Investec Europe Limited

Credit Union Newsletter - Q3, 2020

1. Irish Economic Overview

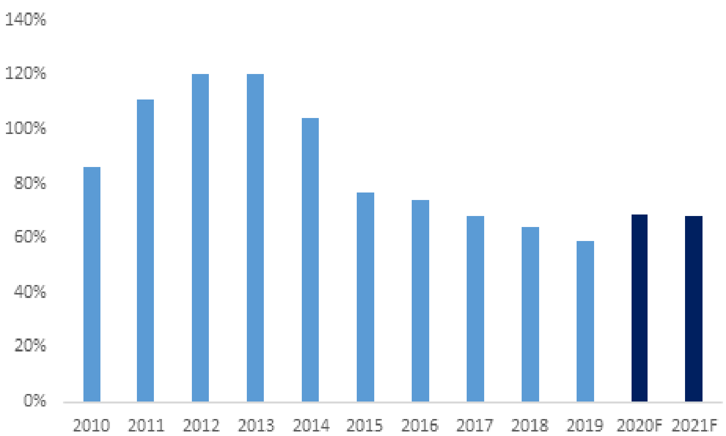
With the country recently moving into Phase 3 of the government's Roadmap for Reopening Society and Business at a faster pace than initially planned for, there are tentative signs that the economic damage wrought by the pandemic, while exceptionally swift and severe, may not be quite as grim as some of the worst predictions. However the outlook remains exceptionally uncertain and dependent on how the public health situation evolves from here.

Government has the financial capacity to respond to crisis

To first look at the positives, the public finances entered the current crisis in a healthier position than at any point in the past decade and the tax base has proved much more resilient than expected during the height of the economic disruption. The country has made significant progress in reducing its debt burden in the past seven years and this has provided the government with substantial borrowing headroom to absorb the dual shock to revenues and expenditures and to support the economy through fiscal stimulus.

In stark contrast with the last economic crisis in this country, there has been exceptionally strong demand for the country's recent bond issues and Ireland has been able to raise long-term debt at close to zero cost. While this is partly due to the improvement in the country's financial position, credit is also due to the considerable support of the ECB since the pandemic struck and the ultra-low interest rate environment that prevails.

Figure 1: Debt / GDP in Ireland



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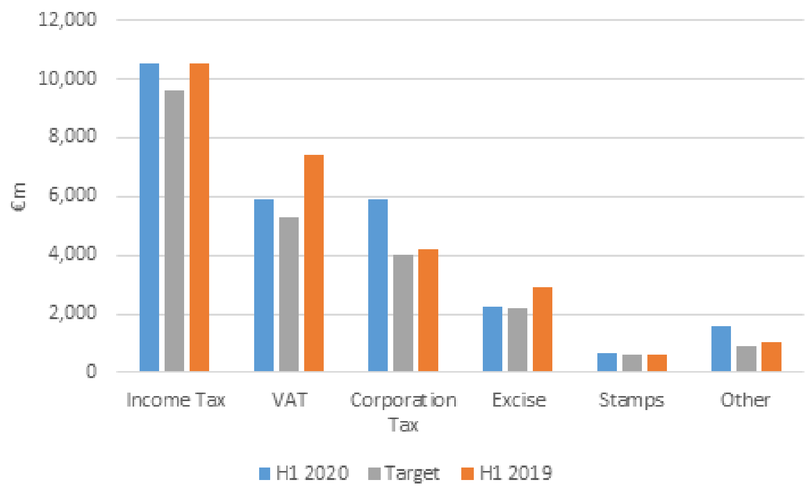
Although the hit to the Exchequer will obviously be enormous, tax revenues have so far been remarkably resilient. Total receipts in H1 were, astonishingly, marginally ahead of the same period of last year and €4.3bn (19%) ahead of expectations (which were revised lower in April). Corporation Tax was the standout performer in the period (which may hint at the defensive nature of the multinational firms that contribute the lion's share of Corporation Tax in this country), but the rate of Income Tax collection was also very impressive in the first half of the year given the huge drop in employment during Q2. We suspect the resilience in this category is due to the loss in employment being weighted towards lower wage sectors as well as the fact that those in receipt of State income supports remain liable for tax on that income. Exchequer expenditure (total net voted) in H1 was €6.8bn (27%) higher than in the same period of 2019 with pandemic-related expenditure, primarily by the Departments of Social Protection and Health, responsible for the increase. However, it now appears that the government will have considerably more flexibility when it comes to drafting its programme of fiscal stimulus.

