanism is put in place that formally recognises the need for the Central Bank to revisit the impact analysis every 12 months for the forthcoming years for the following reasons:

- Exceptional Investment Environment: We are in the midst of an exceptionally low interest rate environment with a flat yield curve, therefore credit unions may be holding surplus funds on demand or short term as there is little incentive to place

DAVY

investments out longer term. In light of the ECB's recent actions which include a large scale quantitative easing programme, it is likely that this situation may persist for a protracted period. Upon normalisation of interest rates when medium and longer term rates may be significantly higher than shorter term rates, the impact of the short term liquidity ratio is likely to be more severe and may have a very punitive impact on the investment returns being generated from credit union portfolios.

- Bank's Implementation of Basel III Liquidity Ratios: Banks are in the process of introducing Basel III liquidity ratios as per CRD IV; the Liquidity Coverage Ratio is already in place and the Net Stable Funding Ratio is being implemented by certain areas of the banking sector well ahead of schedule which is having further negative implications for credit union investment income. The full impact of the implementation of these ratios on credit union portfolios can only be determined when the measures have been transposed in their entirety. In the meantime, we understand that banks are considering more innovative cash deposits and products which improve their metrics with regards to the ratios, such as a 45-day notice account. Once the liquidity ratios have been fully implemented and banks have expanded their deposit offerings accordingly, any potential short term liquidity constraint should be revisited to ensure that the percentage of unattached savings and eight day time constraint is appropriate in the context of the range of deposits and liquid investments available to credit unions.

The above points relate entirely to external factors that directly affect the credit union movement and are outside of its control. It is important therefore that a mechanism is agreed and introduced which allows for a formal and regular review process of the framework and its potential impact on credit unions, in order to ensure that it appropriately reflects the needs and requirements of a sector that is experiencing momentous change. This point is further explored later in this paper.

Similarities with CREDS: We note the similarities of the proposed constraint with the minimum liquidity requirement under CREDS[1] in the UK. In line with CREDS, an eight day timeframe is proposed in determining whether assets should qualify as liquid assets for the purposes of the short term liquidity ratio. In addition, CREDS stipulates that credit unions must ensure that on no two consecutive quarter ends can the level of liquid assets be below 10% of relevant liabilities. The 10% threshold reflects the minimum unattached shares proposed by the Central Bank for the short term liquidity ratio. However, Davy notes that it may be more difficult for credit unions in the Republic of Ireland to meet the ratio proposed because unlike CREDS, transferable securities may not be treated as liquid assets. Whilst Davy considers this approach prudent in that transferable securities can play an important role as a contingent liquidity source, we recommend that the Central Bank reviews this approach in the context of an overall review of the liquidity ratio.

Current liquidity ratio: Davy welcomes the clarification that liquidity levels will be set at 20% of unattached shares.

Transitional period of one year: Davy believes that the one year transitional period proposed for liquidity requirements should be reviewed and extended in light of the extraordinary investment environment in addition to the multiple challenges being faced by the movement as a whole.

[1] The Credit Unions New Sourcebook

DAVY

Section 8: Investments

Do you have any comments on the draft investments regulations? If you have suggestions please provide them along with the supporting rationale.

Section 8.2.1 Classes of Investments: Davy recommends that the authorised classes of investment should be expanded for the following reasons:

- Davy has serious concerns regarding the ability of credit unions to generate meaningful investment returns in the current environment. As a result, Davy recommends that the Central Bank should avoid restricting authorised investment classes so that credit unions have the ability to create diversification by allocating appropriate proportions of the portfolio to higher yielding growth assets. Credit union's investment policies should dictate whether certain investments are appropriate and consistent with the objectives and risk appetite of the credit union while observing the regulatory framework at all times.

- As outlined in our submission to CP76, Davy believes that credit unions should have the ability to allocate surplus funds to a wider choice of asset classes which contribute different benefits to the portfolio. Credit unions have developed their investment policies which are underpinned by improved risk management structures that are subjected to a higher level of regulatory scrutiny. Credit unions should therefore have the scope and autonomy to select and approve appropriate individual asset classes or subsets of asset classes, to assign suitable limits and to determine whether individual investments are consistent with the investment objectives of the credit union. In Davy's view, this approach would facilitate the concept relating to "nature, scale and complexity" of individual credit unions which was a key recommendation of the Report of the Commission on Credit Unions.

