Investment Management Association

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14 July 2014

Dear Sir / Madam

The European Supervisory Authorities consultation paper on risk management procedures for non-centrally cleared OTC derivatives

The IMA represents the UK-based investment management industry. Our members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members manage investments worth more than £5 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the "buy side" of the market, accessing capital markets on behalf of their clients.

We welcome the European Supervisory Authorities' proposals to increase the safety and transparency of OTC derivative markets and hence mitigate the potential systemic risk that can arise.

The key concerns outlined below, represents the views of investment managers and insurers as institutional investors:

- Costs: We support the need for diversification of collateral as proposed in the draft regulatory technical standards. However, the collateral requirements impose disproportionate costs on small and medium-sized entities and in particular on UK pension funds. Pension funds use OTC derivatives to hedge risks to solvency posed by sterling interest rate and inflation movements. The assets used to back these positions are sterling denominated, predominantly UK government gilts. The proposed collateral requirements will require significant changes to underlying investment strategies and the use of assets which are not denominated in the currency of the OTC derivatives exposures. This will lead to greater costs and reduced returns for these investors

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- International consistency: It is important that the proposed collateral requirements are implemented on a consistent basis globally. Risk management for insurance companies and certain other large institutional investors is often conducted at the group entity level in order to increase hedging efficiency. These group entities often operate across multiple jurisdictions. Other investors will have portfolios invested on a global basis and so will be exposed to regulation in other jurisdictions outside the EU. Inconsistency in the global regulations on collateral requirements will lead to high operational costs for such group entities and global investors. This applies to the scope of application as well as the detailed operational requirements. In particular, the inconsistency in the application of variation margin to foreign exchange (FX) forwards and swaps in the EU, compared to the US raises particular concerns and is likely to lead to regulatory arbitrage. It also creates an unfair market for our members' clients to compete on a global basis.

- Operational issues: the proposed regulatory technical standards impose detailed operational and legal documentation requirements on counterparties. The phase-in for initial margin goes some way to minimising the impact of these requirements on small-medium sized entities, but the phase-in itself cannot be relied upon without documentation changes. In the case of variation margin, the impending implementation timeframe of December 2015 is causing great concern for insurers and investment managers, given the very detailed processes, procedures and documentation they will need to have in place to ensure compliance with the regulation. This is particularly acute for investors who only use FX forwards.

Our detailed responses to each of the questions in the consultation paper are attached to this letter. If you would like to discuss the issues raised in this paper in more detail or the impact of the regulation on the investor community, please contact: Catherine Phillips (Catherine.Phillips@investmentuk.org) or Richard Metcalfe (Richard.Metcalfe@investmentuk.org)

Yours sincerely,

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IMA Response to the European Supervisory Authorities' consultation paper on risk management procedures for non-centrally cleared OTC derivatives

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?

Disproportionate costs for small and medium-sized entities and pension funds

The proposed collateral requirements, in terms of concentration limits impose disproportional costs on small and medium-sized investors and pension funds in particular, who may not be able to implement the diversification requirements imposed on the collateral they are required to post, without significant changes to their underlying investment strategies. For example, the majority of UK defined benefit pension schemes invest in Liability Driven Investment (LDI) strategies. In 2013, total pension scheme liabilities covered by the LDI strategies in the UK rose to more than £0.5 trillion[1]. A typical LDI portfolio includes the use of OTC derivatives to hedge risks to solvency posed by sterling interest rate and UK inflation movements. The contracts used to hedge these risks are denominated in sterling, and so the assets held to back these exposures and posed as collateral are also sterling denominated, predominantly UK government gilts, cash and high quality corporate bonds. Imposing concentration limits on collateral requirements will result in an increase in costs of hedging financial risks, as pension funds will be forced to diversify their LDI portfolios to hold assets denominated in other currencies which do not reflect the currency of the derivatives transactions. This will come at a cost both in terms of investment performance, greater haircuts imposed by counterparties on non-sterling collateral assets and mismatch between the liabilities and assets of the pension fund. This will either lead to the costs being passed on to the sponsor of the scheme and/or pensioners and is likely to discourage hedging operations. This in turn will increase the risk that pension fund assets will not be aligned with liabilities. Further detail on our concerns in relation to the diversification requirements imposed on collateral and the resulting increase in costs is outlined in our response to Question 4

