



ABI response to ESMA's draft technical advice on possible Delegated Acts concerning the Regulation on Short Selling and certain aspects of Credit Default Swaps ((EC) No XX/2012)

The ABI

The Association of British Insurers (ABI) is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

The ABI welcomes the opportunity to comment on the technical advice on possible Delegated Acts concerning the Regulation on Short Selling and certain aspects of Credit Default Swaps.

This consultation has had a very short (three week) consultation period.

We find it regrettable, and something of an unfortunate precedent, that these technical standards, which have wide ramifications, are not being given the benefit of a more realistic consultation period. There is a real risk that such short timeframes may impede ESMA's aim of producing high quality and credible standards.

Additionally, we are in the unusual position of having two consultations completed prior to the final text being published in the Official Journal and therefore officially entered into force. We would not wish this to establish precedent either.

We believe that having sight of the EU Commission's Legal Services' advice to ESMA would be most useful to all stakeholders better to understand the policy steer for these Delegated Acts.

The consultation paper and the accompanying draft technical advice on possible Delegated Acts provide essential clarification on some of the Regulation's requirements, but they also present some new questions that will need to be clarified in a short time period if the 1 November 2012 implementation deadline is to be met. Since the true impact of the Regulation on the investment community can only be assessed once all the technical details are finalised, we would like to ensure that the standards produced are practicable, realistic and credible, and achieve their stated objectives.

ANNEX

On Ownership

Q1: Do you agree with the proposal concerning Article 2(1)(r) of the Regulation?

Yes, we agree with the proposal.

Q2: Are there other cases which need to be excluded from the definition of a short sale?

Not at this time

Q3: Are there other definitions in Article 2(1), which need further clarification? Please explain which one(s) and why further clarification is required.

The definition of “long position” as used to calculate a net short seems to capture collateral transferred under an ISDA CSA (which transfers legal title to the collateral to the receiving party). Often government bonds are used as collateral. We do not believe that it was the intention for us to include collateral holdings as part of our net position calculations and suggest that explicit reference should be made to this, in a similar fashion to the reference made to securities lending.

On holding

Q4: Do you agree with the above proposal? If not, please give reasons.

Yes, we agree with the proposal.

Q5: Do you have any suggestions on possible further criteria to describe the holding of a share or sovereign debt?

Not at this time.

Having a net short position and method of calculation

Q6: Do you agree with the above proposal? If not, please give reasons.

We accept the delta-adjusted calculation method for shares.

However, with respect to sovereign debt, we prefer the nominal method. It is more readily understood and it is easier to calculate exposure based on this method.

We are grateful for ESMA’s recent confirmation that it will publish a list of the total outstanding debt for each of the pre-defined sovereign issuers.

Q7: Do you agree with setting a quantitative threshold for high correlation? If so, what would be the best correlation co-efficient to use for this purpose?

Whilst we believe that a quantitative threshold would be clearer, we are not convinced that 90% is the correct number as we believe it too high.

We feel a number between 60 – 75% to be appropriate for the majority of cases.

Q8: Do you think it is practicable to measure correlation for sovereign debt with a liquid market price and a long price history on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out? Do you consider that a 24 month reference period is the most appropriate one?

We believe that 24 months is an appropriate reference period whilst recognising that the 24 months immediately prior to the regulation coming into effect may not provide the most “normal” of bases.

Q9: Do you think it is practicable to measure correlation for assets with no liquid market price or with no sufficiently long price history by using a proxy? What could be a good proxy? What criteria do you think are necessary?

We think a good proxy is another debt instrument with similar duration (not maturity) and credit quality (proxied by rating) which has historically exhibited high correlation measured using daily data for the 12 and 24 months before the position is initiated, and for which there is no evidence of a structural break in correlation patterns. It is recommended to also carry out the test using 60, 90 and 120-day windows prior to the position being taken out.

We believe there may also be qualitative ways to assess the existence of correlation in certain instances.

Q10: Do you consider that this Delegated Act needs to provide further specifications on the calculation of whether the high correlation test is met? Do you have any suggestions on what they may contain (e.g. use of a maturity bucket)?

No comments.

Q11: Do you think that there is a need for a buffer period addressing the issue of temporary fluctuations in the correlation of the sovereign debt (e.g. period of 3 months during which the correlation is less than the standard level (e.g. 90% or 80%) but at least met a prescribed lower threshold (e.g. 75% or 70%)?

Yes, we would support a buffer period given that there will undoubtedly be differences in correlation over time, and we agree that the threshold should probably be below the number (or range) given to define “high correlation” in Q.7.

Q12: Do you think it is appropriate the “delta adjusted method” for the calculation of short position for shares?

