ESMA
103 rue de Grenelle,
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France

30 January 2014

Dear Sir/Madam

ESMA Consultation paper on the Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues

IMA represents the UK-based investment management industry. Our Members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of over €5.0 trillion of assets, which are invested on behalf of clients globally. In particular, they manage both UCITS and non-UCITS.

We support the decision by ESMA to reconsider its position on the requirements on collateral diversification on the basis that they will have a significant adverse impact on UCITS's collateral management policies.

However, the proposed derogation from the 20% issuer limit should be extended to all UCITS and not just to Money Market Funds ("MMFs"). ESMA's proposal would potentially result in UCITS managers operating different collateral policies and procedures across the same fund range, and there is no rationale to make a distinction between MMFs and other types of UCITS. Any UCITS that utilises efficient portfolio management techniques, such as securities lending or repurchase agreements, or that receives collateral from counterparties in relation to OTC derivative transactions should benefit from the derogation.

Also, we also cannot see the logic of imposing the requirement that UCITS must receive collateral comprised of at least 6 different issues. This requirement would necessitate a major

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revision of current arrangements, which would be costly and resource-intensive. In addition, there are operational difficulties that could impact the ability of UCITS managers to manage their funds effectively, to the detriment of investors.

We also urge ESMA to extend the transitional period for compliance with the collateral diversification requirements, due to the ambiguity around what limits will apply at the end of transitional period of 18 February.

Please find attached our detailed response to the questions raised. We would welcome the opportunity to discuss these points with you.

Yours faithfully

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IMA response to ESMA consultation on "Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues"

Q1 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?

We believe that there are two issues with the proposals:-

- The derogation should be available to all UCITS; and
- UCITS should be able to receive collateral valued up to 100% of their net asset value, plus applicable haircuts.

We support the proposed revision of the provisions on diversification of collateral. This will increase the flexibility of MMFs (and other UCITS) to engage in reverse repurchase agreement transactions collateralised by government securities. **However, we are strongly in favour of Option 2, which would enable all UCITS to receive the benefit of the derogation. If there is to be a distinction, ESMA should conduct an impact assessment to clarify the reason for its preference for Option 1 as this would potentially result in UCITS managers operating different collateral policies and procedures across the same fund range.**

Government MMFs are principally impacted by the 20% maximum exposure limit to an issuer of collateral. **However, all UCITS are detrimentally impacted by this restriction and there does not appear to be a rationale for maintaining the distinction. Any UCITS that utilises efficient portfolio management techniques, such as securities lending or repurchase agreements, or that receives collateral from counterparties in relation to OTC derivative transactions, should benefit from the derogation.**

Receiving high quality government bonds by way of reverse repo is essential to the effective operation of both standard MMFs and short-term MMFs. The use of high quality collateral avoids introducing additional asset specific risks (such as reduced credit quality or exchange risk), thereby ensuring that the overall management of the fund is aligned with investor expectations regarding the high quality and the liquidity of MMFs. It is also important given that short-term MMFs can themselves be used as collateral in accordance with Guideline 43 (j).

MMFs use reverse repo as a secure means of investing cash from the portfolio, receiving high quality collateral in return and thereby reducing their bank deposit risk and, ultimately, risk to the end-investor. The vast majority of reverse repos are overnight transactions, that is, the exposure of the MMF to the reverse repo counterparty is also overnight and the risk of default is minimal. Reverse repo is therefore an important tool in the risk manager's toolbox.

In particular, Government MMFs which invest primarily in treasuries, government bonds and reverse repos, aim to provide the most risk-averse investors access to a cash asset class that

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does not have exposure to the more traditional money market instruments and sectors. They are designed to be as close to "risk-free" as possible by investing in government bills.

Indeed, the investment mandates of many Government MMFs do not permit exposure to bank deposits. As government bonds do not mature every day but on weekly and monthly dates set by the auction process of government debt management offices, reverse repo is required for Government MMFs to provide liquidity on a daily basis to meet investor redemptions. Without reverse repo, Government MMFs would have to sell their investments in government bonds before maturity to meet investor redemptions. With standard European government bond settlement of two business days for sales and purchases, selling bonds on the same day can only be accommodated on a best efforts basis by counterparties, which further limits the provision of same day liquidity without the use of reverse repo.

