Comment by

Union Asset Management Holding AG

ESMA's proposal for the treatment of repo and reverse repo arrangements (ESMA/2012/474)

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Volksbanken Raiffeisenbanken
cooperative financial group

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Dear Sirs and Madams,

Union Investment welcomes the opportunity to comment on the ESMA consultation paper "ESMA's guidelines on ETFs and other UCITS issues" including the section 'for the treatment of repo and reverse repo arrangements'.

We are one of the leading asset manager in Germany and asset manager of the German cooperative banking network holding more than € 180 bn assets under management for more than 4.3 million retail and institutional clients.

Please find our specific comments to questions 1 to 5 below.

Yours sincerely

Schindler

Dr. Zubrod

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.**

The average percentage of assets subject to repurchase and reverse repurchase agreements is highly dependent on respective market phase and offered market conditions. In compliance with Sec. 57 of the German Investment Code (Investmentgesetz), a maximum maturity of repos respectively reverse repo arrangements of twelve month is being considered.

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

As far as ESMA's question concerns page 56 of the document issued on July 25, 2012, generally yes. Nevertheless, we would like to highlight that a potential limit (cf. Q3) for fixed term repo agreements (non-recallable) still needs to be high enough to implement profitable strategies and to take advantage of favourable market conditions on behalf of our investors.

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?

Appropriate percentage should be 100% of the assets of the UCITS. Of course, it must be ensured that the sum of all repurchase agreements is limited such that the UCITS is able, at all times, to meet its obligations regarding the redemption of fund units and to fulfil other payment obligations.

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 re-verse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time.

No, non-callable fixed term repurchase agreements should be permitted.
Proposed Requirements set out under no. 3 of the proposed guidelines generally should be sufficient as mitigating measures. Nevertheless, with regards to no. 3 para. a) ESMA should consider that the wording could lead to unintended consequences. If the asset manager only agrees on a small volume repo, it would be obliged to split this small volume which might lead to higher costs for the investors of the UCITS. Furthermore, an asset manager who intends to enter into a short-term repo might be obliged also to enter into a medium-term arrangement – even if the latter is not being required.
According to no. 3 para. c) ESMA should consider that not all and any liquidity gained from repurchase agreements is collateral and should not be treated as collateral. The amount received at the beginning of a repurchase agreement is not collateral but a purchase price and should be treated as such. If ESMA does not amend paragraph 39 of the guidelines in a manner that maintains UCITS' possibility to use the liquidity gained from repos respectively buy- and sell-back agreements for providing cash collateral to the UCITS' counterparty respectively a CCP, it is likely that those transactions will become rare:

UCITS will face either liquidity problems or problems to hedge existing market risks, as the Guidelines consider cash revenues acquired from repurchase agreements ("repos") as equivalent to collateral from securities lending and submit both payments to the same limitations with regards to "re-investment and deposit". In consequence UCITS, respectively their managers, will not be allowed to use the purchase price received under repos for cash collateral contributions.
From the fund's perspective, repos are legally and economically not even familiar with securities lending. The liquidity gained from repos has to be qualified as purchase price and should therefore be available for cash collateral contributions. Any change in value of the securities subject of the repo are to be collateralized – as set out in the standard master agreements. This demonstrates that the amount paid under a repo is not a collateral and therefore should not be treated like if it was cash collateral provided for a security loan transaction.
The liquidity gained by UCITS from repos is required to meet the variation margin requirements of CCPs. The investors' cash paid into the investment fund is being invested by the manager of a UCITS in order to reach the investment goal. In order to be able to redeem fund units and prevent liquidity problems, managers of UCITS are entitled to enter into credits (up to 10 % of the NAV) or to enter into repos. These are the only sources for liquidity.

EMIR requires UCITS and their managers to access CCPs and to clear OTC Derivatives eligible for clearing. Since the variation margin has to be provided by posting cash collateral, UCITS are subject to much higher liquidity requirements as they were prior to EMIR.
As UCITS unlike other financial counterparties are also not allowed to post cash collateral received from a third party as own cash collateral contribution to another party, the new ESMA guidelines lead to the consequence that UCITS and their managers only have access to credits limited at 10% of the NAV in order to access liquidity for any cash collateral contributions. The managers of UCITS cannot use these 10% completely for cash collateral purposes as they have to keep in mind that this source for liquidity might be required for the redemption of fund units.
UCITS will not be able to meet the rising need for cash on the one hand and to comply with the tighter ESMA requirements on the other hand. As a consequence ESMA takes away the ability of UCITS to hedge existing market risks via standardized OTC Derivatives. In the end the level of investor protection will be lower (even though ESMA wanted to reach the very opposite effect). Furthermore there will be a negative effect in terms of pricing because spreads will rise if UCITS as important buy side participants will be de facto excluded from participating in the process of central OTC Derivatives clearing.
The aforementioned consequences do not meet the goals set out by the G-20. According to recital 5 of EMIR the G-20 leaders agreed in Pittsburgh at September 26, 2009 that all standardized OTC Derivatives should be cleared through a central counterparty. In June 2010, G-20 leaders reaffirmed their commitment and also committed to accelerate the implementation in an internationally consistent and non-discriminatory way.
The restrictions for UCITS, implemented by the ESMA Guidelines on ETFs and other UCITS issues, dated July 25, 2012, have discriminatory character (unlike other financial counterparties, UCITS will not have the required access to CCPs).
We would like to highlight that using the liquidity gained from repos for cash collateral contributions especially does not mean any leverage or increase of risk but rather a better protection for investors:
If an OTC Derivative with a UCITS would be uncollateralized the counterparty would have a theoretical default risk at the volume which would be requested as collateral ("theoretical", as UCITS have to comply with the cover rule which makes them the most sound counterparties in the market). In case of a request for cash collateral, UCITS would agree on a repo in order to receive the amount required for posting the requested cash collateral. The UCITS' counterparty of the repo would have the purchased securities and any value movements are subject to collateralization. As a result neither the counterparty of the OTC Derivative nor the counterparty of the repo faces a counterparty risk of the UCITS. Compared to the initial situation, the investors of the UCITS are only facing the issuer risk of the security sold to the counterparty of the repo (because it is already agreed to buy back the same security for a fix price), but even this does not mean an increased risk, as the investors of the UCITS faced the identical issuer risk prior the execution of the repo transaction. As far as supervisory authorities are concerned about any additional OTC Derivatives which might be agreed by the UCITS and their managers, it needs to be pointed out that there are already limitations in place which limit the usage of Derivatives by UCITS (e.g. the

cover rule, by which the UCITS is obliged only to enter into Derivatives which can be fulfilled with the assets belonging to the fund). Allowing the usage of liquidity gained from Repos would not lead to a higher leverage of risk. It would only allow UCITS and their manager to enter into standardized OTC Derivatives to the extent required for a prudential management of the investors' assets within the regulatory frame already set.
We believe that the risks resulting from the current wording of paragraph 39 of the guidelines, which we deem to be unintended by ESMA, will be much higher than the liquidity risks ESMA intends to mitigate by applying the proposed guidelines.

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

The number of counterparties should not be limited in order to maintain the asset managers' ability to act in accordance with the best execution requirements.