

EFAMA Reply to ESMA’s Consultation Paper on the Revision of the provisions on diversification of collateral in ESMA’s guidelines on ETFs and other issues

EFAMA¹ is very pleased to have the opportunity to respond to the ESMA Consultation on diversification of collateral in ESMA’s guidelines on ETFs and other UCITS issues.

For a number of reasons that are explained in our reply, we are convinced that the application of the 20% issuer limit currently foreseen under paragraph 43(e) of the Guidelines will place unnecessary constraints on UCITS’ collateral management policies and would have significant adverse consequences on UCITS and their investors. We, therefore, warmly welcome and strongly support the initiative taken by ESMA to consult stakeholders on a revision of the collateral diversification rules in the Guidelines on ETFs and other UCITS issues.

Executive summary

1. **EFAMA fully supports of the proposal made by ESMA** to review the collateral diversification rules currently foreseen in Paragraph 43(e) when the collateral received by the UCITS consists of “government securities”.
2. We strongly believe, however, that the **derogation from the 20% issuer limit** proposed by ESMA should be **extended to all UCITS funds and not just to Money Market Funds (“MMFs”)**. Clearly, MMFs (and, more specifically, MMFs that exclusively hold government bonds) would be principally impacted by this rule because of their use of reverse repos to manage their daily liquidity. Nevertheless, other UCITS would also be negatively impacted, as it would significantly increase the complexity of handling collateral. There does not appear to be a market rationale for making a distinction in this respect between MMFs and other UCITS. We therefore urge ESMA to consider extending the scope of the proposed exemption to all UCITS funds which receive government securities as collateral (Option 2). UCITS funds should not be put at a substantial (and unnecessary) competitive disadvantage to non-UCITS funds and should be given unrestricted access to the safest and most liquid form of collateral available.

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 60 corporate members about EUR 15 trillion in assets under management of which EUR 9.5 trillion managed by 55,000 investment funds at end September 2013. Just over 35,500 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

3. From an operational perspective, we believe that ESMA's proposal to calculate this collateral diversification (at least six issues, but not more than 30%) on the basis of the collateral received is too complex and costly to both implement and control. While maintaining ESMA's intention to diversify collateral, we would propose that when a UCITS makes use of the derogation from the 20% issuer limit envisaged in ESMA's Consultation Paper, it shall make sure that its **exposure to a single issue should never exceed 20% of the Net Asset Value of the fund** (without proposing any requirement in terms of minimum number of issues).

4. Although we definitely welcome the review of the collateral diversification rules, the revisions proposed by ESMA will temporarily place UCITS managers in an uncomfortable situation. UCITS managers are expected to take all necessary steps to align their portfolios of collateral in order to comply with the collateral diversification requirements by the end of the transitional period (18 February 2014). However, there is a good chance that these requirements will be amended in the coming months. In order to avoid unnecessary costs and efforts, we would welcome a **clarification by ESMA that market participants will not be expected to comply with the 20% issuer limit until ESMA has decided on a possible amendment of Paragraph 43(e) of the Guidelines.**

Preliminary remarks

In order to place our answers to the questions raised in the Consultation Paper into context, we would like to make the following preliminary observations:

- **Good credit quality and liquidity of collateral are more important than diversification:** When assessing the need for collateral diversification it is extremely important to bear in mind that portfolio diversification of assets and collateral diversification serve different purposes, which should not be confused: the objective of diversification of assets held for investment purposes is to prevent excessive concentration of investments, while the purpose of collateral diversification is to reduce counterparty risks. The role of collateral is to ensure that in case of default of a counterparty to a trade, the fund manager is able to replace the missing assets as quickly as possible and with minimal impact on the fund value. For that reason, good credit quality and liquidity of the collateral are much more important in terms of investor protection than its diversification. This also explains why high quality sovereign debt (combining the advantages of credit quality and high liquidity) has always been and continues to be seen as the preferred form of collateral.