Reverse repos perform the same role of providing daily liquidity for government liquidity funds as overnight bank deposits do for prime MMFs (which invest primarily in bank and corporate debt issuers). However, prime MMFs have also increased their use of reverse repo given heightened concerns over certain bank risk and would like to continue to do so given the likelihood that bank deposits could be 'bailed-in' in the future.

In the unlikely event of overnight counterparty default, the MMF may liquidate the collateral received in a repo transaction directly in the market in order to recover the cash lent to the defaulting counterparty. Collateral is specifically not intended to be held to maturity, unlike the assets which are being held in the investment portfolio. Reverse repo is an overnight transaction and should not be treated in the same way as the investment portfolio.

The primary criteria regarding collateral for EPM techniques, such as securities lending, repo and reverse repo, is liquidity and stability in times of market stress. That is why sovereign debt has always been and continues to be seen as the most desirable form of collateral. As currently drafted, the ESMA Guidelines which come into force from 18 February 2014, will force UCITS engaging in EPM techniques to restrict the amount of sovereign debt they can accept as collateral from a single government issuer. This may lead to a number of consequences:

- Investors in funds that engage in EPM techniques expect the UCITS to take reasonable steps to control risk and to protect investor interests. Historically, they have done so by limiting permitted collateral to only high-quality, liquid securities such as sovereign debt.
- As currently adopted, the ESMA Guidelines will restrict lending agents' ability to take sovereign debt as collateral, a result that is counter-intuitive from an investor protection perspective. To obtain appropriate levels of diversification in high quality government issuers as required by Guideline 43 (j), managers in many cases would be forced to take on exposure to currencies other than those of the base currency of the fund. To avoid taking on this currency risk, the alternative is to hold higher levels of cash deposits, but this then comes with increased credit risk to the deposit taker, which is not in investors' interests.

- Collateral is the 'insurance' that managers require to make investors whole in the event of failure to return the securities. The key driver for collateral is the speed at which collateral can be liquidated in order to buy back lent assets on a failure of redelivery. This favours the inclusion of very liquid or short term instruments such as government securities. As borrowers find it increasingly complex to finance the required diversified pool of collateral, they may look at cash collateral as a replacement solution, which is not palatable to many European funds because of the extra credit risk of having cash on deposit. The result would be balances falling off in favour of funds which accept cash.

There is also an issue with the proposed revised guidelines that should be addressed. The wording of the proposed derogation - as it currently stands in both Option 1 and Option 2 - provides that the relevant funds "*may receive collateral up to 100 % of their net asset value in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong.*" A 2% haircut on collateral is typically received by the fund, with the result that that collateral represents 102% of the nominal value of a reverse repo. If a fund invests solely in reverse repo, the value of the collateral could indeed exceed 100% of the NAV of the fund and the implications of this should be considered. On the assumption that it would not be ESMA's intention that such instances would be considered or reported as breaches of the guidelines, we recommend that an appropriate amendment be made to the wording of the proposed derogation to address this so that a fund may receive collateral valued up to 100% of their net asset value, plus applicable haircuts.

Q2 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.

Government securities represent lower default and liquidity risk and this can be seen in the higher issuer concentrations permitted in Articles 52.3 and 54.1 of the UCITS Directive. Rather than creating any additional safeguards, reliance should be placed on the variations in haircuts applied by the markets to collateral received.

UCITS managers use rigorous counterparty selection tools and processes to minimise the risk of the overnight default of the repo counterparty. These operate in parallel to the investment process. Collateral management programmes are also run in parallel to the investment process, typically by specialised third party agents and not by the UCITS manager.

Typically, the UCITS appoints a specialised third party agent to administer the securities received from borrowers as part of reverse repo trades within predefined risk limits (for example, specifying which Government and agency debt is acceptable).