- Credit unions should be permitted to diversify investments across a range of asset classes and to non-financial counterparties whose performance is unlikely to be correlated to that of credit unions or the financial sector as a whole.

Davy recommends the following amendments to the authorised classes[2]:

- **Corporate Bonds**: As proposed by the Central Bank under CP76, Davy recommends that corporate bonds with a minimum rating of 'A' should be included as an authorised investment class. Their inclusion would provide important diversification benefits as credit unions would have an opportunity to allocate a portion of investment portfolios to non-financial counterparties whose performance is not correlated to that of credit unions or the broader financial sector. We recommend the inclusion of a minimum issue size of €100million and also suggest that the concentration limit should be amended to ensure that total investments in bank and corporate bonds should not exceed 70% of the total value of the portfolio.

- **Equities:** The 2006 Guidance Note allows for up to 5% of the credit union's investment portfolio to be allocated directly to equities. We recommend that equities should continue to be authorised under proposed regulations. In the investment universe, the most cautious portfolio mandates include equity exposure and investments in equities provide the only means of accessing real growth assets for credit unions. Davy accepts that equities may not be appropriate for certain credit unions and indeed, they may not be permissible investments as per credit unions own investment policies. However, we believe that more sophisticated credit unions with more enhanced risk management mechanisms should be allowed to allocate a limited proportion of the portfolio to equities if deemed appropriate and consistent with the investment objectives, constraints and risk appetite as laid out by their investment policies. We further recommend that euro-denominated ETFs which track stock indices should also be

[2] Please refer to Appendix 1 for a summary of our recommended amendments to the authorised investment classes.

included as permissible investments so that credit unions can mitigate stock specific risk and access a means of diversifying portfolio exposure beyond companies who are primarily euro-based to include international companies and stock indices. Finally, we recommend that the limits prescribed to the class of equities under the 2006 Guidance Note are appropriate and should be maintained.

- **Bank Bonds**: Davy recommends that the definition of authorised bank bonds should be expanded beyond senior bank bonds to include bank bonds with a fixed maturity date of no greater than 10 years for the following reasons:

    - It would provide a larger universe of bank bonds available for investment because Tier 2 bonds would be authorised in addition to senior secured and unsecured bonds.

    - It would provide access to a higher yielding subset of bonds. Euro denominated Tier 2 bonds are currently yielding c. 1.73% which is over 1% higher than euro denominated senior bonds, which are yielding c. 0.64%[3]. This premium is extremely valuable in the context of the current zero interest rate environment.

    - With the advent of the EU Bank Recovery and Resolution Directive (BRRD), senior unsecured debt will be eligible for bail-in. As a result, one could argue that the risk inherent in senior unsecured bank bonds has increased and the 'gap' in perceived risk between senior unsecured and Tier 2 bonds has narrowed considerably as evidenced by a declining yield differential between the two tiers of bonds. As displayed in Appendix 2, the yield differential has narrowed from over 5% in early 2012 to just over 1% at present. Davy views certain Tier 2 bonds as a suitable investment for credit unions in the event that the features of the bond are consistent with the investment objectives, constraints and risk appetite of the credit union as laid out by their investment policies.

- **Minimum Ratings:** Davy believes that the minimum rating restrictions originally contained within the 2006 Guidance Note served credit unions well, until the financial crisis prompted significant downgrades which meant that the restrictions were no longer feasible. Davy recognises that there are complexities in proposing minimum ratings in the current environment as European sovereigns make slow progress in improving their debt metrics following the sovereign debt crisis and as the Irish banking sector recovers. Davy recommends that the Central Bank gives consideration to introducing minimum ratings for Irish and EEA State Securities and Bank Bonds as part of the review mechanism outlined below.

Investment Advisory Council

Davy has suggested a review mechanism in relation to a number of the proposed regulations. We view this as critically important in light of the challenges facing the credit union business model and indeed the exceptional and unprecedented investment environment which credit unions are currently operating within. Therefore, it might be erroneous to consider the impact of the proposed regulation on credit unions at one point in time and to disregard the evolving status of credit and the extraordinary investment conditions of the present time. There is therefore a requirement for ongoing impact analysis as the credit union's business model evolves and as the investment environment changes. For example, in Davy's view, many credit unions have been insulated from ultra-low interest rates to date because attractive medium to long term deposit rates may have been secured with the Irish banks between 2011 and 2014. However, these deposits have or will mature shortly and investment returns will be under severe pressure with interest rates anticipated to stay at current levels for at least another four years while simultaneously, the Irish banks continue their progressive

