OSSIAM
6, place de la Madeleine
75008 Paris

Bruno Poulin, CEO
Antoine Moreau, Deputy CEO

ESMA
103, rue de Grenelle
75007 Paris

Paris, July 11th 2014

OSSIAM COMMENTS ON THE CONSULTATION PAPER ON DRAFT REGULATORY TECHNICAL STANDARDS ON RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVES CONTRACTS NOT CLEARED BY A CCP (JC/CP/2014/03)

OSSIAM favourably welcomes the European Supervisory Authorities (ESA) consultation paper on the technical standards on risk mitigation for OTC Derivatives contracts not cleared by a CCP.

Headquartered in Paris, France, OSSIAM is a specialist asset management company that develops and manages investment funds, including exchange-traded funds (ETFs), based on systematic investment processes. Affiliate of Natixis Global Asset Management, the company had, at the end of June 2014, USD 2.07 billion in assets under management, consisting of ETFs and institutional mandates.

Before commenting in more detail on the different questions of the consultation paper, OSSIAM would like to insist on the following general comments:

1) As investment funds and asset managers are very strictly regulated and very closely supervised (through UCITS and AIFM regulation for instance), we consider that a specific exemption from the obligation to exchange initial margin would be justified for regulated funds (since their global risk exposure is already limited by regulation).
2) Regarding the application of the 8 billion thresholds, the principle must be that, by default, there shall be no initial margin applicable if one of the parties is below the threshold (while the financial counterparty may usually be above the threshold) and if there is, that shall be by way of mutual agreement between the parties. Indeed, the absence of a clear rule regarding the applicability of that threshold could lead Initial Margin to be commercially imposed to the counterparty that is exempted (e.g. an Asset Manager) by the non-exempted counterparty (e.g. large bank).
3) We consider that the basis for eligible collateral should be very large, as diversified as possible and include many types of assets and specifically funds; according to their quality and their liquidity these assets should be subject to appropriate haircuts and not percentage limits on concentration to reduce risk. Moreover, diversification rules should not apply to collateral amount below a defined threshold.

Question 1. What costs will the proposed collateral requirement create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping with the proposal aligned with interaction standards?

OSSIAM considers it difficult to determine the costs of implementing the proposed RTS considering the currently available information.

The number of new obligations and their scope seem to make their implementation quite expensive, especially for small or midsize funds or asset management companies. Indeed, those asset managers have often outsourced part of the services and this leads to uncertainty around fees and charges caused by the review of contracts and services.

More specifically, we are aware that collateral management for non-centrally cleared OTC transactions will bring the following:

- **Legal and documentation cost**, as agreements must be negotiated or amended to take on board new requirements and some asset managers may have to solicit external advice which tend to increase the cost of compliance;
- **Operational cost** incurred to establish and run processes for collateral management;
- **Opportunity cost** if initial margining is imposed by counterparties: for example, the securities held in the portfolio which are to be used as collateral will no longer be available for securities lending activities that improve the return of the fund;
- **Initial Margin** may commercially be imposed to Asset Manager by large bank even if the aggregate month-end average notional amount of non-centrally cleared derivatives is below 8 billion euros as of December 1^{st} 2019. This Initial Margin may have a significant cost impact on small entities. The default rule should be that, in the absence of a specific agreement between the parties, there is no IM posted.

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If yes, please provide the rationale for the concerns and potential solutions.

1) <u>Impossibility to calculate exposures</u>

We welcome the ESAs view that the threshold relevant for the question whether or not to exchange Initial Margin contributions needs to be considered for each investment fund or sub-fund (compartment) 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 or portfolios (e.g. one segment concerning equities and another segment concerning non-equities) each managed by a certain asset manager.

Similarly, UCITS funds have the opportunity to create sub-funds / compartments that have segregated asset and liabilities from the fund or other sub-funds.

This is considered for collateralization reasons too. The collateral to be posted by the parties is determined with respect to each segment or the sub-fund separately.

In order to maintain the possibility for investors to have their investment fund managed by more than one asset manager or to avoid the creation of legal solidarity between sub-funds, 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 a distinct entity.

This question is even more crucial for funds with sub-funds as it would force each compartment to deliver initial margin.