Given the existing high standards for selecting counterparties and monitoring collateral, additional safeguards would not enhance risk management or better protect the assets of the end-investor.

Q3 Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

We disagree with this proposal.

The selection of issues to deliver as collateral and the quantity of each issue is made by multiple counterparties acting independently. The overall quantity is determined by reference to the value of the particular transaction to be covered, modified slightly by a schedule of haircut levels. There is no requirement for an individual counterparty to know the current net asset value of the UCITS, a figure which could be subject to considerable variation, or to know which particular issues and sizes are being delivered by other counterparties. The collateral agent that receives the collateral is not aware of the particular issues and sizes held by the various counterparties; hence it cannot select the collateral to ensure that specific limits are met. Many reverse repos are dealt for same day settlement, leaving little or no time for the renegotiation of the issues and sizes to be delivered.

We understand that the systems used by the reverse repurchase agreement market across Europe (such as those employed by collateral agents and clearing houses such as CREST and Euroclear) do not have control mechanisms sufficient to ensure reliable compliance with a count of six issues and a 30% cap of NAV per issue. These systems are unable to handle trigger points by value for the application of limits, limits of individual issues by value, or diversification by the number of issues.

In addition, in the U.S., 90% of repos are done on a 'tripartite' basis, with those undertaken on a 'bipartite' basis accounting for only approximately 10% of the market. Tri-party repo is a basket form of transaction managed by a third party clearing agent or bank. Collateral is not provided at the point of trade; rather it is only at the end of the business day (at settlement) that a fund is advised of its collateral. This makes the monitoring of collateral to ensure there is no more than 30% from one issue (and that there are at least six different issues) problematic.

We cannot see the logic of imposing the requirement that UCITS must receive collateral comprised of at least 6 different issues. Using U.S. Treasuries to illustrate, this limit would seem to have the effect of restricting a UCITS's otherwise reasonable use of Treasury reverse-repo without enhancing potential liquidity. If a UCITS takes possession of U.S. Treasury collateral, the liquidity of that collateral does not depend on whether it is comprised of more than six issues. Maturity date of country collateral is not a factor in its liquidity. Overcollateralisation in reverse repo transactions is used to address interest rate risk.

The industry will be challenged to facilitate compliance with a numerical ("minimum number of positions") requirement. If ESMA perseveres with this aspect of the proposal, it should allow sufficient lead time to facilitate compliance. Otherwise, the guideline will have unforeseen, negative consequences, as it would cause UCITS to have to revert to an issue limitation that is likely to be more restrictive than the 30% "safe harbour" for a single issue (as proposed). The operational difficulties could impact the ability of UCITS managers to manage their funds effectively to the detriment of investors

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A six-issue diversification requirement would also necessitate a major revision of current arrangements, which would be costly and resource intensive. With these concerns in mind, we ask ESMA to provide a cost/benefit analysis of imposing a "six issues" requirement.

Instead, we would propose that a diversification mechanism in the form of a 20% cap on the gross exposure to each counterparty should be applied to UCITS that make use of the proposed derogation. This is for the following reasons:

- It is the default of a counterparty that occasions the need to liquidate collateral. In the event that a counterparty delivers only one line of collateral the maximum amount of one issue that the UCITS will have to sell in the market is 20% of the NAV of the fund, compared with 30% in the current proposal. It would take the combined simultaneous default of two counterparties to breach the alternative 20% limit, plus selection of identical issues by both.
- Control of exposure against the diversification standard lies entirely with the UCITS manager in the form of gross exposure limits. These can be readily enforced by pre-trade and post-trade compliance tests.
- There is no requirement to keep counterparties informed of current net asset values and no requirement for coordination between different counterparties.
- No changes will be required to the systems of UCITS managers' collateral agents, counterparties and clearing houses such as CREST and Euroclear. The 7 day maximum tenor permitted for reverse repurchase agreements would permit UCITS managers to quickly implement a 20% cap on gross counterparty exposure by rolling maturing deals into reverse repo agreements capped at 20% gross exposure per counterparty.