Amundi
ASSET MANAGEMENT

AMUNDI RESPONSE TO
ESMA'S DISCUSSION PAPER

CALCULATION OF COUNTERPARTY RISK BY UCITS

FOR OTC FINANCIAL DERIVATIVE TRANSACTIONS

SUBJECT TO CLEARING OBLIGATION

(October 22nd, 2014)

Amundi very much supports ESMA's initiative to address, in relationship with the implementation of EMIR, the question of the counterparty risk on CCPs and Clearing Members (CM) resulting from the central clearing of derivative operations.

Amundi is the leading asset manager in France and in Europe and ranks among the top 10 largest ones in the world. It runs more than 840 billion € in diversified types of portfolios which may use derivatives, both listed and OTC. In that respect Amundi is very much concerned with the discussion on counterparty risk on centrally cleared transactions.

Amundi's position is based on the following principles:

- The **label UCITS** should be preserved and reaffirmed in such a way that it appears as a guarantee of secure investment vehicle for both retail and institutional investors; however UCITS should not be prevented from using collateral received (cash or securities) as margin deposited with CCPs : **ESMA's guidelines on ETF and other issues on UCITS should be modified**;

- Central Counterparties (CCPs) must be **strictly supervised and closely monitored** by competent authorities as they concentrate the counterparty risk of centrally cleared transactions: no one should contest their ability to face even exceptional market conditions;

- **Individual Segregation** is by far the most protective device for UCITS and their holders and it should be encouraged ; it can be operationally facilitated through the possibility for the CCP to use the depository of the UCITS as custodian ; ESMA should make sure that segregation implies that the CCP opens an account for the end-client (via the CM): it should be clearly differentiated from other arrangements where portability and bankruptcy remoteness will not be so well guaranteed ; however the cost of individual segregation is not yet clear and it might impair the decision to use it;

- In terms of risk the dividing line should no longer be traced between listed and OTC

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derivatives but **between cleared and non-cleared** trades; the fact that the clearing is mandatory (or not) is not relevant as long as the quality of the CCP is granted;

- ESMA should be very attentive to maintain a **very high standard of quality for all the CCPs** that will be under its indirect supervision and to make sure that it is implemented in all member States at the same level; furthermore the same requirement should apply to CCPs based in a third country that ask for recognition of equivalence to European standards;

- Exchange traded derivatives have shown that the Omnibus account approach with the clearing member is satisfactory; however, contrary to individually segregated accounts, we think that for omnibus accounts the counterparty risk on the CM should be limited to 20% to 35% of the NAV of the fund and that the limit on global exposure (counterparty, issuer, deposit…) should be increased in parallel by another 15% to reach respectively 35 or 50%; we consider that other segregation arrangements could have intermediary counterparty limitations ; before introducing such a limit regulators should allow **time for asset managers to adapt** and prepare: 2 years after the implementation of mandatory clearing will be necessary.

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1. Do you agree with the working assumptions above?

Yes, Amundi considers however that the above paragraphs present a good definition of the scope more than assumptions. With reference to §7, we insist on the heavy responsibility that relies on regulators that have to agree and supervise CCPs. EMIR favours central clearing and thus limits the former diversification of counterparties that we had; it implies that CCPs must be above suspicion and so to speak "risk-free". We understand that being market infrastructures CCPs are SIFIs and subject to strict requirements in terms of capital structure and risk management as well as continuous monitoring. We consider that some clarification should be made on the access to liquidity granted by central banks to those CCPs which are not banks: explicit arrangements should be made public when they exist and implicit positions should be presented as such.

2. In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA-recognised CCPs for which counterparty risk may not be low? If so, please explain.

Amundi considers that ESMA-recognised CCPs do not present a unique or similar risk profile. Just to give some examples, we see a real advantage in CCPs that are registered as credit institutions or banks and have a direct access to central bank liquidity. We also pay attention, when assessing the risk of a CCP, to the size of capital and guarantee funds and the rules of the default waterfall. Furthermore the list of clearing members and their diversity is another factor of differentiation, in our view. Globally, Amundi agrees that CCPs recognized by ESMA present a very low counterparty risk even if some seem to us safer than others. In particular, we are very sensitive to the fact to achieve a level of segregation that will offer real portability and quick transfer in case of default, and not all CCPs present the same types of contracts.

