AGA - n° 4311_07/Div.

JOINT COMMITTEE OF THE
EUROPEAN SUPERVISORY AUTHORITIES

Paris, 11 July 2014

AFG comments to the consultation paper on the Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

The Association Française de la Gestion financière (AFG)[1] welcomes the consultation paper on the *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*.

We thank the Joint Committee of the European Supervisory Authorities for the opportunity to express the French asset managers' opinion on the risk-mitigation techniques for non-centrally cleared OTC derivative contracts.

General Comments

Our members continue to contribute to EMIR implementation works with the shared objectives towards reduced market risk and a framework of appropriate risk mitigation techniques. After the introduction of the obligation to report derivative transactions and soon to use CCPs to clear standardized liquid derivatives, the OTC world is to be further regulated. The rapid confirmation, daily valuation, reconciliation and dispute procedure requirements have in our members' view significantly improved the risk control of OTC derivatives. The reporting to TR is also mandatory from February 12 in Europe and does facilitate

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

transparency and control by authorities. The following step, now under discussion should concentrate on **systemic risk issues.**

Hereafter, we would like to stress several critical points in our members' view:

- Risk in an OTC derivative transaction stems first from the volatility of the underlying asset that creates price movements sometimes enhanced by leverage in the contract; it comes secondly from the counterparty risk of failure, which is mitigated by collateral; quality of collateral is the third level of risk and more specifically, liquidity of the **collateral would represent the third level risk and concentration the fourth level of risk**; regulators should not too heavily focus on fourth degree risks;
- We welcome Recital (5) which clarifies further that all investment funds are considered single entities for the purpose of EMIR regulation and for the application of the IM threshold. Indeed, all investment funds (open-ended, closed ended, publicly offered, dedicated to certain investors…) are distinct legal entities and should therefore be considered as such for the purpose of exchanging collateral with counterparties when dealing with OTC derivatives.
- As investment funds and asset managers are very strictly regulated and very closely supervised (through UCITS and AIFM regulation for instance), we consider that a **specific exemption from the obligation to exchange initial margin would be justified for regulated funds** (since their global risk exposure is already limited by regulation);
- **Grandfathering**: Deals existing at the time of implementation of a new regulation should be exempted (as mentioned in recital 18) from applying the new rules; their original pricing did not include collateral requirements and the grand fathering clause is necessary; furthermore, any modification of an existing deal that would not result in an increase of exposure should be considered as a **genuine amendment** (as defined in BCBS/IOSCO text) and not a new transaction. Article 1 FP (page 46) should be amended accordingly, especially paragraph 4 which is very confusing.
- Our members fear that market counterparties may in practice impose exchange of margins on smaller players like asset managers even though the latter are far below the thresholds. **Indeed, Initial Margin may be imposed to asset managers by counterparty banks** even if the aggregate month-end average notional amount of non-centrally cleared derivatives concluded into an investment fund or mandate is below 8 billion euros as of December 1st 2019. This Initial Margin may have a significant cost impact on entities that have smaller balance sheets. As small and medium sizes players are bound to post collateral, they will have to develop or buy new collateral management tools. They may face legal costs in order to negotiate and signed appropriate documentation.
- Some other additional costs may be faced by asset managers such as collateral financing and segregation of received collateral from the funds' own assets.
- With a view to reduce procyclicality and to enhance financial stability, we consider that the basis for eligible collateral should be very large as diversified as possible and include many types of assets and specifically funds; according to their quality and their liquidity these assets should be subject to appropriate haircuts and **not percentage limits on concentration** to reduce risk;