Potential for increased costs if lack of international consistency on collateral requirements

It is important that the proposed collateral requirements are implemented on a consistent basis globally. For both insurance companies and other clients of investment managers, risk management on financial markets may be conducted at the group entity level in order to increase hedging efficiency and reduce hedging requirements. These group entities often put in place a group risk-management approach to collateral that may cross multiple jurisdictions. Other investors such as pension funds and investment funds will also be

[1] *Navigating the UK LDI Market,* 2014 KPMG LDI Survey, kpmg.com/uk/investmentadvisory

investing on a global basis and using derivatives governed by the laws of jurisdictions outside the EU. Inconsistency in the global regulations on collateral requirements for non-centrally cleared OTC derivatives, both in terms of scope and the processes and procedures required to be put in place, will lead to higher operational costs for such group entities and other global investors. It is arguable in any case that institutional investors, even if a Financial Counterparty under EMIR or a Non-Financial Counterparty above the clearing threshold should not be subject to the requirements where they are not “financial institutions” or “systemically important non-financial institutions” as provided in the BCBS/IOSCO principles. Further detail on our concerns in relation to the lack of international consistency on margin requirements for foreign exchange (FX) derivatives is included in our response to Question 2.

Increased Operational and up-front legal costs

The proposed regulatory technical standards impose detailed operational and legal documentation requirements on counterparties. Whilst we understand that some level of detail on the operational side is required in order to ensure that counterparties have in place appropriate risk management procedures that require “the timely, accurate and appropriately segregated exchange of collateral” (EMIR Article 11(3)) in relation to OTC derivatives, the requirements in the draft regulatory technical standards go beyond what is required in order to achieve this and in some respects are inconsistent and/or impractical to implement. We set out below some examples of the requirements which we believe are too prescriptive, inconsistent, or impractical to implement. The BCBS-IOSCO principles do not provide for detailed requirements and so it is also important that detailed standards with respect to risk management procedures are developed at an international level in order to ensure a consistent approach across all jurisdictions and markets.

i. The methodology for confirming thresholds and non-collection of initial margin and variation margin

In relation to the initial margin requirement, the starting assumption should be that funds or institutional investors are deemed not to be above the threshold, unless they positively declare otherwise. In more formal terms, for entities which do not provide the service of execution of OTC derivatives, the assumption should be that such entities are *not* above the relevant thresholds set out in the draft regulatory technical standards; and that such entities therefore will not be required to post or collect initial margin, unless they notify their counterparty otherwise. The mechanisms proposed in Articles 2 GEN and 1 FP for confirming the thresholds and initial margin and variation margin collection will place a disproportionate documentation burden on institutional investors (both those which are financial counterparties and those which are non-financial counterparties).

ii. Collateral management

We support the imposition of requirements in relation to the management of collateral in order to ensure that the level of collateral posted is appropriate to cover the exposure and that the assets of the collateral provider are adequately protected. However, we believe that the requirements proposed in Article 2 LEC are in some cases too prescriptive and will require a wholesale review of the legal and operational requirements currently in place in the bilateral OTC market in relation to the exchange of collateral (in particular with respect to variation margin) (e.g.: Articles 2(b), (c), (d), (e) and (f)). Further, these requirements are inconsistent with current legal arrangements in respect of variation margin which are usually on an outright title transfer basis, permitting re-use of collateral by the taker, and in some respects will be impossible or impractical to implement as they are not in the control of the counterparties themselves (for example Article 2(d) LEC).

iii. Threshold monitoring for multi-manager investors

The proposed requirements will impose obligations on counterparties to monitor their overall derivatives exposures and positions, in order to assess whether they cross any initial margin threshold. For the buy-side, however, this will not be as straightforward as it sounds. It will require close coordination between asset owners (such as investment institutions) and the multiple firms across which the owners often spread the asset management responsibility. This situation will be relevant not just to the threshold for initial margin but also to the derogation (in the form of the 'minimum transfer amount' in 2(4) GEN) from de-minimis transfers. The investment management industry's early experience of implementing EMIR is that not enough account was taken in the legislation of the challenges arising from the use of multiple managers, which is of course driven by a desire to seek out specialists in various fields of investment. The threshold monitoring will therefore impose an administrative burden on such investors and the investment managers to whom investment decisions are delegated.

