Comment by

Union Asset Management Holding AG

on the

ESAs' 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/JP/2014/03)

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Volksbanken Raiffeisenbanken
cooperative financial group

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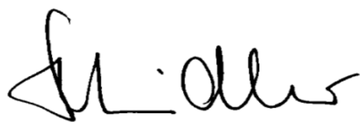
Dear Sirs and Madams,

Union Investment welcomes the opportunity to comment on Consultation Paper on “Risk management procedures for non-centrally cleared OTC derivatives” of the ESAs (JC/JP/2014/03).

We are one of the leading asset manager in Germany and asset manager of the German Cooperative Banking Network holding more than EUR 210 billion assets under management for more than 4.3 million retail and institutional clients.

Please find our comments to the questions below.

Yours sincerely



Schindler Dr. Zubrod

I. Summary

There are valid reasons for amending the proposed requirement of initial margins:

- Certain provisions in the master agreements governing uncleared OTC derivatives already mitigate the risk properly, the ESAs intend to address with the initial margin requirement. Therefore "Qualified Master Agreements" should be recognized in the RTS as an alternative to initial margins;

- Differences between cleared and uncleared OTC derivatives, to be considered by the ESAs, are resulting from the possibility of porting only given for cleared OTC derivatives;

- Especially UCITS are subject to an even tighter regulation, limiting counterparty risks more effective, which should be reflected by the ESAs with an exemption from initial margin requirements;

- G-20 accepted a remaining risk for cleared OTC derivatives and a higher default risk for uncleared OTC derivatives. The operative efforts for implementing and maintaining an initial margin regime make it for the ESAs necessary to evaluate whether a broad requirement of initial margins is an appropriate measure;

- Complying with the cover rule (Art. 51 para. 3 of Directive 2009/65/EC) should be recognized as equivalent to holding own capital;

- The default risk to be borne by the collateral taker with respect to initial margin posted in cash to a deposit makes it inappropriate to request annual legal opinions on other risks in the same chain.

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 hamper UCITS and other regulated investment funds to comply with some of the provisions of the RTS (replacement of defaulted derivatives);

- UCITS and other regulated investment funds already have to comply with concentration limits on collateral;

- The regulation of OTC derivatives (including the drafted RTS) strongly increases the requirement of liquidity. ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN) limit the access to liquidity strictly and therefore limit more and more UCITS' ability to hedge existing market risks, which are not in line with the G-20's goal of building more resilient markets.

Regarding the regulation of Minimum Transfer Amounts, clarification is required with respect to segmented funds.

II. Questions 1 to 6

a. Question 1

It is difficult to determine the costs of implementing the drafted RTS in detail yet. The number of new obligations and their scope seem to make their implementation quite expensive.

However, the costs could be reduced by considering existing regulations, practices and auditing carefully whether or not each single regulation, so drafted, means a significant mitigation of risk and therefore justifies significant costs of implementation.

b. Question 2

We believe that for the reasons explained below, the following aspects are not addressed in an appropriate manner and should be solved in an alternative way:

i. Recital 2 (Initial Margin Requirement)

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 on the drafted initial margin requirements. Such is necessary to make the RTS an appropriate measure when building more resilient financial markets.

Prior to getting into detail, we would like to summarize our key points:

- G-20 did not declare the requirement of initial margins for uncleared OTC derivatives. For that reason the ESAs should evaluate if setting initial margin requirements would be appropriate in all constellations;

- Uncleared 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. Therefore this issue is just relevant for cleared OTC derivatives. The ESAs should consider the differences between cleared

and uncleared OTC derivatives prior stipulating any initial margin requirements for uncleared OTC derivatives.

- G-20 accepted that market participants will use uncleared OTC derivatives in 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 would have a negative impact on G-20's goal to building more resilient financial markets;

- The regulators accepted that even with respect to cleared OTC derivatives a counterparty risk remains. 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 (which is lower than regarding cleared OTC derivatives) is acceptable;

- The overall goal of G-20 was to build more resilient financial markets. UCITS and other regulated investment funds are already subject to even tighter regulation. Prior to establishing initial margin requirements for all market participants, the ESAs should determine if it would be more appropriate to release certain market participants from the obligation to consider the exchange from initial margins, especially if initial margin requirements would not be that relevant for the protection of excessive losses following a counterparties default.

