IRISH FUNDS INDUSTRY ASSOCIATION

Submitted via email to:
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Markets Policy Division
Central Bank of Ireland
Block D
Iveagh Court
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17 October 2014

Re: CP 84: Consultation on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues

The Irish Funds Industry Association (IFIA) is the industry association for the international investment fund community in Ireland, representing custodians, administrators, managers, transfer agents and professional advisory firms.

Ireland is a leading centre for the establishment of UCITS in Europe with approximately €1,207 billion in Irish domiciled UCITS at the end of August 2014. Ireland is also the leading European centre for ETFs, with approximately €200 billion in assets under management in Irish domiciled ETFs, accounting for more than 44 per cent of all European domiciled ETFs. More than 13,000 people are employed in the administration, custody and servicing of funds in Ireland, making the funds industry the single largest sector within Ireland's international financial services sector by employment. Accordingly, all developments in both the UCITS and ETF arena are of particular importance to the Irish industry and, ultimately, to Irish jobs and changes in this area which are out of step with the rest of the EU must be considered cautiously to avoid jeopardising Ireland's market leading position.

We believe that the amendments to ESMA's revised guidelines proposed by the Central Bank in CP 84 constitute 'goldplating' in going beyond EU-wide requirements and creating an uneven playing field. The proposed changes would mean that Ireland's rules on UCITS collateral would be substantially different to and in conflict with those of other EU Member States, to the detriment of Ireland's attractiveness as a UCITS domicile.

We are strongly opposed to the amendments proposed in CP 84 and have outlined our concerns within our responses, which include the feedback which we have received from leading UCITS and ETF managers, their advisors and service providers.

We would welcome the opportunity to discuss any aspect of our concerns with the proposals outlined in CP 84 with the Central Bank.

Yours sincerely,

Patrick Lardner
Chief Executive

Annex I: IFIA responses to individual questions raised under CP 84

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

We understand the concerns of the CBI, however, we do not believe that these concerns merit the approach taken under the proposed amendments to the UCITS Notices.

The IFIA's view in relation to collateral is that liquidity, valuation, correlation and quality of collateral are the most important elements in providing investor protection, while also accepting that diversification provides some limited additional protection. In this respect, it is important to remember that the function of collateral is to mitigate counterparty risk and not to achieve a diversified or well-balanced pool of collateral. ESMA's guidelines on ETFs and other UCITS issues (the "ESMA Guidelines") already provide extensive safeguards in relation to the receipt of collateral arising from OTC derivative transactions and EPM techniques, which are appropriate in addressing the concerns identified by the CBI. In addition to criteria on liquidity, valuation, issuer credit quality and correlation, the ESMA Guidelines embed collateral management in the UCITS risk management process, include stress testing for collateral where this amounts to at least 30% of NAV and mandate a haircut policy. We believe these requirements ensure that a UCITS will take appropriate action in the event of a deterioration in the credit quality of sovereign collateral held by the UCITS.

We have set out below several reasons why we believe that the CBI's proposed additional requirements in response to concerns over sovereign collateral would be misguided, disproportionate and damaging to the UCITS industry.

ESMA has already given extensive consideration to UCITS collateral requirements

During the process of producing and reviewing their guidelines, ESMA had many opportunities, based on industry submissions, to make the quality of collateral received by UCITS the focus of its minimum standards for collateral. However, ESMA determined that it was not necessary to do so and was satisfied to keep such aspects as "quality" and "liquidity" as broadly defined terms, without applying any particular parameters or restrictions around them. We feel that this is a sensible and reasonable approach to take in this area. By contrast, the Central Bank's proposals as contained in CP 84 will mean that an additional layer of requirements on how "quality" should be determined will be imposed solely on UCITS authorised in Ireland.

Impractical and subjective nature of the requirements proposed

Collateral management arrangements for UCITS are, in the majority of cases, highly automated, high volume processes. In other words, a defined set of minimum parameters for acceptable collateral is agreed with the relevant counterparty (e.g. defined rating, liquidity requirements, applicable haircuts, correlation limits, diversification requirements etc.) which is then permitted to post collateral to the UCITS that fall within such defined parameters on an ongoing basis and without repeated reference back to the UCITS. Accordingly, it is critical that such parameters are capable of being defined clearly and agreed with the relevant counterparty, so that (a) the collateral arrangements can operate and be monitored in a systematic, definitive way; and (b) legal entitlement of the UCITS to request additional collateral or replacement collateral and in the event of a credit event can be assured and enforced.

