**EFAMA COMMENTS ON THE CONSULTATION PAPER ON DRAFT REGULATORY TECHNICAL STANDARDS ON RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVES CONTRACTS NOT CLEARED BY A CCP**

**INTRODUCTION**

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 62 corporate members almost EUR 17 trillion in assets under management of which EUR 10.2 trillion managed by 55,000 investment funds at end March 2014. Just over 35,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit [www.efama.org](http://www.efama.org).

We would like to thank the European Supervisory Authorities for this opportunity to comment on risk-mitigation techniques for non-centrally cleared OTC derivative contracts.

**GENERAL REPLY**

The rapid confirmation, daily valuation, reconciliation and dispute procedure requirements have led to significantly improved risk control of OTC derivatives. The mandatory reporting to Trade Repositories (“TR”) does facilitate transparency and control by authorities. The following steps, now under discussion, should concentrate on systemic risk issues.

Before answering the questions asked in the consultation, we would like to insist on the following points:

1. Risk in an OTC derivative transaction comes 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 not mitigated by central clearing in OTC deals but by collateral;

Quality of collateral (and, more specifically, its liquidity) represents the third level in terms of risk mitigation;

Diversification and haircuts rules are the fourth level of risk mitigations. Consequently, quality and diversification of collateral should not be the primary focus of the regulators.

1. The ESAs should be aware of conflicting and overlapping regulation which should be addressed before submitting the drafted RTS to the Commission:
	* Certain provisions of ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN) implemented in all Member States prevent UCITS funds to comply with some of the provisions of the RTS (replacement of defaulted derivatives);
	* UCITS funds already have to comply with concentration limits on collateral.
2. As investment funds and asset managers are very strictly regulated and closely supervised, we consider that a specific exemption from the obligation to exchange initial margin would be justified.
3. Deals existing at the time of implementation of a new regulation should be exempted (as mentioned in recital 18) and this principle should be embedded in the text of the RTS as well (rather than being only written in a recital).
4. With a view to reduce procyclicality and to enhance financial stability, we consider that the basis for eligible collateral should be as diversified as possible and include various types of assets and specifically funds (as opposed to the approach chosen about funds in CRR on liquidity ratios).
5. According to their quality and their liquidity, these assets should be subject to appropriate haircuts and not percentage limits on concentration to reduce risk;
6. The possibility to re-use collateral received can be a major device to leverage a position and should not be granted without restriction. However a total prohibition of re-use or re-hypothecation in all circumstances is not advisable either, as it increases the run for eligible collateral and hence produces procyclicality and reduced liquidity. We consider that OTC transactions being conducted between responsible professionals, re-use should be allowed in exceptional conditions as defined by IOSCO / BCSS rules.

**DETAILED REPLY**

Question 1. What costs will the proposed collateral requirement 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 with the proposal aligned with interaction standards?

EFAMA members consider it difficult to determine the costs of implementing the proposed RTS considering the currently available information.

The number of new obligations and their scope seem to make their implementation quite expensive, especially for small or midsize funds or asset management companies. Indeed, those asset managers have often outsourced part of the services and this leads to uncertainty around fees and charges caused by the review of contracts and services.

Another element of uncertainty of costs is the fact that, even if the costs could be reduced by implementing jointly requirements from various legislation, all the changes coming on a same period of time will have an impact on cost e.g. for contracts reviews and modification or IT systems changes.

In order to ensure that small and medium sizes counterparty are not commercially forced to deliver initial margins, the 8 billion thresholds should be reinforced through the generalization of a Minimum Transfer Amount applicable on the Initial Margin for entities that are below the threshold.

More specifically, we are aware that collateral management for non-centrally cleared OTC transactions will bring the following:

* **Legal and documentation cost**, as agreements must be negotiated or amended to take on board new requirements and some asset managers may have to solicit external advice, which tends to increase the cost of compliance. Furthermore, the responsibility imposed on counterparties (e.g. UCITS/AIF) to obtain and apply legal opinions (Article 1, par. 5) in all relevant jurisdictions in the context of the segregation of initial margins will clearly increase the legal burden and the costs for investment fund management companies outweighing the benefit of such legal arrangements. Moreover, the requirement imposed by counterparties to obtain and apply legal opinions is not covered by article 11, par. 3 of the EMIR regulation;
* **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.
* **Opportunity cost** if initial margining is imposed by counterparties: for example, 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; 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.
* **Initial Margin** may commercially be imposed to Asset Manager by large bank even if the aggregate month-end average notional amount of non-centrally cleared derivatives is below 8 billion euros as of December 1st 2019. This Initial Margin may have a significant cost impact on small entities.