We accept the delta-adjusted calculation method for shares.

Q13: Is there any comment you would like to make in relation to the calculation of the position in shares set out in Box 4?

No comment

Q14: Is there any additional method of calculation for shares that you would suggest ESMA to consider?

Not at this time.

Q15: Which in your view is the most appropriate method for the calculation of short position for debt instruments of a sovereign issuer? Are there methods other than the nominal or sensitivity adjusted ones outlined above which you think ESMA should consider?

We accept that the calculation for debt instruments is significantly more complicated than for equities, and that different firms have different risk regimes, but would argue for simplicity where possible. We believe a sensitivity adjusted calculation would be more complicated for the majority of market participants than the end results warrant, particularly in times of market stress, and would therefore argue for the nominal model to be adopted.

We would also be against having any kind of “pick and mix” approach as we require consistency in the design of our reporting systems.

Q16: Is there any comment you would like to make in relation to the calculation of the position in sovereign debt of a sovereign issuer set out in Box 4?

We would request that ESMA publish a definitive list of sovereign issuers on a pre-agreed schedule, in order for reporting thresholds to be met.

Netting and aggregation

Q17: Do you agree with the approaches described above to cater for specific situations when different entities in a group have long or short positions or for fund management activities related to separate funds? If not, can you state your reasons and provide alternative method(s) of calculation?

We do not agree with the introduction of the concept of “decision maker” as defined, as it would create an unnecessary level of granularity for investment managers. This is because it is unlikely that any two funds for which investment management firms provide portfolio management services would have exactly the same “investment strategy” as also defined, even if they are for the same client. This would mean that a client’s long position may not be taken into account, this providing potentially misleading information.

We would therefore request that ESMA remain faithful to the principle of reporting at the legal entity level, as set out in the Level 1 text. This would ensure consistency since the Regulation aims at disclosure of short positions so as to be able to assess the economic exposure of an entity as a whole.

The expression “fund manager” and “portfolio manager” are both used in Box 5; we would like to understand whether this is intentional or a drafting error.

We would also request more clarity around the position of “fund management”, “fund management companies” and “fund management activities” as there are no definitions included, nor allowance made for where fund management functions and decisions are delegated to other legal and non-legal persons and/or entities. The interpretation of the aggregation guidelines is impacted by the application of these terms.

Q18: Which do you consider the better definition of a group for the purpose of this Regulation?

We prefer Alternative 2 definition of Group. We think it is consistent with disclosures made under the Transparency Directive and thus makes disclosures of long and short positions comparable.

Q19: Are there other situations that should be taken into account?

Not at this time.

Uncovered CDS

Q20: Do you agree with the general conditions proposed for determining when a sovereign CDS position can be considered covered? Are there any modifications you would propose?

We agree with the general principles as set out in the Regulation that such positions must be correlated and proportionate.

We do not agree with ESMA's interpretation of the correlation principle to include the condition that the obligor of (or counterparty to) such asset/liability is located in the same Member State as the reference sovereign for the CDS. We do not see that this is required by the Regulation, or by the Commission's request to ESMA for advice.

There are many situations in which a long position in one country is correlated, even highly correlated with the sovereign debt in a different country. The most obvious and straight-forward example would be were a bank holds a significant amount of debt issued by the government of another country. The value of the bank may well be more correlated to the debt of the other country than to that of its own.

We would point out, that if the proposed text were implemented, then contrary to ESMA's own intention, stated in paragraph 79, 'hedging strategies which meet the criteria set out in the Regulation itself might therefore be unreasonably excluded'.

As to the statement in paragraph 82, we would dispute the fact that 'it was the intention of the co-legislators that the geographical scope of the provision should not be drawn too widely'. If this had been their intention then it would have appeared plainly in the Regulation.

Moreover, it would be inconsistent with Article 375 of the Capital Requirement Directive (CRD IV). The proposals would limit firms' ability to raise regulatory capital and do hedging as incentivised by CRD IV. CRD IV explicitly allows the use of index CDS as an eligible hedge for the purpose of mitigating CVA risk (Credit Valuation Adjustment risk: risk that the creditworthiness of the counterparty deteriorates). By limiting geographical scope of the CDS hedges, the use of indices such as the SovX to cross-country hedge CVA regarding exposures in several Member States seems to be excluded.

CRD IV prohibits the use of neither proxy hedging nor cross-country hedging. Article 375 states that 'for all counterparties for which a proxy is used, an institution shall use reasonable basis time series out of a representative group of *similar* names for which a spread is available.' If such cross-country macro-protection via the most liquid sovereign CDS is not available due to geographical limitation, hedging of an investment in any portfolio of European exposures would become more expensive. This would increase funding costs for sovereign debt and corporate debt.