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However, the draft UCITS Notice included in CP 84 indicates that each UCITS will be expected to take repeated individual, subjective decisions on each and every collateral position on the basis of imprecise and ambiguous criteria (e.g. "apply more detailed assessment of that collateral" / "where there is evidence of deteriorating credit quality of collateral held, the UCITS will put into action a plan to reduce any such exposure" / "unless the board of management company/investment company, explicitly and specifically on each occasion a decision is to be made, decides, otherwise.." etc.). While we have considered the wording of the proposed amendments to the UCITS Notice in greater detail below, on a more general level, this is simply not reflective of how collateral arrangements work globally and would introduce a significantly more inefficient, cumbersome and expensive process for managers of Irish UCITS.

Disproportionate effects on counterparty arrangements and contrary to investors' best interests

Imposing such requirements would greatly increase the amount of interaction required between the UCITS and its counterparties on a day-to-day basis, to ensure that the counterparty was aware of and prepared to continue to trade with the UCITS on the basis of collateral requirements which could change from day to day and with a high degree of subjectivity. In the event that counterparties were not prepared to accept such subjective decisions about the acceptability of certain securities as collateral, their trading arrangements with the UCITS would have to be terminated, again adding to the administrative, operational and cost burdens on the manager.

This would significantly detract from what currently functions as an efficient and systematic process and, if such additional processes were required, a material level of resources and focus would have to be diverted from UCITS managers' core mandates of managing the UCITS' investment exposure in an appropriate manner, which we do not believe would be in investors' best interests. Furthermore, the CBI's proposed requirements in relation to a deterioration of credit quality could have paradoxical outcomes in prioritising diversification over quality. This could ultimately lead to a reduction in the overall credit quality of the pool of collateral held by the UCITS, which would also run contrary to the best interest of investors (see 3.D2 for more information). The practical effect of these additional requirements are likely to be that most managers of Irish UCITS would not be able to take advantage of the increased diversification limits agreed by ESMA for the use of government and supranational organisations' securities as collateral, as the monitoring and operational costs and increased administrative requirements would outweigh any benefit to the fund. It is likely therefore that, if introduced, these proposals would put Irish funds industry at an unnecessary competitive disadvantage relative to its peers.

Operational impact of frequent regulatory changes to collateral requirements

Separately, it is important to highlight that the operational challenges identified above are exacerbated by the fact that rules around collateral have already been changed twice this year (once with the introduction of the initial version of the ESMA Guidelines and once following the amendments to those guidelines) and that the Central Bank's proposals would represent a third change of applicable rules within 12 months. Each such change necessitates significant investment in terms of time, personnel and money to update the systems used to monitor and manage collateral, as well as potentially requiring UCITS to renegotiate their collateral arrangements with counterparties.

Level playing field and need for harmonisation

Finally, distinct from our principled objections to the proposed amendments and the practical difficulty or impossibility of implementing the proposed amendments from an operational point of view, our understanding is that in issuing the ESMA Guidelines, ESMA wished to ensure that a level playing field and consistent regulation was implemented across all Member States in relation to UCITS collateral rules. This was hitherto an area in which a disparity of approaches had been taken by different regulators, hindering the development of a common market for UCITS and a uniform UCITS product. One of the primary attractions of UCITS as an investment vehicle is that there is a consistent body of rules that applies to a broad spectrum of vehicles. Applying different rules in respect of issues that are common to all vehicles could potentially lead to confusion for investors and diminish the significant strength and appeal of the harmonised UCITS product.

We therefore do not understand why the Central Bank of Ireland is proposing to implement its own additional restrictions, effectively undoing the work of ESMA in this respect. Further, we had understood that the Central Bank's accepted policy was to implement ESMA guidelines fully and without amendment in furtherance of the goals of good and uniform governance. We believe it would have been far better for Irish authorised UCITS managers and for the UCITS product generally for the Central Bank to have sought to have any such proposals addressed by ESMA either in the ESMA Guidelines or through the medium of a Q&A document, so that consistency in the application of UCITS rules across the EU could be maintained. In the event that this approach was tried and was not successful, we do not believe that the concerns identified in CP 84 are such as to merit the imposition of the additional requirements proposed, either because we believe that these concerns are already adequately addressed by the existing requirements or because the proposals are wholly disproportionate to the concern that they seek to address.

