INTERNATIONAL SECURITIES LENDING ASSOCIATION

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European Securities and Markets Authority
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Posted on line at: www.esma.europa

31st January 2014

Dear Sirs,

The International Securities Lending Association response to ESMA's Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues ("Guidelines")

On behalf of our members, The International Securities Lending Association ("ISLA") appreciates the opportunity to contribute to ESMA's proposals to reconsider requirements on collateral diversification for UCITS.

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 principally from across Europe comprising banks, securities dealers, asset managers, insurance companies and pension funds. For more information please visit the ISLA website www.isla.co.uk.

Executive Summary

We very much welcome ESMA's proposal to revise the Guidelines for collateral diversification as we believe that the current Guidelines have an unnecessary adverse effect on the ability of UCITS to undertake efficient portfolio management ("EPM") techniques. The existing Guidelines (particularly in relation to government bond collateral) disadvantage UCITS relative to comparable funds, such as those regulated under the Investment Company Act (40 Act) in the US, effectively limiting the amount of EPM activity that they undertake and increasing the costs of their collateral management activities. We strongly believe however that there should be a consistent approach to the diversification Guidelines for all UCITS and urge ESMA to avoid creating a two tier approach which would result from the implementation of option 1 of the proposal. We believe that this approach will have unintended consequences and will result in inconsistencies in collateral policies and procedures for funds within the same UCITS ranges.

Whilst recognising the specific difficulties faced by Money Market Funds ("MMFs") in their use of reverse repo, the complexity of compliance with the current requirements will also have a significant negative impact on other UCITS in their management of collateral, and we see no clear rationale to exclude any UCITS from the derogation of the 20% diversification requirement.

We therefore strongly support implementation of option 2, and provide a number of reasons for this. This approach would also ensure UCITS are not disadvantaged in the markets whilst assuring their ability to access the most secure and liquid collateral available.

Diversification is in most cases an appropriate risk mitigant, but there are circumstances where its application may increase or negatively affect the level of risk or cost associated with EPM techniques. The current diversification rules may drive UCITS to take risk that they otherwise would not take, such as cross currency risk and in some cases cash re-investment risk.

Whilst our members believe that all UCITS funds may be restricted in their activity relative to other comparable retail funds, the diversification rules may disproportionally disadvantage smaller, specialist or niche UCITS that may achieve higher levels of exposure to EPM techniques than 20% of their NAV because of the nature of their portfolio. The Guidelines also have a very direct impact on fixed income or government bond specific UCITS which may wish to employ EPM techniques with a narrow collateral policy focused only on government bonds (for example a UCITS invested in US fixed income securities may wish to restrict collateral to US government bonds only). Such funds would be forced to restrict EPM techniques to 20% of their NAV or would be required to accept some currency, market or country risk in their collateral pool.

Restricting EPM techniques, such as securities lending, will negatively affect investment performance for these funds and may serve to increase the costs of management and administration (which are ultimately borne by investors).

We do of course accept that assuring the safety of UCITS is, and should be, a high priority for ESMA. We believe the current guideline provisions, specifically those contained in paragraphs 43 (a) to (d) - which require that collateral be liquid and of high issuer credit quality and that in certain circumstances UCITS must undertake stress testing - should allow for a less prescriptive approach to the diversification of government issued collateral. These existing provisions, combined with an option 2 approach would protect against the risk that a UCITS becomes exposed to a high concentration of “lower quality” government bond collateral.

We reason that implementing a diversification requirement by number of issues received adds complexity without necessarily mitigating any risk. The appropriate level of diversification will depend on a number of factors which are already considered in the Guidelines, such as quality of issuer and liquidity and which are further described in our answer to question 2.

We would also point out that amending diversification rules only for MMFs will make cash collateral re-investment more restrictive as these funds will be disqualified as investment options as they may no longer meet the diversification requirements for non-MMFs.

In answer to the specific questions asked:

Q1 Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of MMFs in the context of efficient portfolio management techniques and OTC transactions? If yes do you agree with ESMA's proposal?

We believe that the current diversification Guidelines have an adverse effect on the ability of UCITS to undertake EPM techniques, and that the complexity of compliance creates a competitive disadvantage for them. Accordingly, we welcome ESMA's consideration of a change to the Guidelines for collateral diversification. However we believe that there should be a consistent approach to the diversification Guidelines for all UCITS and ESMA should not effectively create a two tier approach to the treatment of collateral diversification. Whilst recognising the specific difficulties faced by MMFs in their use of reverse repo, the complexity of compliance with the current requirements will also have a significant negative impact on other UCITS in their management of collateral, and we see no clear rationale to exclude any UCITS from the derogation of the 20% diversification requirement. We therefore reason that option 2 detailed in the consultation paper is more appropriate. This approach would ensure that UCITS are not disadvantaged in the market whilst not restricting their ability to access the most secure and liquid collateral available.

We have further detailed our reasoning below.

