Response

Union Asset Management Holding AG

Second Consultation Paper

Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11 (15) of Regulation (EU) No 648/2012 - (JC/CP/2015/002)

10th of July 2015

A. General remarks

We appreciate the opportunity to provide our response in a second consultation regarding the Draft-RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP.

When explaining the background and rationale, the ESAs point out that not all OTC derivatives contracts will be subject to the clearing obligation or would meet the conditions to be centrally cleared and that the absence of a CCP-clearing provokes the requirement of robust risk mitigation techniques (cf. page 6 of the 2nd Consultation Paper).

Taking into account that only the "*minimum international standards on margin requirements*" shall be ensured (cf. page 6 of the 2nd Consultation Paper), one could have the impression that the given Draft-RTS are far too restrictive. This impression is supported by ESMAs Opinion published on May 22, 2015 (2015/ESMA/880). Para. 21 of the aforementioned Opinion clarifies as follows:

"In particular, under omnibus client segregation, UCITS will be exposed to both the default of the CM and of other clients of the CM."

Furthermore para. 27 substantiate as follows:

"[…] UCITS should apply a counterparty risk limit to the CM and the level should not be lower than the one for omnibus client segregation because omnibus client segregation should be considered as the clearing arrangement that provide the lowest level of protection."

ESMAs Opinion comes along with the fact that regulation does not focus of the individual risks related to an specific individual clearing model of a specific CCP. Instead all the numerous models of segregation approaches are classified as "individual segregation" and "omnibus segregation". In this context it is generally up to the individual market participant to audit the Rulebooks of numerous CCPs and to determine in how far it is protected in case of the insolvency of a CM or other clients of that CM under the relevant segregation model. "Generally" – because such audit by the market participant takes place on a voluntary basis. The broad regulatory approach by solely classifying different segregation models does not require the audit of risks related to a particular segregation model. It is not even a condition in the process of authorizing a CCP (cf. Art. 14 et seqq. of EMIR). Therefore it is seems reasonable that ESMA states within para. 27 as follows:

"*The counterparty risk limits should be proportionate to the degree of protection offered to the UCITS.*"

It is evident that from the perspective of the client of a CM, the "clearing-obligation" set-out in Art. 4 para. 1 of EMIR can be fulfilled with the outcome that (i) the initial counterparty risk towards one party is replaced by the counterparty risk towards an

unknown number of parties, (ii) one standardized method applied to the default of any counterparty to OTC derivatives (laid down in the master agreements governing the transactions) is replaced by a different complex mechanisms differing from CCP to CCP and (iii) the extent to which the client is protected in case of the insolvency of the CM is only known by those market participants who audited the relevant documentations and segregation models on a voluntary basis.

As the required Draft-RTS are only intended to lay down “minimum standards” for mitigating risks related to uncleared OTC derivatives, one must question if it is proportionate to either have these rules applying on uncleared OTC derivatives that strict or to requiring market participants to bear costs for switching into the “cleared-status” potentially reaching a less resilient level of protection.

Therefore it should be taken into account that the consideration of Credit Value Adjustments (CVA) under Regulation (EU) No. 575/2013 for uncleared OTC derivatives could not be justified anymore, if uncleared OTC derivatives would be subject to a higher level of protection than cleared OTC derivatives.

Against this background we would welcome if the ESAs would evaluate once more whether or not the requirements considered for market participants in the current Draft-RTS should be less strict.

B. Answers to the specific questions of the ESAs

I. Question 2

1. Art. 1 para. 5 VM

In practical terms it is a matter of fact that the time that lapses between a margin call and the receipt of collateral in most cases last more than one business day if non-cash collateral is posted.

The European Commission set up the “*Harmonisation of Settlement Cycles Working Group*” in 2009. Such group decided that T+1 in practical terms would be insufficient for the settlement and recommended T+2. Today the maximum period for settlement of t+2 for transferable securities which are executed on trading venues is set out in Art. 5 para. 2 of Regulation (EU) No. 909/2014.