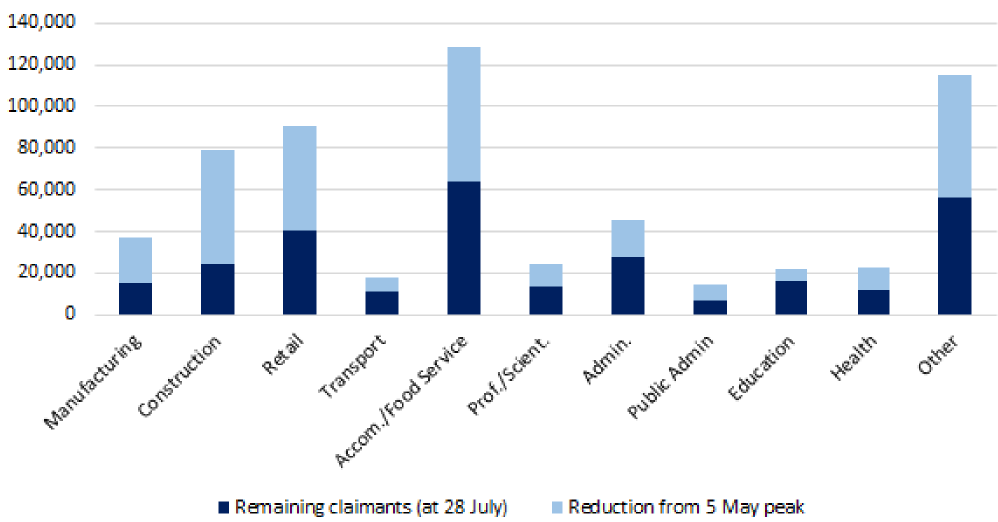
Figure 2: Tax Revenues



Labour Market clearly shows economic distress

Nevertheless, significant economic losses are inevitable and a GDP contraction of less than 10% this year would, in the present circumstances, represent a good outturn. The economic damage is most severely being felt in the labour market. As we write, 286,900 people are in receipt of the Pandemic Unemployment Payment (PUP) and a further 400,000 are being supported by the Temporary Wage Subsidy Scheme. Combined, this represents more than a quarter of the country's labour force (2.4 million). The situation is improving however and the rate of reduction in PUP claimants associated with the commencement of Phase 3 of the government's reopening roadmap on 29 June was the highest since the peak in early May. More people will be able to return to work in the coming weeks as economic activities resume but there is still considerable uncertainty regarding the 'rump' of unemployment that will remain once all economic restrictions have been lifted.

Figure 2: Pandemic Unemployment Payment recipients



Consumer response will be key

Consumer spending has clearly been severely disrupted, both in absolute volumes and patterns of expenditure. The latest data from May show that retail sales were 27% lower than in May of last year, although they had risen 30% from April's trough. Of the 13 retail sales categories, as classified by the Central Statistics Office, ten had lower sales volumes in May compared with the same month last year, and seven of these recorded declines of more than 50%.

However more up to date figures on debit and credit card spending indicate that expenditure continued to recover throughout June and was close to pre-pandemic levels by the end of the month. How consumers respond following the pandemic – whether by maintaining a high level of precautionary savings, as is currently the case, or by spending saved resources – will play an important role in determining the strength of the recovery in the consumer sector.

