BLACKROCK

17 October 2014

Adoption of ESMAs revised guidelines on ETFs and other UCITS issues
Markets Policy Division
Central Bank of Ireland
Block D
Iveagh Court
Harcourt Road
Dublin 2

Submitted via email to: fundspolicy@centralbank.ie

RE: CBI Consultation on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues (Consultation Paper CP 84)

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to the Central Bank of Ireland's Consultation on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 30 September 2014, the assets BlackRock manages on behalf of its clients totalled €3.6 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public and private sector pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.

BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy changes and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and we will continue to contribute to the thinking engaging with the Central Bank of Ireland ("CBI") on any specific issues that may assist in improving the final rules.

Key points

Scope of change

We do not believe that the proposed changes should be limited to money markets funds and recommend the CBI apply the ESMA guidelines to all UCITS collateral arrangements. We believe the scope of the proposed exemption should be extended to all UCITS funds which receive government securities as collateral. This may occur, for example, by the use of techniques such as securities lending or reverse repurchase agreements (examples of "efficient portfolio management" techniques, or EPM), or where the fund receives collateral from derivative counterparties when it enters into OTC derivative transactions. We support the detailed arguments made by the IFIA in this respect.

Credit rating and quality of collateral

We note that collateral management processes rely on a high degree of automation and on the establishment of clear and pre-defined collateral schedules between manager and third party collateral agents. A high degree of automation is required to ensure investors' interests are protected as efficiently as possible. A number of the CBI's proposed rules contain a degree of subjectivity which is hard to accommodate in an automated system and would require the key triparty collateral agents - to deliver significant system changes to support. While the manager always has the right to change collateral schedules, any change requires recoding in either the bilateral or triparty collateral systems with the result that managers tend to set collateral requirements in a way which allows them to meet their overriding duty to investors over the longer-term (removing the need for regular updates) ensuring continued liquidity and creditworthiness of collateral received while maximising operational efficiency. A number of the proposals are likely to increase the level of interaction between the UCITS and its counterparties on a day-to-day basis which will reduce operation efficiency and add unnecessary cost to the process while not, in our view delivering additional benefits to the investor.

On the other hand, hard coding specific credit ratings seems to run counter to current regulatory calls to avoid a mechanistic reliance on credit ratings and we would recommend a reference to collateral of the highest quality which will achieve the same result without imposing a procyclical approach to potential credit downgrades.

Timing

We would welcome a clear position from the CBI on timing. While the existing domestic waiver from applying the full diversification rules to money market funds was strongly welcomed by the industry we are working on the assumption that it has been extended until the implementation date of the new Irish rules rather than the official ESMA implementation date to ensure clean implementation of the new regime.

While fund managers have been working to prepare to implement changes on the basis of the ESMA Q&A, any inconsistency with the rules such as those on credit eligibility will require additional operational capability to be built and tested. We would strongly urge the CBI gives sufficient time (our recommendation would be at least 2 months between the finalisation of the rules and their implementation) to allow suitable implementation by the industry. We have been in contact with a number of triparty collateral AGENTS in advance of the rule changes and they have indicated the need for further clarity as to the final form of the rules before finalising any necessary system changes.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation Paper and will continue to contribute to the thinking of CBI on any specific issues arising out of this consultation.

We would welcome any further discussion on any of the points that we have raised.

Yours faithfully,

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Responses to questions

1. Do you agree that the concerns of the Central Bank outlined in this paper are valid?

The concerns raised by the Central Bank are similar to those raised by ESMA earlier last year and we believe that the concerns have been sufficiently addressed in the final form of the ESMA guidelines. We would urge the CBI to implement change to its Rulebook in a manner which is consistent with the position taken by ESMA. This will ensure consistency in the collateral management process of UCITS across major European fund domiciles, contributing to operational efficiency and investor confidence.

In particular, we do not support mandating specific credit ratings as this is likely to lead to an automatic move to sell off collateral as soon as there is a ratings change which is likely to have a procyclical effect. Comparable regulatory requirements made by other EU regulators refer to the highest credit quality without actually mandating a specify rating and we would recommend that this form of wording is adopted.

