Consultation paper

Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues

20 December 2013 | ESMA/2013/1974

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- indicate the specific question to which the comment relates and respond to the question stated;
- contain a clear rationale, clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by **31 January 2014**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper?

This document will be specifically of interest to asset management companies and trade associations of asset management companies managing UCITS, as well as to institutional and retail investors and their associations.

Table of Contents

I. Executive Summary 5
II. Management of collateral received in the context of efficient portfolio management techniques and OTC transactions. 6

Annex I: List of questions
Annex II: Cost-benefit analysis
Annex III: Draft guidelines

Acronyms used

CESR	Committee of European Securities Regulators
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
OTC	Over-the-counter
UCITS	Undertaking for Collective Investment in Transferable Securities

Executive Summary

Reasons for publication

In December 2012, ESMA published the guidelines on ETFs and other UCITS issues (ESMA/2012/832)[1] (hereafter the guidelines). Since the entry into force of the guidelines on 18 February 2013, ESMA has been asked by stakeholders on numerous occasions to reconsider its position on the requirements on collateral diversification (paragraph 43(e) of the guidelines) on the basis that they have a significant adverse impact on UCITS' collateral management policies. Stakeholders drew particular attention to the consequences for money market funds that place cash into reverse repurchase agreements.

Therefore, ESMA is publishing a consultation paper which seeks stakeholders' views on the merits of revising the requirements on collateral diversification and, should this be necessary, on the best ways to address stakeholders' concerns while retaining the appropriate level of investor protection.

Contents

This consultation paper sets out ESMA's proposal for amending paragraph 43(e) of the guidelines on the diversification of collateral received by UCITS in the context of efficient portfolio management techniques and OTC transactions. The draft guidelines are set out in Annex III.

Next steps

ESMA will take into account responses to this consultation paper in finalising the guidelines on the diversification of collateral received by UCITS in the context of efficient portfolio management techniques and OTC transactions for adoption in Q1 2014.

---

[1] http://www.esma.europa.eu/content/Guidelines-ETFs-and-other-UCITS-issues

II. Management of collateral received in the context of efficient portfolio management techniques and OTC transactions.

1. ESMA proposes to amend the provisions on collateral diversification in paragraph 43(e) of the guidelines on ETFs and other UCITS issues as set out below.

   Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, a UCITS that meets the criteria for the definition of Money Market Fund or Short-Term Money Market Fund of the guidelines on a common definition of European money market funds (Ref. 10-049)[2] may receive collateral up to 100 % of the UCITS' net asset value in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30 % of the collateral received. This derogation does not affect the other criteria for collateral management as set out in paragraphs 41 to 47 of the guidelines.

Questions

Q1. Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of money market funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

Q2. Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.

Q3. Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

[2] http://www.esma.europa.eu/content/Guidelines-Common-definition-European-money-market-funds

Annex I – List of questions

Q1. Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of money market funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

Q2. Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.

Q3. Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

Annex II – Cost benefit analysis

1. Introduction

1. Pursuant to Article 16 of the Regulation establishing ESMA[3], ESMA is empowered to issue guidelines and recommendations addressed to competent authorities or financial market participants with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervision, and to ensuring the common, uniform and consistent application of Union law. The same article obliges ESMA to conduct open public consultations regarding the guidelines and recommendations and to analyse the related potential costs and benefits, where appropriate. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.

2. Policy options

2. When developing the consultation paper, ESMA has identified the following two options for amending the rules on the diversification of collateral.

   - Option 1:

   Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its net asset value. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, UCITS that comply with the definition of Money Market Funds and Short-Term Money Market Funds of the guidelines on a common definition of European money market funds (Ref. 10-049) may receive collateral up to 100 % of their net asset value in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30 % of the collateral received.

   Option 2:

   Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its net asset value. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, UCITS may receive collat-

[3] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010.

eral up to 100 % of their net asset value in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30 % of the collateral received.

3. The likely economic impacts

3.1. Costs

Option 1: Under option 1, UCITS that do not comply with the definition of Short-Term Money Market Funds or Money Markets Funds of the guidelines on a common definition of European money market funds (Ref. 10-049) should ensure a minimum diversification of collateral of 20% of their net asset value per issuer of collateral.

Option 2: Under option 2, UCITS that do not receive as collateral transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong should ensure a minimum diversification of collateral of 20% of their net asset value per issuer of collateral.

The scope of option 2 is wider than the scope of option 1. Indeed, option 2 applies to all UCITS receiving a certain type of collateral whereas option 1 is limited to UCITS that comply with the definition of Short-Term Money Market Funds and Money Market Funds (as set out in the guidelines on a common definition of European money market funds). However, the wider scope of option 2 could increase the risk of UCITS holding collateral that is less diversified.

3.2. Benefits

Option 1: Option 1 introduces the possibility only for Short-Term Money Market Funds and Money Market Funds to receive collateral up to 100% of their net asset value that takes the form of transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Option 1 would retain the benefits of the diversification principle for the wider universe of UCITS, while recognising the specific collateral management practices of UCITS that take the form of money market funds (MMFs). In particular, Option 1 would have a positive impact for denominated Short-Term Money Market Funds and Money Market Funds that enter into reverse repurchase agreements as a form collateralised deposit because no issuer diversification would be necessary.

Option 2: Option 2 introduces a derogation for collateral that takes the form of transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. UCITS may receive up to 100% of their net asset value in such collateral without applying any issuer diversification. Option 2 would place fewer constraints on UCITS in general in terms of collateral management because no issuer diversification would be necessary if the collateral takes the form of government securities. This option would also address the potential adverse consequence of the current guidelines, namely that UCITS would be forced not to accept collateral that would generally to be considered to be of high quality simply to meet the 20% issuer limit. Option 2 would have a particularly positive impact for Short-Term Money Market Funds and Money Market Funds that enter into reverse repurchase agreements as a collateralised deposit because no issuer diversification would be necessary.

Having carefully considered the costs and benefits of both options, ESMA decided to propose the approach set out under option 1 for consultation.

Annex III – Draft guidelines

ESMA proposes to replace the text in paragraph 43(e) of the guidelines on ETFs and other UCITS issues (ESMA/2012/832) with the following text:

Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, a UCITS that meets the criteria for the definition of Money Market Fund or Short-Term Money Market Fund of the guidelines on a common definition of European money market funds (Ref. 10-049)[4] may receive collateral up to 100 % of the UCITS' net asset value in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30 % of the collateral received. This derogation does not affect the other criteria for collateral management as set out in paragraphs 41 to 47 of the guidelines.

[4] http://www.esma.europa.eu/content/Guidelines-Common-definition-European-money-market-funds