In order to reduce the costs for the envisaged collateral requirements without compromising the objective of sound risk management, we are of the opinion that the ESAs should also carefully take into account existing regulations. Those regulations are already aiming at mitigating counterparty risk and credit risk for bilaterally concluded OTC derivatives transactions.

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.

1. Impossibility to calculate exposures

Sub-funds and segmented investment funds

We welcome the ESAs view in recital 5 that the threshold relevant for the question whether or not to exchange Initial Margin contributions needs to be considered for each investment fund or sub-fund (compartment) separately. We understand that sub-funds, which are totally risk segregated, and without any solidarity between them are different entities when considering collateral requirements and thresholds.

In some cases, the investor of an investment fund (AIF) wishes that more than one asset manager manages the investment fund. This is achieved by creating segments or portfolios (e.g. one segment concerning equities and another segment concerning non-equities) each managed by a certain asset manager.

This is considered for collateralization reasons too. The collateral to be posted by the parties is determined with respect to each segment separately.

In order to maintain the possibility for investors to have their investment fund managed by more than one asset manager or to avoid the creation of legal solidarity between sub-funds, it would be helpful if the ESAs would clarify in Recital 5 that in case of segmented investment funds, each segment should be considered as a distinct entity.

This question is even more crucial for funds with sub-funds as it would force each sub-fund from a fund to deliver initial margin, even when the size of the sub-fund may be below 2 million euros.

Investment funds established in accordance with contract law (Art. 1, par.. 3 of the Directive 2009/65/EC)

As far as the ESAs determine an exemption from the rule that the threshold shall be considered for each investment funds separately, it should clarify that just the circumstance that an investment fund is established in accordance with contract law (cf. Article 1, par. 3 of EU Directive 2009/65/EC) does not mean that the threshold always needs to be applied at the level of the asset management company (“investment advisor” in Recital 5). As a matter of fact, it is the asset management company who becomes contractual party to OTC derivatives (acting for the joint account of the investors of the relevant investment fund established in accordance with contract law. It should be clear that this direct liability of the asset management company should not be understood as one of the exemptions from the general rule that the threshold is to be applied on the fund level.

First of all it needs to be pointed out that there is no incentive for the asset management company to breach the cover rule set out in Art. 51, paragraph 3, of Directive 2009/65/EC[[1]](#footnote-1). According to the cover rule, it is not allowed to enter into derivatives that cannot be fulfilled with the assets of the fund. If the investment fund is established in accordance with contract law, whatever the asset management company receives from a transaction relating to an investment fund automatically becomes part of this investment fund. In consequence, there is no possibility of the asset management company to make own profits from any transactions being in breach of the cover rule. In case of transactions the asset management company has agreed on for the joint account of the investors of an investment fund established in accordance with contract law, any liability arising from an OTC derivative is a liability of the asset management company. The latter only has a respective claim for reimbursement against the joint group of investors of the investment fund, which is limited to the assets of the funds. Any liability exceeding the value of the investment funds assets are to be borne by the asset management company. For that reason, it is the overall interest of the asset management company to comply with the cover rule.

The above demonstrates that just the circumstance that investment funds are established in accordance with contract law gives no reason for deviating from the principle of a fund-by-fund view when applying the threshold. Since the wording in Recital 5 leaves space for interpretations, the ESAs should clarify that aspect accordingly, at least in Recital 5.

Besides the legal aspects, we would raise a second point in that context.

Since in each Member State there is always one leading practise how investment funds are established (statute, trust or contract law) which very much relates to what structure retail investors are used to, any interpretation of the RTS being in conflict with the above would mean a discrimination of the funds industry in the relevant member states. Applying IM requirements is expensive and creates costs, which are finally borne by the investors. Treating investment funds established in accordance with contract law different from those being established by statute would create unequal conditions for managing the investors’ assets.

Neither EMIR nor the UCITS directive nor BCBS/IOSCO differs between the ways an investment fund is being established. We have no reason to believe that the ESAs think otherwise. For that reason, we would welcome a clarification by the ESAs in the favoured manner either in Recital 5 and/or Art. 2 GEN, paragraph. 3

Calculation of group exposure

Moreover, the fact that a client may have concluded several mandates with different asset managers brings additional difficulties in calculating margins. It is then not possible for the asset manager of one mandate to calculate the threshold or deliver the margins, as the global exposure remains impossible to define.