By imposing the proposed additional restrictions on Irish UCITS only, we consider that the Central Bank would be:

a. imposing additional, unnecessary administrative and operational burdens and expenses on Irish authorised UCITS and their investors;

b. introducing subjectivity and ambiguity into, and thereby confusing, a system that would otherwise continue to operate on clearer and a more efficient basis; and

c. introducing national divergence into the operation of the pan-European UCITS model at a time when ESMA and national regulators have been working consistently to harmonise UCITS rules and their implementation.

Fund providers with UCITS domiciled in more than one jurisdiction will also face significant operational difficulties (distinct from the practical difficulties in implementing the Central Bank's proposals referred to above) and increased expense through being forced to apply different collateral management criteria for their ranges of funds with each of their counterparties. There is a clear risk that this will lead some to exit the "problematic" UCITS jurisdiction and re-domicile their funds in other EU jurisdictions which seek to apply only those rules that are common to all EU jurisdictions.

We strongly believe that the combination of the three results outlined above would place the Irish funds industry at an obvious competitive disadvantage relative to other UCITS jurisdictions, without delivering any compensatory advantages in the form of additional investor protection.

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

No, we believe strongly that there is no need to distinguish between UCITS that take the form of money market funds and other forms of UCITS. In this respect, we note that this issue has already been considered by ESMA and decided in favour of expanding the derogation to all UCITS. We believe that the arguments that were accepted by ESMA as part of that process are equally valid here and see no reason to distinguish between Irish UCITS and Irish UCITS MMF and those from other EU jurisdictions.

Separately, as we understand that the Central Bank has communicated to ESMA that it will comply with the ESMA Guidelines, it would not be consistent with that approach or in compliance with the ESMA Guidelines to exclude UCITS which are not MMFs from the scope of this derogation.

3. ***Do you agree with the proposed rule to be included in the UCITS Rulebook?***

For the general and detailed reasons that we have set out above, we do not agree with the proposed amendments to the UCITS Notices.

Looking more specifically at the language used in the draft UCITS Notice, we can see that our principled concerns outlined above are borne out by a detailed review of the text.

A. "In determining whether collateral is of high quality, UCITS shall conduct an assessment prior to accepting the collateral which takes into account: (i) the credit quality of the instrument; (ii) the nature of the asset class represented by the collateral; (iii) any operational risk; (iv) any other significant related counterparty risk; (v) the liquidity profile."

The text of the consultation implies that the Central Bank is seeking to bring clarity to what it views as a "vague" reference in the ESMA Guidelines to "high quality". Unfortunately, the proposals above only add further difficulty for a UCITS manager in making a determination of what "high quality" means, as each of the items to be assessed are themselves undefined and open to interpretation and ambiguity. We believe that it is counterproductive to try to define a "vague" reference by utilising equally vague considerations. By way of example, it is not clear how "operational risk" or "other significant related counterparty risk" relate to determining the "quality" of collateral. We would question whether "the nature of the asset class" criterion adds to the previous credit quality requirement or the existing requirement to have suitable haircuts in place where collateral exhibits high volatility. We would also question whether the reference to the "liquidity profile" requires a different approach to the requirements relating to liquidity for collateral which are already in place or whether this amounts to duplication.

As noted above, from an operational perspective, given the automated nature of UCITS collateral arrangements, attempting to agree and set parameters that meet considerations of (i) – (v) and then, in turn, agreeing such parameters with each counterparty so that the counterparty can be certain what will constitute acceptable collateral would be difficult, time consuming and subjective. It would also inevitably lead to inconsistency across the UCITS industry, both within Ireland and between Ireland and the rest of the EU.

B. "Where the acceptance of the collateral would mean that the collateral issuer constituted more than 20% of the total collateral held by the UCITS, the UCITS will apply the additional resources which a prudent UCITS would apply to a more detailed assessment of that collateral."

We understand that there is an error in this sentence in that the reference to a percentage of "the total collateral held" should be replaced by a reference to NAV and we would appreciate it if you could confirm this understanding.

If our understanding is not correct, please note that expressing this limit as a percentage of collateral held and not as a percentage of NAV is inconsistent with the general issuer diversification test applied by ESMA and most of the general UCITS investment restrictions and would create further misalignment and potential cause of confusion. In addition, assessing this requirement by reference to a percentage of collateral held appears to require these additional steps to be undertaken by managers even where they hold collateral which represents a small proportion of the UCITS' assets. For example, a UCITS holding collateral worth 5% of its NAV would be required to apply these additional requirements where an issuer's securities represented more than 1% of the UCITS' NAV, which is clearly disproportionate.

