



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

2014

**Consultation on the adoption of
ESMA's revised guidelines on ETFs
and other UCITS issues**

Consultation Paper CP84

Contents

Introduction	2
Format of this Consultation Document	3
Questions for consideration	4
Consultation responses	4

Introduction

In December 2012 ESMA published guidelines on ETFs and other UCITS issues (*ESMA/2012/832*). The Guidelines included those relating to collateral which UCITS may receive on foot of an Efficient Portfolio Management techniques (securities lending or repo) (“EPM”) or in the context of an OTC derivatives transaction. An amendment to the requirements on collateral diversification, set out in paragraph 43(e) of those guidelines, was subject to a consultation published by ESMA on 20 December 2013 (*ESMA/2013/1974*). The proposal by ESMA in that paper would provide a derogation from the collateral diversification requirement where collateral consisted of securities issued or guaranteed by a Member State, one or more of its local authorities, a third country or a public international body of which one or more Member States belong. The derogation would only apply to UCITS which were Short Term Money Market Funds or Money Market Funds (both “UCITS MMFs”).

Respondents to the consultation unanimously supported the ESMA proposal but the majority also considered that the disapplication should not be limited to UCITS MMFs and should apply to all UCITS. This was accepted and the Final Report from ESMA which issued on 24 March 2014 (*ESMA/2014/294*) provided the derogation to all UCITS. Additional disclosure requirements apply to the prospectus and periodic reports of UCITS who avail of the derogation.

The revised Guidelines must now be translated into the official EU languages and published on the ESMA website. Once published, national competent authorities have two months within which they must notify ESMA whether they comply or intend to comply with the guidelines.

Implementation in Ireland - Central Bank concerns

The Guidelines published in December 2012 included two requirements to provide assurance as to the quality and diversification of the collateral received by UCITS. The first required collateral to be of “high quality” and the second requires UCITS to have an exposure of no more than 20% of their collateral basket to any one issuer. High quality is not a defined term within the Guidelines.

The Central Bank supported the change in the consultation which provided a derogation to UCITS MMFs only. UCITS MMFs are subject to quite specific requirements with regard to credit quality which means that even where collateral is not diversified, a UCITS MMF will still be required to hold collateral which if rated will have been awarded one of the two highest available short-term credit ratings by the credit rating agency that has rated the instrument or, if the instrument is not rated, it is of an equivalent quality as determined by the management company’s internal rating process. The effect of the disapplication to all UCITS is that the only protection in place with regard to the kind of sovereign debt collateral a non-UCITS MMF can take is an undefined requirement that it be of “high quality”. The vagueness of that requirement was acceptable under the original Guidelines because it was counter-balanced by the precision of the 20% diversification requirement.

The Central Bank is concerned that there is a realistic scenario where, in stressed market conditions, UCITS holding sovereign collateral which is of deteriorating credit quality will leave that collateral in place. While loss to investors would only occur if a sovereign collateral issuer

defaulted and the repo counterparty also defaulted in the same period this may happen in circumstances where the sovereign default impacted on the repo counterparty.

Proposal

In the light of the concerns outlined above, the Central Bank believes that there are strong grounds for limiting the derogation set out in the revised ESMA guidelines to UCITS MMFs. However, we recognise that this would mean that Irish rules on UCITS collateral would be substantially different from other Member States. If we can achieve a satisfactory risk mitigation effect without creating that difference we prefer to do so.

The Central Bank is proposing therefore to implement the revised ESMA guideline as follows:

- Provide that all UCITS may avail of the derogation from the collateral diversification requirement where the collateral consists of securities issued or guaranteed by a Member State, one or more of its local authorities, a third country or a public international body of which one or more Member States belong;
- Delete the existing rule in the UCITS Notices which requires that collateral received by UCITS must be “of high quality”; and
- Replace this with a rule to be added to the UCITS Rulebook, that UCITS may only accept ‘high quality’ collateral and that in determining whether collateral is of high quality 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.

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 the credit quality of that collateral.

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

Format of this Consultation Document

The proposed rules to apply to collateral diversification will be included in the UCITS Rulebook. Your view is sought, in particular, on whether these rules constitute a proportionate regulatory regime for collateral received by UCITS on foot of an EPM transaction or on foot of an OTC derivative transaction.

Questions for consideration

We would welcome stakeholders' views on the following questions in particular:

- 1. Do you agree that the concerns of the Central Bank outlined in this paper are valid?**
- 2. Do you consider that the Central Bank should implement the ESMA guidelines but limit the derogation to UCITS MMFs?**
- 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?**

Consultation responses

The Central Bank invites all stakeholders to provide comments on the draft amendments to the UCITS Rulebook which form part of this Consultation Document and on the questions raised in this Consultation Paper.

Please make your submissions electronically by email to fundspolicy@centralbank.ie or in writing to:

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

Responses should be submitted no later than 17 October 2014.

It is the policy of the Central Bank to publish all responses to its consultations. All responses will be made available on our website. Commercially confidential information should not be included in consultation responses.

We will send an email acknowledgement to all responses sent by email. If you do not get an

acknowledgement of an emailed response please contact us on +353 1 2246000 to correct the situation.

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Amendment to UCITS Rulebook



Chapter 1 - Product Requirements

Amendment to Part 1, Section 1 (vi) – paragraph 5

5. A UCITS shall ensure that collateral received by it at all times meets the following criteria:
- (a) Liquidity: Collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the provisions of Regulation 74.
 - (b) Valuation: Collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.
 - (c) Issuer credit quality: Collateral received should be of high quality. 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.

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.

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

- (d) Correlation: Collateral received should be issued by an entity that is independent from the counterparty and is not expected to display a high correlation with the performance of the counterparty.
- (e) Diversification (asset concentration): Collateral should be sufficiently diversified in terms of country, markets and issuers with a maximum exposure to a given issuer of 20% of the UCITS net asset value. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, a UCITS may be fully collateralised in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' net asset value. UCITS that intend to be fully collateralised in securities issued or guaranteed by a Member State should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral for more than 20% of their net asset value.

The UCITS' annual report should contain details of:

- the identity of the issuer where collateral received from an issuer has exceeded 20% of the NAV of the UCITS; and
 - whether the UCITS has been fully collateralised in securities issued or guaranteed by a Member State.
- (f) Immediately available: Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

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