Level of costs and how to reduce costs

It is not possible to provide details of the potential costs for investors at this early stage, and bearing in mind that the initial margin procedures are not currently widely used within the market for non-centrally cleared OTC derivatives. For some investors who currently only use physically settled FX forwards on a short-dated and uncollateralised basis, these requirements will require new documentation to be put in place with all counterparties, and development and implementation of new procedures and policies. There will also be costs associated with the practicalities of the threshold monitoring for variation margin and MTAs where investors have multiple asset managers (see *iii* above).It is important to note that any additional costs rising out of the collateral requirements will, directly or indirectly, be passed on to the sponsors of pension schemes, pensioners, insurance policy holders and investors

in retail funds.

Costs could be reduced by making every effort to ensure that the application of collateral requirements is implemented in a proportionate manner, with an appropriate phase-in for variation margin as well as initial margin requirements, especially for small and medium-sized investors and pension funds. Further detail on our proposals for a proportionate approach to the collateral requirements is included in our response to Question 5.

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.

Clarity around the definition of a 'new' contract

Recital 18 (page 21) of the consultation paper states that "in order to avoid any retrospective effect the margin requirements apply to new contracts not cleared by a CCP entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on contracts not cleared by a CCP entered into before these dates are subject to existing bilateral agreements". We support this recital as we believe that back-loading existing trades would be both operationally and financially burdensome to investors. However, there remains some ambiguity as to what constitutes a 'new' contract. We suggest that a 'new' contract should not include a contract which has been transferred, even if from a legal perspective this means that the contract is deemed to have been terminated and replaced by an exact substitute with a different counterparty. If it is not clear that transferred contracts are out of scope, and this will hinder counterparties' ability to transfer contracts in order to manage exposure limits and credit risk. We ask that the recital be enshrined in the body of the draft regulatory technical standards and that clarity be provided as to what constitutes a 'new' contract.

Clarity around the definition and application of the minimum transfer amount (MTA)

We note that article 2(6)GEN appears to be a definition of the total collateral amount, whereas 2(4) GEN cross-refers to that article as though it defines the minimum transfer amount (MTA). The MTA, though, is a different concept. The MTA relates to any amount of collateral requirement that arises, including by virtue of a change in the mark-to-market value of a contract or portfolio thereof. Thus, it does not necessarily refer to the total collateral amount but to an incremental change in that total collateral amount, which may or may not be operationally worth transferring. In other words, the MTA is relevant when the change in total amount of collateral is below a de minimis level (in this case, a proposed level of €500,000). We suggest the European Supervisory Authorities amend the text so that it is clear that 2(4) GEN refers to the MTA, and not the total collateral amount.

Potential for increased costs if lack of international consistency on collateral requirements and FX

As indicated in our response to Question 1, if the proposed risk management procedures for non-centrally cleared derivatives are not implemented on a consistent basis with other jurisdictions globally, they are likely to lead to increased operational costs and add unnecessary complexity to firms' internal processes and procedures.

For example, when it comes to scope of the application of variation margin requirements for non-centrally cleared FX derivatives, there is inconsistency between the current US approach and the proposals set out in the consultation for the EU. In the US, physically settled FX forwards and swaps are not in scope for variation margin requirements, in accordance with the November 2012, US Treasury determination[2]. However, in the EU, physically settled FX forwards and FX swaps are in scope for variation margin. This inconsistency increases the risk of regulatory arbitrage and it will put EU investors and businesses at a competitive disadvantage.