Moreover, the fact that a client may have concluded several mandates with different asset managers brings additional difficulties in calculating margins. It is then not possible for the asset manager of one mandate to calculate the threshold or deliver the margins as the global exposure remains impossible to define.

2) Grand-fathering clause

We wish to insist on the necessity to fully and explicitly establish the fact that the regulation will only apply to transactions conducted after its implementation date.

It should not only be mentioned under recital 18 but also included in the text of the regulation itself. Furthermore, we consider that a clarification should be added to make sure that "genuine amendments" as referred to in the BCBS/IOSCO final report (§ 8.9 and footnote 20, p. 24) made to existing derivative contracts shall not be in the scope of the new regulation. An explicit mention in article 1 FP § 4 would bring the necessary clarification.

3) Eligible collateral

The eligible collateral should not be limited to the list of the main indices. Eligible collateral list should be extended to other indices as well.

The RTS should also provide an assessment method for the calculation of haircuts on equities.

As far as we understand, the application of two different methods by the parties to evaluate and calculate haircuts may result in discrepancies and we see no procedure in the RTS to solve those discrepancies.

4) Ban of re-use of initial margin

We would like to highlight that as per the "Guidelines on ETFs and other UCITS issues" published by ESMA on the 18th December 2012, a UCITS is bound to invest the cash collateral it receives. Therefore, banning the re-use of cash received as initial margin is in contradiction with other guidelines and rules imposed to UCITS funds.

Cash collateral should be placed on deposits, invested on high quality investment bonds, used for the purpose of reverse repo or invested in short term money market funds. Such investments must be in compliance with additional security constraints. We consider this regime adequately secures transactions and avoid risk in case of default of the receiving party.

5) Post capital or hold assets

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

UCITS 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). A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio.

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.

6) Conflict in diversification rules

There are some contradiction between diversification limits resulting from the application of article 7 LEC of the RTS (pages 38-39) and the concentration limits resulting from the ESMA Guidelines on ETFs and other UCITS issues.

The proposed regulation refers to the total amount of the collateral when computing the diversification ratio. It is inconsistent to consider that there is a risk on the collateral of small amount that could be mitigated with a diversification rule; it is not workable to ask counterparties to split small amounts of collateral on several issues for even smaller amounts, uneasy to manage and costly to transfer. Indeed, regarding a fund, the denominator of the ratio is what is important in the fund, i.e. the net asset value or the net capital available in the fund.

The harmonization within each Member State as regards those concentration limits in UCITS implementation and in EMIR is a necessary pre-requisite to improve legal certainty, liquidity as well as the level playing field between market players.

If concentration rules were to apply, we strongly suggest that there should be a realistic threshold under which they should not, simply because it is not workable to ask for a split over different issuers of collateral on smaller amounts than 100 million EUR.

7) IM Calculation Method

From an asset managers' viewpoint, we believe that a standardized margin schedule should be the preferred approach, which would lessen the risk of disputes as compared to quantitative portfolio models developed by counterparties.

8) Different MTA for IM and VM

The proposed regulation suggests a Minimum Transfer Amount (MTA) of 500 000 €. This amount includes the net variation of IM and VM exchanged between 2 counterparties.

We would prefer to have two MTAs. We hence suggest to follow two MTAs of at least 250 000 € each instead of one of 500 000€.

Question 3. Does the proposal adequately address the risks and concerns of the counterparties to derivative in cover pools or should the requirement be further tightened? Are the requirements, such as the use of CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in the cost-benefit analysis section, e.g. where a third party would post the collateral on covered bonds which for not meet the conditions mentioned in the standards?

OSSIAM has no comment.

Question 4. In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate adequate understanding to their supervisory authority?

We approve the requirement that banks communicate on the models that they use and the data that they take into account when running these models. From the perspective of the asset managers, our responsibility towards our clients includes the verification of the prices of the financial instruments that we use and the level of collateral is within the scope of our controls.

For both the IRB model (eligible collateral and haircut) and the internal model of Initial Margin calculation, small and medium size player will be exposed to non-transparent models.