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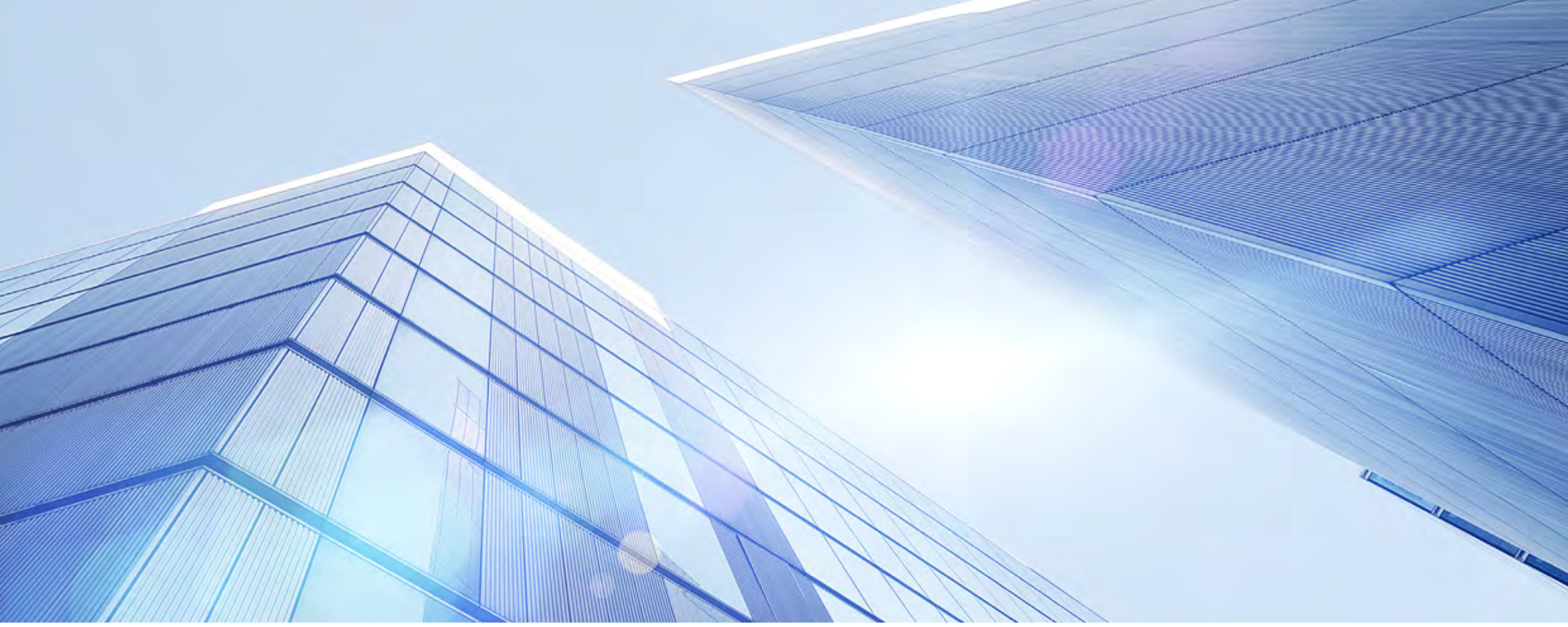


2. Financial Sector Overview

As was the case with the public finances, the domestic banking system entered the current crisis in a much healthier position than in the 2007/08 period. Although profitability metrics were weakening in the current ultra-low interest rate environment, the sector had resilient balance sheets, new lending was growing steadily and credit stresses were low.

Banking sector has substantial loss absorption capacity

As at end-2019, the aggregate transitional CET1 ratio across the retail banking system was 19% which gives the sector substantial capacity to absorb future loan losses. In addition, the CBI's decision to reduce required capital buffers is intended to counteract the downward pressure on credit supply and expand banks' ability to extend credit to those encountering temporary cashflow challenges and provides additional headroom to the sector.

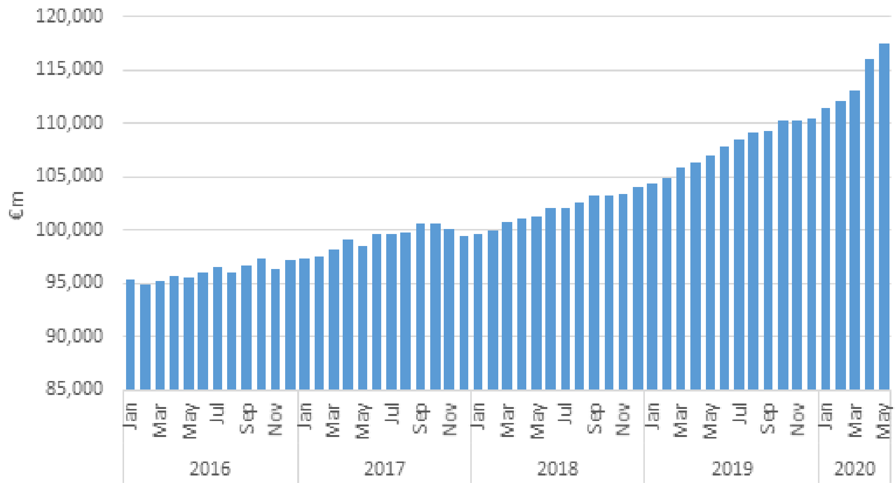
The losses that will arise due to the pandemic will not become apparent for some time and will be particularly dependent on how the economy recovers through the remainder of this year and beyond. According to the CBI, close to two-thirds of commercial lending and half of residential mortgages are to borrowers in vulnerable sectors. As of 29 May, 11% of the Irish mortgage book in the main retail banks and 23% of balances to non-financial corporations were on payment breaks. These payment breaks will help many borrowers endure the crisis, although clearly long-term debt restructurings will be required for a proportion of such borrowers who suffer more than short-term income disruption.

