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European Fund and Asset Management Association

EFAMA RESPONSE TO ESMA's CONSULTATION PAPER ON GUIDELINES ON THE TREATMENT OF REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

EFAMA welcomes the opportunity to contribute to ESMA's Consultation Paper on possible guidelines on the treatment of repurchase and reverse repurchase agreements.

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 57 corporate members approximately EUR 14 trillion in assets under management of which EUR 8 trillion was managed by approximately 54,000 funds at the end of 2011. For more information about EFAMA, please visit www.efama.org.

PRELIMINARY REMARK

In this response, EFAMA focuses essentially on the questions raised by ESMA in its additional Consultation Paper on the treatment of repurchase and reverse repurchase agreements. However, we would like to take this opportunity to draw ESMA's attention to the serious concerns raised within the EFAMA membership by some of the already published guidelines on UCITS ETFs and other UCITS issues (notably, although not exclusively, in relation to the management of collateral and on financial indices). We are currently in the process of mapping all these issues and will revert to ESMA on this in a separate letter.

DETAIL ANSWER TO THE QUESTIONS IN THE CONSULTATION PAPER

Q1: What is the average percentage of assets of UCITS that are subject to repurchase and reverse repurchase agreements? For the purposes of this question, please have regard to arrangements covered by the provisions of Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive (i.e. those arrangements which do not fall under the definitions of transferable securities and money market instruments, in accordance with recital 13 of the Eligible Assets Directive). In addition, please provide input on the following elements:

i) The extent to which assets under such arrangements are not recallable at any time at the initiative of the UCITS.

ii) The maximum and average maturity of repo and reverse arrangements into which UCITS currently enter. Please provide a breakdown of the maturities with reference to the proportion of the assets of the UCITS.

First of all, it may be useful to briefly recall the main reasons why a number of UCITS enter into repurchase (“repo”) or reverse repurchase (“reverse repo”) agreements:

- **Repo arrangements** are typically used by UCITS as a low risk alternative to securities lending and direct borrowing allowing the fund to receive cash which is either:

    - re-invested via one of the methods described in paragraph 40j) of the published guidelines with a view to generate additional returns for investors;

    - used as eligible collateral to CCPs where the UCITS does not naturally hold appropriate assets. This use of cash proceeds from repo arrangements was expected to become much more important in the future as a result of the entry into force of EMIR and ESMA’s current suggestion that UCITS will be required to post only “highly liquid assets” as collateral under Central Clearing arrangements. It is however unclear if this will remain possible in the future due to the restrictions on re-investment of cash collateral in the recently published ESMA guidelines (please refer to our answer to Question 2 below for further details on this issue); or

    - used to satisfy redemption requests from investors as a much cheaper alternative to direct borrowing.

- **Reverse repo arrangements** are commonly used by UCITS (and, in particular, by Money Market Funds) as a safe, flexible and profitable alternative to time deposits or other types of money market instruments. UCITS managers use reverse repos also in other funds for general asset management purposes in order to invest in securities with a fixed date of disposal.

Repo and reverse repo are actually the same kind of transaction but described from opposite view points – that of the seller and the buyer of the repo and it is essential to distinguish if a UCITS is acting as cash giver and collateral taker (investment) or cash taker and collateral giver (funding). Given the different economic purpose of repo and reverse repo arrangements and their divergent treatment in legal terms, EFAMA recommends to properly account for these differences in the ESMA guidelines.

From the feedback EFAMA received from its members, it appears that the percentage of UCITS assets subject to repo or reverse repo agreements may vary significantly from one UCITS to another depending on a number of criteria such as the yields, liquidity management or the UCITS strategy. As a result, it is extremely difficult to provide meaningful average figures applicable to all types of UCITS.

Q2: Do you agree with the proposed guidelines for the treatment of repo and reverse repo agreements? If not, please justify your position.