- Keeping in mind that the objective of the regulation is to reduce risk and avoid systemic risk to appear and spread, diversification requirements should only apply to counterparties with a higher level of collateral exchanged; following the idea of the threshold of 50 million that enables smaller counterparties to be exempted from the obligation to exchange collateral when the collateral to be, theoretically, posted does not amount to that threshold (at the level of the group), we consider that a de minimis principle should apply for small amounts of collateral effectively exchanged between two counterparties. Our members are thus definitely in favour of a proportionality regarding the application of the diversification rules and propose for the sake of harmonization throughout Europe to set a threshold : **collateral below 100 million € should be exempted from diversification rules.**
- Our members strongly support the need to have adequate **diversification** requirements in the context of fund investment. Those rules already exist for all UCITS and some "UCITS - Like" funds. **Double layer of constraints should be avoided; thus an alignment should be sought. Collateral diversification rules for funds should continue to be based on the fund net assets as per their current regulation**[2] (whereas the CP's rules propose to base their calculation on the collateral pool).
- There is no global coherence between AIFM and UCITS rules regarding reuse. Restrictions on the reuse of cash collateral in UCITS guidelines make it more and more difficult to find collateral to post. The possibility to re-use collateral received can be a major device to leverage a position and should not be granted without restriction; however total prohibition of re-use or rehypothecation in all circumstances is not advisable either, as it increases the run for eligible collateral and hence produces procyclicality and reduced liquidity ; as OTC transactions are conducted between responsible professionals, **re-use should be allowed in exceptional conditions as defined by IOSCO / BCSS rules**;
- **Models**: our members fear to be imposed in practice to refer to the counterparties' model. A standard model would be more appropriate.The reference to models developed by banks acting as counterparties of the funds in order to assess the level of variation margin, initial margin and haircut for each type of collateral can only be applicable when the banks give large transparency on their models and the data they use; an asset manager must be in a position to validate the principles and architecture of a model and to challenge the results in order to guarantee proper investor protection.
- **Internal ratings**: Furthermore, we feel that the favour made in the models to internal credit assessment as opposed to external ratings is not fair and that the acceptable CQS should be positioned at the same level, level 3 for usual bonds, in both cases.
- Our members highlight that it would **not** be **feasible** operationally for an asset management company **to calculate group consolidated eligibility thresholds** on behalf of their clients. There is also to be mentioned the case of a mandate signed with several asset management companies. Regarding the threshold referred to in the Recital (3) that is counted per single fund in the case of investment funds should be more precise by stipulating also mandates (page 18 (5)).

[2] We urge ESMA to take into consideration its own ruling on the matter that did not came at no cost for our members and that is recent enough so as not to be obsolete.

- We strongly suggest reformulating more clearly the point 3. on Final Provisions (page 46) so as to state that when one of the parties is below the threshold (while the other counterparty may be above the threshold), the agreement in writing is required if parties still wish to implement Initial Margins. Indeed the principle must be that, **by default, there shall be no initial margin** applicable if one of the parties is below the threshold (while the financial counterparty may usually be above the threshold) and if there is, that shall be by way of mutual agreement between the parties.

Please see our detailed responses below:

Question 1. What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

There is no doubt that our members are experiencing concretely the cost resulting from the new regulation under EMIR, however it would be misleading to force them into expressing it in monetary terms.

The aim of the Draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP is to implement robust risk mitigation techniques to bilateral relationships in order to reduce counterparty credit risk and mitigate systemic risk.

The spirit of the technical standards is to avoid unnecessary costs and negative effects without jeopardizing the global objective of risk mitigation and the harmonization of the international regulatory framework.

Nonetheless, the implementation of the RTS will not come at no cost.

We have identified the below three main types of costs to be supported by market participants:

- Legal and documentation cost, as agreements must be negotiated or amended to take on board new requirements as far as collateral is concerned; legal teams are overbooked with other new developments mainly linked to the implementation of EMIR and the central clearing process but also to the future MIF requirements in terms of distribution and some asset managers may have to solicit external advice which tend to increase the cost of compliance;

- Operational cost exposed in order to establish and then run processes for orderly collateral management; operational costs could be reduced if the suggestions expressed in the answer to the following question were accepted. These costs are related to need of higher operational capabilities (sophisticated collateral management

tools, operational staff, daily pricing capability,…) as well as to the development of initial margin models and internal rating-based models (model calibration, back-tests, audit,…);

- Opportunity cost (Financial costs) related to the lower yield realized on the assets; For example, the reduced facility to sell assets transferred as collateral makes the process to arbitrage positions more difficult and might prevent the manager from seizing opportunities; the securities held in the portfolio which are to be used as collateral will no longer be available for securities lending activities that improve the return for the fund and its client holder.

Hereafter, our members provide some more detail regarding the costs related to each requirement:

Counterparties' risk management procedures

The requirement for daily exchange of variation margin between counterparties for both financial and non-financial counterparties will call for new / higher operational capabilities (collateral management tools, operational staff, …) as all bilateral OTC relationships will have to be covered by a bilateral legal agreement, trades will have to be priced on a daily basis and risk management procedures will have to be in place and all market participant involved in bilateral OTC trades will have to be able to monitor the exchange of variation margin on a daily basis.