1. Grand-fathering clause

We wish to insist on the necessity to fully and explicitly establish the fact that the regulation will only apply for transactions conducted after its implementation date.

It should not only be mentioned under recital 18 but also included in the text of the regulation itself. Furthermore, we consider that a clarification 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 would bring the necessary clarification.

1. Eligible collateral

The eligible collateral should not be limited to the list of the main indices. Eligible collateral list should be extended to other indices as well.

The RTS should also provide an assessment method for the calculation of haircuts on equities.

As far as we understand, the application of two different methods by the parties to evaluate and calculate haircuts may result in discrepancies and we see no procedure in the RTS to solve those discrepancies.

1. Implementation of collateral transfer made of units or shares of UCITS

We greatly welcome the possibility for counterparties to use units or shares in UCITS as eligible collateral as it supports the need for liquidity in the markets, even if it does not benefit directly to the funds.

In order to support even more the liquidity, we would urge the ESAs to provide solutions to the following constraints that may arise in the practical use of such possibility:

* The settlement system of UCITS does not allow transfer of shares or units in a proper manner when they are not eligible to a CSD’s operations. As of today, an integrated European settlement circuit for such UCITS does not exist. This is an impediment to the implementation of such collateral transfer between counterparties when they are not located in the same country. Even if the counterparties are both located in the same country, the consent from the depositary of a given UCITS for the delivery of the shares/units as collateral is rarely granted by the depository, due to operational constraints when they are not eligible to a CSD’s operations;
* The banking regulation Capital Requirement Regulation (CRR, June 26th, 2013) has introduced two new ratios in order to ensure a better monitoring of liquidity risks: (i) the Liquidity Coverage Ratio (LCR – that measures the liquidity risk with a time horizon of 1 month, and ensures that banks own sufficient reserves and cash inflows in order to face potential cash outflows) and (ii) the Net Stable Funding Ratio (NSFR that measures the liquidity risk with a time horizon of 1 year, and ensures that the Available Stable Funding (with a maturity over 1 year) is sufficient to face the Required Stable Funding).

However, Mutual Funds have generally speaking not been taken into account in the CRR regulation n°575/2013, for the computation of liquidity ratios (LCR and NSFR).

Under a strict interpretation of CRR, funds could then be assimilated into the less liquid categories of assets and suffer from a particularly adverse processing as, in the LCR computation, funds would not be eligible at all for the computation of inflows, i.e. they could be considered assets with a maturity over one month.

Concerning this later point, we would be happy to engage with the ESAs to further elaborate on this topic and propose concrete solutions that could enable banks to hold a portfolio of funds eligible as collateral without being unduly penalized.

1. Ability to return to the liquidator unused collateral proceeds

According to the draft RTS, this capability must be included in the risk management procedure of the counterparty receiving collateral.

The issue is that current market documentation of OTC derivatives is not compliant with such possibility.

ISDA Master Agreement but also other master agreements (like the German Master Agreement for Financial Derivatives Transactions) allow the non-defaulting party to net any payment owed by this party (the defaulting party) with all amount he may have to pay to its counterparty.

The non-defaulting party can then retain any amount received as collateral provided it is inferior to the amount that results from the addition of the sums due by its counterparty.

For that reason we consider that, in some cases, unused collateral proceeds shall not be returned to the liquidator of the defaulting party. This netting should continue to apply as it reduces settlement risk between the parties.

We consider that the regulatory regime of collateral should take into account this point.

1. Ban of re-use of initial margin

We consider the ban of re-use of initial margin may trigger some adverse consequences on UCITS legal regime and furthermore will increase the cost of OTC transactions. We ask for an authorization to agree to re-use in some circumstances. See question 6 below.

1. Necessity of initial margin

As per the “Guidelines on ETFs and other UCITS issues” published by ESMA on the 18th December 2012, a UCITS is bound to invest the cash collateral it receives.

Cash collateral should be placed on deposits, invested on high quality investment bonds, used for the purpose of reverse repo or invested in short term money market funds. Such investments must be in compliance with additional security constraints. We consider this regime adequately secures transactions and avoids risk in case of default of the receiving party.

We do not share the ESAs’ opinion that it is necessary to consider initial margins in order to properly manage counterparty risks arising from certain OTC derivatives.

Therefore we would like to point the ESAs’ attention once more to the drafted initial margin requirements. Such is necessary to make the RTS an appropriate measure when building more resilient financial markets.