Ensuring global consistency of these risk-management procedures will minimise both the cost and regulatory burden on these global entities. In order to ensure consistency of approach, operational requirements (over and above when margin should be posted and what collateral is eligible), should be limited and kept to a high level in order to maintain flexibility for investors to operate on a global basis. Too much prescription in each jurisdiction will inevitably lead to inconsistencies and increased operational costs with little overall benefit. Further detail on our suggested solution to the international inconsistency in relation to FX forwards and swaps is set out below.

Operational difficulties in implementing variation margin requirements for short-dated FX

The proposed draft regulatory technical standards subject physically-settled FX forwards and swaps to variation margin, but not initial margin. These requirements mean that counterparties would need to collect variation margin on at least a daily basis, starting from the business day following the execution of the contract.

Whilst we support the application of variation margin to FX forward and swap contracts which have a medium to long-term duration (i.e. at least over three months and preferably much longer), we do not see the benefit of requiring variation margin to be posted in respect of contracts which are short-dated. This is inconsistent with the variation margin requirements in the US, as noted in our comments above. Further, we do not believe that FX

[2] http://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20Determination%20pdf.pdf

contracts are exactly comparable to other OTC derivative contracts. We note that the FX market has found ways to mitigate the key risks associated with these transactions, notably via settlement under CLS. Settlement risk will always dominate in physical settlement contracts, because 100% of the value will, by definition, change hands, whereas the replacement cost or counterparty / pre-settlement risk will be a fraction of that amount, in the order of a few percent, merely reflecting changes in the market rate.

More generally, the FX market has already attained, under its current regulatory structure, the goals of transparency, liquidity, financial security and efficiency, due in part to the proliferation of electronic trading platforms where market participants can view real time pricing data and facilitate straight through processing and confirmation of trades.

The biggest risk for FX, though, remains settlement risk, as outlined above. This is acknowledged under EMIR in Article 19. In instances where counterparties have dealt with this by using formal settlement systems such as CLS, we suggest that for short tenor contracts of three months or less, margin exchange should not be necessary. This would be consistent with the IOSCO/BCBS framework which promotes a risk-based approach to the collection of variation margin for FX contracts requiring banks to consider whether it is required in relation to replacement risk.

Rather than increasing regulatory requirements in the manner proposed, banks should be encouraged to join settlement platforms and these platforms should be encouraged to extend the range of currencies covered.

Unlike many other derivative instruments whose payment obligations fluctuate daily in response to changes in underlying variables, such as interest rates, the payment obligations of physically settled FX swaps and forwards are fixed at the onset of the agreements and involve the actual exchange of full principal for settlement. Further, the vast majority of FX swaps and forwards have short average maturities, posing significantly less counterparty risk than other derivatives, while trades are largely cash covered.

The operational consequences of implementing margining for short-dated forward FX contracts may also pose material risks to systems. This is because the number of collateral transfers will increase greatly. In addition, provision of collateral is likely to result in funds whose only use of derivatives are forward FX derivatives having to maintain higher levels of cash / near-cash equivalents resulting in lower returns for investors' assets.

Phase-in needed for variation margin

The current proposed start date, for the variation margin requirements, of December 2015, does not appropriately address the operational and technical requirements that investors will need to implement to ensure compliance with the regulatory technical standards. Whilst, OTC trades (other than forward FX) are likely to already be subject to bilateral variation

margin requirements, the legal and operational changes required by the draft regulatory technical standards make the implementation timeframe quite difficult.

We believe a phase-in similar to that for initial margin requirements would be helpful, so that most buy-side firms will have until December 2019 to implement the variation margin requirements. This is consistent with the European Supervisory Authorities' aim of minimising the regulatory impact on small to medium sized firms.