1. Collateral received by UCITS in the context of EPM techniques should be liquid and of good quality. Whilst collateral diversification is, in most cases, seen as an important risk mitigant, there are some situations where other factors should be prioritised, and we believe that the current Guidelines may mean that UCITS take additional risks that otherwise would not be considered by the UCITS in order to comply.

For example a UCITS fund investing only in US domiciled assets may wish to avoid cross currency risk. In order to ensure the quality of their collateral they may have historically accepted only US government bonds but, under the current Guidelines, would have to include a broader range of lower quality US assets in their collateral criteria, or restrict their activity to 20% of the UCITS NAV in order to avoid currency risk. This means the UCITS must either forego revenue or take lower quality collateral than they may have in the past.

2. The Guidelines have a greater impact on smaller UCITS which may be more niche or specialist and therefore see more demand for their lendable assets. Larger UCITS are less likely to lend more than 20% of their NAV and so will be less impacted by the diversification requirements. Indeed, a straw poll of some of our members suggests that up to 80% of

UCITS are unlikely to lend more than 20%. Smaller UCITS are far more likely to utilise more of their portfolio relative to their NAV, and complex diversification rules disadvantage these funds disproportionally.

3. It should also be noted that of the 20% or so of UCITS that lend more than 20% of their NAV we estimate 80-90% are fixed income UCITS with all or a majority of their securities comprising government bonds. If securities lending is effectively capped at 20% of NAV because of the complex diversification requirements this could restrict the supply of quality collateral to the market for other purposes and deprive the UCITS of important incremental revenue. In an informal survey of our members, the vast majority either do, or intend to, simply restrict securities lending to 20% of their NAV in order to comply with the diversification requirement.

4. Under the current Guidelines, UCITS can accept cash as collateral provided it is re-invested according to the stated Guidelines for non-cash collateral (paragraph 44: *Re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral*) but paragraph 43 (j) allows a UCITS to invest cash collateral into defined European MMFs. It could be argued that amending the Guidelines only for MMFs may drive UCITS to accept cash collateral for EPM techniques which may then be invested in these MMFs effectively avoiding the complexity of complying with non-cash collateral diversification requirements. However, the use of cash collateral can increase transaction charges (which include both the receipt of cash and its reinvestment) and introduces re-investment risk to the UCITS.

However, it should also be noted that reading paragraph 44 in conjunction with option 1 of the consultation paper, UCITS defined MMFs effectively become an ineligible cash collateral re-investment choice for UCITS, as the non-cash collateral diversification rules would not necessarily be met by them. This further restricts the UCITS ability to accept cash as collateral, and we assume that should ESMA decide to implement option 1, this issue would also be addressed.

Q2 Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as specific issuer limits) in order to ensure a certain level of diversification? Please give reasons for your answer.

We believe there are already a number of safeguards in the Guidelines that apply to all collateral, including government bonds, such as issuer credit quality and liquidity requirements and therefore further safeguards are not required.

For example, the requirement to stress test collateral portfolios if more than 30% of the fund NAV is exceeded in collateral value ensures that collateral portfolios are appropriately analysed and risk levels remain appropriate. Equally if option 2 is adopted paragraph 43 (a) to (d) will continue to apply ensuring that collateral is of high quality, liquid and valued daily.

Issuer limits within government bonds is problematic for UCITS that wish to maintain collateral from specific countries. For example in the case of a UCITS with an investment mandate to invest in European government bonds, introducing a diversification requirement within government bonds may force the fund to curtail EPM activity or take collateral exposure outside the European markets.

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

We reason that implementing a diversification requirement by number of issues received adds complexity without necessarily mitigating any risk. The appropriate level of diversification within an individual limit will depend on a number of factors which are already considered in the Guidelines such as quality of issuer and liquidity and which are further described in our answer to question 2.

For EPM activity, implementing a 6 issue diversification requirement with a maximum of 30% to any single issue may be more difficult and costly to implement (for all UCITS) than the current 20% issuer diversification. Furthermore, whilst diversification by issue may improve liquidity post a default for corporate issued collateral, the general liquidity for high quality government issues is such that, especially in a crisis where there is generally a 'flight to quality', liquidity in government bonds is not impacted and so an issue limit in this asset class does not reduce the risks taken in EPM techniques. For example, requiring a UK Government Bond UCITS with a value of EUR100m and securities lending volumes of 50% of NAV to hold at least 6 different issues of UK Government bonds as collateral would appear unnecessary to reduce risk, and would simply increase administration and transaction costs.

However, if ESMA believe that an issue limit should be implemented as part of the derogation from the 20% issuer requirement, we respectively request that this should be applied as a percentage of NAV. This approach would be more operationally aligned with current practices and be simpler to implement. In terms of an appropriate level we would suggest an issue limit of 20% of NAV would be appropriate (given this limit is possible under existing Guidelines) whilst making clear of course, that the UCITS must also ensure compliance with Guidelines 43 (a) – (d).

We hope that this response to your consultation is helpful to you. Should you have any questions concerning our comments we would be happy to discuss these with you in more detail.

Yours sincerely,

Kevin McNulty, Chief Executive