In summary, here are the key points we wish to draw to your attention in that respect:

* The G-20 did not impose the requirement of initial margins for non-cleared OTC derivatives. For that reason the ESAs should evaluate if setting initial margin requirements would be appropriate in all circumstances;
* Non-cleared OTC derivatives, subject to standardized Master Agreements including an automated early termination, already mitigate the risk the ESAs intend to decrease with the initial margin requirement.
Therefore, having in place respective Master Agreements should be recognized as reliable alternative to initial margins. The risk initial margins are mitigating is related to the requested portability;
* We know that BCBS and IOSCO is in favor of IM requirements. Nevertheless the ESAs should keep in mind that the goals have been set by G-20 and that the ESAs have been established with the power to draft RTS which are independent from BCBS/IOSCO`s view. Declining any and all variances from the aspects suggested by BCBS/IOSCO would place BCBS/IOSCO in the position of a legislator, which it is not.

The ESAs should consider the differences between cleared and non-cleared OTC derivatives before stipulating any initial margin requirements for non-cleared OTC derivatives.

The G-20 accepted that market participants will use non-cleared OTC derivatives in the future and that their use may bear higher risks than the use of cleared OTC derivatives.

The ESAs should consider that creating too big burdens on the use of OTC derivatives sets an incentive not to hedge existing market risks which, in turn, would have a negative impact on the G-20’s goal to building more resilient financial markets.

Therefore the ESAs should evaluate whether it is appropriate to decrease the low risk of market movement effects after the OTC derivatives counterparties default by setting initial margins requirements or, if this risk is acceptable.

For those reasons, the proposed above-mentioned rules should be applicable to counterparties entering into non-cleared derivative transactions.

1. Post capital or hold assets

According to Recital 3, a counterparty shall have the choice either to post / collect (initial) margins or hold own capital if the amount of initial margin is below the threshold.

UCITS investment funds are subject to the cover rule (cf. Art. 51 para. 3 of Directive 2009/65/EC as well as CESR consultation 10-108, Box 28). That means, they are only allowed to enter into derivatives which can be fulfilled with the assets of the investment fund.

In order to avoid any misinterpretation, the ESAs should clarify in Recital 3 that in case of investment funds, be they UCITS or FIAs, own capital is represented by the NAV of the fund.

1. Conflict in diversification rules

There are some contradiction between diversification limits resulting from the application of article 7 LEC of the RTS (pages 38-39) and the concentration limits resulting from the ESMA Guidelines on ETFs and other UCITS issues.

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.

The harmonization within each Member State as regards those concentration limits in UCITS implementation and in EMIR is a necessary pre-requisite to improve legal certainty, liquidity as well as the level playing field between market players.

If concentration rules were to apply, 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.

1. Harmonized approach to IM calculation

From an asset managers’ viewpoint, we believe that a standardized margin schedule should be the preferred approach as UCITS’ regulations require that they set their own valuation process (in accordance with article 51 of the UCITS Directive), which must be independent and not rely on its counterparty’s valuation.

A standardized margin schedule used by both parties would also lessen the risk of disputes as compared to quantitative portfolio models developed by counterparties.

1. Different MTA for IM and VM

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.

Many EFAMA members are monitoring IM and VM separately and we would prefer to have two MTAs of 500.000,00€ each.

Question 3. Does the proposal adequately address the risks and concerns of the counterparties to derivative in cover pools or should the requirement be further tightened? Are the requirement, such as the use of 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 covered bonds which for not meet the conditions mentioned in the standards?

EFAMA has no comment.

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 adequate understanding to their supervisory authority?

We approve the requirement that banks communicate on the models that they use and the data that they take into account when running these models. From the perspective of the asset managers, our responsibility towards our clients includes the verification of the prices of the financial instruments that we use and the level of collateral is within the scope of our controls.

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

In order to avoid such comparative disadvantage for asset managers, some tools may be proposed:

* capping the difference between the internal model and the standard model;
* entrusting a third party for the calculation with a commitment to stability of the model;
* facilitating the use of specialized models issued by professional provider such as Rating Agencies used for securities ratings and suggest they should be as often as possible public data;
* excluding some OECD government debts from eligibility rating requirements to avoid the cliff risk criteria;
* as regards the Initial Margin calculation, to 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?

As a general comment, we are convinced that concentration limits are not the first and most important element to take into account. The relevant order of priority should be the following: (i) the analysis of the counterparty’s risk; (ii) the capacity to liquidate the collateral (its liquidity) and (iii) the diversification and possible concentration constraints.

