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The International Securities Lending Association response to ESMA's guidelines on ETF's and other UCITS issues consultation paper

On behalf of our members, The International Securities Lending Association (ISLA) appreciates the opportunity to contribute to ESMA's consideration in relation to providing guidance for ETF's and other UCITS issues. We hope to continue further dialogue with the regulatory community and policy makers and welcome the opportunity to discuss in depth the responses provided in this paper at your convenience.

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than sixteen countries in Europe, and the rest of the world.. For more information please visit the ISLA website www.isla.co.uk

Given ISLA's focus our comments are restricted to matters that consider the use of securities lending.

Executive Summary

We appreciate the opportunity to contribute to ESMA's considerations in respect of ETF's and other UCITS issues (ESMA 2012/44). We hope our comments are helpful and welcome the opportunity to discuss in depth our responses at your convenience.

Our main feedback is as follows:

I. Transparency

We welcome further transparency to investors for EPM techniques such as securities lending activity and agree that information about the costs, benefits and risks should be incorporated into the prospectus. However we would like to recommend that ESMA produce some pro forma wording which can be used to ensure a consistent approach to describing the risks. UCITS may adapt this pro forma to take account of any specific approaches Further transparency via the fund rules, including publishing exposures as described in paragraph 10 of Box 6 of the guidance, is also welcomed. However consideration should be given to the complexity and cost of publishing information when determining the frequency of these requirements.

II. Collateral and Cash re-investment

Collateral received by UCITS in the context of EPM techniques should be liquid and of good quality. The main purpose of collateral is to mitigate the risks of counterparty default. Our view is that by setting guidelines which look to correlate collateral to the UCITS portfolio, or combine collateral with UCITS unlent holdings, may be operationally complex, cumbersome and costly to manage, while resulting in additional risks to the UCITS. Whilst correlation is certainly a factor that should be taken into account by UCITS when considering what collateral is appropriate, other factors such as liquidity may be more important. For example requiring a high degree of correlation may preclude the use of German Government Bonds as collateral by an equity fundThe guidance pertaining to the re-investment of cash collateral is confusing and we would appreciate the opportunity to clarify and better understand the approach taken. It would seem that the guidance restricts cash re-investment to cash deposits with approved counterparties only. This will make accepting cash as collateral un-economical and will effectively prohibit a UCITS from accepting cash collateral. It is important to note that from a capital and liquidity perspective there is no safer form of collateral than cash. In seeking to regulate how it is reinvested, regulators should not eliminate the viability of accepting cash as a collateral form altogether. We believe that it should be acceptable for the fund to re-invest cash collateral in vehicles that are an acceptable form of investment for UCITS retail investors e.g. other UCITS money market funds.

III. Counterparty limits

Limiting the proportion of the portfolio that can be lent, by counterparty or at portfolio level will limit the opportunities for UCITS in securities lending and lead to reduced competitiveness for UCITS in the global securities lending market. Provided the risk management techniques are robust and appropriate collateral and haircuts are received, limits are not necessary and will be detrimental to the UCITS ability to ensure best pricing and to maximise returns, and for smaller UCITS, such limits may cause them to exit from lending.

If limits were imposed on securities lending activity for UCITS we would expect corresponding restrictions to apply to synthetic instruments that have a similar effect in other funds.

We and our respective members again thank you for the opportunity to participate to this consultation paper. We have aimed to provide as much detail and constructive feedback to the questions posed in the document as possible. We remain fully at your disposal for further engagement and correspondence.

Yours sincerely,

Kevin McNulty

Chief Executive

<u>General comments not relating to specific questions</u>

Benefits and costs of EPM techniques

We are aware that some commentators have called for the inclusion of costs of securities lending arrangements to be included in the published expense ratios of funds. It is important that investors see the full picture – funds that lend would often appear more expensive than those that don't and the additional performance produced from EPM techniques would not always clear. It is therefore important that both the costs and performance created by securities lending are recorded and disclosed as a separate line item in the total expense ratios of the fund.