We believe that the proposed geographic condition is unnecessary. The overarching requirement that there be 'correlation' and 'proportionality' already imposes a hedging obligation on market participants. Where a correlation exists and a hedge is proportionate market participants should be permitted to use CDS as a proxy hedging tool, irrespective of location. This is a particularly important principle in the context of the Single Market as well.

We understand that ESMA has already had legal opinion from the EU Commission's Legal Services, and we believe that all stakeholders would benefit from sight of these opinions.

Q21: Do you have any comments or alternative suggestions on the proposed test for correlation? Do you have any estimates of the costs which applying the qualitative test envisaged by ESMA would entail for market participants or the costs which would be associated with the imposition of a quantitative test?

We do not believe a quantitative correlation calculation can be adequately justified and are therefore pleased to support a qualitative definition instead.

Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

Given the different methodology that could be applied to determine correlation, any of these could breakdown at any time thus introducing uncertainty, which would form the basis of an argument for a non-specific period. However, we do believe there should be consistency in this regard, and so support a 12 month period, but would suggest ESMA consider also applying the 3-month buffer as proposed for sovereign bonds.

Q23: Are any changes required to the proposals for determining whether a sovereign CDS position is proportionate?

We do not believe a quantitative correlation calculation can be adequately justified and do not believe anyone can set arbitrary thresholds, and are therefore pleased, again, to support a qualitative definition instead.

However, we would suggest that given the market convention that CDSs now often have standardised maturity dates and the implementation of duration cannot be implemented as closely as previously, that the wording for the condition of proportionality be amended to read, "as closely as practicable."

Q24: Do you think that a position that had become partially uncovered due to fluctuations in the value of the assets or liabilities being hedged and/or the CDS used as the hedge should be allowed only for a certain period of time? If so, what would be an appropriate time limit?

We accept that any excess position can only be held for a specific time period but would ask that this be limited to "as soon as is practicable, given market conditions", and additionally, to be "in the best interests of the client".

Q25: Do you agree that sovereign CDS positions which are obtained involuntarily as a result of the operations of a CCP clearing sovereign CDS should not fall to be considered as entering into a CDS transaction for the purposes of the Regulation?

Yes, we agree.

Q26: Do you consider there are any other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position which should be included in the indicative list?

Not at this time.

Q27: Do you agree that the net CDS position is the correct one to use in the calculations?

Yes, we agree.

Q28: Do you consider that there should be different methods for calculating the value of the positions to be hedged by the sovereign CDS according to whether a static or dynamic hedging strategy is used?

We believe the methodology in Box 7 is flexible enough.

Q29: Are there refinements which can be made to the proposed methodology? Are there any standard calculation formulae which can be used when applying risk adjustments which we should include in the draft advice?

None at this time.

Q30: Do you agree with the proposed method of treating indirect exposures?

Yes, we agree.

Levels of the notification thresholds for sovereign debt position

Q31: Do you agree that the relevant notification threshold should be based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer?

Yes.

Q32: Do you agree with the proposal to convert these percentages into monetary amounts which would be updated quarterly to reflect changes in the issued sovereign debt? If not, what other arrangement would you suggest?

We support the proposal to use the monetary amount as the actual outstanding is often difficult to know. We also support quarterly reporting to allow for new issues and redemptions thus ensuring the data is more consistent.

Q33: Do you agree with ESMA's proposal to group sovereign issuers into categories for the purposes of setting the notification thresholds or would you prefer an alternative approach (e.g. a single threshold for all sovereign issuers or setting individual thresholds for each sovereign issuer)? Please state your reasons.

We agree with the three groups of sovereign issuers as proposed.

Q34: If you support grouping sovereign issuers into categories, do you agree with ESMA's proposal to set the three categories of notification thresholds suggested above? If not, what other grouping would you suggest and why?

Whilst we consider the thresholds somewhat arbitrary, we do support the notification thresholds.

It would be helpful to have clarification to determine if competent Authorities need to prove which group they are in to ESMA, or if ESMA is to decide and for the Competent Authorities to challenge the decision.

Additionally, it would appear uncertain if a country moves groups whether it will require a new Delegated Act or whether it will be in this framework to allow change, and we would request clarity on this.

Q35: Do you consider the proposed initial amounts and the incremental levels as reasonable and optimal? If not, what amounts and incremental levels do you consider as more appropriate and why?

Yes, we consider these initial amounts reasonable.

Q36: If given the thresholds ESMA has proposed above are implemented, how many notifications do you expect to make in a month to each relevant competent authority?

As the ABI makes no notifications, ESMA should expect responses from individual firms.

