ASSET MANAGEMENT BY
LYXOR

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ESA JOINT DISCUSSION PAPER ON DRAFT REGULATORY TECHNICAL STANDARDS ON RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVES NOT CLEARED BY A CCP UNDER THE REGULATION ON OTC DERIVATIVES, CCPS AND TRADE REPOSITORIES

Lyxor Asset Management ("Lyxor") is an asset management company regulated in France according to the UCITS Directive. At end of February 2012, Lyxor, together with its subsidiaries, manages approximately 77 billion Euros.

Lyxor welcomes the opportunity to participate in this consultation. We have limited our comments to some questions that have a significant impact on our business.

OPTIONS FOR INITIAL MARGINS

Option 3: PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold

Q7. What is the current practice in this respect, e.g.
- If a threshold is currently in place, for which contracts and counterparties is it used?
- Which criteria are currently the bases for the calculation of the threshold?

Notwithstanding our comment to Q11, we believe that undertakings for collective investment in transferable securities ("UCITS") should not be required to post Initial Margin ("IM") on un-cleared trades if the global net absolute exposure, aggregating all the OTC derivatives transactions traded with a same counterparty, is below the regulatory threshold set outs in article 52 of UCITS Directive n°2009/65/CE on the coordination of laws, regulations and administrative provisions relating to UCITS ("UCITS Directive"). This threshold is set at 10% of the fund assets when the counterparty is a credit institution or 5% of its assets, in other cases.

Q8. For which types of counterparties should a threshold be applicable?

The threshold should apply to all OTC derivative counterparties.

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

We believe that the threshold should be calculated based on the credit risk and commercial judgment of the firms concerned. The UCITS should be free to set appropriate thresholds for collecting IM depending on the type of counterparty, as set out in article 52 of the UCITS Directive.

On all options:

Q11. Are there any further options that the ESAs should consider?

We strongly believe that there should be no requirement to collect IM on un-cleared trades. Counterparties should be allowed to exercise proper commercial judgment to deploy other procedures to mitigate credit risk.

Some UCITS use financial derivatives, usually a total return swap (TRS), to provide investors with a predefined payout at the end of a specific period based on the return on underlying assets. Generally the UCITS portfolio is comprised of a TRS with a single counterparty that is a PRFC.

The UCITS undertakes to pay the return of the portfolio of securities (unfunded swap) to the swap counterparty. In return the counterparty provides the UCITS with a return based on the underlying assets. The UCITS portfolio is dynamically managed in order to maintain the market value of the TRS below the limits set out in article 52 of UCITS Directive.

The swap counterparty and the UCITS management company can agree that the counterparty risk will be mitigated by resetting the portfolio of securities on a regular basis rather via the posting of collateral.

ESA should consider that in the case of such swaps, the portfolio of securities is economically acting as collateral and neither IM nor VM should be posted by the UCITS.

VARIATION MARGIN

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

Generally the counterparties should be free to make their own risk-mitigation decisions and to set appropriate thresholds for collecting Variation Margin ("VM") in order to minimize costs (notably to implement the necessary systems) and operational risks. Notwithstanding this principle, UCITS should not be required to post VM on a daily basis if the global net absolute exposure, aggregating all the OTC derivatives transactions traded with a same counterparty, is below the regulatory threshold set out in article 52 of UCITS Directive.

Initial Margin Calculation

Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

It is our opinion that both methods are reasonable standardized approaches for the calculation of initial margins. The "Mark-to-market method" is easier to verify given that the initial margins are expressed as a percentage of the notional of the OTC transactions but usually determined in a more conservative way by the counterparties. The "Standardized Method" which is based on risk sensitive can be less expensive in terms of amounts to be posted for swaps given that it integrates amongst others the notion of netting between the two legs of the transactions.

Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?

We don't have more reasonable alternative methods to suggest for the calculation of initial margin requirements. This remark does not apply to UCITS funds as mentioned in Q7.

Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

Current practices are mostly static for the initial requirements at the trade level during the maturity of the transaction. Some exceptional cases documented in the ISDAs can trigger a recalculation of the initial independent amounts such as the super collateralization process. In the event of an additional termination event trigger (such as a monthly NAV decline), the total amount of initial margins will be increased by a certain percentage agreed in the legal documentation.

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

Not enough information in our hands with regards to the “Internal Model Method” defined by CRR to reply to this question.

Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?

Not enough information in our hands with regards to the “Internal Model Method” defined by CRR to reply to this question.

Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.

The largest issue that we can envisage is the fact that the trade does not happen due to discrepancies in the calculation of the initial margin. This could also potentially delay the execution of a particular trade.

Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?

In our view, this is a feasible option assuming that the internal model has been presented and explained in a clear manner to the other party.

Q26. Do you see other options for treating such differences?

An alternative option can be the use of a third party agreed by both counterparties to calculate the initial margin in case of disputes.

Segregation and Re-use

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

Segregated accounts for initial margins or the use of a third party custody account with a tri-party agreement among dealer, counterparty and custodian can provide a better protection. However there would be an additional cost for both solutions that should be considered and balanced with the additional protection provided. Furthermore the use of a third party custodian implies legal, credit and operational specificities to be taken into consideration.

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

The first option is to create a segregated account as described in Q27. The second option could be to segregate the initial margins posted with a counterparty in an omnibus account segregated from the own assets of the bank but commingled with the initial margins of all the other clients of the bank.

Q29. What are the practical problems with Tri-Party transactions?

Please refer to our answer to Q27.

Q30. What are current practices regarding the re-use of received collateral?

Most commonly, cash is re-used by both parties with a bilateral rating threshold documented in the CSA, meaning that if the rating of one of the parties is below a certain threshold, re-utilization of cash is not longer permitted.

Q31. What will be the impact if re-use of collateral was no longer possible?

One of the impacts would be the lack of remuneration for the cash posted as collateral.

ELIGIBLE COLLATERAL

Q32. What are, in your view, the advantages and disadvantages of the two options?

Concerning the first option proposed, Lyxor is broadly in agreement with the criteria based approach exposed in the article 118 and the concept of “wrong-way risk” limitation discussed in the article 119. As far as article 120 is concerned which describes the criteria defining highly liquid cash and non-cash collateral, we believe that the “low credit risk” component mentioned in this article should be clearly defined by ESMA. We suggest the European authority considering for instance parameters such as credit rating and/or credit spreads to clarify which entity should be considered as “low credit risk”. The same remark applies to “low market risk” concerning the criteria highlighted for financial instruments.

Otherwise, Lyxor is in the opinion that highly liquid cash, financial instruments and bank guarantees have been clearly and exhaustively exposed. We don't recommend accepting gold as collateral given that markets experienced severe drawdown lately on a weekly basis for precious metals such as 20% moves for gold and 30% for silver. This commodity appears to be too volatile to be considered as highly liquid collateral in our view.

With regards to the second option, we don't have enough information on the eligible collateral under the CCR to opine.

The ESA shall consider that the collateral should be sufficiently diversified and matches qualitative criterion based on an indicative list of assets (see paragraph VII, Consultation paper on ESMA's guidelines on ETFs and other UCITS issues ESMA 2012/44)
Cash;
Shares or units of money market fund that comply with CESR Guidelines (see CESR/10-049);
Shares of UCITS that offer daily dealing
Sovereign debt issue by an EU or OECD member state;
Share admitted to trading in a regulated market that are component of an index compliant with UCITS Directive;
Bonds admitted by the European Central Bank; and
Money market instruments that would be eligible to be held in a money market fund or short term money market fund complying with CESR guidelines (see CESR/10-049).

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so, which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

We suggest to keep the collateral management process as simple as possible and as such we don't recommend to include non-financial assets (see our answer to Q32 for gold) because it can create volatility, liquidity and/or valuation issues. We also recommend that the eligible collateral as set out in the UCITS Directive shall be taken into account.

Q34. What consequences would changing the range of eligible collateral have for market practices?

Please refer to our answer to Q33.

Q35. What other criteria and factors could be used to determine eligible collateral?

Please refer to our answer to Q32.

COLLATERAL VALUATION / HAIRCUTS

Q36. What is the current practice regarding the frequency of collateral valuation?

Collateral valuation is mostly done daily through the margin call process.

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?

We are in the opinion that the collateral valuation of all types of transactions (for all counterparties) should be performed daily.

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

We believe that counterparties should be allowed to use own estimates of haircuts.

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

We suggest own estimates of haircuts to be allowed to both PRFCs and NPRFCs.

We are at the disposal of ESAs for further information or discussion. Please contact us at the following email address and telephones.

Yours faithfully,

Alain Dubois
Chairman
Lyxor Asset Management

Email: alain.dubois@lyxor.com
Tel: +33 1 42 13 94 71
Mobile: +33 6 03 82 14 5