Annex IV

We note the comments made by ESMAs Securities and Markets Stakeholder Group in Annex IV, paragraphs 38-41. We do not agree that securities lending represents a critical issue in respect of ETF's. The risks taken by participating in securities lending can be managed to very low levels provided the activity is managed well and regulated appropriately. We would be happy to meet with members of the ESMA Stakeholder Group should they wish to know more about securities lending.

<u>Questions to stakeholders</u>

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

Taking each paragraph within Box 6 separately:

1. ISLA members welcome greater transparency to investors for securities lending activity. It is important that investors understand the risks undertaken on their behalf, however, equally important should be the disclosure of the benefits generated. We suggest that pro forma wording is developed by ESMA to ensure a consistent approach in describing risks and benefits. Individual UCITS can then expand this wording where risks and techniques adopted, materially deviate from ESMAs proposed wording. However, the requirements should not be so detailed, such that constant updates will be required to the prospectus with the associated costs to the UCITS of this.

2. Agreed as per paragraph 1 above.

3. In terms of disclosure we agree that fee arrangements should be disclosed in the prospectus of the UCITS. However, paragraph 3 suggests that "*as a general rule*" all fees should be returned to the UCITS. Securities Lending is a complex and costly activity which is usually undertaken by a third party specialist (this may be the asset manager, custodian or independent third party) who has invested in specialist systems and expertise to manage the process in a risk controlled manner. The service offering by the third party specialist may also include borrower default indemnification. It is usual for this third party to seek re-imbursement and compensation for the various services it offers, including but not limited to, indemnification through a fee sharing arrangement rather than charging a flat fee. This ensures that the UCITS only incurs costs when revenues are generated and aligns the interests of the third party to the UCITS in respect to ensuring that the activity is profitable for the UCITS. Other parties such as asset managers may also undertake activity relating to securities lending such as performing the oversight function required by regulations and should also reasonably expect to be compensated for this activity. We would therefore suggest that all third party fees are aggregated and simply reflected as a percentage against the amount the UCITS collects. For example, 'the UCITS receives X% of lending revenue, with X% being paid as fees (including management company share and lending agent).'

We also understand and expect that disclosure regarding 'other fees' that may be deducted from the return delivered to investors, as described in the prospectus, will be described in general terms.

4. Agreed as per paragraph 1 above.

5. It is normal practice that the security or equivalent securities would be returned and it is important that this process remains to allow the process to operate efficiently. Whilst there is activity in term lending and repo that UCITS will not be able to benefit from, we can accept this requirement. However, as a general rule we believe that the UCITS manager owns the strategy of the fund and should be free to decide if term activity is appropriate for the individual fund.

6. We have concerns about the imposition of certain of the requirements of Box 26 of CESR's guidelines (Ref. CESR/10-788). Firstly consideration should be given to the eligible assets that a UCITS may invest in and these should be automatically considered eligible as collateral.

Secondly the guidance states that cash collateral can only be invested in *risk free* assets and this conflicts with certain other aspects of the guidance. These are further detailed in our response to Q18. Limiting cash collateral to *risk free* investments means that UCITS will not be able to generate sufficient returns and effectively removes cash collateral as an option for UCITS funds. The UCITS should be able to invest cash collateral in similar funds to those that the UCITS may invest its own cash balances.

Thirdly, we are also concerned with the principle in Box 26 that collateral must be held by a third party custodian. In the securities lending industry, there are other ways that collateral may be held, including by the lender or, for those markets that use Central Counterparties, the collateral is required to be held by the Central Counterparty.