We understand that the exchange of collateral can take place after t+1 but must take place on t+3 respectively three business days from the calculation date latest and that the risks connected with this delays shall be considered when determining the initial margin amount (cf. Art.2 para. 2 MRM). However, as the exchange of initial margins shall only be required, where the threshold of Art. 7 para 1 GEN is reached. In return where no initial margin is required, the collection of collateral shall not exceed one business day according to Art. 1 para. 5 VM .

The provision in Art. 1 para. 5 VM is extremely problematic for UCITS and their managers. UCITS and their managers would be obliged to collateralize uncleared OTC derivatives by posting cash collateral. Unfortunately ESMA has closed UCITS main source for liquidity in December 2012 and at least one NCA (German BaFin) has extended this to AIF.

It has to be born in mind that managers of UCITS and AIFs are required to invest the investors' money. Besides short term credits, which are allowed up to an amount of 10% of the total value of the relevant funds' assets, managers of UCITS and AIFs had used repurchase agreements for gaining liquidity especially required for the redemption of fund units.

One of the consequences of EMIR has been that more liquidity is required (clearing standardized OTC derivatives require the provision of cash collateral as variation margin; collateralizing uncleared OTC derivatives must take place in cash, where the UCITS respectively AIF does not contain assets that are accepted by the counterparty as eligible). The current draft of the RTS, especially Art. 2 para. 5 HC will lead to the consequence that the variety of non-cash collateral, being agreed between the counterparties as eligible collateral, is squeezed and the need for more liquidity will be further increased.

ESMA used the "instrument of a Guideline" to amend the existing European regulation of efficient portfolio techniques (repurchase agreements and security loan transactions). ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937) determine in para. 42 that the purchase price gained under a repurchase agreement is deemed to be collateral. According to para. 43 j) of the aforementioned Guidelines, "collateral" can neither be used for making collateral contributions nor for fulfilling fund redemption requests.

These Guidelines have been "ratified" by the NCAs accordingly and therefore became binding to UCITS and their managers (as well as AIF and their managers in Germany and eventually further Member States).

Accordingly it seems questionable on how the provisions set out within the aforementioned EMSA Guidelines shall interplay in an adequate manner with EMIR.

We believe that as consequence of the said provisions of ESMA's Guidelines conflicting EMIR, one will see that liquidity will not be sufficient any more in UCITS for complying with either EMIR or the redemption of fund units. As unintended consequence UCITS might respond by abstaining from either mitigating existing market risks or from investing physically, in order to have access to sufficient liquidity. In cases where UCITS are invested in non-equity instruments the ESMA-driven lack of liquidity will further force UCITS to sell assets in illiquid markets in short term which might result in worse purchase prices to the disadvantage of investors.

Art. 1 para. 5 VM will tighten the aforementioned effects of ESMA's Guidelines.

The ESAs approach for determining a EUR 8 billion threshold which is to be breached before becoming subject to the initial margin requirement seems well considered.

However, ESMA's Guidelines in combination with Art. 1 para. 5 VM will force even smallest UCITS to consider the exchange of initial margins as they could not apply the "EUR 8 billion threshold"-exemption.

Art. 11 para. 3 reads as follows:

"Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after 16 August 2012."

As the ESAs see sufficient leeway regarding the term "*timely*" for allowing minimum transfer amounts, we believe that there should also be sufficient leeway for deleting Art. 1 para. 5 VM of the Draft-RTS.

As explained in our general remarks, we believe that the intended Draft-RTS are too unbalanced in the way that the mitigation of risks associated with OTC derivatives might take precedence over the clearing of OTC derivatives via a CCP.