2. Do you consider that the Central Bank should implement the ESMA guidelines but limit the derogation to UCITS MMFs?

No – we believe that both MMF and non-MMF's should be given the option to adopt the terms of the derogation to ensure a consistent approach to collateral management across efficient portfolio management techniques (EPM) techniques that may be employed within a single UCITS.

At the time of the ESMA consultation earlier this year we expressed a clear preference for ESMA's Option 2 by expanding the derogation to all UCITS which receive government securities as collateral. This may occur, for example, by the use of EPM techniques such as securities lending or reverse repurchase agreements or where the fund receives collateral from derivative counterparties when it enters into OTC derivative transactions. We were very supportive of ESMA's decision to agree with this position.

The primary criteria regarding collateral to manage risk exposure in EPM techniques is liquidity and stability in times of market stress. Sovereign debt has always been and continues to be seen as the most desirable form of collateral. If the 20% diversification restrictions remains in place, non-money market UCITS will be forced to restrict the amount of sovereign debt they can accept as collateral from a single government issuer. This may lead to a number of adverse consequences:

- Investors in UCITS funds that engage in EPM techniques expect their lending agents and other service providers to take reasonable steps to control risk and to protect investor interests. Historically, they have done so by limiting permitted collateral to only high-quality, liquid securities such as sovereign debt.

- Without the derogation, the ESMA Guidelines will restrict lending agents' ability to take sovereign debt as collateral, a result that is counter-intuitive from an investor protection perspective. To obtain appropriate levels of diversification in high quality government issuers as required by Guideline 43 (j), managers in many cases would be forced to take on exposure to currencies other than those of the base currency of the fund. To avoid taking on this currency risk the alternative is to hold higher levels of cash deposits but this then comes with increased credit risk to the deposit-taker which is not in investors' interests.

- Collateral is the 'insurance' managers require to make investors whole in the event of failure to return the securities. The key driver for collateral is the speed at which collateral can be liquidated in order to buy back lent assets on a failure of redelivery. This favours the inclusion of very liquid or short-term instruments such as government securities. As borrowers find it increasingly complex to finance the required diversified pool of collateral, they may look at cash collateral as a replacement solution, which is not palatable to many European funds because of the extra credit risk of having cash on deposit or reinvested.

The result would be, for example, a drop in Securities Lending balances and the subsequent revenues for those UCITS who are not willing to accept cash.

3. Do you agree with the proposed rule to be included in the UCITS Rulebook? Is there another way to achieve a satisfactory risk mitigation effect?

Blackrock views the credit rating of the instrument received as only one component of the overall assessment of collateral quality. We consider it in the interest of the UCITS to not rely solely upon the rating of a sovereign or organisation when assessing the appropriateness of collateral - this approach may greatly reduce the breadth of available collateral instruments. We believe that the securities accepted as collateral to support clients' open counterparty exposures should be sufficiently liquid and of sound quality rather than being subject to a specific ratings measure.

Whilst we do not agree with the proposed amendments should, however, the CBI wish to retain reference to specific credit rating we recommend that:

- the CBI further clarify the Proposal and in particular to state at which point the requirement to apply a minimum rating to collateral received would be applied
- the CBI confirm whether, when referencing collateral quality, they are referencing long or short-term ratings. We believe that the reference should be to short term ratings to be consistent with the references to short term ratings earlier in the consultation.

We are also concerned by the countercyclical effect of the guidance on action to be taken in the event on "deteriorating credit quality". Would this still apply if a jurisdiction was downgraded from AAA? This type of downgrade would be an indication of deteriorating credit quality which according to the proposed rules would force the UCITS to "put into action a plan promptly to remedy its exposure to that collateral of deteriorating quality in an orderly manner and will prioritise the reduction of its exposure to any collateral counterparty who represents more than 20% of the collateral held." However an AA exposure would still be creditworthy so it would seem reasonable not to reduce exposure in this circumstance.