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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

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CONTENTS

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 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 www.davy.ie/creditunions

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