

European Securities and Markets Authority

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Purpose: ESMA's consultation paper on the treatment of repurchase and reverse repurchase agreements

Natixis Asset Management (NAM) thanks the European Securities and Markets Authority for giving it the opportunity to respond to the Consultation Paper on the treatment of repurchase and reverse repurchase agreements.

With assets under management of 293 billion Euros (31/03/2012), NAM ranks among the leading European asset managers. It offers a wide range of effective management solutions, based on extensive expertise in European and specialized asset management including mandates, UCITS and AIF. NAM provides services to a diverse client base: institutional investors, large companies, distributors, and clients of Banque Populaire and Caisse d'Epargne.

For more information about NAM, please visit www.am.natixis.fr.

NAM has actively participated in discussions with the "*Association Française de Gestion*" (AFG) and the European Fund and Asset Management Association (EFAMA) on the Consultation Paper, but wishes to express its own views separately.

General Comments:

NAM fully understands the regulators general objective to limit systemic and liquidity risks and support those of the proposed guidelines that help fulfilling this objective and that take into account all relevant interconnections with the other players in the markets.

Callability at any time and termination at valuation price

NAM supports the regulator's view related to the callability at any time. However, there is a crucial point that should be clarified regarding the unconditional termination on an accrued basis.

Indeed, NAM strongly disagrees with rule 2.b.i. (unconditional termination on an **accrued basis**) which is unnecessarily restrictive, which is not justified, and which would deprive investors of a useful and safe tool.

We believe that our investors' interests should not be overlooked so that solutions proposed address the high level areas of concern and in the same time are appropriate in practical terms at the fund level.

Thus, we suggest referring to **termination at valuation price** or, alternatively, propose a slightly amended rule which completely fulfils the regulators objectives (please see our answer to question 2).

We also suggest clarifying the term "at any time" in order to cover the right to terminate only. Such term should not encompass the settlement timing.

Paragraph 40 – link to government issuance and covered bonds

As stated in our answer below to Question 2, we believe that it should clearly be specified an exception to paragraph 40 for government issuance and covered bonds (as it is the case for the risk spreading on the asset side of a UCITS).

Indeed, the 20% diversification rule on collateral should authorise a UCITS to receive collateral up to 100 per cent of its NAV in securities and money-market instruments issued or guaranteed by EU member states or local authorities. In this case, the aggregated collateral received should hold securities from at least six different issues, each of which should not account for more than 30 per cent of its total assets.

For covered bonds, the 20% diversification rule on collateral should authorise a UCITS to receive collateral under the form of covered bonds up to 25 per cent of its NAV per issuer (as it is the case on the asset side of UCITS). We strongly believe the 20% should replace the 5/10/40% ratio, but not the government or covered ratios.

"Puzzling" overlapping regulations

At last, we take the opportunity of this consultation to express our concerns that ESMA guidelines are apparently taking views on topics that are not yet decided at a higher regulatory level. More specifically, the European Commission currently consults on a future UCITS VI Directive and asks questions about practices and possible regulations in the matter of collateral for example. This does not help in our understanding of European Union procedures and hierarchy. Moreover, IOSCO and BCBS consult as well on margin requirements for non-centrally-cleared derivatives and ask questions about collateral too.

Specific questions:

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 callable 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.

The French asset management industry covers a full spectrum of strategies under the UCITS framework that uses repurchase and reverse repurchase agreements (from money market funds to structured funds). Some funds use these techniques to a limited extent and some others may use them up to 100%. These arrangements are all set up with the UCITS being able to recall at any time (please see details on “recallability” hereafter).

Reverse Repo

The French industry funds may use Reverse Repo in different proportions and maturities. In certain types of UCITS, 100% of the UCITS assets are invested in reverse repos. The maturity of such reverse repos is on average about a single digit number of years, but can go up to 20 years. These reverse repos are **callable at any time**

- on a **mark-to-market** basis,

- and some of them are callable on an **accrued basis**, but only in cases when the UCITS needs cash to execute redemption requests.