We stress that we would not have the same level of confidence in a CCP of a third country recognized as equivalent by ESMA but that would not be supervised by NCAs with the participation of ESMA. As mentioned the strict supervision of CCPs on a continuous basis is key to gain confidence from market participants and our confidence in the supervising authority is a factor of confidence in the quality of the CCP.

3. Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?

No, Amundi supports the conclusion that ESMA–recognised CCPs do not present a significant counterparty risk and that there should be no limit on this marginal risk.

We may even argue that imposing a limit would be counterproductive as it would suggest that supervisors are not confident enough in their own capacity to maintain safe infrastructures.

4. Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.

Yes, Amundi considers that individual segregation best protects clients' interests. The CCP opens an account in the name of each individual client and the clearing member only acts as an intermediary between the CCP and the client. This enables portability on short notice of the securities deposited and not of an equivalent amount and the counterparty risk on the clearing member(CM) is very temporary (what is called "un instant de raison" in French to designate the delay for transferring deposit to the CCP) or residual (in case of excess margin not transferred to the CCP). On the contrary, when the CM uses an Omnibus account the client is largely at risk in case of default of the CM.

Amundi is very much concerned that CCPs and clearing members have not to date been able to exactly price their offer for individual segregation. We consider that ESMA should require them to publish it very rapidly and check that it is an offer on reasonable commercial terms.

5. When assessing the counterparty risk for centrally-cleared OTC derivative transactions, do you think that UCITS should look at other factors than the segregation arrangements? If yes, what are those factors?

As mentioned in question 2, we believe that risk assessment of CCPs requires a close examination of their rules, their financial situation, the diversity and strength of their members, their access to central money…For example, the default waterfall has to be studied attentively as the time when individually segregated accounts of clients may be called to finance a default and participate to a mutualized funding varies from one CCP to another. We insist on the fact that end clients with individual segregation at the CCP should never be called by the CCP and participate financially in case of default of their CM. However the key factor to determine counterparty risk is the type of segregation that determines the split between the counterparty risk existing on the CCP (very low) and the CM.

Practically, UCITS should determine their ability to transfer their assets from one to another CM (i) in their entirety and not up to a portion limited to their share in the deposit made by the initial CM with the CCP (ii) in their integrity and not for an equivalent amount and (iii) on short notice and without delay. These questions are dealt with when deciding for the level of segregation.

6. Do you agree that under an individual client segregation UCITS have a low counterparty risk vis-à-vis the CM for all the assets posted (initial margins, variation margin and excess margin if applicable)? If not, please justify your position.

Yes, Amundi agrees on the fact that the counterparty risk vis-à-vis the CM is very limited in case of individual segregation. We even consider that it is negligible provided that the client makes sure

that all of its assets are passed on to its account open with the CCP by the CM. It implies that initial margin, variation margin and excess margin are all held, cash or securities, by the CCP. Generally CCPs will deposit these assets with a Central Securities Depository, that is a totally safe infrastructure. However UCITS may reach an agreement with the CCP to use their own depositary as custodian in order to facilitate the operational process. We believe this last scheme is appropriate and recommend that ESMA encourage it.

7. Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?

No, we consider that in case of real segregation of accounts there is more an operational risk than a counterparty risk with the CM when clearing OTC derivative transactions with a CCP. It must however be extremely clear that individual segregation implies that all assets will be deposited with the CCP and that none will be kept by the CM, including excess margin. It raises the question of haircuts that the CM may ask for on top of the level of collateral required by the CCP. We consider that the CM is not entitled to haircuts in case of total individual segregation. This is an efficient way to avoid procyclicality as it prevents the CM to introduce personal haircuts that may vary unilaterally and only relies on the decision of the CCP which are supervised by the competent authorities. It also gives full transparency on the effective margin requirements and forbids any opaque increase or credit quality arbitrage on the part of the CM.