Prior to providing the Commission with drafted RTS considering initial margin requirements, the ESAs should once more evaluate, whether initial margin requirements are an appropriate measure in all constellations to create a more resilient financial system.

1. G-20 did neither request the consideration of initial margins for uncleared OTC derivatives nor are these required in all cases

G-20 did not set a requirement for initial margins. G-20 just aimed to build a more resilient financial system (G-20, Cannes summit final declaration, para. 24):

> *"Reforming the over the counter derivatives markets is crucial to build a more resilient financial system. All standardized over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and centrally cleared, by the end of 2012; OTC derivatives contracts should be reported to trade repositories, and non-centrally cleared contracts should be subject to higher capital requirements. We agree to cooperate further to avoid loopholes and overlapping regulations. […].We call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) together with other relevant organizations to develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012,*

and on the FSB to continue to report on progress towards meeting our commitments on OTC derivatives."

(Markings by the editor of this comment)

G-20 considered correctly, that unstandardized OTC derivatives remain necessary, because they are perfectly tailored for the needs of market participants. With respect to those uncleared OTC derivatives, G-20 only requested the consideration of higher capital requirements as well as the development of standards on the margining in order to build a more resilient financial system.

We believe that the ESAs share our opinion that a financial system is more resilient if existing risks are mitigated and that "initial margin requirements" shall address the requested "development of standards on the margining".

The ESAs explain in Recital 2 the purpose of an initial margin as protection as follows:

"against losses occurring after the default of the counterparty, which could stem from movements in the market value of the derivatives position before a replacement contract is entered."

At this point, we would like to differentiate between cleared OTC derivatives and uncleared OTC derivatives. Uncleared OTC derivatives are subject to standardized Master Agreements. Those include provisions like the follows:

"The Agreement shall terminate, without notice, in the event of an insolvency."

(no. 7 para. 2 Sentence 1 of the German Master Agreement for Financial Derivatives Transactions)

[…]

"In the event of Termination, the party giving notice or the solvent party, as the case may be, (hereinafter called "Party Entitled to Damages") shall be entitled to claim damages. Damages shall be determined on the basis of replacement transactions, to be effected without undue delay, which provide the Party Entitled to Damages with all payments and the performance of all other obligations to which it would have been entitled had the Agreement been properly performed. Such party shall be entitled to enter into contracts which, in its opinion, are suitable for this purpose. If it refrains from entering into such substitute transactions, it may base the calculation of damages on that amount which it would have needed to pay for such replacement transactions on the basis of interest rates, forward rates, exchange rates, market prices, indices and any other calculation basis, as well as costs and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be.[…]."

(no. 8 para. 1 of the German Master Agreement for Financial Derivatives Transactions; Markings by the editor of this comment)

This means:

OTC derivatives end automatically with the insolvency of one of the counterparties. Claims are calculated on basis of replacement transactions or hypothetical replacement transactions taking place with undue delay.

The mechanism is different for cleared OTC derivatives. It is our understanding that the required possibility of portability leads to the circumstance that cleared OTC derivatives cannot be closed-out in the same time frame than uncleared OTC derivatives. Therefore, initial margins make sense in the context of cleared OTC derivatives but not for uncleared OTC derivatives.

For the reasons given we believe that an initial margin requirement should only be relevant where parties of uncleared OTC derivatives have not agreed that all OTC derivatives end automatically in case of an insolvency. In all other cases, we do not see a relevant risk which needs to be mitigated in order to make the financial markets more resilient.

Please also see our suggestion regarding a new para. 3a of Art. 2 GEN as well as a new subpara. (o) under Art. 1 DEF para. 1.