Figure 4: Flow of credit to Irish households (three-months sum)

Credit and deposit flows underscore the stressed circumstances

Reflecting lower demand, lending to Irish households declined by €310m during May following a similar fall in April. Consumer lending has fallen significantly in recent months with the growth rate in this category turning negative (-2.3% y/y in May) for the first time since early 2016.

Figure 5: Deposits of Irish households



In contrast, bank deposits of Irish households have surged during the crisis period. Annual growth in household deposits reached almost 10% in May, the highest growth rate since 2007. This is attributable to both precautionary savings from Irish households in the face of a highly uncertain economic outlook and the lack of opportunities to spend given widespread business closures. This growth is likely to taper in the coming months as businesses reopen and an element of pent-up consumer demand is released, although ongoing precautionary saving is expected to support deposit balances despite de minimus interest rates.

Figure 6: Average household deposit rate

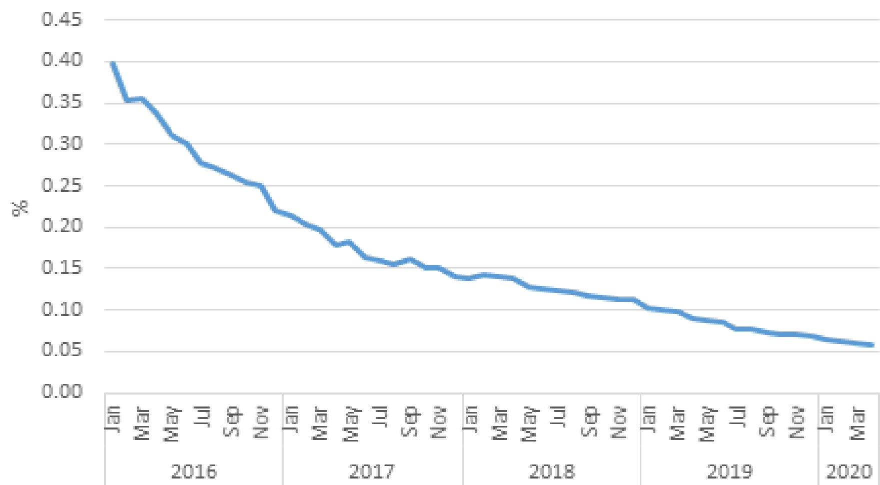
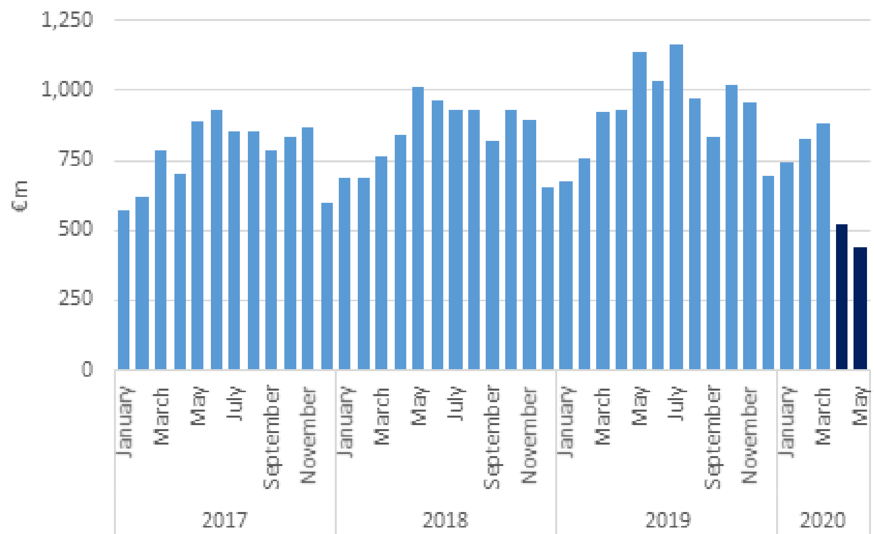


