

J.P. Morgan Asset Management's comments on ESMA's Consultation on Recallability of Repo and Reverse Repo Arrangements

This submission reflects the views of J.P. Morgan Asset Management ("JPMAM"), the investment management division of JPMorgan Chase & Co. JPMAM manages a large range of UCITS funds mainly domiciled in Luxembourg and the United Kingdom.

We welcome the opportunity to respond to ESMA's consultation on the recallability of repo and reverse repo arrangements. Please do not hesitate to contact us if you would like to discuss any of the issues raised.

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 callable 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.**

Regarding the average percentage of assets subject to repurchase and reverse repurchase agreements, concentrations differ significantly between the two types of instrument.

Repurchase agreements are a form of borrowing. In UCITS funds, borrowing is capped at 10% of NAV. Therefore percentages in excess of 10% cannot be envisaged. In practice borrowing in our UCITS funds occurs only in the form of overdrafts at the custodian and repurchase agreements are not used.

We use reverse repurchase agreements in certain of our liquidity funds. Our AAA rated sovereign liquidity funds invest up to 100% of net assets in reverse repurchase agreements.

- i) Our reverse repurchase agreements normally contain put and call provisions which make them as readily callable as normal time deposits.
- ii) We primarily use reverse repurchase agreements for overnight transactions, with few exceeding maturities of one week.

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

We have no objections to the following guidelines:

- 1. a. No compromise of the ability to execute redemption requests: we use reverse repurchase agreements in funds specifically designed to offer high daily liquidity.

1. b. and 2. Limits on non-recallable reverse repurchase agreements: we would not envisage using non-recallable reverse repurchase agreements.

3. a. Balance between short-term and medium-term fixed term arrangements: we use only short term recallable reverse repurchase agreements.

3. b. Diversification of counterparties to non-recallable reverse repurchase agreements: although net counterparty exposure is slightly negative, due to the haircut by which collateral exceeds exposure, we apply a maximum 25% gross counterparty exposure limit derived from the standards set by Moody's for the awarding of a triple A rating, and in normal market conditions we apply a tighter 20% internal limit matching the regulatory counterparty limit for deposits.

We do not agree with the following guideline:

3. c. Collateral should agree with the criteria set out in paragraph 40 of ESMA/2012/474 Annex III.

Justification for our position:

1. In AAA rated sovereign liquidity funds the 20% cap on single issuer exposure in collateral received will cause the funds to diverge from their objective by creating a conflict between the two primary objectives, namely provision of 100% sovereign credit exposure and provision of high liquidity.

Funds such as a Gilt Liquidity Fund or US Treasury Liquidity Fund are established to offer the investor 100% sovereign exposure, which in all currencies other than the Euro implies a single issuer. In times of increased market volatility, liquidity funds adopt the defensive strategy of increasing their short dated liquidity to levels of up to 50% of NAV. The 20% cap in paragraph 40, e) will limit readily available short dated liquidity to 20% and force the funds to invest the remaining 80% in direct issues of the sovereign. When requiring a further 30% of short dated liquidity to adopt a defensive strategy, the funds will have to compete for expensive short dated treasury bills, which are subject to restricted supply. If such supply is inadequate they will be forced to take longer dated sovereign issues which, if redemption levels force funds to sell longer dated sovereign issues before their maturity, could give rise to realised duration risk and dealing spreads. Such limiting of holdings of short dated cash runs counter to the objectives of a liquidity fund.

2. Paragraphs 38 to 42 lack clarity with reference to non-traditional reverse repurchase agreements. Paragraph 39 refers to all assets received by a UCITS in the context of efficient portfolio management techniques and classifies them as collateral. It also states that they should comply with the criteria in paragraph 40. Paragraph 40 deals with collateral which is used to reduce counterparty exposure. What is not clearly explained is that paragraph 40 creates two subsets of collateral, that which is used to reduce counterparty risk exposure and that which is not used to reduce counterparty exposure. Interpretation relies on the grammatical distinction between (a) 'all collateral [which is] used to reduce counterparty risk should comply with the following criteria' and (b) 'all collateral, which is used to reduce counterparty risk, should comply with the following criteria'. The actual wording used, 'all collateral used to reduce counterparty risk' is a shortened form of (a). Type (a) is a specifying relative clause which creates two subsets, collateral which is used to reduce counterparty risk and collateral which is not used to reduce counterparty risk. We therefore have the result that:

All assets received are classified as collateral

All collateral must comply with the criteria set out in paragraph 40

Subset 1 'Collateral which is used to reduce counterparty risk' must comply with criteria a) to j)

As a consequence collateral which does not comply with all of criteria a) to j) cannot be placed in subset 1 and must be placed in subset 2, collateral which is not used to reduce counterparty exposure.

At stake are non-traditional reverse repurchase agreements with underlying debt, which are used in certain of our money market funds. Counterparties are drawn from our lists of permitted deposit counterparties and maturities are overnight to one week. Our liquidity funds and money market funds are subject to Luxembourg regulations, in particular CSSF circular 08/356, which makes a clear distinction between securities which may be purchased under a reverse repurchase agreement (page 6) and securities which may serve as a guarantee which reduces counterparty exposure (page 8). Any shortfall is covered by the 10% counterparty limit, which is reduced to 5% if the counterparty is not a credit institution. This limit has been used to date to cover non-traditional reverse repurchase agreements based on non-government debt collateral below investment grade. Criterion c) 'Issuer credit quality – collateral received should be of high quality' is not defined, but if we equate first class with 'investment grade' then non-government investment grade bonds with adequate liquidity would fall into subset 1, collateral which is used to reduce counterparty risk, while non-government non-investment grade bonds would fall into subset 2, which would trigger reliance on the 10% or 5% counterparty limits in Article 52 of the UCITS directive.

In economic terms if we take a reverse repurchase agreement with a credit institution and ignore the collateral we have a time deposit. It is anomalous that a UCITS fund should be able to have a 20% counterparty exposure to a credit institution through a totally uncollateralised time deposit yet could have no exposure to the same counterparty through a reverse repurchase agreement with identical size and maturity simply because the assets purchased do not qualify as a guarantee. We therefore recommend that greater clarity is introduced to paragraphs 38 to 42, with a view to retaining such non-traditional reverse repurchase agreements in the universe of approved investments.

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?

The range of funds to which any limit is applied will vary widely in the volume of redemptions experienced. A percentile limit which is appropriate to one fund will be inappropriate for another. Rather than setting a hard limit we prefer the application of a principle, namely that the ability to meet redemptions should not be compromised.

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.

We refer you to our answer to Question 3. We prefer the setting of the principle that the ability to meet redemptions should not be compromised.

Q5: Do you think that there should be a minimum number of counterparties of arrangements under which the assets are not callable 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.

Recallability terms are bilateral, so not only would the fund be able to recall a reverse repurchase agreement, but also the counterparty would be able to do so. A recall by the counterparty could be disruptive for the orderly cash management of a fund. A case can therefore be made for imposing a structure of gross counterparty limits on all reverse repurchase agreements, irrespective of whether they are callable or not, that is similar to the 25% gross counterparty limit in Moody's criteria for awarding a triple A rating to a liquidity fund.