In addition we note from paragraph 45 of the consultation paper, that it is the intention to apply the CESR restrictions for OTC transactions, which restrict the re-use of collateral received (Re-hypothecation), on securities lending activity and we are concerned about the cost implication this may have for the investor when using Central Counterparties (CCP's) for derivative activity. CCPs usually only accept cash and government bonds as collateral. The cost-saving of posting non-cash instead of cash can be 10s of basis points and repo is used as a cost effective method of obtaining eligible non-cash collateral. For example, the most cost effective collateral to deliver to LCH at present is Spanish and Italian government bonds. Many of the UCITS funds are not natural holders of Spanish or Italian bonds, and it is

more economical for the UCITS to "borrow" these bonds through reverse repo, and post them with the CCP than to deliver other bonds or cash as collateral. However the bonds received in the reverse repo transaction are typically considered to be the collateral against the cash leg, so the proposal to apply the OTC transaction restrictions to securities lending and repo will stop the UCITS from taking the most cost effective approach. Apart from the economic motive there are two more reasons why an exemption for securities lending and repo with CCPs make sense:
a) There is virtually no liquidity risk: the CCP keeps the collateral in a segregated account, and the CCP collateral can be recalled or substituted on a same-day basis.
b) The reverse repo transaction adds liquidity to the market, which is not the case if posted to the CCP.
It is in the interest of the investor and market liquidity to allow reverse repo for CCP collateral purposes and we would suggest that either this restriction is not applied or that an exemption is made for activity for this specific purpose.

7. We do not believe that incorporating collateral with unlent assets to calculate compliance with UCITS diversification rules is practically achievable or necessary. The UCITS portfolio retains the market risk of securities that have been lent and does not incur the market risk of collateral during the life span of a loan. Therefore unless a counterparty default occurs the market exposure of the UCITS remains unchanged by lending activity. Collateral is designed to be liquidated as soon as possible, so needs to be high quality and sufficiently liquid. It is not designed to act as a substitute investment, and with a counterparty default will need to be liquidated but the unlent portfolio will not.

As lending activity is undertaken by a third party and as lent positions can change daily, there are a number of practical issues to consider and we believe that if this additional requirement is implemented many UCITS may simply withdraw as it would be expensive to implement and impractical to manage. There are also complications with a collateral diversification requirement for the lenders whose lending program is only versus cash collateral, which is re-investment. It is not clear whether under collateral diversification requirements, such lenders would have to change their collateral profiles to accept new collateral types that they are not otherwise authorised to accept.

8. The reference to cash *deposited* requires clarification. Cash collateral has to be re-invested in order to rebate, to the cash provider, a pre agreed interest rate as well as to generate a return for the UCITS. Cash collateral is rarely left on deposit as this would represent an un-secured exposure.

9. We agree that UCITS should have a policy in place for defining haircut requirements. However if the UCITS is required to describe each haircut applicable by asset class in the prospectus this will restrict their flexibility in reacting to specific market conditions and will be difficult for the management of an agency lending business. There is also a risk that if detail is provided, there is a danger that a smaller, less sophisticated UCITS may simply “copy” the haircut strategy that some of the larger UCITS have put in place, without full regard to their own specific situation or circumstances. It is preferable for a UCITS to publish a haircut policy and criteria for defining haircut requirements rather than details of each applicable haircut. In addition, as we have seen in the past, margins in the industry will vary according to counterparty and economic conditions. Providing a description of all haircut levels, as opposed to general criteria for the setting of haircuts, requires a level of details, exceptions and qualifications that is not helpful or constructive.

10. We agree that EPM activity should be detailed in the annual report. A snap shot of end of year exposures is consistent with the existing investment disclosures and the data is readily available for any fund.

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If not, please explain.

We believe that setting prudent criteria for collateral requirements such as those in Box 26 of CESRs guidance (10-788) ensures that the collateral received is of good quality. We do not believe there is a need to further define collateral requirements in the manner that these guidelines propose.

Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

The guidance for cash re-investment is not clear and requires further detail. Whilst there are references to restricting cash re-investment to *risk free* assets as defined by CESR, there is also reference in Box 6 paragraph 8 to *deposits* complying with Article 50(f) of the UCITS directive which suggests that unsecured loans to credit institutions is acceptable.

