BLACKROCK

Response

ESMA guidelines on ETFs and other UCITS issues and proposal for the treatment of repo and reverse repo arrangements

BlackRock welcomes the opportunity to submit comments on the European Securities and Markets Authority's (ESMA's) proposed guidelines for the treatment of repo and reverse repo arrangements. Financial regulatory reform fundamentally impacts asset managers and end-investors. As a fiduciary for our clients, BlackRock supports the creation of a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets, while preserving consumer choice and assessing benefits versus implementation costs. We support the current initiative by ESMA to the extent it provides positive outcomes for Europe's end-investors by strengthening the globally successful UCITS-brand.

We understand "repo" and "reverse repo" to be the same kind of transaction just being described from the opposite viewpoints – that of seller and buyer of the repo. To facilitate the investment strategies BlackRock executes on behalf of its clients, we may act as the seller of the repo (to raise cash for certain strategies) or could become buyer of repo (such as when our Money Market Funds lend surplus funds) if future regulation requires raising cash to meet regulatory requirements.

Where the UCITS is the buyer of the repo, we take highly liquid bonds as collateral for the cash loan and over-collateralise the exposure to protect end-investors from any losses in value of the securities at the outset of the transaction. To further protect end-investors, we are particularly selective as regards the repo counterparties we engage with.

General comments

The Consultation Paper neither expressly sets forth the regulatory purpose nor identifies the market failures that ESMA is seeking to address. Therefore, the specific rationale for issuing additional Guidelines for UCITS in respect of the treatment of repo and reverse repo remains unclear. We would welcome clarity from ESMA in this regard.

Generally, we would be concerned about additional limitations being imposed on the repo markets through Guidelines or further revisions of UCITS. Restricting the ability of a UCITS to enter into non-recallable repo transactions would ultimately increase frictional cost, reduce the number of counterparties willing to take on the additional risk of fully recallable repo transactions and suppress activity in the repo markets. End-investors benefit most when the capital transfer mechanism is as efficient as possible; efficient capital transfer mechanisms create liquidity and liquidity ultimately reduces costs for end-investors. In other words, specific restrictions on repo transactions would ultimately translate into a performance drag for end-investors whilst concentrating risk in a smaller number of counterparties.

Specifically, restricting the ability of a UCITS to enter into non-recallable repo transactions would, we believe, transform the behavior of UCITS counterparties. UCITS counterparties would demand a reciprocal right to recall assets, potentially giving rise to detrimental consequences for a UCITS and its investors. In particular it would result in a greater tendency towards overnight repo financing, thus weakening the stability of UCITS funding arrangements. This means that a UCITS would be more susceptible to re-rates/punitive haircuts and circumstances where, to satisfy redemption requests, it is obliged to sell positions into a precipitously declining market.

Finally, we encourage ESMA to consider the impact of the proposed Guidelines in the context of the increased demand for cash the European Market Infrastructure Regulation (EMIR) will impose. If variation margin collateral requirements under EMIR are not expanded to include highly liquid securities as well as cash, something which the buy-side considers to be very important, asset managers will be obliged to make ever increasing use of the repo markets to raise the necessary cash to meet the CCPs' variation margin requirements.

Specific comments

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 recallable 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.

We understand use of repo and reverse repo by UCITS to be quite limited, at present. However, these transactions are likely to become much more important when asset managers are required to post more liquid collateral in the future under the European Market Infrastructure Regulation (EMIR). Additional restrictions on repo transactions would ultimately impact the ability of market participants to meet the variation margin requirements under EMIR, and could ultimately lead to the forced sale of assets to generate alternative sources of cash.

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

No, principally because of how the application of the proposed Guidelines might transform the behaviour of UCITS counterparties. A limit on the ability of a UCITS to enter into non-recallable repo transactions is likely to result in UCITS counterparties demanding a reciprocal right to recall assets, potentially giving rise to detrimental consequences for a UCITS and its investors.

The objective of the ESMA guidelines should be to ensure that the UCITS does not incur significant cost or experience liquidity issues in unwinding Efficient Portfolio Management (EPM) techniques when required to meet redemptions. Steps that can be taken to limit this cost include:

- Limiting the maturity date of the reverse repo arrangement to a specific number of months. The longer the maturity date, the higher the potential unwind cost (or profit).
- The liquidity profile of the reverse repo arrangement could be between for example, 0-10 business days for a specific percentage of the fund's net asset value (where the percentage is the level that is sufficient to meet large redemption requests).

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?

We do not support the imposition of a specified percentage of assets of UCITS that could be subject to repurchase and reverse repurchase agreements without recall provisions. Given the heterogeneous characteristics of UCITS funds, a limit that is appropriate to one fund may very well be inappropriate for another. It is sufficient that there be a guideline to the effect that a UCITS should ensure that an arrangement does not compromise its ability to meet its redemption obligations in accordance with Article 84.

In general, restricting the ability of a UCITS to enter into non-recallable repo transactions would ultimately increase frictional cost, reduce the number of counterparties willing to take on the additional risk of fully recallable repo transactions and suppress activity in the repo markets. This situation translates into a performance drag for end-investors whilst concentrating risk in a smaller number of counterparties.

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.

No, we do not consider that additional Guidelines are necessary to address this point.

Details of when redemption can be requested and subsequently granted typically form part of UCITS documentation. We are also comfortable that UCITS requirements already provide for sufficient safeguards regarding liquidity.

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

Whereas with term repo there are typically many counterparties to the trade, we would expect that number would decrease significantly for fully recallable repo transactions. This would be due to fewer counterparties being willing to accept the higher degree of risk associated with unilateral re-callability. In practice it would be difficult to mandate firms to take on risk they were unwilling and/or unable to accept and ultimately contrary to sound risk management principles.

About BlackRock

BlackRock is one of the world's pre-eminent investment management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world.

As at 30 June 2012, BlackRock's investments under management totalled €2.74 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds ("ETFs"). Through BlackRock Solutions®, the firm also offers risk management, strategic advisory and enterprise investment system services to a broad base of clients, including governments and multi-lateral agencies.

BlackRock has a pan-European client base serviced from 14 offices across the region. Public sector and multi-employer pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.