On the other hand when the CM offers extra services such as collateral swap or Repo – and we urge ESMA to reconsider its position expressed in the guidelines on ETF and other UCITS issues to enable UCITS to use the received assets as deposit with CCPs- we agree that there is a counterparty risk; but it relates to another transaction that is independent from the cleared deal and it is monitored on its own with a limit on counterparty risk.

8. To what extent do you think that the liquidation of derivative positions by a CCP in respect of a defaulting CM (and the associated market risk) is a significantly likely scenario that should be taken into account by the UCITS?

Amundi thinks that this scenario can be made extremely improbable not to say be avoided if the level of segregation is properly negotiated and documented. In case of individual segregation, CCPs know the final clients and have identified their holdings. CCP should only liquidate positions of a CM cleared through an Omnibus account where there is no visibility on positions and related margins. Practically when opening a segregated account the client appoints a backup CM who is ready to take over when and if required to. The client may also easily ask for transfer before any default occurs. We have a strong view that the point should be taken into consideration in the documentation and clarified in the CCP's rules that are agreed upon by supervisors.

9. Do you agree that UCITS should apply the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs? If not, please justify your position.

As a first remark, we want to state that we have not suffered any difficulty in our operations relating to ETDs cleared through an Omnibus account in the name of our CM. CCPs have generally developed in silo with market places and their closeness has reinforced their will to establish a common image of professionalism and safety.

The diversification of clearing possibilities, the obligation to clear some instruments have led to the conclusion that individual segregation, provided it is offered on reasonable commercial terms, is preferable in the interest of our clients. We agree that this conclusion should apply to both OTC

and ET Derivatives. Amundi believes that the distinction between derivatives when it comes to a risk assessment should no longer be made between listed or OTC derivatives but between centrally cleared or non-centrally cleared derivatives. The fact that the clearing is mandatory or not should not be considered as long as it is made within a ESMA-recognised (and supervised) CCP.

In order to avoid to disturb the existing processes for ETDs that have proved safe, we think that a phase in period of 24 months after the application date of the requirements for centrally cleared OTC derivatives in terms of counterparty risk should be granted to market participants.

10. Notwithstanding the choice of segregation model, do you believe that the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk should be assessed on a case-by-case basis?

No. Amundi believes that it is the responsibility of supervisors, and eventually ESMA in Europe, to make sure that CCPs present a very high level of financial and operational stability. ESMA should only have one standard of agreement positioned very high and applicable to all applying CCPs. As a consequence, we do not think there is room for a case by case assessment of CM counterparty risk apart from, as mentioned in the question, the segregation level.

11. Do you agree that, under an omnibus client segregation, UCITS have a higher counterparty risk vis-à-vis the CM than under an individual client segregation? If not, please justify your position.

Yes, when clearing through an omnibus account the risk is shared with other clients of the CM and remains with the CM. The end client does not fully benefit from the close monitoring and strict supervision of the CCPs.

12. Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus client segregation? If yes, do you agree that UCITS should apply those limits to the amount of collateral posted to the CM (i.e. initial margin, variation margins and excess collateral if applicable)? What should be the limits?

Yes, Amundi agrees that UCITS should have a counterparty risk limit to the CM under an Omnibus account. There is effectively a counterparty risk with respect to all assets transferred to the CM be it Initial, or Excess Margins as well as haircuts. In our view, Variation is margin effectively paid daily and is not at risk: at the end of the day it has either been transferred to the client or converted into excess margin. Cash, especially if not identified as client's money, is without doubt a direct counterparty risk on the CM. However, one should take as risk mitigation the margins effectively deposited by the CM with the CCP.

Because of this factor, we strongly recommend that the risk limit should be expressed as a significant proportion of the AUM of the UCITS: somewhere between 20 to 35%, knowing that this figure limits the counterparty risk on a Clearing Member as such and that it should be possible to continue having CDs, Deposits or Repos with the same entity or group for another 15%. For example in case of a limit at 25%, total risk exposure on one single counterparty should be extended from 25% for the counterparty risk on omnibus centrally cleared operations to 40% all included. We would not be in a position to properly run UCITS if the existing global counterparty exposure limit of 20% were to include the risk linked to central clearing without being raised to 35%. For the computation of this limit the counterparty risk on collateral that is bankruptcy remote should not be included. This would not prevent asset managers form introducing lower limits on some CM in certain specific circumstances.