Figure 7: Mortgage approvals



Unsurprisingly, mortgage lending has been severely impacted by the pandemic. Figures from the BPFI show that mortgage approvals were -44% y/y in April but, given that this probably reflects many applications that were commenced earlier in the year, the 61% y/y drop in May approvals better reflects the current environment. We tentatively expect a 35-40% drop in full-year mortgage lending volumes to c.€6bn. However given that drawdowns in Q1 continued to grow robustly (+6% y/y to €2.0bn), this implies that lending volumes in the remainder of the year will be approximately half of last year's level. Approval data in the coming months will provide a clue to sentiment in the consumer and residential sectors.

Impact on residential sector is uncertain

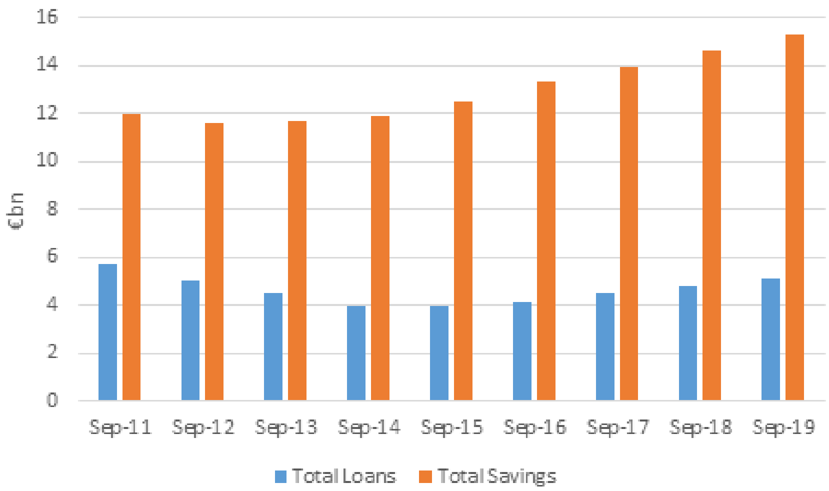
The effect of the pandemic on residential property prices has yet to become apparent. Official price data from the CSO (through its RPPI series) showed an immaterial impact in May (prices were 0.3% higher y/y), but these transactions largely reflected deals that were struck before the scale of the current problems became apparent. Other indicators, such as asking price data from listings websites, suggest that the pandemic's effect on prices to date has been negative, but only modestly so. We expect that the downward pressure on prices will be mitigated to some extent by the decline in new housing output and the effect that this will have on the structural undersupply of housing in the country. Nevertheless it is too early to pass judgement on those that have predicted double-digit declines in property prices but the evidence has not been supportive so far.

There may be a greater impact on housing market transaction volumes and turnover than price. The market was already suffering from low stock levels before the outbreak took hold – data from daft.ie show that February 2020 had the lowest number of properties listed for sale on the platform at that time of year on record. This situation deteriorated in March, which recorded the lowest number of sale listings in any month since daft.ie began collecting data 13 years ago. In compiling its RPPI for May, the Central Statistics Office noted that the number of transactions available for analysis fell by 45% from March. As severe a fall as this is, the number of transactions was in line with the average monthly total seen in the 2010-2011 period, although we are again mindful that such transactions largely represent deals that were agreed before the pandemic. We also note that data from the UK suggest that housing market activity is rebounding at a faster rate than might have been expected.