This type of arrangement provides a very safe, flexible and profitable investment:

- **safe**: as the credit/ counterparty risk is collateralised, such an investment is safer than an investment in senior debt, and it is even safer than covered bonds, because the collateral is direct property of the UCITS;

- **flexible**: in order to avoid a liquidity risk in the case of a “run”, the arrangement allows the fund manager to terminate the reverse repo at any time what means within less or more than 3 days the current settlement delay;

- **profitable**: the rate paid by the counterparty is a long term rate, because the counterparty is able to recognize the arrangement as a long term one. This recognition is possible in the case of callability at any time on a mark-to-market basis. It is obviously not possible in the case of callability at any time on an accrued basis, since this type of arrangement is similar to overnight repos. However, this recognition is possible in the intermediary case of accrued basis for redemption needs only, because the counterparty takes into account the historical redemptions statistics of the UCITS to determine an

average probable length of the deal and is then able to consider the deal as a long term funding.

Repos

Repos are one of the most secure money market operations for funds. They are contractually well-defined and implemented so as to reduce legal and operational risks. In general, repos are used with a call enabling the fund to get its securities back without delay.

Repos in MMFs

Repos are an integral part of a money market fund (MMF) normal dealings, especially so for "government MMFs" (MMF's whose investment policy only allows government securities). They represent about 5% - 15% on average in portfolios, and more in a govies MMF. French MMFs use only very short term **callable** (24h/48h) repos entered with MMF eligible counterparties.

In France, from a legal standpoint, the repo financial assets buyer has full property over the assets having been delivered to it. All transactions are governed by so-called "master agreements" and are subject to the legal regime of "pension livrée" as set out in the French Code Monétaire et Financier. This legal feature intends to completely remove a risk because the financial assets buyer would be able to keep the financial assets in case of failure of the financial assets seller.

Repos offer a very useful, flexible and safe financial instrument in MMFs. For a given counterparty/issuer, repos are safer than other typical MMF investments. For example, it is safer for an MMF to engage into a repo transaction with Bank XYZ where the MMF buys financial assets, pays the price and receives or pays variation margins, as opposed to just buying a CD for that same Bank XYZ without any guaranty such as collateral.

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

We fully agree with the global objective to mitigate systemic risk and liquidity risk but we disagree with some of the guidelines proposed by ESMA for the treatment of repo and reverse repo agreements:

1) First, we disagree with proposed rule 2.b.i. (unconditional termination on an accrued basis). Such a rule is unnecessarily restrictive and does not help in any manner to mitigate systemic risk or liquidity risk. We do not understand the motives for this proposal. If the concern is to be sure that the UCITS net asset value (NAV) reflects the true value of the UCITS assets, **the guidelines could specify that any arrangement that is not callable on an accrued basis, but which is callable on a mark-to-market basis should be valued on a mark-to-market basis in the UCITS accounts and NAV computation.**

In order to mitigate systemic and liquidity risk, what is important is to ensure that an adequate portion of a UCITS assets is liquid enough to enable the UCITS to execute redemption requests. This objective is fulfilled by guideline 1.b. which requires a minimum proportion of arrangements that allow the assets to be recalled at any time by

the UCITS. There is no objective need to add rule 2.b.i. which specifies that the recallability should be on an accrued basis. Therefore, **we request the deletion of this rule or the replacement of “on an accrued basis” by “at the valuation price”**:

“2. For the purpose of paragraph 1b:

a. overnight repo and overnight reverse repo arrangements should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS.

b. repo and reverse repo arrangements on terms that allow the assets to be recalled at any time by the UCITS should permit the UCITS to:

*i. recall the full amount of cash ~~on an accrued basis~~ **at the valuation price** or terminate ~~on an accrued basis~~ **at the valuation price** the reverse repo transaction into which it has entered; and*

ii. recall any securities subject to the repo transaction or terminate the repo transaction into which it has entered.”

