The International Securities Lending Association
4 Lombard Street
London EC3V 9AA

***Emailed to: fundspolicy@centralbank.ie***

Date 17th October 2014

Dear Sir,

**The International Securities Lending Association response to Central Bank of Ireland's consultation CP84: Consultation on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues**

On behalf of our members, The International Securities Lending Association (ISLA) appreciates the opportunity to further contribute to the Central Bank of Ireland's consolidation on the publication of the UCITS Rulebook ("Rulebook").

The ESMA Guidelines[1] require a UCITS to satisfy a number of criteria relating to collateral received for EPM techniques (in addition to further criteria surrounding the choice of counterparty). These include that collateral must be:

- Captured within the overall UCITS risk management process
- Highly liquid
- Valued daily
- Of high quality
- Uncorrelated to the counterparty
- Sufficiently diversified in terms of county, market and issuer

The ESMA derogation allows a UCITS to be fully collateralised in transferable securities issued by a member state provided diversification levels are maintained at an issue level.

These requirements are amongst the strictest in the world for funds and institutions participating in EPM techniques. There are a number of additional safeguards, alongside diversification in the Guidelines that apply to all collateral (including government bonds) and therefore we do not believe that further safeguards are not required.

In respect to the Central Bank's specific concern, existing market practices means that where accepted collateral deteriorates in credit quality to less than is acceptable to the UCITS, this will be identified immediately and the collateral issue replaced with acceptable collateral. It is well established practice that collateral in securities lending and repo markets is reviewed by the parties on a daily basis. We therefore believe that the concerns are better addressed through the requirement that the UCITS must ensure that collateral

[1] ESMA Guidelines for ETFs and other UCITS issues 18.12.2012/ESMA/2012/832N

meets the criteria in the Guidelines on an ongoing basis and that arbitrarily further restricting the collateral that can be accepted is not necessary.

Our members have also expressed concern that, specific to the collateral management framework being suggested, implementing a different approach for Irish UCITS to other European UCITS will create a two tier market in Europe which may disadvantage Irish domiciled UCITS. With investors focusing on the cost profile of funds, securities lending can provide a low risk revenue stream. In a competitive market, having different and potentially more restrictive collateral requirements that will need additional resources to manage means that Irish UCITS may become less attractive to borrow from and therefore generate less return. Whilst this would not be a deciding factor, this may be a consideration when a new UCITS is deciding on jurisdiction.

We further note that the proposal to reintroduce a reliance on credit rating as a measure of collateral quality is counter to the FSB's principle for financial markets to move away from mechanistic reliance on credit rating agencies[2].

Finally, a key objective of the Guidelines is to provide harmonised rules for UCITS across Europe and achieving this relies on local regulators adopting them without further amendment.

In answer to the specific questions in the consultation paper:

***Q1. Do you agree that the concerns of the Central Bank outlined in this paper are valid?***

Before a UCITS enters into a securities lending arrangement, details of acceptable collateral are documented between the UCITS and the lending agent. This information will include regulatory requirements such as the UCITS definition of 'High Quality' and diversification requirements.

These collateral eligibility criteria are applied to the transaction on an on-going basis, meaning that where an issue that has been received as collateral falls outside of the parameters, for whatever reason, but including a deterioration in credit quality, the issue held as collateral will be immediately substituted with the borrower for a different asset that continues to meet the criteria.

This recognised market practice means that we do not believe that the scenario the Central Bank describes should be a realistic concern.

We believe that the diversification requirements within the Guidelines are sufficient and that implementing a different approach for Irish UCITS to other European UCITS will create a two tier market in Europe which will disadvantage Irish domiciled UCITS. We strongly recommend that the ESMA derogation should be implemented without further amendment or requirements.

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[2] FSB's *Principles for Reducing Reliance on Credit Rating Agencies* Oct 2010 (http://www.financialstabilityboard.org/publications/r_101027.pdf)

***Q2. Do you consider that the Central Bank should implement the ESMA guidelines but limit the derogation to UCITS MMFs?***

We believe that there should be a consistent approach to diversification guidelines for all UCITS and that the Central Bank should not effectively create a two tier approach to diversification by implementing a different approach for UCITS MMFs and other UCITS, which we believe may have unintended consequences.

***Q3. Do you agree with the proposed rules to be included in the UCITS Rulebook? IS there another way to achieve a satisfactory risk mitigation effect?***

Our members are concerned about the proposal to introduce a reliance on credit rating as a measure of collateral quality. In the FSB publication 'Principles for Reducing Reliance on Credit Rating Agencies, Principle 1 states: *Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.*

We believe there are already a number of safeguards in the Guidelines that apply to all collateral including government bonds and therefore further safeguards are not required. For example, the requirement to stress test collateral portfolios if more than 30% of the fund NAV is exceeded in collateral value ensures that collateral portfolios are appropriately analysed and risk levels remain appropriate. This process would capture the deterioration of credit quality.

Yours sincerely,

**Kevin McNulty**

**Chief Executive**

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members principally from across Europe comprising banks, securities dealers, asset managers, insurance companies and pension funds. For more information please visit the ISLA website www.isla.co.uk.