A more challenged outlook for the Credit Union sector

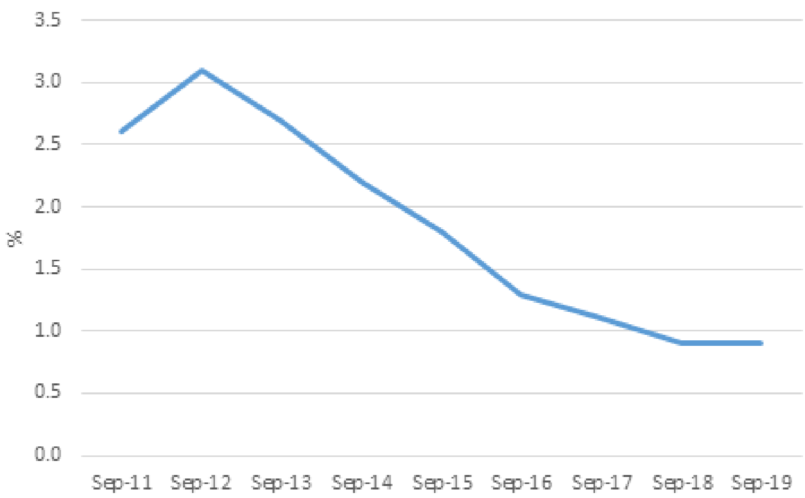
Turning to the credit union sector itself, it is currently contending with much of the same pandemic-related challenges as the banking sector. Credit quality will be impacted by the scale of the disruption to employment and household income. 62% of credit unions have introduced payment holidays for borrowers according to a recent survey by the Irish League of Credit Unions, although the CBI reported in early June that forbearance requests amounted to just 5% of gross loans which would indicate that the sector will be able to withstand these difficulties provided that the situation doesn't deteriorate from here.

Figure 8: Credit Union Loans and Savings

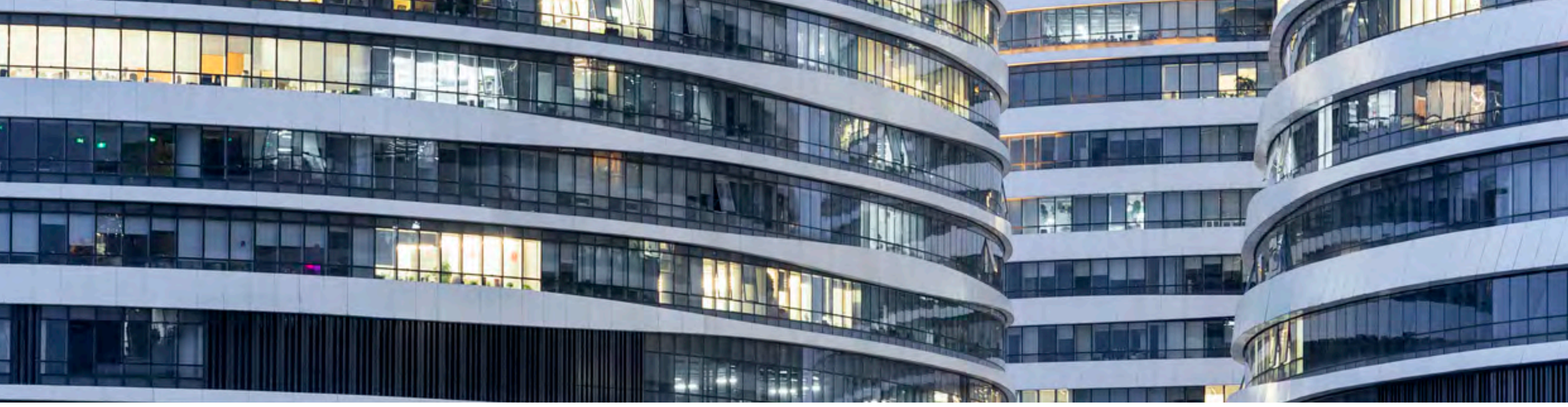


The strong growth in savings and deposits seen in the economy recently, in conjunction with muted demand for new lending, will not help close the gap between loans and savings however. Although both total loans and total savings have grown at a similar rate in recent years, the different starting points mean that the value of that gap has grown and, given the current circumstances, we would not be surprised to see it expand further. While this has provided credit unions with ample ability to respond positively to members' borrowing requirements, it poses challenges to profitability, and viability in some cases, particularly given the ultra-low interest rate environment and declining returns on investment portfolios – neither of which are likely to improve as a result of the pandemic.