If, however, ESMA decided to keep the reference to the “accrued basis” for any reason, we would request the following amended wording:

“2. For the purpose of paragraph 1b:

a. overnight repo and overnight reverse repo arrangements should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS.

b. repo and reverse repo arrangements on terms that allow the assets to be recalled at any time by the UCITS should permit the UCITS to:

*i. **to the extent necessary to execute redemption requests,** recall the full amount of cash on an accrued basis or terminate on an accrued basis the reverse repo transaction into which it has entered; and*

ii. recall any securities subject to the repo transaction or terminate the repo transaction into which it has entered.”

This amended wording has the advantage, as explained in our answer to Q1, to allow the counterparty to apply a statistical approach and consider the deal as a long term funding, thus giving a better rate of return to the UCITS. However, the drawback of this wording is that it forbids any “mark-to-market” transaction, which, once again, seems unjustified and unnecessarily restrictive (provided that mark-to-market arrangements are valued at mark-to-market in the UCITS accounts).

Repos vs bonds

Lastly, to make a parallel, when UCITS invest into standard bonds, they do not have any obligation to be able to redeem or sell these bonds at any time on an accrued basis. Otherwise, overnight investments would become de facto the only permitted investments. The same reasoning can be applied to repos.

2) Furthermore, we believe that the term “at any time” should be clarified to avoid any misinterpretation, and should relate to the right of termination only, which may occur at any time. It should not encompass the settlement timing, which may vary from one fund to the other and thus should be kept at the discretion of the fund’s manager.

3) NAM also has reservations in relation to paragraph 3 of the proposed guidelines:

Paragraph 3.a): in our view, it is not necessary to require an appropriate balance between short-term and medium-term arrangements in general. For instance, if a UCITS engages only in short-term arrangements, it should not be forced to conclude also repo arrangements for the medium-term.

Paragraph 3.b): we are not convinced that there is a need for diversification at counterparty level. Should ESMA insist on such requirement, it should then be dependent on the size of repo transactions in relation to the fund portfolio. In case a UCITS concludes fixed-term repos only in relation to a small part of its assets, no diversification at counterparty level appears necessary.

Paragraph 3.c):

a. Paragraph 40 – link to EMIR

With reference to applicability to repo and reverse repo of paragraph 40 of the Guidelines (proposed guide lines §3-c), NAM would like to draw ESMA’s attention to the necessary coherence of the proposed rules with new requirements to post Initial Margin (IM) under EMIR. In that respect, we understand from §40-j that cash collateral received can be posted as collateral but that the non-cash collateral cannot be re-used as IM.

NAM recommends that the position of cash revenues acquired from the use of repo transactions is clarified in the guidelines in order to avoid potential confusion. Cash revenues generated from the sale of investments should not be viewed as collateral. UCITS hold genuine ownership of cash acquired from repo trades and should therefore be allowed to use it for any legitimate purpose, be it investment, collateralisation or satisfaction of redemption requests by investors. In these circumstances, it is not acceptable to submit cash proceeds from repos to the same restrictions as cash collateral from securities lending.

In practical terms, such outcome would have grave implications for the UCITS’ ability to collateralise OTC derivative transactions under EMIR. In the context of EMIR, we understand that ESMA itself is currently suggesting that collateralisation of both centrally cleared and bilateral derivative trades shall be limited to “highly liquid assets” which, in ESMA’s view would exclude equities from the range of eligible collateral. In addition, the variation margin required as a reaction to price movements in underlying securities shall be acceptable in cash only. In case of UCITS, however, liquidity from unit subscriptions is usually used for investment purposes in line with the defined investment strategy in order to generate returns for investors and to satisfy redemption requests. Hence, UCITS must rely on other sources of liquidity in order to obtain assets eligible for collateral. **Should repos be no longer usable in this context, it must be feared that UCITS might no longer engage in derivative contracts to an economically reasonable extent or that they might be forced to retain some cash from subscriptions in order to collateralise OTC derivative trades.**

Either result would have negative effects on the UCITS' ability to realise its investment strategy and consequently, would be detrimental to the interests of investors

For similar reasons, we also suggest that **non-cash collateral received in the case of a reverse repo transaction should be specifically authorised to be posted as IM under EMIR. This should be mentioned in the guidelines on Repos as an exception to §40-i.** The same applies also for variation margin which belongs totally to the beneficiary who may use it as it wishes.