It has to be contemplated on the one hand that Draft-RTS are only intended to lay down "minimum standards" for mitigating risks related to uncleared OTC derivatives and on the other hand that Regulation (EU) No. 575/2013 considers Credit Value Adjustments (CVA) for uncleared OTC derivatives but not cleared derivatives. Against this background it seems questionable as to whether Art. 1 para. 5 VM is proportionate in its current version.

2. Art. 1 para. 3 EIM

For the reasons provided in our response concerning Art. 1 para. 5 VM, we believe that in Art. 1 para. 3 Sentence 1 EIM the words

"one business day"

should be replaced by

"*three business days*".

As explained in our general remarks, we believe that the intended Draft-RTS are too unbalanced in the way that the mitigation of risks associated with OTC might take precedence over the clearing of OTC derivatives via a CCP. Like already mentioned the Draft-RTS are only intended to lay down "minimum standards" for mitigating risks related to uncleared OTC derivatives. Furthermore Regulation (EU) No. 575/2013 considers Credit Value Adjustments (CVA) for uncleared OTC derivatives but not cleared derivatives. Against this background it seems questionable as to whether Art. 1 para. 3 EIM is proportionate in its current version.

II. Question 3

1. Maintenance of the option to collateralize via full transfer of title

The provision in Art. 2 para. 1 (e) LEC in association with Recital 33 is suggestive of prohibiting the exchange of collateral by full transfer of title. We do not belief that such a way is intended by the ESAs, especially with respect to variation margin contributions. For that reason clarification is required.

2. Complexity of initial margin calculations

It has to be born in mind that Art. 1 para. 5 VM is likely to lead to the effect that many market participants will not be able to abstain from making use of the exemptions related to the thresholds laid down in Art. 6 and 7 GEN (cf. our response to Question 2 regarding Art. 1 para. 5 VM). Against this background we believe that Standardised Model (cf. Art. 1 SMI) reaches a level of complexity which makes its implementation too difficult and expensive especially for those who hampered from making use of the exemptions related to the thresholds laid down in Art. 6 and 7 GEN even when being clearly below those thresholds.

III. Question 4

1. Diversification of Collateral

With respect to Art. 7 para. 4 LEC we would like to refer to the provisions in para. 43 e) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937) which has been implemented in the Member States regarding UCITS (as well as regarding AIFs in Germany).

Even when it is highly unlikely, that UCITS and their managers (respectively AIFs) will ever be a counterparty belonging to one of the categories listed in Art. 7 para. 3 LEC, it should be added to Art. 7 para. 2 LEC:

"[…] unless stricter provisions requiring the diversification of collateral apply.".

2. Collateral Valuation

According to the current draft of Art. 2 para. 5 HC, counterparties shall update their data sets and calculate haircuts at least once every three months and whenever the volatility of market prices changes materially. Furthermore, procedures shall determine ex ante the levels of volatility that trigger a recalculation of the haircuts.

We believe that the provision in Art. 2 para. 5 HC is problematic for UCITS and AIF.

First of all, reference is made to para. 45 and 46 of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937) which has been implemented in the Member States regarding UCITS (as well as regarding AIFs in Germany). Insofar, UCITS (and AIF) are already today required to consider haircuts, to measure liquidity of collateral and to consider the results from stress testing the liquidity when determining haircuts. The liquidity stress testing policy shall at least prescribe the design of stress test scenario analysis including calibration, certification & sensitivity analysis; the empirical approach to impact assessment, including back-testing of liquidity risk estimates, the reporting frequency and limit/loss tolerance threshold/s; and the mitigation actions to reduce loss including haircut policy and gap risk protection.

Insofar, the application of haircuts and measuring liquidity of collateral is not new for UCITS and their managers.

