

ASSET MANAGEMENT AND INVESTORS COUNCIL

Richard Stobbo
Investment Management SC Secretariat
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

September 25, 2012

Sent by email

Dear Richard,

ESMA Consultation Paper on recallability of repo and reverse repo arrangements

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the ESMA Consultation Paper on recallability of repo and reverse repo arrangements. As explained in [its response](#) to the consultation paper on ESMA Guidelines on ETFs and other UCITS issues, the AMIC supports the creation of a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets – and more importantly strengthen the UCITS-brand.

General comments

Generally, AMIC members are concerned that ESMA guidelines are setting principles on a key topic already in discussion at other international or European bodies levels. For instance the FSB will make by the end of the year its own recommendations on securities lending and repos based on the extensive work they have undertaken under the G20 work programme. UCITS VI will also look into some of the aspects of collateral management. AMIC members believe there is a need for coherence and consistency in the approach on this topic at all regulatory levels.

AMIC members are also concerned about the limitations proposed in the guidelines, which in effect affect the UCITS access to the repo market. Restricting the ability of a UCITS to enter into non-recallable repo transactions for instance would ultimately increase frictional cost, reduce the number of counterparties willing to take on the additional risk of fully recallable repo transactions and suppress activity in the repo market. End-investors benefit most when the capital transfer mechanism is as efficient as possible; indeed efficient capital transfer mechanisms create liquidity and liquidity ultimately reduces costs for end-investors.

AMIC members are concerned by the wording of paragraph '40.e. Collateral diversification' of the guidelines on ETFs and other UCITS issues – referred to in point 3.c of the proposed guidelines. The new guidelines from ESMA could be interpreted so as to require such managers to accept collateral which is riskier and may not be as liquid in comparison to their own collateral management policy – and create new market risks.

Finally, the impact of the proposed guidelines should be considered in the context of the increased demand for cash that will result from implementation of the European Market Infrastructure Regulation (EMIR) as currently drafted. If variation margin collateral requirements under EMIR are not expanded to include highly liquid securities as well as cash, the buy-side will have to increase its use of the repo markets to raise the necessary cash to meet the CCPs' variation margin requirements. Any proposed restrictions on repo transactions would therefore impact the ability of market participants to meet the variation margin requirements under EMIR, and could lead to forced sales of assets to generate alternative sources of cash.

Specific comments

Q1: What is the average percentage of assets of UCITS that are subject to repurchase and reverse repurchase agreements? For the purposes of this question, please have regard to arrangements covered by the provisions of Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive (i.e. those arrangements which do not fall under the definitions of transferable securities and money market instruments, in accordance with recital 13 of the Eligible Assets Directive). In addition, please provide input on the following elements:

i) the extent to which assets under such arrangements are not recallable at any time at the initiative of the UCITS.

ii) the maximum and average maturity of repo and reverse arrangements into which UCITS currently enter. Please provide a breakdown of the maturities with reference to the proportion of the assets of the UCITS.

AMIC members believe that the use of repo and reverse repo by UCITS is quite limited at present. However, these transactions are likely to become much more prevalent when asset managers are required to post more liquid collateral in the future under the EMIR, and other regulatory proposals related to non-CCP cleared OTC derivatives margin calls.

Funds use reverse repo in different proportions and maturities. Money market funds are the largest user of reverse repo – these are arranged with very short-term maturities. In certain types of UCITS, 100% of the UCITS assets are invested in reverse repos and these funds are using Efficient Portfolio Management (EPM) techniques. The maturity of such

reverse repos would be on average around 6 years, but can go up to 20 years. These reverse repos are callable at any time to fulfil UCITS requirements to execute redemption requests. They are callable for the majority on a mark-to-market basis, and some of them on an accrued basis.

The rate paid by the repo counterparty is a long-term rate, when the callability arrangement is on a mark-to-market basis and therefore considered as a long-term one. Indeed, under such arrangements, the counterparty takes into account the historical redemptions statistics of the UCITS to determine an average probable length of the deal and is then able to consider the deal as a long-term funding arrangement. It is obviously not possible in the case of callability at any time on an accrued basis, since this type of arrangement is similar to overnight repos.

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

AMIC members fully agree with the global objective to mitigate systemic risk and liquidity risk. However the AMIC believes that the proposed Guidelines will hinder UCITS access to the repo market, for 3 main reasons:

The proposed guidelines might change the behaviour of UCITS counterparties.

A limit on the ability of a UCITS to enter into non-recallable repo transactions is likely to result in UCITS counterparties demanding a reciprocal right to recall assets, potentially giving rise to detrimental consequences for a UCITS and its investors. It may result in a greater tendency towards overnight repo financing, thus weakening the stability of UCITS funding arrangements. This means that a UCITS would be more susceptible to re-rates/punitive haircuts and circumstances where, to satisfy redemption requests, it is obliged to sell positions into a precipitously declining market.