2. Accepted counterparty risk regarding cleared OTC derivatives

When G-20 stated that non-centrally cleared contracts should be subject to higher capital requirements (please see above), it seems that G-20 expected and already accepted that uncleared OTC derivatives may remain subject to higher risks than cleared OTC derivatives.

The ESAs should also be aware that even regarding cleared OTC derivatives, the counterparty risk is not fully eliminated, which also is accepted.

We would like to point-out two examples (keeping in mind that there are various further examples which very much depend on the relevant CCP and the selected segregation model):

- If a Clearing Member goes bankrupt after it has received a Variation Margin from the CCP but before the Variation Margin was forwarded to the relevant Client, the Client suffers a loss as consequence of the Clearing Members default;

- If a Client has provided a collateral contribution to its Clearing Member and that Clearing Member becomes bankrupt before it was able to forward the Client's collateral contribution to the CCP, the Client suffers a loss as consequence of the Clearing Members default.

If there were not any remaining counterparty risks, market participants subject to Art. 306 para. 1 lit. a) of Regulation (EU) 575/2013 would not be obliged to consider at least a 2% risk to be covered by equity capital.

3. Some Counterparties are already subject to a tighter regulation

UCITS and other regulated investment funds are already subject to a regulation which is tighter than the regulation other market participants need to comply with, especially when the counterparty risk is being concerned.

It is one key element to risk mitigation measures obligatory for UCITS and other regulated investment funds that they have to comply with risk limits:

- The counterparty exposure related to derivatives, security loan transactions and repurchase agreements in total is not allowed to exceed 10% of the investment funds value (cf. Art. 52 para. 1 of Directive 2009/65/EC). This does also mean that UCITS and other regulated investment funds have to consider the counterparty risks regarding any over-collateralization provided (a limit other market participants do not have to comply with).

- The above exposure as well as any exposure arising from securities issued by the counterparty (e.g. bonds) and the default risk related to bank accounts maintained at the counterparty shall not exceed 20% of the investment funds value (cf. Art. 52 para. 2 of Directive 2009/65/EC).

There are further obligatory risk mitigation measures, UCITS and other regulated investment funds already have to comply with (e.g. maximum leverage, the cover rule set out in Art. 51 para. 3 of Directive 2009/65/EC, concentration limits regarding collateral).

All of these obligatory risk mitigation measures further reduce and limit the risk of losses resulting from the default of a counterparty.

Building a more resilient financial system does also mean to identify parts of the “financial building” which are not required being part of a “refurbishment”.

For G-20 appropriateness has been an important issue (please see above). Considering the (existing) additional risk mitigation measures obligatory for UCITS and other regulated investment funds make it necessary to release those from any initial margin requirement. Otherwise the requested risk mitigation techniques would not be appropriate at least with respect to UCITS and other regulated investment funds.

Please also see our suggested amendment of Art. 1 GEN.

ii. Recital 3 (investment funds)

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

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). 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, complying with the cover rule is an equivalent to holding own capital.

iii. Recital 5 (segmented investment funds)

We welcome the ESAs view that the threshold relevant for the question whether or not to exchange of Initial Margin contributions needs to be considered for each investment funds separately.

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 (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 investors the possibility having its investment fund managed by more than one asset manager, 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 distinct entity.

iv. Recital 5 (Insolvency)

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 para. 3 of EU Directive 2009/65/EC) does not mean that the threshold always needs to be applied on level of the asset management company ("*investment advisor*" in Recital 5).

EMIR defines UCITS and AIF as separate Financial Counterparties (who are subject to the obligations, the RTS intend to further clarify) and does not differ between investment funds established in accordance with contract law or statute. Leaving the level of the investment fund in single aspects of EMIR would create uncertainty regarding any obligation under EMIR as to whether it applies to the investment fund or the asset management company.