This is expected to create significant operational costs (especially for those market participants that had few / no collateralized exposures).

The requirement for two-way initial margin to be exchanged to cover the potential future exposure resulting from a counterparty default will probably lead the counterparties that are above the threshold to support important financial costs: those counterparties will have to post large amounts of cash / securities and this will prevent them from investing those funds. As a consequence they will incur an opportunity cost and realize a lower yield on their assets.

Margin methods

The use of margin models may put the small & medium size players (e.g. small investment managers, non-financial counterparties) at comparative disadvantage vis-à -vis other larger players (e.g. large investment firms, broker /dealers) because they may not have the necessary operational resources to develop those models.

They may have to agree on the results of margin models developed by their counterparties and / or third parties and suffer a lack of information to assess the appropriate calibration and the integrity of the model.

This lack of transparency may lead to frequent disputes regarding the amount of initial margin to be posted and end up with situations where the amount of collateralised exposure is not at its highest level.

To avoid to find themselves at a comparative disadvantage, the small & medium players may decide to support the costs associated with the development of initial margin internal models or at least implement the tools to enable them to understand the rational (of the models developed by others), verify the inputs and eventually challenge the figures computed by their counterparties.

In all cases those firms will incur the following costs:

- Costs related to the development of the initial margin model (although these costs may be shared by two counterparties in case were the model is jointly developed) or to the implementation of a sophisticated collateral management tool (able to incorporate the initial margin values computed by another counterparty).
- Costs related to the initial validation of the model.
- Costs related to the periodical back-tests
- Costs related to the regular audit process
- Costs related to the documentation of the model assumptions, its limitations and all operational details.
- Costs related to the eventuality that the model ceases to comply with the requirement or that the change in market conditions dictates a change in margin requirement.
- Costs related to the collection of the necessary market data to construct the appropriate time series.

Eligibility and treatment of collateral

The requirement that the counterparties to bilateral OTC trade have the operational capabilities to appropriate the collected collateral and manage the collateral in the event of the default of the other counterparty implies that the counterparty receiving collateral will incur the operational costs related to:

- The daily re-evaluation of collateral
- The necessary legal arrangement and an effective collateral holding structure
- An alternative custody account for all asset types in the list of acceptable collateral (in case where the collateral is maintained with the provider) to manage the assets following the default of the provider
- The access to an active outright sale or repurchase agreement market (in case where the collateral provider defaults)
- Cash accounts in all acceptable currencies with a party other than the collateral provider for depositing cash collateral and crediting the proceeds of repurchase agreements on the collateral

- The ability to return the unused collateral proceeds to the liquidator
- The necessary arrangements to ensure that the accepted collateral is freely transferable

The requirement that the counterparties to bilateral OTC trades have the ability to assess the credit risk on collected collateral implies that they may have to support the operational costs associated with:

- The development of an approved internal model (thus reducing the reliance on external rating)
- The documentation of detailed procedures in case that the credit quality of the collateral collected no longer meets the requirement of the RTS
- The ability to identify collateral assets the quality of which falls below the required level
- The ability to define a schedule for the replacement of collateral assets already accepted following a downgrade (in order to mitigate the risk of introduction of "cliff effects")
- The ability to assign haircuts to collateral assets and monitor the value of the haircuts to ensure consistent valuation of the collateral held

The introduction of proportionality threshold for the application of the concentration limits may help to achieve a good balance between costs and benefits.
Still, to fulfil the requirement on the concentration limit (if above the threshold), counterparties will have to support significant operational costs:

- They will have to monitor all collateral flows (including initial and variation margin) on a daily basis to ensure that the amount of collateral collected for each eligible asset class is not above the limit.
- They must have the ability to propose a large range of asset classes as initial and / or variation margin to their counterparties who would have to avoid going over the same limits and may refuse eligible assets as collateral due to that limit.

The requirement on the concentration limit will inevitably increase time delays in collateral exchanges and ultimately risk.

Operational procedures

The RTS requires robust risk management procedures to be in place to ensure the timely exchange of collateral for contracts not centrally cleared. Those risk management procedures relate to:

- The policy and procedures regarding the exchange of collateral
- The escalation process with counterparties
- The reporting of exceptions to senior management
- The operational process for the exchange of collateral
- The storing of all agreements
- The timely settlement of margin calls

- The mitigation of risks arising from collateral assets collected
- The setting of collateral levels
- The verification of the liquidity of the eligible collateral
- The periodic testing of the risk management procedures
- The substitution of collateral

These requirements will result in significant costs in terms of higher operational burden for market participants. They will have to supports higher costs (collateral management tools, operational staff and front to back proprietary management systems) to be able to meet those requirements. These costs may fall unequally on small and medium size players and on those who had few collateralized contracts.