Figure 9: Credit Union sector return on assets



More positively, the revised lending framework for credit unions that came into force on 1 January should help the sector expand its lending capability in a prudent manner over time. Ongoing consolidation activities, enhanced customer offerings, an extensive membership base and unparalleled brand value and trust all provide opportunities, but the sector will not be immune from the economic headwinds that are blowing.



3. Investment Markets Review

Figure 10: Performance of major stock indices

Index	Q2	YTD	12-months
Eurostoxx 50	16%	-12%	-6%
S&P 500	20%	0%	7%
FTSE 100	9%	-19%	-20%
ISEQ	16%	-13%	-1%

Equity markets shake off economic stresses

Despite the severe economic consequences of the coronavirus outbreak, equity markets rallied in Q2 and drew support from the rapid return of risk appetite, unprecedented levels of central bank support, the promise of fiscal stimulus and the easing of lockdown measures.

Buoyed by the relaxation of restrictions and a remarkable job recovery, equity markets in the US led the way with the S&P 500 posting a 20% gain in Q2. This was close to being sufficient to recover the falls in the index in Q1 and pushed the 12-month index performance into positive territory. Exuberance was tempered later in the quarter however as COVID-19 cases climbed sharply and some regions reintroduced targeted lockdown measures which spurred fears that the economic rebound will lose momentum or stall completely.

The economic recovery has been slower in Europe and the UK but there are now clear signs that activity is recovering and stringent lockdowns have greatly reduced the number of virus cases. Although GDP in the Eurozone is thought to have declined by double-digits in Q2, equity markets are looking to the subsequent recovery, the ECB's support package which has been increased to €1.35trn as well as political progress on a prospective €750bn stimulus package under the auspices of the European Commission.

The scale of the collapse in output in the UK was laid bare by April's 20.4% (mom) GDP fall. By the end of April the UK economy was 25% smaller than pre-pandemic levels, which compares with a peak-to-trough fall of 6.9% over 13 months during the last financial crisis. However a range of indicators now suggest that the nadir is passed and the size of the fall leaves plenty of room for growth in the coming period. The Chancellor on 8 July unveiled a £30bn stimulus package aimed at 'supporting, protecting and creating' jobs.

The Eurostoxx 50 index posted a 16% gain in Q2 and the 12-month decline had reduced to 6% by the end of the quarter. Following a flat performance in June, the FTSE 100 recorded a 9% rise in Q2 but remains 19% lower in the past year.

Looking forward, equity markets will continue to balance unprecedented levels of policy support and economic recovery with the risks that still abound from the virus. Sentiment very much favoured the former in Q2 but this may not remain the case in the second half of the year.

Bond market also supported by central bank interventions

Sovereign bond markets have remained relatively calm in recent months in spite of the turmoil. The bellwether German 10-year yield traded in a tight range during Q2, while credit concerns around the Italian sovereign that emerged in the early stages of the pandemic have effectively been blown away by the ECB's largesse. Outside the Eurozone, US 10-year yields ended the quarter close to unchanged, although they did rise for a period during June following a strong labour market release. UK 10-year gilt yields moved a little lower to 18bps by quarter-end, while 2-year bond yields turned negative for the first time in May.

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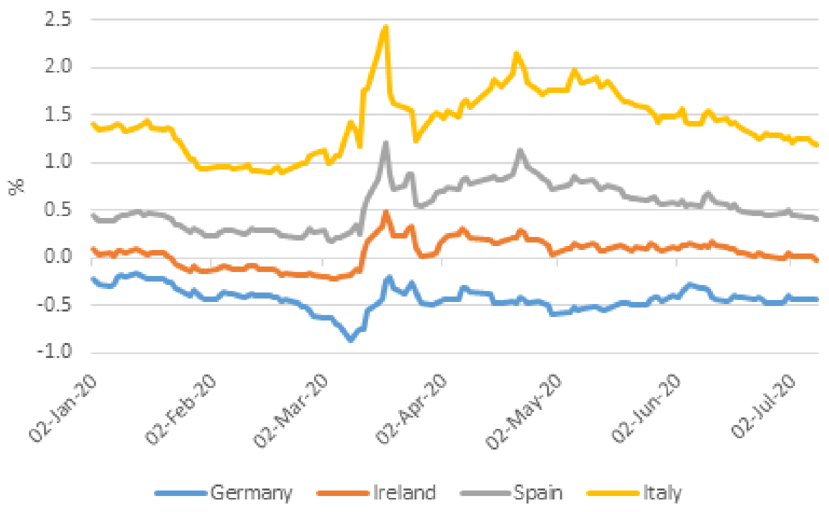
Figure 11: Sovereign bond yields (10 - year)