Implementation of the proposals will require a significant amount of work for counterparties, at a time when they are also still in the process of implementing quite substantial changes in other areas of EMIR, such as putting in place clearing arrangements. In particular the proposals are likely to require the following steps:

i. a wholesale review of legal requirements and documentation in place between counterparties and in many cases, the negotiation of new documentation;

ii. changes to local laws to ensure that the provisions, for instance of Article 2 LEC can be implemented by counterparties;

iii. a complete review of operational and collateral management processes and procedures;

iv. review, agreement and implementation of ratings models and initial margin models;

v. implementation of new account structures with custodians in respect of the holding of collateral received, including new documentation or changes to existing documentation; and

vi. establishment of arrangements to enable liquidation or transformation of collateral assets (for instance with repo counterparties).

Initial margin requirements

There are a couple of operational challenges in relation to the implementation of initial margin requirements:

- The proposed draft regulatory technical standards specify that initial margin needs to be collected within the business day following the execution of a new derivative contract. We request that this obligation be clarified, to state that it is the call for collateral that must be made by the end of following business day, rather than settlement of that call. We note in this regard that even cash transfers will typically settle a full day after a call, while non-cash collateral takes longer, and calls would currently be made a day after execution. An alternative would be to push the deadline back to T+3, in order to minimise any operational difficulties.

- Implementing the €50 million consolidated group level initial margin threshold is likely to create significant operational difficulties.

There remains some uncertainty as to the permanence of the €8 billion threshold in relation to the final phase-in period for initial margin. Under the BCBS-IOSCO framework, the €8 billion threshold proposed for phasing in initial margin applies on a *permanent* basis from 1 December 2019[3]. However, in the draft Regulatory Technical Standards, under Article 1, Final Provisions, paragraph 3(e) states that "From 1 December 2019, when at least one of the counterparties belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year is below €8 billion" and then in paragraph 4 that: "Only contracts entered into during the one-year period from 1 December of the year referred to in subparagraphs (a) to (e) to 30 November of the following year, may include an agreement that initial margins are not collected in accordance with the procedures prescribed in this Regulation". We note that this is inconsistent with the BCBS-IOSCO framework provisions and request that the European Supervisory Authorities amend the draft Regulatory Technical Standards to ensure that the €8 billion threshold applies on a *permanent* basis.

Appropriate use of internal models for eligible collateral and haircuts and initial margin calculation

The current proposals regarding the use of internal model for collateral and haircuts and initial margin are more appropriate for the requirements of the banking sector, and do not meet the specific needs or position of investors.

Whilst we welcome the possibility of developing internal models for initial margin and haircuts calculation, we note that the requirement that models be developed by one of the two counterparties, or jointly by the two counterparties, will in practice be unworkable. Banks are likely to be reluctant to share their models with their counterparties and whilst both parties may agree to use a bank's model, the other requirements proposed in the draft regulatory technical standards will mean that the buy-side counterparty will need to carry out

[3] Paragraph 8.7, page 24: "On a permanent basis (i.e. from 1 December 2019), any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year exceeds €8 billion will be subject to the requirements described in this paper during the one-year period from 1 December of that year to 30 November of the following year when transacting with another covered entity (provided that it also meets that condition). Any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year is less than €8 billion will not be subject to the initial margin requirements described in this paper", http://www.bis.org/publ/bcbs261.pdf

due diligence on the bank's models, in order to be comfortable that they comply with the requirements specified in the draft regulatory technical standards. Banks are unlikely to provide the level of detail required to undertake this assessment. Ironically, the more banking counterparties across which a buy-side firm diversifies its counterparty exposures, the greater the challenge as the related due diligence will need to be repeated for each counterparty. Further detail on the concerns we have with respect to the use of a counterparty internal rating based (IRB) model and the information available to buy-side counterparties is included in our response to Question 4.

Investment managers acting on behalf of institutional clients

When investment managers act on behalf of their institutional clients, they may not have sight of the details of all of the institutional clients' derivative trading relationships (notably, where a client has appointed more than one investment manager). As a result, it will be difficult for an investment manager to calculate the total outstanding derivatives notional for an institutional client with multiple investment managers; or whether the €50 million threshold for initial margin posting has been exceeded by their institutional client (who may be part of a wider group entity) at an entity level. Obtaining this information from the institutional client will be hard to document or implement operationally.