Furthermore, as referred to above, the proposed requirement to "apply the additional resources which a prudent UCITS would apply" is a very ambiguous and unclear requirement. Rules around collateral require certainty in order for the arrangements to work from an operational perspective. In addition, it is not clear what additional assessments could be made at this point and why a UCITS would not be acting "prudently" in complying with the existing rules set out in the ESMA Guidelines, including, for example, the requirement to perform stress testing on collateral received where it is worth more than 30% of NAV.

C. "Credit quality of already accepted collateral will be monitored on an on-going basis."

The opening sentence of the relevant section of the UCITS Notices states "A UCITS shall ensure that collateral received by it at all times meets the following criteria". Since a UCITS must already assess collateral received by it on an ongoing basis to ensure that it is of "high quality", this proposal appears to repeat an existing requirement.

D. "Additional resources will continue to be applied to the more frequent and more detailed re-assessment of collateral issuers who constitute more than 20% of the collateral of a UCITS. Where there is evidence of deteriorating credit quality of collateral held, the UCITS will 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. Unless the board of the management company/investment company, explicitly and specifically on each occasion a decision is to be made, decides otherwise, the UCITS will not accept as new or replacement collateral, or continue without a timely remediation plan to hold, any rated collateral which has not been awarded or does not continue to hold one of the two highest available ratings by each recognised credit rating agency that has rated the instrument."

We find this text extremely confusing and ambiguous and it is not always clear how these proposals relate to the credit quality of the collateral issuer. The proposals appear to create significant additional operational and organisational burdens for UCITS managers, which are further increased by the lack of clarity in the proposals. It is not clear whether the proposals are intended to be consecutive (i.e. the later requirements only apply where the former conditions are met) or whether it is proposed that they apply independently of each other. Finally, we note the references to thresholds as a percentage of collateral held and not NAV and refer to our previous points about this.

Taking each of the above sentences in turn:

D1 "Additional resources will continue to be applied to the more frequent and more detailed re-assessment of collateral issuers who constitute more than 20% of the collateral of a UCITS."

There appears to be an inherent contradiction in requiring additional resources to continue to be applied, so it is not clear what the proposed requirement is. In addition, it is unclear what additional resources are required to be applied and how a UCITS manager could demonstrate compliance with this requirement – i.e. is it proposed that the UCITS manager should employ additional staff or put in place additional systems for this purpose? Neither of these may be proportionate or feasible for a manager, particularly in light of the issues highlighted above in respect of setting thresholds as a percentage of collateral held.

Further, UCITS are already obliged to ensure that all collateral positions comply at all times with six different criteria (as contained in sub-paragraphs (a) to (f)), so it does not seem possible or necessary to also require them to undertake more frequent or more detailed assessments of issuers.

D2 "Where there is evidence of deteriorating credit quality of collateral held, the UCITS will 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."

UCITS are currently obliged to ensure that the collateral that they receive is of high quality and to ensure that it meets this requirement at all times. As a result, in the event that

collateral held by a UCITS no longer meets this requirement, the current rules require it to be replaced, which we think is an appropriate, reasonable and clear requirement.

While it is not entirely clear what is intended here, the proposed amendment either seems to require (i) action where credit quality may be deteriorating but where the collateral remains "high quality" or (ii) that where collateral may be deteriorating, such that it is no longer "high quality", it is only necessary to put in place a plan to reduce exposure to that collateral but not necessarily to replace it entirely. Neither interpretation appears to be appropriate to us. Option (i) would mean that being "high quality" is not actually sufficient for collateral to be eligible under this criterion in and of itself, which is counterintuitive, contradicts the ESMA Guidelines and adds an additional and unnecessary layer of complexity. Option (ii) would actually weaken collateral management requirements relative to current rules, to the detriment of shareholder protection.

In addition, the proposal appears to apply to all collateral, without applying a minimum standard or threshold. Thus it would be activated where collateral which was rated A1 was downgraded to A2, even though we believe that collateral rated A2 would be acceptable from a credit quality point of view if received as new collateral. It refers to "any collateral counterparty", which we assume should be read as the issuer of the collateral which has deteriorated in credit quality and not to (i) counterparties posting collateral or (ii) all collateral issuers, both of which could be understood from the wording of the proposed amendment. It also requires UCITS to reduce exposure to such "collateral counterparties" but without giving any indication to what the exposure should be reduced: should it be reduced to below 20% of collateral/NAV, to zero exposure or just reduced from then current levels.