1. Risk management perspective

From a risk management perspective, and as far as funds and asset managers are concerned, some elements must be highlighted:

* From a quantitative perspective, initial and variation margins represent a minor portion of the assets and are already subject to diversification requirements. The investment process emphasizes a risk mitigation component that aims at spreading the risk across many counterparties to the OTC transaction;
* From a qualitative perspective, the selection of the different counterparties is governed by clear criteria and principles applied in the selection of counterparties with credit quality.

Those two dimensions should be considered jointly when assessing counterparties and risk management. For a fund or an asset manager, there are already risk management measurement tools and processes in place. Adding new processes or requirements without considering the existing ones might create conflict between the requirements, reducing their efficiency and increasing legal uncertainty.

When it is allowed under the RTS to fulfil Initial Margin requirements in cash, the default risk of the counterparty is just replaced by the default risk of the bank who maintains the account the initial margin is booked to (typically a counterparty to other OTC derivatives).

While it is not sure whether the default of the counterparty of a non-cleared OTC derivative leads to a loss at all (subject to market conditions), the insolvency of the bank, maintaining the account to which the initial margin (cash) received is booked, leads to losses for sure.

1. Concentration and liquidity

As collateral is taken in order to reduce counterparty risk, we are convinced that the first criterion to control counterparty risk is a thorough credit quality analysis of the counterparty.

Secondly, the liquidity of the collateral is also an extremely important element. The list of eligible collateral should be large, diversified and include funds.

The larger the list is the lesser the risk for procyclicality and collateral squeeze. The trouble with a large list of eligible collateral is that it may include assets of lesser quality. The solution lies also in appropriate haircut.

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 government debts might become totally illiquid overnight. Liquidity assessment should include the possibility to use securities lending and Repo markets to gain it.

We also feel that in certain cases – e.g. G7 government debt – haircuts are a more appropriate measure given the quality of that debt. We also feel there should be a *de-minimis* cut-off for concentration limits at 100 million €. Beside the reduction of operational cost and difficulties in splitting small amounts of collateral over several issuers, the *de-minimis* rule applying on the diversification ration of collateral will not introduce any systemic risk.

We would like to insist on the crucial need to maintain the capability to deliver eligible collateral in the most efficient manner for both the collateral giver and collateral taker.

Indeed, a bad calibration of eligible criteria would raise the following difficulties:

* a counterparty would not be compelled to refuse good quality collateral because of the breach of the limit by issuer. As explained above, what is essential in our view in order to mitigate a counterparty risk is the quality of collateral, not its diversification;
* it should also be underlined that the constraints resulting from collateral diversification obligations may significantly increase the complexity linked to collateral management and therefore the costs of such collateral management;
* this cost increase could finally have a negative impact for investors. For that reason, we would be of the opinion that securities issued by the governments or central banks should be exempted from concentration limits;
* the ESAs should bear in mind that some banks are only willing to accept a small variety of security collateral (e.g. just German and French government bonds) as well as cash. Typically, in such cases, banks focus on the same kinds of eligible collateral.

Since EMIR came into force, we see an increased demand for liquidity and expect a further increase:

* according to Art. 11 paragraph 3 EMIR, it is necessary to collateralize non-cleared OTC derivatives (if no eligible securities collateral is available, a cash collateral contribution is required). In case of cleared OTC-Derivatives, Variation Margin can only be provided in Cash;
* if the RTS oblige Financial Counterparties to consider Initial Margins for non-cleared OTC derivatives, legal uncertainty regarding the numerous kinds of insolvency laws and property laws (they are different from country to country) and the required legal opinions but also the obligation specified under Art. 1 SEG paragraph 2 of the Draft RTS will set an incentive for banks only to accept cash collateral as Initial Margin for non-cleared OTC derivatives;
* the clearing obligation under MiFIR as well as Art. 30 paragraph 1 MiFIR will lead to the circumstance that market participants who access ETD (Exchanged Traded Derivative) either by becoming client of a clearing member or agreeing on indirect clearing arrangements will have to post Variation Margin in cash.

Thirdly, then the diversification would be used to provide extra protection.

Making concentration limits regarding securities collateral mandatory for all financial counterparties will lead to the consequence that UCITS and other regulated investment funds could be forced to provide cash collateral even if, in general, eligible securities collateral would be available.