The requirement for collected initial margin to be segregated from proprietary assets on the books and records of a custodian and for the collecting counterparty to provide the posting counterparty with the option to individually segregate its collateral may also come at significant costs for the collecting counterparty. This will probably translate into higher custody fees for the collecting counterparty.

The full ban of the initial margin re-use will prevent market participant from using repurchase agreements to transform securities received as collateral into cash and pursue higher yield investment opportunities. In the same fashion they won't be able to use reverse repurchase agreements to loan the cash received as collateral. This will result in an opportunity cost for market participants.

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If yes, please provide the rationale for the concerns and potential solutions.

We indeed think that some particular requirements may be addressed in a more appropriate manner or still need to be clarified, in order to reduce the costs and avoid any comparative disadvantage for small and medium size players. Here is a brief summary of our thoughts:

The requirement for initial margin will apply subject to a threshold value of EUR 8 billion for gross notional outstanding of OTC derivatives. A key point is the scenario where at least one party to the trade is below the threshold. In this case, it is clear that it should not be forced to post initial margin without consenting. It is of paramount importance to ensure that the larger counterparty will not force collateral to be posted unilaterally by the fund or exchanged bilaterally. Otherwise, costs may still fall disproportionately on smaller market participants.

The requirement for the implementation of internal initial margin models and the resulting obligation to agree on the outcomes of different models will lead to a sub-optimal situation. We would rather recommend the use of the standardized method or the election of a single

initial margin model (market best practice) that would only need to be validated once by a third party and / or the regulator.

In general, we would like to put more emphasis on the fact that small and medium size players should not suffer from decisions taken by larger players or support substantial costs to mitigate systematic risk inferred by those larger players.

Grand fathering clause: we insist on the necessity to fully establish the fact that the regulation will only apply for transactions conducted after 1st December 2015 and for the IM, depending on the thresholds defined in article 1 FP; it should not only be mentioned under recital 18 but also included in the text of the regulation itself. Furthermore, we consider that a precision should be added to make sure that **"genuine amendments"** as referred to in the BCBS/IOSCO final report (§ 8.9 and footnote 20, p. 24) made to existing derivative contracts shall not be in the scope of the new regulation. An explicit mention in article 1 FP § 4 shall bring the necessary clarification. As a matter of fact, investment funds often amend existing contracts to reduce their notional amount to adjust their exposure, as a consequence of redemptions. Thus, it is very important for them to keep these existing contracts outside the scope of the regulation.

Reverse the presumption that IM will not be collected: in article 1FP §3, the current wording says that the possibility to exempt transactions between counterparties under the threshold requires a prior formal agreement. **The default rule should be** that, in the absence of a specific agreement between the parties, there is **no IM posted**. Legal services are overworked and this suggestion would simply make things workable.

100 million € of collateral as Threshold for concentration rules; alignment with UCITS collateral diversification rules: if concentration rules were to apply,- and we strongly suggest that there should be a realistic threshold under which they should not, simply because it is not workable to ask for a split over different issuers of collateral on smaller amounts than 100 million-, they should be coherent with existing requirements. ESMA guidelines asks for UCITS to spread received collateral in order not to exceed an exposure higher than 20% of the NAV of the fund on one single issuer. The denominator of the ratio is what is important in the fund, i.e. the net asset value or the net capital available in the fund. The proposed regulation refers to the total amount of the collateral when computing the diversification ratio. It is inconsistent to consider that there is a risk on the collateral of small amount that could be mitigated with a diversification rule; it is not workable to ask counterparties to split small amounts of collateral on several issues for even smaller amounts, uneasy to manage and costly to transfer.

Group consolidated eligibility thresholds: In the case of portfolio management for a client, it would be impossible for an asset manager to calculate group consolidated eligibility thresholds of its client. In addition, the fact that a client may have signed several mandates with several Asset Managers brings additional difficulties in calculating margin. Which entities will be responsible for calculating and paying the required amount of margin on behalf of the client?

The application of two different methods by the parties to evaluate and calculate haircuts may result in discrepancies. It seems that there is no procedure in the RTS to solve those discrepancies.