[3] Yields are as at 23rd February 2015 and are sourced from the Bank of America Merrill Lynch Euro Senior Banking Index and the Bank of America Merrill Lynch Euro Lower Tier 2 Index. Please refer to Appendix 2 for further information.

implementation of Basel III liquidity ratios. This pressure on investment returns may trigger changes in the composition of investment portfolios and therefore, the impact analysis conducted by the Central Bank based on portfolio composition of 2014 may become largely redundant. Furthermore, it has been nine years since the Guidance Note was published in 2006 and apart from amendments that were a direct reaction to the financial crisis, there have been no updates or improvements to the measures set down at that time. The regulatory and investment universe was vastly different in 2006 so it is therefore, no longer reasonable for credit unions to continue to operate within static conditions that allow no scope to adjust, particularly given the extent of the changes that are taking place within the banking industry, which have direct ramifications for credit unions and their operations.

In this context, Davy recommends the formulation of a committee, potentially an Investment Advisory Council. The details of the proposed group should include the following key features:

(1) The members of the Committee would feature a panel of industry experts (including experts on investments and accounting) together with members of the main representative bodies (CUDA, CUMA and the ILCU).

(2) The terms of reference could include but would not be limited to:

    Impact analysis:
    Reviewing and assessing the ongoing impact of the proposed regulations on credit unions and reporting the findings to the Central Bank. This research would include income trends and projections, updates on investment product developments and the impact of quantitative easing and other market factors directly related to the credit union business model.

    Sector developments affecting credit union investments including the new regulatory framework, Basel III, legislation on bail in's and FRS 102:
    During 2013 and 2014, when researching the Basel III liquidity ratios and in educating the movement and representative bodies about the potentially disastrous consequences of the ratios for credit unions, Davy recognised that there is a significant void in relation to understanding, educating and communicating industry wide changes that have become fundamental to the operation of the movement as a whole. There is a clear requirement for a committee or advisory council which would collectively research and assess developments affecting credit unions. In Davy's view, there is an urgent need for a platform to exist that incorporates representative bodies and industry experts which have an established reporting function to the Central Bank while simultaneously, building efficient channels of communication which would permeate and educate the whole sector.

(3) Ideally, the Committee should have a formal statutory basis.

Transitional period of two years

Davy believes that the two year transitional period for investments should be extended for a further 12 months until 2018, as a result of the extraordinary investment environment, in addition to the multiple challenges being faced by the movement as a whole. As previously stated, it is no longer appropriate to expect credit unions to operate within static conditions while the global banking industry imposes ongoing changes which will directly impact the sector. We therefore recommend, that the transitional period is extended to accommodate the introduction and implementation of the review mechanism as outlined.

Conclusion

Davy welcomes the consultation process by the Central Bank in relation to regulations for credit unions on commencement of the remaining sections of the 2012 Act. As set out in our submission to

CP76, we believe that it is important that the regulations on investments strike the right balance between risk management and viability.

Whilst we believe that the proposed investment limits outlined in CP88 strike a more appropriate balance than the original proposals, we have made a number of important recommendations which are aimed at ensuring that credit unions have the ability to manage liquidity and to allocate surplus funds to a diversified range of asset classes which contribute different benefits to the investment portfolio at different stages of the economic cycle. We further recommend, that the Central Bank gives consideration to the unprecedented investment environment that credit unions are currently operating in, and suggest that a mechanism is created for a formal review of the proposed regulations on investments and liquidity on an ongoing basis.

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 report. 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.