Also paragraph 52 of the explanatory text refers to *(g) Money market instruments* and it is not clear if this is cash collateral re-investment or considered as non-cash collateral. We believe that the restriction of cash re-investment to *risk free* assets as defined by CESR's guidance CESR/10-788 is unnecessarily restrictive but believe that it is reasonable that cash re-investment should follow prescriptive guidelines that ensure capital preservation and liquidity, but that can still generate above risk free returns which enable cash collateral to continue being a viable option. We would welcome further clarification in respect of ESMA's proposals for cash collateral re-investment.

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

No. It is important to differentiate between the assets of the UCITS fund which comply with the fund's investment objective and for which the fund takes the risks, and assets held temporarily for EPM techniques which do not change the underlying investments exposures of the funds. As argued by ESMA in other consultation papers, it is the UCITS (lender) which maintains the economic exposure to the assets lent, these are still valued in the NAV of the UCITS and are included in the exposure calculations of the UCITS.

Collateral is held by the UCITS for the duration of the loans and returned when the loan assets are returned. If an asset held as collateral defaults, the counterparty immediately replaces it with another.

In the event of a counterparty default the collateral held by the UCITS has to be liquidated and the lent positions restored. In order to achieve this quickly and efficiently the liquidity and volatility of collateral needs to have been considered and appropriate haircuts applied to mitigate the risk of having insufficient funds to replace the lent assets. The correlation between lent security and collateral is an important factor when determining collateral haircut requirements and should be considered as part of the UCITS policy when defining these policies. Correlation with the UCITS investment objectives is not relevant. For example, government debt may have low levels of correlation with an equity fund but this does not mean that it is an inferior form of collateral. There also needs to be a clear exit strategy and procedure in place so that roles and responsibilities in the event of a counterparty default are clearly defined and understood.

We also seek clarity in respect of footnote 7 of paragraph 53 which states *It should be noted that for UCITS ETFs, collateral received (excluding cash collateral) has to be held by the depositary.* It is not clear why this refers to UCITS ETFs specifically, and collateral may be, but is not exclusively, held by the third party agent who is managing the EPM activity or a separate tri-party collateral manager both of whom will have the appropriate systems, operational capability and legal expertise as defined in Box 26 of CESR's guidelines (Ref. CESR/10-788). This entity is not always the depositary.

Whilst it is important that collateral is held under arrangements that are safe, requiring that it is held by the depositary may preclude the use of the specialist triparty collateral management services offered by certain large banks and very widely used for collateral management services.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

We do not agree. As previously explained, the market risk of collateral is not taken by the UCITS whilst they hold the asset. Including these assets in the diversification calculations would give a false view of the UCITS actual risk profile.

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

We believe that defining qualitative criteria for eligible collateral without further expansion would be the best approach. This allows a level of flexibility for the UCITS to react to changes in market conditions without the need to amend regulation whilst ensuring that the quality of collateral is always maintained.

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

As stated above, we believe that a list of qualitative criteria would be the best approach. However if an exhaustive list is considered there are some concerns relating to the list provided in paragraph 52:

I. Item c. and e. may conflict with each other. C. suggests that any equity, provided it has a daily dealing offering, would be acceptable, whereas e. seems to limit this to shares admitted to trading on a regulated market or exchange.
II. Certain Central Counterparty securities lending systems have their own list of acceptable collateral that does not necessarily match the list provided in paragraph 52. For example, other acceptable collateral types may be standard to accept in the local market where the securities are lent and such collateral may satisfy the qualitative criteria listed but because all the acceptable types of collateral with that central counterparty does not fit neatly within the exhaustive list, the lender may be precluded from undertaking any securities lending in that market.
III. The reference to EU or OECD member states no longer provides assurances of quality and we would suggest this is amended to a minimum credit rating

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transactions when calculating the maximum exposure under Article 52(1) of the S Directive?