For that reason it is necessary to provide clarification to avoid any misinterpretations of EMIR.

v. Recital 9 and Art. 2 LEC para. 1 (d) (Repos)

The ESAs deem it important that the collateral taker is able to liquidate the collateral and use the cash proceeds to replace the defaulted derivative contract by an equivalent contract with another counterparty. The ESAs state:

> *"The pre-existing access to the market should enable the collateral taker to either sell the collateral or repo it within a reasonable amount of time. This capability shall be ensured independently from a possible default of the collateral provider, e.g. by having broker arrangements or repo arrangements with other counterparties than the collateral provider […]."*
>
> (Recital 9, Markings by the editor of this comment)
>
> "Risk management procedures of the counterparty receiving collateral shall include the following operational and technical capabilities: […]
>
> (d) access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions and in the case of default of the collateral provider;"
>
> (Art. 2 LEC para. 1 (d) Markings by the editor of this comment)

According to ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN) respectively their implementation into national law, regulated investment funds, such as UCITS, lost their ability to use the purchase price received under a repurchase agreement for the replacement of the defaulted derivative contract by an equivalent contract (cf. paragraph 42 and 43 j) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN)).

Without either overwriting or amending the said Guidelines of ESMA, at least UCITS might have problems to comply with Art. 2 LEC para. 1 (d).

With the aforementioned Guidelines, ESMA also cut away UCITS' most important liquidity source (cf. our response to **question 5 (ii)**). In light of the increased demand for liquidity following the regulation of OTC derivatives the Guidelines have the potential to hamper UCITS from hedging risks arising from the portfolio via derivatives (lack of liquidity required for collateralization) and therefore make financial markets less resilient.

G-20 pointed out that overlapping regulation should be avoided.

Art. 13 para. 1 of EMIR sets out:

> *"The <u>Commission shall be assisted by ESMA in monitoring and preparing reports</u> to the European Parliament and to the Council on the international application of principles laid down in Articles 4, 9, 10 and 11, <u>in particular with regard to potential duplicative or conflicting requirements on market participants, and recommend possible action.</u>"*

We believe that when submitting a draft of the RTS concerning risk mitigation techniques to the Commission, the ESAs should consider the requirement to amend to ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN) in a way that UCITS are allowed to use the purchase price gained under a repurchase agreement at least for entering into the aforementioned replacement transactions as well as for making cash collateral contributions.

An alternative would be to clarify in the RTS that UCITS are allowed to use the purchase price gained under a repurchase agreement at least for entering into the aforementioned replacement transactions as well as for making cash collateral contributions. As regulation, the RTS would overwrite any conflicting provision in ESMA Guidelines.

vi. Article 1 DEF para. 1 (b)

Article 1 DEF para. 1 (b) should be supplemented as follows:

"[…], as the case may be, *<u>other than the purchase price gained under a repurchase agreement;"</u>*

This amendment is necessary to overwrite para. 42 of ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN) which reads as follows:

> *"All assets received by UCITS in the context of efficient portfolio management techniques should be considered as collateral for the purpose of these guidelines and should comply with the criteria laid down in paragraph 43 below."*
>
> (Paragraph 43 limits the usage of collateral received)

As explained above (cf. II. b) v. of our comment), the said Guidelines are conflicting regulation prohibiting UCITS to use the purchase price under a repurchase agreement for making cash collateral contributions and undertaking replacement transactions in the manner of Recital 9 and Art. 2 LEC para. (d) of the drafted RTS.

As it was one of the goals of G-20 to avoid overlapping regulations and to build more resilient financial markets, we believe that this amendment would support both goals of G-20.

vii. Art. 1 GEN (new para. 4)

Article 1 GEN should be supplemented by the following new paragraph 4:

> *“4. For derivative contracts with UCITS and other financial counterparties subject to requirements equal to those laid down in Art. 52 para. 1 and 2 of Directive 2009/65/EC it is not mandatory to collect initial margins.”*

In order to accommodate the appropriateness of the RTS it is necessary to release OTC derivatives with UCITS and financial counterparties subject to requirements equal to those laid down in Art. 52 para. 1 and 2 of Directive 2009/65/EC form any initial margin requirement.

The costs and efforts for collecting initial margins are expected to be high. The overall goal of G-20 has been to build more resilient financial markets. Nevertheless, G-20 also accepted that not all and any risks can be eliminated and that any measures shall be appropriate.