Ossiam - 80, avenue de la Grande Armée - 75017 Paris France Tél. +33 1 78 40 56 90 - Fax +33 1 78 40 60 77 - www.ossiam.com
An affiliate of Natixis Global Asset Management

Question 5: How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated?
What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

As a general comment, we are convinced that concentration limits are not the first and most important element to take into account. The relevant order of priority should be the following: (i) the analysis of the counterparty's risk; (ii) the capacity to liquidate the collateral (its liquidity) and (iii) the diversification and possible concentration constraints.

As collateral is taken in order to reduce counterparty risk, we are convinced that the first criterion to control counterparty risk is a thorough credit quality analysis of the counterparty.

Secondly, the liquidity of the collateral is also an extremely important element.

We would also like to insist on the crucial need to maintain the capability to deliver eligible collateral in the most efficient manner for both the collateral giver and collateral taker.
Indeed, a bad calibration of eligible criteria would raise the following difficulties:

- a counterparty would not be compelled to refuse good quality collateral because of the breach of the limit by issuer. As explained above, what is essential in our view in order to mitigate a counterparty risk is the quality of collateral, not its diversification;
- it should also be underlined that the constraints resulting from collateral diversification obligations may significantly increase the complexity linked to collateral management and therefore the costs of such collateral management;
- this cost increase could finally have a negative impact for investors. For that reason, we would be of the opinion that securities issued by the governments or central banks should be exempted from concentration limits;
- the ESAs should bear in mind that 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.

In general, we consider that the entire field of the investment grade (as defined by CRAs) issues should be considered as eligible. Since they do not show the same level of safety, it is clear that appropriate haircuts have to be provided.

We do not share the idea to include shares of components of the main indices in the 40% limit that is suggested for convertible, shares and other instruments. First, this proposal is not consistent with the fact that shares are highly liquid and remain one of the few actively traded instruments in periods of stress, probably because of the diversity of types of shareholders. Secondly, this limitation would profoundly alter the investment strategy of many funds that are required to invest exclusively or to a very large proportion in shares: hundreds of PEA funds in France for example have to show a minimum investment of 75% in eligible shares. They might be prevented to use derivative contracts and dramatically reduce the investment universe of their holders. This is particularly true if the 40% ratio were computed on the basis of total collateral and not NAV for funds.

For concentration limits, we strongly believe that they should not apply below a threshold of 100 million € in collateral. Managing concentration limits below 100 million € would be an operational nightmare, would introduce delays, high complexity and risk in collateral management. We also suggest that the diversification calculation be computed on the basis of the NAV for funds (and each sub-fund if any), both UCITS and AIFs (when of course those investment funds individually are above the threshold). Alternatively, the diversification calculation basis could be the notional amount of outstanding OTC non-cleared derivatives concluded by a given entity (investment fund included when they are above the threshold individually). Asset managers cannot be subject to a double layer of constraints.

Therefore we kindly ask the regulator to choose between the two set of rules - Guidelines on ETFs and other UCITS issues and the proposed RTS in order apply the diversification of collateral rules.

Question 6. How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?

We believe that the prohibition or authorization of re-use should not be determine on a regulatory level but on case by case basis within a bilateral agreement between the parties.
We are of the opinion that BCBS/IOSCO principles have taken a prudent and pragmatic approach when strongly limiting the possibility to re-use or re-hypothecate received collateral. We think that there is no reason not to follow these principles. OTC derivatives are traded between professionals. If counterparty agrees that the re-use of collateral will be positive and made for the benefit of its clients, re-use should not be prohibited.

An example of circumstances where re-use will be helpful is to be found in the case of back to back transactions where a counterparty A manages the exposition it took from a derivative contract with a fund through a reverse transaction with counterparty B; the collateral received from the fund by A may be re-used and posted in favour of B that finally takes the market risk. All the more if A is a financial institution that provides the fund with a guarantee.
The required prior explicit approval by the poster of the collateral (transaction by transaction), the fact that it can check that the re-use is made in conjunction with a further transaction aiming at managing the risk initially taken from the fund and not to take further exposure, the possibility to earmark the collateral…all is made to limit the re-use to a very few cases when professionals fully agree.

CONTACTS

Bruno Poulin	Antoine Moreau
bruno.poulin@ossiam.com	antoine.moreau@ossiam.com
+33 1 78 40 56 83	+33 1 78 40 56 81