In addition, it is likely that most institutional clients with multiple investment managers will not be able to net positions with the same counterparty across separate portfolios for margin purposes. This will cause excessive margining that would be detrimental to the performance of funds.

UCITS & AIFs issues

Article 51 (1) of the UCITS Directive (2009/65/EC) requires a management or investment company to *"employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.*

It shall employ a process for accurate and independent assessment of the value of OTC derivatives.

It shall communicate to the competent authorities of its home Member State regularly in regard to the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS."

In addition, Article 15.2 of the AIFMD requires AIFMs to "implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

AIFMs must also "implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF (Article 15.3)

Therefore, both UCITS and AIFs are already subject to strict requirements in this area.

UCITS should be exempt from the proposed initial margin obligations. Article 52.1 of the UCITS Directive limits counterparty exposure to a maximum of 10% of the value of the UCITS. Furthermore, under Article 51.3, a UCITS must ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio. These risk measures reduce the impact of any counterparty default.

The ban of the re-use of initial margin is also inconsistent with the requirements of ESMA's Guidelines on ETFs and other UCITS Issues (ESMA/2012/832). Paragraph 43(j) requires cash collateral to be placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive; invested in high-quality government bonds; 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 or invested in short-term money market funds as defined in ESMA's Guidelines on a Common Definition of European Money Market Funds.

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?

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 an adequate understanding to their supervisory authority?

The use of a counterparty IRB model for credit risk assessment is not common among insurers and other investors. In most cases, they will lack the resources and expertise to develop these internal rating models. The more common industry practice is the use of external credit ratings and additional risk management tools.

However, the current proposals differentiate (in terms of collateral eligibility) between assets

in relation to which one utilises an internal model to make a credit risk assessment and those where one utilises an external provider. Whilst we understand that this is the intention of the European Supervisory Authorities, we do not believe that users of external credit risk assessments should be penalised in terms of collateral eligibility. When it comes to determining collateral eligibility, there should be no discrimination between IRB models and external credit ratings.

In instances where the banking counterparty uses an internal model, it is unclear how the buy-side counterparty will gain access to key information required in order to assess the model. In some instances, credit ratings generated by internal models could be considered intellectual property of the banking counterparty, and so they are unlikely to share this information with their buy-side counterparts.

We support an industry wide, standardised approach for both collateral and haircuts and initial margin. This will limit the potential for disputes arising between counterparties and enable greater transparency and certainty between the sell-side and buy-side. The use of a standardised approach will, of course, be consistent with the centrally cleared / CCP environment.

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?

Impact of concentration limits on management of collateral

The types of collateral currently used by institutional investors include cash, government bonds and high-quality corporate bonds. The arrangements currently in place for these buy-side counterparties focus on the quality (rather than the quantity) of collateral.

Collateral that is reflective of portfolio assets held is the preferred approach going forward. Limiting collateral to just cash would lead to well-known operational challenges, given the limited allocation that institutional investors have to cash and restrictions on the use of repos which exist in some jurisdictions. It is important that we maintain the capability to deliver eligible collateral in the most efficient manner for both counterparties.

Whilst we support the need for concentration risk to be addressed, we believe that the current proposals create a number of unintended consequences, without a clear mitigation of risk:

- Investors will have to assess whether the weights of assets in the collateral pool are in line with the concentration limits; and do this on a daily basis, regardless of whether additional variation margin is required, as the weights of assets in the collateral pool would change as a result of market movements.

- Rebalancing the collateral portfolio to meet concentration limits will likely lead to additional operational costs, unless there is a grace period in which to fulfil the diversification obligations.

- If investors are required to engage in asset transformation transactions to meet cash margins, they are likely to find this impossible in jurisdictions where: (i) use of repos is limited or even banned for certain entity types; and (ii) the only possibility of gathering cash is therefore selling assets, which in stressed market conditions would only encourage pro-cyclicality. Transformation would also generate additional costs, such as cost of guaranteed lines, borrowing / lending opportunity loss and illiquidity premiums in illiquid repo markets.