The provisions of Art. 52 para. 1 and 2 of Directive 2009/65/EC respectively their implementation into national law already ensure that UCITS and other regulated investment funds have to consider all default risks related to a certain counterparty and to comply with limits.

In light of the said provisions, UCITS already consider

- the default risk regarding any overcollateralization provided (derivatives),
- minimum transfer amounts (derivatives),
- the default risk of the broker mandated for maintaining exchange traded derivatives on exchanges,
- the issuer risk regarding securities issued by a counterparty or a company of the same group and purchase for the investment fund,
- the default risk related to bank deposits held with a counterparty (counterparties of OTC derivatives are concluded typically with banks),
- any counterparty risks related to securities loan transactions,
- any counterparty risks related to repurchase agreements,

The sum of all these risks shall not exceed 20% of the investment funds volume.

The counterparty risks arising from derivatives are not allowed to exceed 10% of the investment fund’s volume.

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If the UCITS counterparty is not a credit institution, the said limit is not 10% but 5 %.

In light of these limits it is already ensured that the default of one counterparty has a very limited direct impact (especially if one considers that typically the dividend paid by the liquidators is clearly above zero per cent).

We believe that the high degree of existing regulation already ensures that sufficient protection must be considered in order to establishing appropriate RTS.

viii. Art. 2 GEN (new para. 3a) and Art. 1 DEF (new para. 1 (o))

Article 2 GEN should be supplemented by the following new paragraph 3a:

> *"3a. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties may instead agree in writing or equivalent permanent electronic form with its financial or non-financial counterparties that all OTC derivatives between them shall be subject to a Qualified Master Agreement."*

Art. 1 DEF should be supplemented by the following new paragraph 1 (o):

> *"(o) 'Qualified Master Agreement' means a standardized master agreement, setting out an automated early termination in case of the insolvency of one of its parties as well as a close-out netting provision, by which claims are calculated on basis of replacement transactions, to be effected without undue delay or hypothetical replacement transactions which are deemed being effected without undue delay."*

According to the ESAs explanation, initial margins shall mitigate the risk of losses occurring after the default of the counterparty, which could stem from movements in the market value of the derivatives position before a replacement contract is entered (cf. Recital 2).

Typically standardized master agreements, governing OTC derivatives include provisions, already mitigating this risk properly (cf. our citation of provisions of the German Master Agreement for Financial Derivatives Transactions, included in our comment on Recital 2).

Since any measures taken in order to build more resilient financial markets shall be appropriate, we deem it necessary to include these additional provisions in the RTS.

ix. Art. 2 GEN para. 3

It should be clarified that a determination on level of the investment fund (cf. Recital 5) shall also apply as far as Art. 2 GEN para. 2 refers to a "group".

According to Art. 2 GEN para 3 but also Recital 3, a counterparty shall have the choice either to post / collect (initial) margins or holding own capital if the amount of initial margin is below the threshold of EUR 50 million.

Investment Funds are subject to the cover rule (cf. Art. 51 para. 3 of Directive 2009/65/EC and CESR consultation 10-108). That means, they are only allowed to enter into derivatives which can be fulfilled with the assets of the investment fund. Therefore, the ESAs should clarify in Art. 2 GEN and Recital 3 that in case of investment funds, complying with the cover rule is an equivalent to holding own capital.

x. Art. 6 MRM para. 2 and Art. 1 SEG para. 5

We believe that it is problematic to ensure that initial margin contributions are made legally valid, at least if they shall be in compliance with Principle 5 of BCBS' consultation paper on margin requirements for non-centrally cleared derivatives, considered in Art. 1 SEG para. 1-4.

If initial margins shall be segregated from the regular collateralization, such can only take place via the pledge of collateral or by appointing a trustee. The trustee arrangement must be in compliance with the relevant insolvency laws. A similar situation would be given with respect to the pledge of security collateral. The pledge is subject to the national law of property. Furthermore there is legal uncertainty regarding the applicable law of property when the relevant security is certified in a multiple share document.