This type of measures should not be overlooked as it ensures coherence between different types of regulations that are superposing in a same field.

b. Paragraph 40 – link to government issuance and covered bonds

A second exception should clearly be specified for government issuance and covered bonds (as it is the case for the risk spreading on the asset side of a UCITS).

Indeed, the 20% diversification rule on collateral should **authorise a UCITS to receive collateral up to 100 per cent of its NAV in securities and money-market instruments issued or guaranteed by EU member states or local authorities. In this case, the aggregated collateral received should hold securities from at least six different issues, each of which should not account for more than 30 per cent of its total assets.**

There is indeed no objective reason to apply rules for collateral that are stricter than rules for direct investments (which authorise UCITS to invest up to 100% in a single sovereign issuer) nor to impose funds (for instance MMFs) to receive government backed- collateral systematically diversified through 5 different countries. It is not protective for investors. In addition, euro MMFs will have serious difficulties to find high quality euro-labelled government backed issues from 5 different countries; and to say nothing of the fact that sterling MMFs or US dollar MMFs simply could not find sterling/US dollar labelled issuances from 5 different countries...

For covered bonds, the 20% diversification rule on collateral should authorise a UCITS to receive collateral under the form of covered bonds up to 25 per cent of its NAV per issuer (as it is the case on the asset side of UCITS). We strongly believe the 20% ratio should replace the 5/10/40% ratio, but not the government or covered ratios.

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?

If rule 2.b.i. is kept as it is in the consultation document, the consequence will be de facto that all repos other than overnight repos will be non-callable repos or reverse repos (in such case, we consider that the appropriate percentage should be up to **100% of the NAV** in order to continue the current safe, flexible and profitable investments). But we are of the opinion that such case would automatically trigger a liquidity risk in case of high level of redemption requests.

Thus we strongly insist on rule 2.b.i. to be abandoned or at least to be amended as we propose in our answer to Q2, so that callability on a **marked to market basis** is acceptable (in line with market practices). In such case, we consider that the **appropriate percentage can be low, even zero.**

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.

The answer depends heavily on the definition of arrangements “that do not allow the assets to be recalled by the UCITS at any time”, and thus, the answer depends heavily on the wording of rule 2.b.i.

We agree with the idea of a prohibition for UCITS to contract repos and reverse repos that do not allow assets to be recalled at any time, provided that rule 2 b i is redrafted and callability at market price is accepted.

Should rule 2.b.i. be kept as it is in the consultation document and require a call on an accrued basis to pass the test of recallability at any time, the consequence of the suggested prohibition would be de facto that all repos other than overnight repos would be forbidden for UCITS, which would deprive investors of a useful and safe instrument. We cannot support such a prohibition.

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

Again, the answer depends heavily on the definition of arrangements “that do not allow the assets to be recalled by the UCITS at any time”, and thus, the answer depends heavily on the wording of rule 2.b.i.

If rule 2.b.i. is kept as it is in the consultation document, the consequence will be de facto that all repos other than overnight repos will enter into the category 1.b., even the safest repos. We thus consider that there should not be a minimum number of counterparties.

If, as we suggest, rule 2.b.i. is abandoned, only the riskiest arrangements will fall into category 1.b. We thus consider that such a diversification rule would be acceptable. It should be expressed as a maximum percentage of the NAV of the fund transacted with the same counterparty and not as a requirement to split small transactions between two counterparties.