As asset managers, we believe that a ***standardized margin schedule*** may be the preferred approach as a standardized margin schedule used by both parties would lessen the risk of disputes as compared to quantitative portfolio models developed by counterparties.

UCITS derivative close out rule: The funds are required in Europe to negotiate a possibility to ask for an exit out of a derivative at any time. It implies the possibility to put to an end the initial operation with the initial counterparty. The point is that if for the sake of best execution the asset manager has a better price with another counterparty for an opposite transaction it will have to post collateral for two opposite exposures as long as a netting is not accepted between counterparties (and there is no possibility to force such a netting). This is not an issue if no initial margin is exchanged but may become an obstacle to best execution if there is.

The proposed regulation suggests a **Minimum Transfer Amount** (MTA) of 500 000 €. This amount includes the net variation of IM and VM exchanged between 2 counterparties. Some of our members monitor IM and VM separately and we would prefer to have two MTAs. We hence suggest that be added if it is possible to follow two MTAs of 500 000€.

On the legal point of view, we fear that the ability **to return excess collateral to the liquidator** of the defaulting counterparty that posted it might be difficult to guarantee in all jurisdictions. We think that it requires a full monitoring of the local legal framework and depends also very much on the type of segregation that is provided for.

Question 3. Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in the cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?

Asset managers are not directly concerned with the hedging of a pool refinanced by covered bonds. However, as an investor in covered bonds, our members strongly believe that the pool behind the bonds is the guarantee of the investor and should not be encumbered at all. Thus we consider that no collateral should be posted by the pool even in relationship with derivative contracts signed to cover its risks.

Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?

We comment hereafter the use of a counterparty IRB model, but also the use of the IM model of the counterparty.

Our members agree to the requirement that banks communicate on the models they use and the data they take when running these models. Our members' responsibility towards their clients includes the verification of the prices of the financial instruments used and the level of collateral is within the scope of the controls. We would advocate for a specific requirement to discuss the key structure of the models and the source of data used and we suggest they should be as often as possible public data. As we fear that it might be difficult to receive the necessary information, we would consider as a good leverage that the client be recognized the possibility to seize the competent authority if he cannot obtain satisfactory explanations.

Managing money for third party implies not only to comply with supervisory authorities, but also to ensure that customers' money is managed within a defined risk framework. Therefore one must ensure that both the client needs and the supervisory rules are understood. Sufficient information and appropriate transparency would imply due diligence made by the Asset Manager on the IRB used by the counterparty. When managing money for third parties, the validation of the IRB by a supervisory body is an important step that should be supplemented by the Asset Manager's due diligence. When deciding the list of allowed counterparties to trade OTC derivatives, the client can also carry out a due diligence on the IRB counterparties.

The collateral should be used as a guarantee should the counterparty default on its commitment. The quality of collateral rated by a "failed" counterparty may make its sale very difficult (and thus limit considerably the purpose of posting collateral). Typically, if the IRB is used for non-rated securities it can make the sale of the collateral in a stress period more difficult in the absence of an external rating.

For this reason, combined with the fact that small/medium size asset managers will not be able to have approved IRB models nor to monitor their counterparties IRB models, we feel that the advantage given to IRB models as opposed to external ratings is not fair and that the acceptable CQS should be positioned at the same level, level 3 for usual bonds, in both cases.

It should also be mentioned that the use of margin models may put the small & medium size players (e.g. small investment managers, non-financial counterparties) at comparative disadvantage compared to other larger players (e.g. large investment firms, broker /dealers) because they may not have the necessary operational resources to develop those models. They may have to agree on the results of margin models developed by their counterparties and / or third parties and suffer a lack of information to assess the appropriate calibration and the integrity of the model. This lack of transparency may lead to frequent disputes regarding the amount of initial margin to be posted.

For both the IRB model (eligible collateral and haircut) and the internal model of Initial Margin calculation small and medium size players will be exposed to non-transparent models.

In order to avoid such comparative disadvantage faced by Asset Manager some tools may be proposed

- to cap the difference between the internal model and the standard model;

- to entrust a third party for the calculation with a commitment to stability of the model.

- the possibility to use specialized models issued by professional provider such as Rating Agencies used for securities ratings;

- to exclude OECD Govies from eligibility rating requirements to avoid the cliff risk criteria;

Regarding the Initial Margin calculation, the regulation should require Banks to leave the choice for the client and for each transaction between internal model and standard.