For concentration limits, we already expressed our view above that they should not apply below a threshold of 100 million € in collateral. We also suggest that for funds (both UCITS and AIFs) the percentage be computed on the basis of the NAV. Even if introducing a specific rule for funds may seem difficult, we strongly think that it is justified. As an alternative that would not be specific to funds, we could establish the ratio with reference to the Notional Amount of the derivative contracts and then apply a much lower figure. This reference would be totally consistent with the thresholds for applicability of the IM requirement (from 3000 billion to 8 billion €). Furthermore, we ask that funds complying with ESMA guidelines be considered as compliant with EMIR requirements in terms of collateral diversification.

1. 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;
* if no securities eligible as collateral are part of the investment fund, only cash collateral contributions are possible.

According to Art. 51 paragraph 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.

With the implementation of ESMA’s Guidelines on ETFs and other UCITS issues into national law, regulated investment funds, such as UCITS, furthermore lost their ability to access liquidity via repurchase agreements. According to paragraph 42 and 43 j) of those guidelines (it especially is not allowed to use the purchase price received under a repurchase agreement for posting cash collateral or for buying eligible securities collateral:

* loans as source for liquidity (and cash collateral contributions) are limited by 10 per cent of the investment funds assets and for a 3 months maximum time (Art. 83 of Directive 2009/65/EC);
* the asset manager is obliged to invest and any remaining liquidity or liquidity gained via loans (please see above) is primarily required to fulfill redemption requests of the investment fund.

As explained, 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[[2]](#footnote-2).

According to Art. 5 paragraph 3 LEC of the Draft RTS the ESAs’ are of the opinion that UCITS are able to use derivatives for hedging permitted investments without losing their eligibility as collateral.

As it has never been the intention of the G-20 to limit the market participants’ ability to hedge existing market risks, we wish to stress that it is one of the most important issues to solve the problems created by the aforementioned Guidelines of ESMA.

For the reasons given above, negative effects following the implementation of collateral concentration limits by all financial counterparties could be mitigated either by amending ESMAs Guidelines (Article 43 j and more precisely Q6j on the Q&A) or considering a provision in the RTS that all financial counterparties (or at least UCITS) shall be allowed to use the purchase price gained under a repurchase agreement for making Initial or Variation Margin contributions.

1. Shares composing main indices should not be capped at 40%.

We 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 for the following reasons:

* 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,
* this limitation would profoundly alter the investment strategy of many funds that are required to invest exclusively or to a very large proportion of their assets invested in shares.[[3]](#footnote-3) They might be prevented to use derivative contracts and dramatically reduce the investment universe of their holders. This is particularly true if, for funds, the 40% ratio was computed on the basis of total collateral and not on the basis of the NAV.

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?

EFAMA’s view is that BCBS/IOSCO principles have taken a prudent and pragmatic approach when authorizing under strict limitations the possibility to re-use or re-hypothecate received collateral. We think that there is no reason for the ESAs not to follow these principles.

OTC derivatives are traded between professionals. There are many arguments that limit the re-use to a very few cases when professionals willfully agree to this regime:

* 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.

If a counterparty agrees that the re-use of collateral will be positive and made for the benefit of its clients, re-use should be allowed and duly reported for information to shareholders.

However, one should note that there is currently an important discrepancy between IOSCO and ESMA’s views at it is prohibited for regulated investment funds, such as UCITS, to re-hypothecate, re-pledge or otherwise re-use collateral received. The prohibition or authorization of re-use should not be decided on a regulatory level and should rather be agreed on case by case basis within a bilateral agreement.

As written in our reply to question 5, when it is allowed under the RTS to fulfil Initial Margin requirements in cash, the default risk of the counterparty is just replaced by the default risk of the bank who maintains the account the initial margin is booked to (typically a counterparty to other OTC derivatives).

While it is not sure whether the default of the counterparty of a non-cleared OTC derivative leads to a loss at all (subject to market conditions), the insolvency of the bank, maintaining the account to which the initial margin (cash) received is booked, leads necessarily to losses for the non-defaulting counterparties.

\* \* \*

Peter De Proft

Director General

Brussels, 14 July 2014

[14-4047]

1. Please see also CESR consultation n°10-108 on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, Box 28 [↑](#footnote-ref-1)
2. . (cf. G20, Cannes summit final declaration, para.graph 24 - https://www.g20.org/sites/default/files/g20\_resources/library/Declaration\_eng\_Cannes.pdf ) [↑](#footnote-ref-2)
3. For example, hundreds of PEA funds in France have to show a minimum investment of 75% in eligible shares. [↑](#footnote-ref-3)