The reference to "evidence" of deteriorating credit quality adds a further layer of uncertainty and imprecision as it appears that UCITS are required to act before the credit quality has actually deteriorated and without the ability to take any evidence to the contrary into account. It is also not clear whether or not the reference is to evidence in the possession of the UCITS or whether a UCITS could breach this requirement despite not being aware of the evidence.

Further, the proposed requirement mandating the prioritisation of the reduction of exposure - which we understand as a requirement to prioritise the removal of collateral from an issuer where total collateral from that issuer exceeds 20% of collateral/NAV, although as noted above, this is not clear to us - does not make seem to make sense. We believe that priority in any replacement of collateral should be determined by credit quality rather than diversification requirements. By way of example, under your proposed amendments, in the event of a credit event, which lowered credit ratings for US treasuries by 1 notch from AA+ to AA and for those for Russian government securities by 6 notches from AA to BBB, we understand that a UCITS holding US treasuries to the value of 81% of its NAV and Russian government securities for 19% of its NAV would be required to prioritise replacing the US collateral and not the Russian collateral, which would in fact further reduce the credit quality of the collateral pool as a whole, contrary to the best interests of investors.

D3 "Unless the board of the management company/investment company, explicitly and specifically on each occasion a decision is to be made, decides otherwise, the UCITS will not accept as new or replacement collateral, or continue without a timely remediation plan to hold, any rated collateral which has not been awarded or does not continue to hold one of the two highest available ratings by each recognised credit rating agency that has rated the instrument."

As noted above, it is not clear when this proposed requirement would apply – at all times or only where the circumstances outlined earlier in the paragraph apply.

It is also not clear whether the proposed requirement is that collateral, if rated, must be of two highest ratings at all times, or whether this only applies where there is evidence of a deterioration in the credit quality of any collateral held? If the former, there is surely then no need for any of the other credit quality requirements which have been proposed. If the latter, which we assume, why should this requirement apply to all collateral held and received into the future merely because the credit quality of collateral issued by one issuer may have deteriorated? Surely the appropriate reaction to a possible deterioration of the credit quality of collateral held is to replace that collateral with eligible collateral, as is currently required. Imposing a minimum standard or additional administrative process for all collateral held or received after the possible deterioration of the credit quality of one issuer seems a hugely disproportionate and open-ended requirement.

Separately, applying a standard of "the two highest available ratings by each recognised credit rating agency that has rated the instrument" may be unworkable in practice, for example in an extreme market event (i.e. where US treasuries, gilts and bunds could all be downgraded). It is also a significantly higher standard than applies to determining whether fixed income securities are investment grade or not and is also at odds with other regulatory definitions of high quality assets.[1]

Further, mandating specific minimum credit ratings will lead to an automatic move to sell off collateral as soon as there is a downwards ratings change, which is likely to have to a "pro-cyclical" effect, increasing the adverse effect of such credit changes and potentially creating a vicious circle of sell offs leading to further downgrades, which, in turn, require further sell offs.

Finally, imposing the proposed requirement would appear to run counter to recent Irish and EU policy in respect of reliance on credit ratings, in particular the statement recently inserted into the UCITS Regulations by Regulation 6 of the European Union (Alternative Investment Fund Managers) (Amendment) Regulations 2014[2], that "A [UCITS] management or investment company, when monitoring and measuring risk in accordance with subparagraph (a), shall not solely or mechanistically rely on a credit rating issued by a credit rating agency".

[1] ECB http://www.ecb.europa.eu/paym/coll/standards/marketable/html/index.en.html, BIS http://www.bis.org/publ/qtrpdf/r_qt1309z.htm

[2] S.I. No. 379/2014 - European Union (Alternative Investment Fund Managers) (Amendment) Regulations 2014, http://www.irishstatutebook.ie/2014/en/si/0379.html

Is there another way to achieve a satisfactory risk mitigation effect?

As noted above, we believe the existing rules set out in the ESMA Guidelines achieve much of the effect that we understand was sought to be introduced by the proposed amendments. UCITS are already obliged to ensure that the collateral that they hold meets a series of detailed requirements at all times and take remedial action in the event that they do not. In addition, the UCITS counterparty requirements also afford additional comfort in this respect.