- Article 7, LEC, in the draft regulatory technical standards, states that concentration limits are meant to limit the potential for substantive losses in the value of collateral, in the likelihood of a counterparty liquidating large amounts of a single type of collateral. Hence, Article 7, LEC links concentration limits to the lack of liquidity, via the use of absolute weights. In situations where there is a small-medium sized entity posting the collateral in accordance with the concentration limits, the systemic effect of liquidating a small amount of collateral, is minimal – with or without the concentration limit. In fact the concentration limit only serves to add an extra layer of operational burden on a small-medium sized entity, without a relevant reduction in systemic risk.

- In instances where the collateral portfolio is small, as part of total assets (which is likely to be the case for a number of investors), achieving the prescribed diversification will be challenging. In line with the arguments noted above, we suggest the implementation of a de-minimis exemption, where small to medium-sized entities are exempt from the 50% cap, as they do not pose any systemic risk and should therefore not be subject to the collateral concentration limits.

- Concentration limits could encourage pro-cyclical behaviour in the following situations: when eligible collateral is not (directly) available on the balance sheet, transformation is necessary, the market is stressed, with significant market movements (variation margin), higher value at risk for initial margin and lower ratings of bonds available on the balance sheet.

UCITS issues

There are a number of issues that arise for UCITS funds from the proposed collateral requirements:

- It is only possible to post securities collateral from the assets that are part of the UCITS portfolio. If there are no eligible securities held within the portfolio then only cash collateral would be able to be posted. In addition, a UCITS would not be allowed to use a borrowed security for posting eligible security collateral under paragraph 43(i) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832).

- Paragraph 42 and 43 j) of ESMA's Guidelines on ETFs and other UCITS issues also do not allow a UCITS to use the purchase price received under a repurchase agreement for posting cash collateral or for buying eligible securities collateral.

- Introducing concentration limits on collateral will force UCITS to provide cash collateral even where eligible securities collateral is available. However, ESMA's Guidelines on ETFs and other UCITS issues, limits a UCITS's ability to access liquidity by closing its main source. These negative effects could be mitigated by either amending paragraphs 42 and 43 j) of ESMA's Guidelines on ETFs or other UCITS Issues or a provision in the draft regulatory technical standards that UCITS shall be allowed to use the purchase price under a repurchase agreement for making Initial or Variation Margin contributions.

Exemption of specific securities from concentration limits

To help minimise the impact of these operational challenges, we believe that concentration limits should *not apply to government bonds* for the reasons outlined below:

- Insurers are more inclined to receive mostly government bonds as collateral in times of market stress. A concentration limit on government bonds would add greater operational burden for such firms that in turn, would lead to higher costs for policy holders.

- Requiring investment managers or pension funds to hold non-sterling securities could require them to hold assets they do not wish to hold, thus impacting on the investment performance of the fund or scheme, possibly to the detriment of end investors or policy holders. This issue will be of particular concern to non-Eurozone members, as Eurozone members have a wider choice of sovereign issuers available.

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- The pricing of OTC derivatives reflects the economic cost of the collateral that is eligible within a specific contract. The market will price swaps that are subject to multi-currency CSA (which will be required to meet the concentration limits) differently from vanilla swaps that are collateralised in the same currency as the underlying swap exposure. This will disadvantage pension schemes or funds by increasing their funding cost and reducing their financial solvency. It will also have the effect of requiring higher levels of collateral transformation activity. E.g.: through the repo market.

We believe that there should be a higher concentration limit on corporate bonds. This would be less volatile and subject to segregation requirements. A higher limit would require less diversification and reduce the number of adjustments needed. The end result would be less onerous for investors, whilst maintaining a level of diversification (as preferred by the draft regulatory technical standards).

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?

We believe that the reuse of initial margins should be permitted as outlined in the BCBS-IOSCO framework, as long as both counterparties give explicit consent.

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