No. Due to the daily collateralisation process (mark to market and collateral transferred same day) in securities lending and the additional margins taken, it is difficult to consolidate these with OTC derivative transactions which often don't have additional margins and where collateral is usually delivered on a next day basis (creating overnight un-secured exposures). Consolidating securities lending activity with OTC derivative exposure often decreases the level of exposure reported for OTC derivatives because of the additional haircuts required in securities lending.

Also, in many cases lending activity is undertaken by a third party who provides a level of indemnification against potential default losses. This can be for instances where non-cash or cash collateral is accepted and we believe where an indemnity is in place adding securities lending activity supported by agent indemnification to other counterparty exposures will provide a misleading view.

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

Our understanding is that Article 50(f) of the UCITS Directive refers only to cash deposits and on this basis we agree with this approach.

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

Limiting the proportion of the portfolio that can be lent, by counterparty or at portfolio level would limit the opportunities for UCITS in securities lending and lead to reduced competitiveness. Provided the risk management techniques are robust and appropriate collateral and haircuts are applied limits are not necessary and will be detrimental to the UCITS ability to ensure best pricing and to maximise returns, and for smaller UCITS, such limits may cause them to exit from lending. Each UCITS should determine appropriate levels of lending based on their own circumstances and risk profile.

If limits were imposed on securities lending activity for UCITS we would expect corresponding restrictions to apply to synthetic instruments that have a similar effect in other funds.

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

Whilst it is usual for 100% of a portfolio to be available to borrow, the proportion of securities lent at any one time can vary through-out the year and is dependent on the composition of the fund. As typical examples, a UK equity fund is likely to be 5-10% lent and a balanced equity fund 15-20%. Fixed income, particularly government bond portfolios may be significantly higher.

The decision is usually taken by fund Boards and based on specific circumstances of the fund, nature of the portfolios, liquidity and risk/return profile.

Agent lenders undertake on-going counterparty assessments and will manage limits more broadly than on an individual UCITS or fund level. Where the agent is concerned or markets necessitate it, these limits and collateral parameters can be changed quickly.

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

As explained in our answer to question 25 we do not believe that it is appropriate to apply specific limits to the proportion of the portfolio which can be lent. In any event, Lenders and Lending Agents are not privy to the use made by the counterparty of the lent securities, nor are counterparties willing to share such information and any requirement to do so, will seriously hamper securities lending volumes.

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

We believe that if the same policies and criteria defined in the prospectus are re-stated in the fund rules, this may help with ensuring that investors are fully aware of the activity undertaken on their behalf, so we welcome this proposal.

This said, consideration should be given to the fact that incorporation into fund rules may give rise to costs to shareholders as changes can only be made through the engagement with the shareholders themselves. Transparency through the prospectus may therefore be deemed sufficient.

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

It is common for UCITS to receive information about EPM counterparties on a frequent basis from their lending agent (at least monthly) and so believe it would be possible for the UCITS to publish this information regularly, again helping to improve transparency to the investor. However, the frequency and medium for publication is not something we have a view on, other than if the UCITS is required to publish too frequently this may act as a disincentive to participate in securities lending which may be detrimental to market liquidity as explained previously.

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interest? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps.

Whilst there may be occasion that the depositary or administrator and collateral provider are affiliated entities, they are very unlikely to be the same legal entity and there will always be appropriate controls such as Chinese walls in place. Even where they are affiliated the administrator has a fiduciary duty to act appropriately and on behalf of the investors so we do not believe there is a risk of conflict of interest in this situation. It should also be noted that the UCITS 5 regulation will provide further guidance in this respect for depositories.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

We do not believe there is any risk that the automation of portfolio management can conflict with the provision of effective safeguards provided collateral is kept segregated from the UCITS investments and treated as separate for risk management purposes.