- **Consequently, any rule which might force a UCITS manager to accept collateral of a lower quality only to comply with diversification requirements would be detrimental in terms of**

investor protection. As ESMA rightly notes, this is precisely the expected effect of the 20% issuer limit², which is why we strongly support ESMA's decision to revisit this rule.

- We further note that the 20% issuer limit for collateral under paragraph 43(e) of the Guidelines is in fact much stricter than the diversification limits for government issuers applicable to the portfolio itself respectively under Article 52.3 and 54.1 of the UCITS Directive. Such stricter diversification requirements appear difficult to justify given the purpose of collateral to ensure liquid and reliable means of recourse in case of counterparty default.
- In this context, it is also useful to remember that EMIR will significantly raise the bar when it comes to the size of the collateral requirements, thereby increasing the demand for highly rated collateral. If UCITS funds are forced, on the one hand, to increase the market value of posted collateral and, on the other hand, face limitations on the collateral they can accept from counterparties, there is little doubt that this will lead to increased costs for the fund and, ultimately, for the end-investor.

Response to questions

1. Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of money market funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

Yes, for the reasons already highlighted in our preliminary remarks, we support the decision of ESMA to revise the rules for the diversification of collateral received by UCITS in the context of efficient portfolio management (EPM) techniques and OTC transactions.

However, as mentioned above, we disagree with ESMA's assessment that the scope of this revision should be limited to Money Market Funds. While we understand that the ultimate objective of the collateral diversification requirements is to increase investor protection and financial market stability, especially in times of adverse financial and economic scenarios, we believe that the introduction of these requirements, as currently proposed, could have the opposite effect and lead to overall lower collateral quality and therefore unnecessary risks for investors.

We therefore urge ESMA to extend the derogation from the collateral diversification to all UCITS receiving government securities as collateral, be it the context of EPM techniques or of OTC derivative transactions (as envisaged in Option 2 of the cost-benefit analysis presented in the Consultation Paper).

² The Consultation Paper indeed mentions (about policy option 2): *"this option would address the potential adverse consequence of the current guidelines, namely that UCITS would be forced not to accept collateral that would generally be considered to be of high quality simply to meet the 20% issuer limit"* (page 9).

The 20% issuer limit negatively impacts UCITS Money Market Funds ...

It is clear that Money Market Funds and, more specifically, MMFs that exclusively hold government bonds would be those principally impacted by the 20% issuer limit as currently foreseen in paragraph 43(e) of the Guidelines³. As already explained in a letter EFAMA sent to ESMA on 10 October 2013 (see Appendix 1), this is essentially a consequence of the fact that Money Market Funds, more than other UCITS, use reverse repos as a secure means of investing cash from the portfolio (mostly as overnight placements), receiving high-quality collateral in return and thereby reducing their deposit banking risk and, ultimately, risk to the end-investor. Reverse repos are very important tools for the functioning of MMFs that exclusively hold government bonds as they provide the daily liquidity needed to facilitate outflows. Reverse repos are collateralised and the collateral provided to the MMFs that exclusively hold government bonds will, in the vast majority of cases, also consist of Government paper issued by countries with the highest level of creditworthiness.

... but is also detrimental for other types of UCITS

It is equally clear, however, that other types of UCITS would also be detrimentally affected by the current collateral diversification requirements contained in the Guidelines.

The negative impact from the current diversification rules for collateral stems for the forced diversification out of highly secure issuers into issuers with lower credit quality, ultimately leading to an overall deterioration of the credit quality of the collateral portfolio, to the detriment of investor protection. While the issue may be more visible for MMFs relying on reverse repos as an investment strategy to manage their liquidity, the same argument also applies to any other form of UCITS fund⁴.

³ The 20% issuer limit for collateral would considerably reduce the possibility for MMFs to invest in reverse repos because:

- (1) It would force fund managers to accept a broader range of sovereign debt for the purpose of collateralisation which would imply a pick-up in credit risk – which is precisely the risk that investors in MMFs are trying to avoid;
- (2) It would also have a significant negative impact on yields generated by MMFs (as illustrated in Appendix 1) to the detriment of investors.