However, requiring counterparties to calculate haircuts at least once every three months and whenever the volatility of market prices changes materially is way too strict. In consequence of para. 42 and 43 j) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937), especially UCITS do not have sufficient liquidity for providing counterparties with cash collateral contributions. Though the asset universe of UCITS is limited by the constitutive documentation of the fund, the assets universe varies from UCITS to UCITS. In this light it is of high importance that the assets being part of the UCITS correspond with the list of eligible collateral. For that reason, in practice the lists of eligible collateral, being part of credit support annexes agreed regarding UCITS and AIFs are quite long (in case of our company more than 20 pages).

The provision in Art. 2 para. 5 HC requires a time consuming procedure (involving the negotiation of an update to the credit support annex with each and any counterparty) and therefore sets an incentive for counterparties to only agree on a short list of eligible collateral.

A short list of eligible collateral would mean for many UCITS and AIF that it is not possible for them any more to provide their counterparties with collateral and finally to comply with the requirements of Art. 11 para. 3 of EMIR.

In this context we would be very pleased, if ESMA could also take into account our responses in earlier consultations regarding the problems, especially UCITS face since it is not allowed any more to use the purchase price received under repos especially for making cash collateral contributions. If Art. 2 para. 5 HC remains unchanged it, will become extremely difficult, if not even impossible for UCITS to hedge existing market risks via OTC derivatives. We expect that asset managers will switch from investing physically into synthetically in order to gain the liquidity they require for protecting investors from losses resulting from market risks which will have impact on the liquidity of markets (because decreasing physical investments).

In order to avoid these unintended effects, ESMA should either waive the provision in para. 42 of its aforementioned Guidelines (in order to at least make these unintended

effects less likely) or the ESAs should amend the requirements in Art. 2 para. 5 HC by replacing the words:

"three months and whenever the volatility of market prices changes materially"

by

"year".

Moreover we would appreciate it, if the ESAs would put market participants into the position of more flexibility regarding the way haircuts are determined.

IV. Question 5

The ESAs should clarify with respect to the provision in Art. 2 para. 2 OPD that the requirement of an "independent legal review" can be achieved by internally verifying legal opinions obtained by associations representing the financial sector or a part of it.

The above recommendation would underline the importance of the legal opinions organized by organizations that have published relevant master agreement documentation. Those organizations take a neutral position. Otherwise the aforementioned framework would open the floor to discourage market participants in entering into OTC derivatives. The results might be additional (costs) and markets might become less resilient and robust where market participants restrain the mitigation of existing market risks.

V. Question 6

It is uncommon to include the reference "legally binding" regarding required arrangements (cf. Art. 1 para. 1 SEG). The provision assumes that counterparties typically enter into agreements that are void, which is wrong.

However, including the reference "legally binding" increases the risk for asset manager of UCITS and AIFs of becoming liable where a provision turns out to be void and therefore sets an incentive to mitigate the liability risk by "pro forma" mandating law firms, even where in-house lawyers could undertake the review without additional costs for the firm.

The above also makes it necessary to remove in Art. 1 SEG Para 3 the requirement of "legally binding" arrangements.

VI. Question 7

No. We currently have the following concerns:

- As explained above para. 42 and 43 j) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832, respectively in the updated version ESMA/2014/937) have led to the consequence that especially UCITS do not have access any more to their main source of liquidity. For that reason it is unlikely that UCITS (and AIF) will make cash collateral contribution where they can provide non-cash collateral.

- If a counterparty would provide cash as initial margin and the collecting counterparty would have to re-invest for the purpose to protect the collateral poster, it may become liable for any value decreases.

- The intended concept is unclear as it leaves open, whether the re-investment is to be effected for the account of the collateral poster (which may require the collecting counterparty to obtain an additional authorization from the relevant NCA) or for the account of the counterparty having collected the cash collateral contribution Last but not least it remains unclear whether or not interest must be paid on the cash collateral contribution even if it has been re-invested and who would be entitled to any proceeds resulting from the re-investment.

If the collateral poster wants to avoid being exposed to the default risk of the bank maintaining the cash account, it should invest the amount by itself and should provide the collecting counterparty with the non-cash collateral so acquired.