EFAMA fully agrees with the principle that when UCITS enter into repo or reverse repo arrangements they should ensure that these arrangements do not compromise their ability to execute redemption requests but **disagrees** with some of the guidelines proposed by ESMA for the treatment of repo and reverse repo agreements:

1) The objectives that ESMA is pursuing with proposed guideline 2.b.i (unconditional termination on an accrued basis) as well as the precise meaning of the words "on an accrued basis" are unclear to us. If the purpose was to forbid the termination of term repos and reverse repos on a "mark-to-market" basis then EFAMA would disagree with such a rule as it would be unnecessarily restrictive and would not help in any manner to mitigate systemic risks or liquidity. If ESMA's concern is to make sure that the UCITS NAV reflects the fair value of the UCITS assets, the guidelines could specify that any arrangement that is not recallable on an accrued basis but which is recallable on a mark-to-market basis should be valued on a mark-to-market basis for accounting and NAV calculation purposes.

   To draw a parallel, when a UCITS invest into standard bonds, they do not have any obligation to be able to redeem or sell these bonds at any time on an "accrued basis". Otherwise, overnight investments would *de facto* become the only permitted investments. The same reasoning should, in our view, be applied to repo and reverse repo arrangements.

   In order to avoid any diverging interpretation or legal uncertainty, EFAMA therefore strongly recommends clarifying the meaning of the proposed guideline 2.b.i via the replacement of the words "on an accrued basis" by "at the valuation price".

2) EFAMA also has reservations in relation to paragraph 3 of the proposed guidelines:

   <u>Paragraph 3.a)</u>: in our view, it is not necessary to require an appropriate balance between short-term and medium-term arrangements in general. For instance, if a UCITS engages only in short-term arrangements, it should not be forced to conclude also repo arrangements for the medium-term.

   <u>Paragraph 3.b)</u>: we are not convinced that there is a need for diversification at counterparty level. Should ESMA insist on such requirement, it should then be dependent on the size of repo transactions in relation to the fund portfolio. In case a UCITS concludes fixed-term repos only in relation to a small part of its assets, no diversification at counterparty level appears necessary.

   <u>Paragraph 3.c)</u>: we believe that an exception to the 20% diversification rule for collateral (as foreseen in paragraph 40 of the published guidelines) should be specified for securities and money market instruments issued or guaranteed by EU Member States or local authorities. There is indeed no objective reason to apply rules for collateral that are stricter than rules for

direct investments (for direct investments, UCITS are allowed to invest up to 100% in a single sovereign issuer). Moreover, the 20% diversification rule does not make sense for reverse repos in relation to which securities acquired by the fund are already taken into account when calculating the portfolio investment limits.

3) **EFAMA recommends that the position of cash revenues acquired from the use of repo transactions is clarified in the guidelines in order to avoid potential confusion**. Cash revenues generated from the sale of investments should not be viewed as collateral. UCITS hold genuine ownership of cash acquired from repo trades and should therefore be allowed to use it for any legitimate purpose, be it investment, collateralisation or satisfaction of redemption requests by investors. In these circumstances, it is not acceptable to submit cash proceeds from repos to the same restrictions as cash collateral from securities lending.

   In practical terms, such outcome would have grave implications for the UCITS' ability to collateralise OTC derivative transactions under EMIR. In the context of EMIR, ESMA itself is currently suggesting that collateralisation of both centrally cleared and bilateral derivative trades shall be limited to "highly liquid assets" which, in ESMA's view would exclude equities from the range of eligible collateral. In addition, the variation margin required as a reaction to price movements in underlying securities shall be acceptable in cash only. In case of UCITS, however, liquidity from unit subscriptions is usually used for investment purposes in line with the defined investment strategy in order to generate returns for investors and to satisfy redemption requests. Hence, UCITS must rely on other sources of liquidity in order to obtain assets eligible for collateral. **Should repos be no longer usable in this context, it must be feared that UCITS might no longer engage in derivative contracts to an economically reasonable extent or that they might be forced to retain some cash from subscriptions in order to collateralise OTC derivative trades**. Either result would have negative effects on the UCITS' ability to realise its investment strategy and consequently, would be detrimental to the interests of investors

4) For similar reasons, we also suggest that **non-cash collateral received in the case of a reverse repo transaction should be specifically authorised to be posted as collateral under EMIR**. We recommend mentioning this in the guidelines on repos as an exception to paragraph 40.i of the ESMA guidelines.