Q37: What level of net short position do you regard as significant for the particular sovereign debt markets?

No comment.

Liquidity thresholds

Q38: Do you agree with the general proposal suggested by ESMA for setting the parameters and methods for calculating the threshold of liquidity of the issued sovereign debt for suspending restrictions on short sales? If not, please state your reason and explain what could be an appropriate alternative.

Yes, we consider the proposal a sensible one.

Q39: In particular, do you agree that a measure in percentiles of the monthly volume traded in the last twelve months is suitable to define a threshold that represents a significant decline relative to the average level of liquidity for the sovereign debt concerned?

We are happy to support a 12-month period which incorporates all the main seasonal effects.

***Q40: In light of your response to the question above, do you think that a threshold of
a) the 5th percentile,
b) 2nd percentile or
c) 1st percentile would best represent a significant decline relative to the average level of liquidity for sovereign debt? Please explain why providing data if possible.***

We would support option a) the 5th percentile as being easy to calculate.

Significant fall in value

Illiquid shares

Q41: Do you agree that three categories are necessary? If not please state your reasons.

We are happy with the proposals as they relate to shares.

Q42: For the more illiquid shares, do you agree that EUR 0.50 is the correct cut off point to use? If not please state your reasons.

We believe this is as appropriate a cut-off point as any other.

Q43: Do you agree that 10%, 20% and 30% are the correct percentages to use in relation to the fall in value? If not, what other levels would you propose; please state your reasons.

Given that these are fairly arbitrary numbers, we would support them as being no worse than any other numbers, with the possible exception that the 10% level may be triggered too frequently.

Sovereign bonds

Q44: Do you agree that an increase in the yield across the yield curve is the appropriate measure to use for sovereign bonds? If not, what other measure would you propose, please state your reasons.

We are less happy with the proposals in relation to bonds. We think that the proposed 5% limit for government bonds is too tight. We would support a 10% limit.

ESMA has indicated it would accept a tiered approach which we believe it should investigate further.

Q45: Do you agree that an increase of 5% or more in the yield across the yield curve is the correct percentage to use? If not, please say what alternative threshold you would favour and state your reasons.

We believe that 5% is too small as in some cases it is not that uncommon to have such an intraday move across the yield curve, although in the UK it would be rare.

We understand that there may be further consultation on this approach which would be appreciated.

Corporate bonds

Q46: Do you agree that an increase of 7% or more in the yield is the correct percentage to use for corporate bonds? If not please state your reasons.

In respect of corporate bonds we think 7% is too tight. We would support doubling this to 14%. We are concerned with the effect the proposed limit may have on market liquidity. For some already illiquid bonds the bid / ask spread forms a material amount of the proposed price limit. We fear that this may have a further detrimental effect on liquidity in this market segment and make it more difficult and expensive for an investment manager to source such bonds.

ESMA has indicated that it would consider a tiered approach which we believe would help all involved.

Money market instruments

Q47: Do you agree that an increase of 10% or more in the yield curve is the correct percentage to use for money market instruments? If not please state your reasons.

No comment.

UCITS

Q48: Do you agree with the proposed ESMA approach to units in collective investment undertakings? If not please state your reasons.

Yes, we agree with the proposal.

Q49: If you consider that a trigger threshold in relation to fall in value in UCITS should be defined, what should be this percentage threshold and why?

No comment.

ETFs

Q50: Do you agree that 10% or more is the correct percentage to use for ETFs? If not please state your reasons.

No comment.

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.

We would hope for no threshold for derivatives, but understand that the multiplicity of instruments that exist means there is a need for an underpinning threshold where the underlying is traded.

Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward

***rate agreement or other derivative instrument, including financial contracts for difference?
If not, what alternative would you propose?***

We would support any proposal that is consistent with other levels set globally.

Q53: What could be an appropriate threshold to define a significant fall in price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

We support the general principle that if it is not centrally cleared and there is no underlying traded, then a threshold is needed. However, given the multiplicity of potential derivatives that would fall into this category, we do not feel that a “catch-all” threshold will be appropriate.

On the method for calculating the fall

Q54: Do you agree with the abovementioned proposal for the methods of calculation for various types of financial instrument? Do you have alternative or complementary methods to suggest, in particular in relation to the yield curve calculation method?

Yes, we agree with the proposals.

Adverse events and threats

Q55: Do you agree with the proposal for qualitative criteria should be set out?

Yes, we support the qualitative approach taken here. We support giving the Competent Authorities reasonable discretion without forcing the triggers, but would suggest that they need to explain themselves prior to undertaking extra restrictions.

Q56: Are there any additional criteria or factor that you would suggest adding to the list?

Not at this time.