Rule 2.b.i. as currently drafted is unnecessarily restrictive

More specifically rule 2.b.i. explains that '*repo and reverse repo arrangements on terms that allow the assets to be recalled at any time by the UCITS should permit the UCITS to: (i) recall the full amount of cash on an accrued basis or terminate on an accrued basis the reverse repo transaction into which it has entered*'. Such a rule is unnecessarily restrictive and will not allow end-investors to benefit from more favourable long-term rate under the arrangements described in our response to Q1. Therefore, we would suggest the deletion of this rule or the replacement of 'on an accrued basis' by 'at the valuation price'.

Inconsistencies with EMIR

With reference to applicability to repo and reverse repo of paragraph 40.e. of the Guidelines (proposed guidelines para 3(c)), AMIC members would like to highlight the inconsistency between ESMA's proposed rules with the new requirements to post Initial Margin (IM) under EMIR. Cash collateral received can be posted as collateral but non cash collateral cannot be re-used as IM.

Q3: What are your views on the appropriate percentage of assets of the UCITS that could be subject to repurchase and reverse repurchase agreements on terms that do not allow the assets to be recalled by the UCITS at any time and that would not compromise the ability of the UCITS to execute redemption requests?

AMIC members do not support the application of a specified percentage of assets of the UCITS that could be subject to repurchase and reverse repurchase agreements. Given the heterogeneous characteristics of UCITS funds, a limit that is appropriate to one fund will likely be inappropriate for another. They believe the reference in the guideline to the requirements of UCITS Article 84(1) is sufficient to ensure that UCITS will execute redemption requests. The objective of the ESMA guidelines should be to ensure that the UCITS does not incur significant cost or experience liquidity issues in unwinding EPM techniques when required to meet redemptions. AMIC members believe that to mitigate systemic and liquidity risk, it is important to ensure that an adequate portion of a UCITS assets is liquid enough to enable the UCITS to execute redemption requests. This objective is fulfilled by guideline 1.b. which requires a minimum proportion of arrangements that allow the assets to be recalled at any time by the UCITS.

Separately adding requirements regarding collateral diversification may also be damageable. Some investment managers may have decided to adopt a very conservative collateral policy, for example, only accepting the following as collateral for OTC derivative transactions: US treasuries; German government bonds; Cash. A manager might adopt this policy because, in its view, these instruments usually offer the lowest level of risk of capital loss combined with a high level of liquidity. AMIC members are concerned that the new ESMA guidelines as well as the proposed guidelines could be interpreted so as to require such managers to accept collateral which is riskier and may not be as liquid, particularly at times of market distress – and in fact compromise their ability to execute redemption requests. In fact the UCITS Directive permits a UCITS to invest 100% of its assets in securities issued by governments, suggesting that the primary UCITS legislation recognises that the usual UCITS diversification requirements are not necessary for high quality government assets. “Sufficiently diversified” in the Guidelines para. 40.e. should be in line with UCITS requirements and could consist of 100% high quality government bonds.

Q4: Do you consider that UCITS should be prohibited from entering into repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time? If not, please indicate possible mitigating measures that could be envisaged in order to permit UCITS to use repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time.

No, we do not consider that additional Guidelines are necessary to address this point.

Details of when redemption can be requested and subsequently granted typically form part of UCITS documentation. UCITS requirements already provide for sufficient safeguards regarding liquidity.

Should rule 2.b.i. be kept as it is in the consultation document and require a call on an accrued basis to pass the test of recallability at any time, would mean that all repos other than overnight repos would be forbidden for UCITS, which would deprive investors of a useful and safe instrument.

Q5: Do you think that there should be a minimum number of counterparties of arrangements under which the assets are not callable at any time? If yes, what should be the minimum number? To answer this question, you are invited to take into account your response to question 2 above.

The wording as per 3(b) which requires 'an appropriate diversification at the level of the counterparties' is sufficient. Indeed the key issue is the credit quality of the

counterparty and the quality of the collateral received to mitigate that counterparty risk. A multiple number of low quality counterparties would not reduce the risk to the UCITS, and setting a minimum number would be problematic where there is a relatively low value of outstanding transactions.

Whereas with term repo there are typically many counterparties to the trade, we would expect that number would decrease significantly for fully callable repo transactions. This would be due to fewer counterparties being willing to accept the higher degree of risk associated with unilateral re-callability. In practice it would be difficult to mandate firms to take on risk they were unwilling and/or unable to accept and ultimately contrary to sound risk management principles.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Robert Parker". The signature is written in a cursive style with a long horizontal stroke at the end.

Robert Parker
AMIC Chairman