Question 5. How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

Eligible Collateral

Before discussing concentration limits it is of prime importance to open the discussion about eligible collateral.

AFG members share the view that the list of eligible collateral should be large, diversified and include funds. The larger the list, the lesser is the risk for procyclicalilty and collateral squeeze. The trouble with a large list of eligible collateral is that it may include assets of lesser quality. Quality of the collateral is assessed on the basis of its liquidity and creditworthiness.

Liquidity: the purpose of collateral is to be able to convert it into cash when (i) the counterparty defaults and (ii) there is a difference between the price on which the derivative contract was settled and the last level of the variation margin. Liquidity tends to fade or increase very quickly. However, it is a fact that large cap stocks are among the most liquid assets in any circumstances and that government bonds are usually very actively traded as well. But the recent experience has shown that govies might become totally illiquid overnight. Liquidity assessment should include the possibility to use securities lending and Repo markets to gain it.

Credit quality: if we agree with the fact that investors should not rely overly on credit rating agencies analysis and should develop internal credit assessment capacities, we do not consider that it is fair to introduce a difference of one notch of CQS when determining the eligible collateral depending on whether it is based on an internal rating or an external one provided

by a CRA. This causes a particular concern on our part as we will rely on models developed by banks and as such taking into consideration their internal credit estimates. In order to challenge these models we want to be able to take rating published by CRA as reference, especially because the CRAs produce extensive research on credit performance of rated issues over a long period of time.

In general, we consider that the entire field of the investment grade (as defined by CRAs) issues should be considered as eligible. Since they do not show the same level of safety, it is clear that appropriate haircuts have to be provided. We feel that the proposed schedule can be used as a reference.

Our members do not share the idea to include shares of components of the main indices in the 40% limit that is suggested for convertible, shares and other instruments. First, this proposal is not consistent with the fact that shares are highly liquid and remain one of the few actively traded instruments in periods of stress, probably because of the diversity of types of shareholders. Secondly, this limitation would profoundly alter the investment strategy of many funds that are required to invest exclusively or to a very large proportion in shares; for example:

- classical equity funds that are benchmarked to equity indices have no choice but giving equities as collateral (knowing that UCITS are forbidden to reuse collateral and thus cannot use collateral transformation services)

- PEA funds in France have to show a minimum investment of 75% in eligible shares. These funds might be prevented to use derivative contracts and dramatically reduce the investment universe of their holders. This is particularly true if the 40% ratio were computed on the basis of total collateral and not NAV for funds.

Concentration limits

As explained above, concentration of collateral is only a third level risk. We advocate that the main risks are already covered by haircuts. Furthermore, it does not make sense to impose diversification for small amounts of collateral and the ESAs should take into account the need for proportionality. As a consequence, we strongly believe that concentration limits should not apply below a **threshold of 100 million € in collateral.**

We also suggest that the diversification calculation be computed **on the basis of the NAV** for funds, both UCITS and AIFs (when of course those investment funds individually are above the threshold). If introducing a specific case for funds is not possible, we could establish the ratio with reference to the Notional Amount of the derivative contracts. This reference would be totally consistent with the thresholds for applicability of the IM requirement (from 3000 billion to 8 billion €). As a matter of fact, it does not make sense to impose diversification if, for example, the total collateral represents only 1% of the notional of the derivative contract. In such a case, the cost is completely disproportionate to the risk reduction.

Furthermore, **asset managers cannot be subject to a double layer of constraints**. We strongly militate in favour of **alignment of rules**. Since collateral diversification and counterparty risk are already regulated and monitored in certain types of investment funds (UCITS and equivalent[3]), we are asking strongly for an exemption from the diversification rules of collateral under EMIR for these funds. **Practically, funds that comply with ESMA guidelines should be considered as compliant with EMIR rules on collateral** diversification.

A reminder: The regulation for UCITS in relation to collateral and counterparty risk monitoring is based on following main principles:

- The risk exposures to a counterparty arising from OTC financial derivative transactions and efficient portfolio management techniques should be combined when calculating the counterparty risk limits of Article 52 of UCITS Directive.