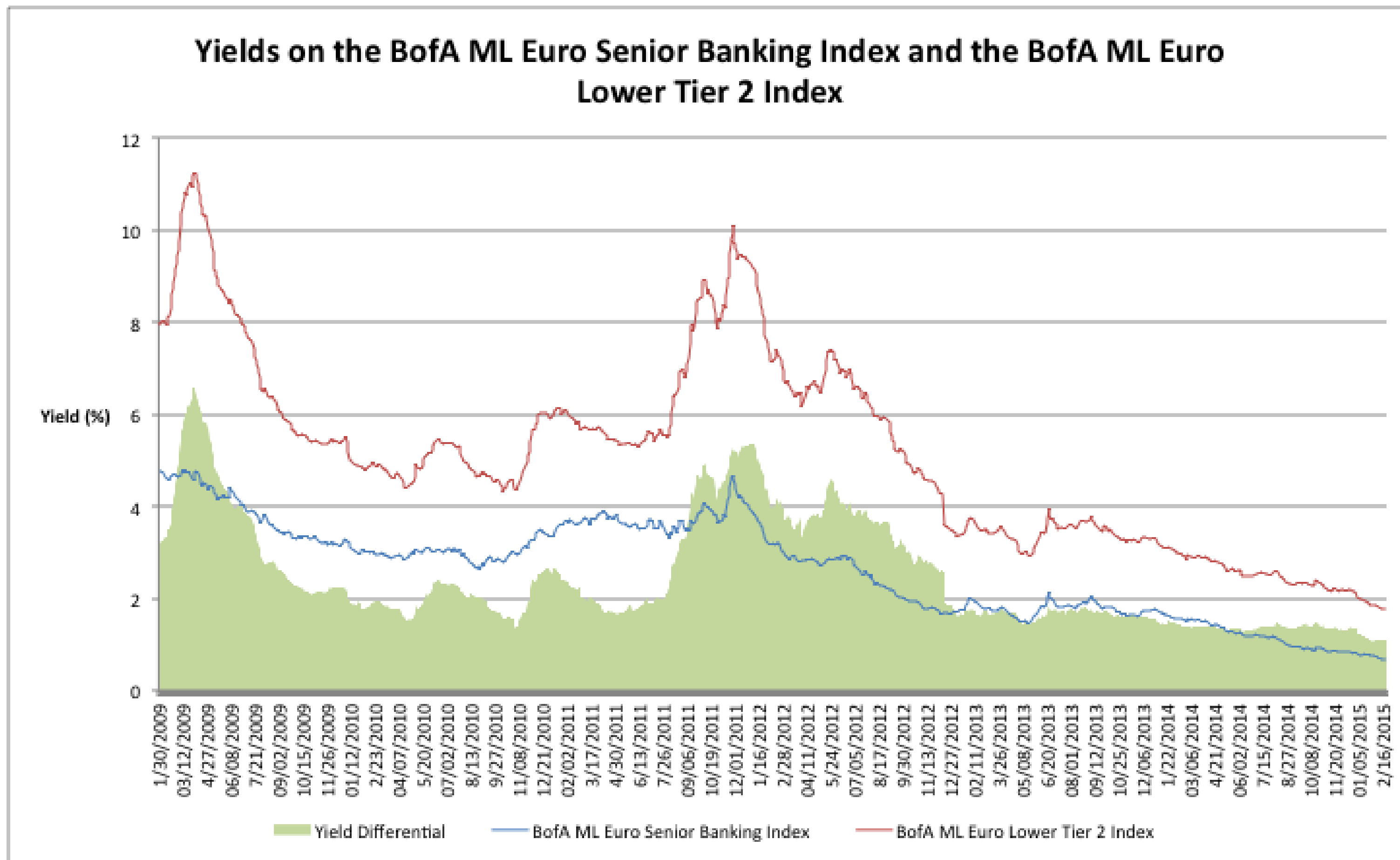
Our Conflicts of Interest policy is available at www.davy.ie J&E Davy (trading as Davy) is regulated by the Central Bank of Ireland. Davy is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext.

Appendix 1: Recommended amendments to the authorised classes

	Proposed Description	Benefits				Proposed Limits
		Income	Diversification of Counterparty Risk	Asset Class Diversification	Growth	
Corporate Bonds	Corporate bonds that are listed on a registered exchange with a rating that is not lower than 'A' or its equivalent.	✓	✓	✓		- Minimum issue size of €100million. - Investments in bank and corporate bonds shall not exceed 70% of the portfolio.
Equities	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 €1.5billion.			✓	✓	- The issuing corporate shall have a minimum market capitalization of not less than €1.5billion. - Investments in equities shall not exceed 5% of the credit union's investment portfolio. - Investments in a single equity shall not exceed 1% of the total value of the credit union's investment portfolio.
Bank Bonds	Bonds with a fixed maturity date of no greater than 10 years issued by a credit institution authorised pursuant to Directive 2013/36/EU and traded on a regulated market where the capital amount invested is guaranteed by the issuer.	✓	✓			- A minimum rating should be introduced within the next 2 years.

DAVY

Appendix 2: Yields available on Euro denominated senior bank bonds and lower tier 2 bank bonds, as represented by Bank of America Merrill Lynch Indices



Source: Bloomberg with reference to BofA Merrill Lynch Bond Indices