Auditing all these aspects with respect to all relevant jurisdictions is time consuming and extremely expensive. For that reason, we fear that financial counterparties will limit the scope of collateral eligible for providing initial margins very much. It is likely that initial margins will be limited to cash collateral. In consequence of ESMAs Guidelines on ETFs and other UCITS issues, UCITS and other regulated investment funds have very limited access to liquidity (cf. our response to **question 5 (ii)**) which is extremely problematic which we have already stressed at other parts of our comment).

The ESAs intend to allow cash as being eligible for making initial margin contributions. Cash amounts are deposited with banks (third parties). Such deposit creates a default risk for the collateral taker which typically is not mitigated. Currently the ESAs just focus on the relationship between the collateral provider and the collateral taker but do not consider the new risk the receiver of cash collateral becomes subject to (and has not been before). Such risk is equal to the risk of the provider of a cash initial margin contribution made by it.

Hence, it would be disproportionate to require market participants auditing a potential default risk, if the default risk related to the deposits of the cash collateral contribution is not considered by ESAs.

We would therefore suggest either refraining from requesting initial margins in cash or deleting Art. 1 SEG para. 5.

xi. Art. 7 LEC para 1

For UCITS and further regulated investment funds, subject to national regulation, there are already obligatory concentration limits on collateral in place (cf. para. 43 e) of ESMAs Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN).

Since overlapping regulation is to be avoided, it should be clarified by the ESAs, which rules UCITS shall be bound by in this regard.

xii. Art. 1 SEG para. 2

In case of investment funds the requirement laid down in Art. 1 para. 2 could cause operational problems.

If one asset management company manages 1,000 investment funds and uses 20 counterparties, the mentioned provision would lead to the consequence that 20,000 accounts are to be opened.

The ESAs should evaluate whether the annual operation costs related to initial margins (accounts, transfers, trustee agreements, and legal opinions) are higher than the volume of risk they shall mitigate.

xiii. Art. 1 FP

It should be clarified that a determination on level of the investment fund (cf. Recital 5) shall also apply as far as Art. 1 FP refers to a “group”.

c. Question 5

i. Existing regulation

As Asset manager we already consider concentration limits on collected collateral. Reference is made to paragraph 43 e) of ESMA’s Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN) which has been implemented by the German supervisory authority BaFin not only for UCITS.

In case that the intended RTS will differ from paragraph 43 e) of ESMA’s Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN), the ESAs should evaluate if the intended differences justify to impose the costs of implementation on those who recently have been obliged to implement a similar regulation. At least market participants having implemented para-

graph 43 e) of ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/832EN) should have the option to either remain with the already implemented concentration limits or to implement the new requirements on concentration limits.

ii. Limited access to collateral following overlapping regulation

The ESAs should bear in mind that quite 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.

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 para. 2 of Directive 2009/65/EC, Member States have authorized UCITS and other regulated investment 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 (ESMA/2012/ 832EN) 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 ESMA's Guidelines on ETFs and other UCITS issues (ESMA/2012/ 832EN), 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 (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.

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

- According to Art. 11 para. 3 EMIR, it is necessary to collateralize uncleared 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 uncleared 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 para. 2 of the Draft RTS will set an incentive for banks only to accept cash collateral as Initial Margin for uncleared OTC derivatives.

- The clearing obligation under MiFIR as well as Art. 30 para. 1 MiFIR will lead to the circumstance those 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.

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

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 (ESMA/2012/ 832EN) 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 G20's goal. (cf. G20, Cannes summit final declaration, para. 24).

According to Art. 5 para. 3 LEC of the Draft RTS it also seems ESAs' opinion that UCITS should remain able to use derivatives for hedging permitted investments. As it has never been the intension of G-20 to limit the market participants' ability to hedge existing market risks, we 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 (Articles 42 and 43 j) 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.

d. Question 6

Currently it is prohibited for regulated investment funds, such as UCITS, to re-hypothecate, re-pledge or otherwise re-use collateral received.

When it is allowed under the RTS to fulfill 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 an uncleared 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.