  ESMA/2012/832 (Guidelines on ETFs and other UCITS issues)
- Where a UCITS enters into OTC financial derivative transactions and efficient portfolio management techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times:
  - **a) Liquidity** – any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the provisions of Article 56 of the UCITS Directive.
  - **b) Valuation** – collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.
  - **c) Issuer credit quality** – collateral received should be of high quality.
  - **d) Correlation** – the collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty.
  - **e) Collateral diversification (asset concentration)** – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of **20% of its net asset value**. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer.
  - f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.
  - g) Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.
  - h) Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.
  - i) Non-cash collateral received should not be sold, re-invested or pledged6.
  - j) Cash collateral received should only be:
    - - placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive;
    - - invested in high-quality government bonds;

[3] The regulation for "Fonds d'investissement à Vocation Générale" under French Laws in relation to collateral and counterparty risk monitoring is based mainly on article 422 -62 of Règlement general from AMF and states mainly 8 criterias for assets to be eligible as financial guarantee for reducing counterparty risk within said investment fund type.

- - used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis;
- - invested in short-term money market funds as defined in the Guidelines on a Common Definition of European Money Market Funds.

ESMA/2014/294 (Revision of the provisions on diversification of collateral in ESMA's Guidelines on ETFs and other UCITS issues)

- 8. Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, a UCITS may be fully collateralised in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' net asset value. UCITS that intend to be fully collateralised in securities issued or guaranteed by a Member State should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral for more than 20% of their net asset value. This derogation does not affect the other criteria for collateral management as set out in paragraphs 41 to 47 of the guidelines.

We would also like to highlight UCITS funds' limited access to collateral following overlapping regulation.

Regulated investment funds already have problems to meet these collateral requirements:

- it is only possible to post securities collateral from the assets being part of the investment fund. According to Art. 51 para. 2 of Directive 2009/65/EC, Member States have authorized UCITS funds to agree on efficient portfolio management techniques.
Nevertheless, in most Member States, regulated investment funds are not allowed to borrow securities which they could use in order to provide eligible collateral to their counterparty (cf. recital 13 of Directive 2007/16/EC); but even if they were allowed to, according to paragraph 42 and 43 i of ESMA's Guidelines on ETFs and other UCITS issues - ESMA/2012/ 832EN, implemented in all Member States), at least UCITS would not be allowed to use the borrowed security for posting eligible security collateral.

- if no securities eligible as collateral are part of the investment fund, only cash collateral contributions are possible. Or cash collateral cannot be used to post margins under EMIR following Question 6j of ESMA's Q&A on ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN).

New regulations lead to an intensive increase of liquidity demand. At the same time ESMA's Guidelines on ETFs and other UCITS issues especially limit UCITS' ability to gain liquidity by closing the UCITS' main source of liquidity. This overlapping regulation makes it more and more difficult to hedge existing market risks, which was not the G-20's goal.

We firmly believe that this aspect should be clarified by considering a provision in the RTS that all financial counterparties (including UCITS) shall be allowed to use the purchase price gained under a repurchase agreement for making Initial or Variation Margin contributions

(and ESMA's aforementioned Guidelines and Q&A subsequently amended on this particular aspect).

Question 6. How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?

Our members believe that the prohibition or authorization of re-use should not be determine on a regulatory level but on case by case basis within a bilateral agreement between the parties.

AFG members have the view that BCBS/IOSCO principles have taken a prudent and pragmatic approach when strongly limiting the possibility to re-use or rehypothecate received collateral. We think that there is no reason not to follow these principles. OTC derivatives are traded between professionals. If a counterparty agrees that the re-use of collateral will be positive and made for the benefit of its clients, re-use should not be prohibited.

AIFs are currently permitted to re-use collateral (certain disclosure requirements are necessary). These new rules are therefore inconsistent with the rules applying to AIFs and with the way existing AIFs have been structured.

The interdiction of collateral re-use would pose a business problem for some types of funds. If prime brokers are unable to re-use the collateral they receive, access to financing will become more difficult for these funds, and much more expensive.

An example of circumstances where re-use will be helpful is to be found in the case of back to back transactions where a counterparty A manages the exposition it took from a derivative contract with a fund through a reverse transaction with counterparty B; the collateral received from the fund by A may be re-used and posted in favour of B that finally takes the market risk. The more so if A is a financial institution that provides the fund with a guarantee.

The required prior explicit approval by the poster of the collateral (transaction by transaction), the fact that it can check that the re-use is made in conjunction with a further transaction aiming at managing the risk initially taken from the fund and not to take further exposure, the possibility to earmark the collateral…all is made to limit the re-use to a very few cases when professionals fully agree.

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Sincerely Yours,

Pierre Bollon