As well as expanding its PEPP bond-buying programme to €1.35trn and extending its timeframe until June 2021, the ECB has left the door open to further measures and an unsatisfactorily low inflation outlook provides it with the cover to act if required. As a result Italian yields at the half-year point were lower than where they started the year. Significantly, the ECB's PEPP purchases do not need to follow its capital key – that is, it can direct its purchases towards a particular's country's bonds if that country was having difficulty accessing the market at a reasonable cost.

As at end-May, the ECB had purchased €3bn of Irish government bonds via the PEPP programme and the NTMA has already seen the benefit of this demand. In June, the NTMA raised €6bn through the syndicated sale of a new 10-year benchmark bond at a yield of 0.285%. The successful issuance at a tight yield was not a great surprise, but the size of the order book, €66bn, was extraordinary. The NTMA's previous syndicated issuance of a new benchmark bond in April (a 7-year bond which also raised €6bn) attracted orders of €33bn, which was the highest order book on record until the June sale. By the end of H1, the NTMA had raised €18.5bn of its full-year target of €20-24bn.

Compliance Digest

Criminal Justice (Money laundering and Terrorist Financing) (Amendment) Bill 2019 - Transposition of the 5th EU Money Laundering Directive

The Government approved the drafting of the Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill on 3 January 2019. The Bill will transpose many of the provisions of the 5th EU Money Laundering Directive which has the aim of strengthening laws in the EU to combat money laundering and terrorist financing.

Although no date has been agreed on when Ireland will transpose the 5th EU Money Laundering Directive, Firms should be aware of the details of the Directive which has expanded the scope of obliged entities to include virtual currency exchange service providers, tax related services, letting agents, art dealers and electronic wallet providers.

Key Changes:

- The EU Commission has clarified the timing for the implementation of registers of beneficial ownership.
  - Each member state must establish its own register of beneficial ownership for corporates by the 10 January 2020.
  - Each member state must establish its own register of beneficial ownership for trusts by the 10 March 2020.
    - The Register of Beneficial Owners (RBO) was established in Ireland in November 2019
- The EU Commission has also added additional responsibility for ensuring the accuracy and reliability of the registers of beneficial ownership on both Member States and obliged entities* including the requirement for obliged entities to notify discrepancies between the information they hold and the information obtained on the register.
- Extension of Access to Beneficial Ownership information including unfettered access to competent authorities and Financial Intelligence Units ("FIU") as well as access to the general public with some limitations.
- Enhance Due Diligence requirements for business relationships with high risk third countries. Additional compliance checks, mitigation measures and additional monitoring are required for these accounts.
- Member States will be required to identify and maintain a list of activities that qualify as 'prominent public functions'** in their jurisdictions. The EU Commission will maintain an equivalent EU-level list.
- Additional powers have been provided to FIUs. An FIUs powers may now be invoked even in the absence of a Suspicious Activity Report (SAR).
- Member States must create automated and centralised mechanisms, such as a computerised database or register, to facilitate the timely identification of bank and payment account holders and holders of safe deposit boxes held by financial and credit institutions. These centralised mechanisms must be directly accessible in an immediate and unfiltered manner to national FIUs.

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*Obliged entities under 5AMLD include all credit and financial institutions, various Designated Non-Financial Businesses and Professions (DNFBPs), gambling services, Fiat-to-crypto exchanges and custodian wallet providers, Art dealers, and real estate agents acting as transaction intermediaries where the combined value is over €10,000

**Prominent Public Function refers to the definition under the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 - http://www.irishstatutebook.ie/eli/2010/act/6/enacted/en/pdf

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We are a distinctive financial services company, offering a diverse range of financial products and services to a niche client base in Ireland (Europe), the United Kingdom, Southern Africa and Asia-Pacific. We know you want solutions relevant to your needs and ambitions, so we fashion everything we do around you, the client.

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