13. Do you agree that UCITS should be subject to the same counterparty risk limits to CMs under omnibus client segregation for both OTC derivatives and ETDs? If not, please justify your position.

Please refer to our answer to question 9. Amundi insists on the necessity to proceed step by step : first make applicable, within a reasonable delay, the new requirements under EMIR on centrally cleared OTC derivatives and afterwards consider extending to ETDs these requirements and limits. There should be a minimum phase in period of 18 months on one hand between the publication of new UCITS limits and their application and 24 months on the other hand between the application dates on OTCs and ETDs.

14. Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangement? What should be the limits and the criteria for setting them?

Yes, we consider that mechanisms that do not offer to UCITS as clients a full portability of real assets and not on the basis of their equivalent value should be subject to counterparty risk limits. In that matter, Amundi encourages ESMA to closely analyse the different types of contractual arrangements that CCPs and CM offer in order to draw lines between the following categories:

1. Individual segregation, that must be total immediate and permanent;

2. Intermediary situations where portability should be rapidly manageable because CCPs have a direct and continuous knowledge of the end clients' situations and do not rely on information held exclusively by the CM; UCITS holders will be better protected if, as we ask for, collateral is maintained in a bankruptcy remote account that enables UCITS to directly reclaim and regain full possession of its assets;

3. Intermediary situations where CCP has to reconcile positions claimed by end clients and information transmitted by the CM (or that should have been transmitted by the CM), what implies delays and further exposure to market movements; the bankruptcy remoteness of the accounts where security collateral is deposited is another key element that characterizes the safety for end clients;

4. Omnibus account.

We fear that LSOC as developed in the US is not always in the second category and may fall in the third depending on the degree of transparence towards CCP and the level of equipment for CCPs to process the data received. The Omnibus gross account mechanism as presented in §18 does not qualify either to category 2 since there is a lack of direct knowledge by the CCP of individual positions.

In our view, there should be a gradual approach and intermediate levels of limits should be determined. We suggest an absence of limit for individual full segregation as well as category 2 transactions, a 35% to 50% limit for category 3 transactions and a 20% to 35% for standard Omnibus account transactions.

15. Do you agree that UCITS should be subject to the same counterparty risk limits applying to the CM under these other types of segregation arrangement for both OTC financial derivatives and ETDs? If not, please justify your position.

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Yes, provided an appropriate delay is granted to transform current arrangements. Please refer to our answer to questions 9 and 13 above.

16. Do you agree that UCITS should treat OTC derivative transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.

Yes, Amundi shares the view that non-EU CCPs outside the scope of EMIR should continue to be treated as counterparties of a bilateral transaction and subject to a 5 or 10% limit. However, we stress that the introduction of such a limit to CCPs that clear ETDs should not be introduced abruptly. There is a need for a better impact assessment on this subject in order to prevent difficulties for some investment strategies developed by UCITS.

17. Do you agree that ICAs should be considered equivalent to direct clearing arrangements and that the same limits envisaged for the different segregation models in a direct clearing arrangement should apply to an ICA? If not, please justify your position.

Amundi does not intend to use services of clearers that are not members of CCPs. Therefore, we express our concern that ESMA should not decide an obligation to compensate on contracts that are not cleared on several, at least 2, CCPs. It offers a better chance that one of our selected CM will be a member of one of the CCPs.

In terms of risk, we consider that there is a possible addition of counterparty risk when using ICAs. If the clearing intermediary which is not a member of the CCP uses an Omnibus account with the CM it creates a second layer of risk in case of default of the CM. Thus we do not agree at first sight with the assessment of equivalence of the direct and indirect clearing arrangements. However, we consider that it is not sufficient a reason to introduce different risk limits but that these limits should apply at each of the levels, clearing intermediary and CM.

18. Do you believe there might be circumstances under ICAs where UCITS have an exposure to the client of the CMs? If yes, what are those circumstances and do you think that UCITS should be subject to counterparty risk limits applying to the clients of the CMs? What should be the limits?

Please, refer to our first sight analysis under question 17**.**

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