Q3: What are your views on the appropriate percentage of assets of the UCITS that could be subject to repurchase and reverse repurchase agreements on terms that do not allow the assets to be recalled by the UCITS at any time and that would not compromise the ability of the UCITS to execute redemption requests?

EFAMA disagrees with the principle of setting a limit to the percentage of assets that can be subject to repo and reverse repo agreements on terms that do not allow the assets to be recalled by the UCITS at any time. Given the wide range of UCITS, a limit that is appropriate for one fund would indeed likely be inappropriate for another.

In our opinion, it is sufficient that there be a guideline to the effect that a UCITS should ensure that an arrangement does not compromise its ability to meet its redemption obligations in accordance with Article 84. Proposed guideline 1a meets this need. It is then for the UCITS, when making an investment decision as regards a repo and reverse repo transaction, to consider the potential impact upon the UCITS redemption obligations. It is no different to other investment decisions which a UCITS takes. Taking an analogous example, transferable securities, it is worth noting the approach taken in the Eligible Assets Directive (2007/16/EC). One of the criteria to be considered in determining whether a transferable security can be purchased is whether its liquidity does not compromise the ability of the UCITS to comply with Article 37 (now Article 84). The EAD did not place percentage limits on the holding of potentially less liquid securities. The accompanying CESR guidelines (CESR/07-44) likewise did not put in place such limits. Rather, the guidelines specify that if a security is assessed as insufficiently liquid to meet foreseeable redemption requests, the security must only be bought or held if there are sufficiently liquid securities in the portfolio so as to be able to meet the requirements of Article 84.

Should ESMA nevertheless deem it appropriate to set a percentage limit on the amount of allowable transactions, we believe that a difference should be made between repo and reverse repo arrangements. The latter are treated in practice as a portfolio management tool and the related exposure is accounted for in the calculation of portfolio investment limits. Therefore, reverse repo transactions should not be further subject to a hard volume cap. Moreover, the determination of a reasonable percentage depends on the wording of paragraph 2.b.i of the. If that provision was amended as we suggest in our answer to question 2, so that recallability on a mark-to-market basis is acceptable, the percentage limit for repo transactions could then be set at a relatively low level.

Q4: Do you consider that UCITS should be prohibited from entering into repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time? If not, please indicate possible mitigating measures that could be envisaged in order to permit UCITS to use repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time.

EFAMA disagrees that a UCITS should be prohibited from entering into repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time, in particular if the wording of paragraph 2.b.i. was left unchanged (please refer to our comments under Question 2).Indeed, the consequence of such a rule would be that all repos other than overnight repos would de facto be forbidden for UCITS, which would have a damaging effect on the returns from such activities with little benefits from a risk perspective.

In our opinion, it should be sufficient that UCITS are required to be liquid enough to be able to meet redemptions. It has long been recognised (as reflected in the abovementioned CESR guidelines) that a UCITS can hold less liquid securities provided that portfolio as a whole is such that a UCITS can meet is redemption obligations. Similarly it should be recognised that repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time should continue to be permitted provided that portfolio as a whole is such that the UCITS can meet is redemption obligations.

Q5: Do you think that there should be a minimum number of counterparties of arrangements under which the assets are not recallable at any time? If yes, what should be the minimum number? To answer this question, you are invited to take into account your response to question 2 above.

The answer to that question would again depend to a certain extent on the wording of rule 2.b.i. and the conditions that should be met to consider that the assets are recallable at anytime.

As a general rule, EFAMA considers that there is no need to prescribe a limit in terms of number of counterparties of arrangements under which the assets are not recallable at any time. Such limit would be even less necessary if, as ESMA contemplates under paragraph 1.b, a limit was set to the percentage of repo and reverse repo arrangements on terms that do not allow recallability at any time.

Should ESMA nevertheless decide to set rules on the number of counterparties, we believe these rules should then be expressed as a maximum percentage of the NAV of the UCITS and not as a requirement to split small transactions between counterparties.

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