⁴ To further illustrate this point, please let us provide two practical examples:

- (1) Any UCITS fund investing more than 20% of its asset portfolio in reverse repos would be affected. For example, many structured UCITS like “formula funds” invest up to 100% of their assets in reverse-repo, especially when the fund must be able to face strong redemptions on anticipated maturity dates.
- (2) Another practical example would be that of a fund taking US treasuries or German government bonds as collateral. It would have to diversify into other countries with weaker credit quality or into smaller government related issuers in the same country with less liquidity and 100% correlation in a stress scenario. A diversification across five sovereigns in the EMU area may already lead to significant average credit deterioration, measured, for example, as the default weighted average agency ratings. Additionally, a diversification out of US Treasuries into other sovereigns implies currency hedging, requiring additional collateral.

Consequently, there is no market rationale for justifying a distinction to be made in this respect between MMFs and other UCITS. We note that the cost-benefit analysis conducted by ESMA does not contain a clear justification to support such distinction and we respectfully disagree with ESMA's assessment that "*the wider scope of option 2 could increase the risk of UCITS holding collateral that is less diversified*" (page 9 of the Consultation Paper).

We also wish to draw attention to the fact that maintaining an unjustified distinction between MMFs and other forms of UCITS funds would create operational inconsistencies whereby different collateral policies and procedures would have to be applied across the same UCITS range.

Lastly, we believe that it is the combination of all criteria laid down in the guidelines, and in particular those regarding credit quality, haircuts and collateral liquidity that ensures an optimal level of investor protection.

For all these reasons, we strongly support the extension of the derogation from the collateral diversification rules to all types of UCITS (Option 2⁵), as it provides an equal treatment and a justified flexibility to all UCITS.

- 2. Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.**

No. Given the existing high standards for selecting counterparties and monitoring collateral to which UCITS are already subject, we do not believe additional safeguards for government bonds would enhance risk management or better protect the assets of end-investors.

Rather than creating additional safeguards, reliance should be placed on the variations in haircuts applied by the markets to the collateral received.

- 3. Do you agree with the proposed requirement to diversify the government securities across at least six different issues?**

We acknowledge ESMA's intentions to maintain appropriate level of investor protection, while ensuring a practical and workable solution for all stakeholders. We are still of the opinion that the credit quality and liquidity of collateral are – by far – the most important criteria. Some of our members believe that collateral diversification in addition to efficient portfolio management of collateral will not further enhance investor protection and are against any additional restrictions.

⁵ As discussed as policy option 2 in Annex II on page 8f of the consultation paper.

In the event that ESMA still wishes to maintain its position to diversify the government securities across different issues, we would like to propose changes from an operational perspective, as we believe that ESMA's proposal to calculate this diversification⁶ on the basis of the collateral received is too complex and costly to implement and control.

Some of our members therefore would propose a simpler alternative, which is more in line with the existing concentration calculation methodology for UCITS, while preventing excessive concentration of the collateral received on a single issue. Along the lines of the above argumentation, our suggestion would be the following:

When a UCITS makes use of the derogation from the 20% issuer limit envisaged in ESMA's Consultation Paper, it shall make sure that its exposure to a single issue should never exceed 20% of the Net Asset Value of the fund (without proposing any requirement in terms of minimum number of issues)⁷.

Brussels, 31 January 2014

[14-4003]

⁶ The proposed collateral diversification requirement reads as follows: "Such a UCITS should receive securities from at least six issues, but securities from any single issue should not account for more than 30% of the collateral received."

⁷ Such a rule would be much easier to implement from an operational point of view and would also be in line with the objective to prevent any excessive concentration of the collateral received on a single issue. For example, if the collateral received (with a haircut applied), consisting of government securities issued by a single issuer, represents 105% of the NAV, it will have to be diversified across minimum 6 different issues: 20%+20%+20%+20%+20%+5%.