SUBMITTED ONLINE AT:
www.esma.europa.eu *under "Your input – Consultations"*
European Securities and Markets Authority
103, rue de Grenelle
75007 Paris
France

31 January 2014

RE: Response to ESMA consultation on Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues

INTRODUCTION

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. As you are aware, Ireland is the leading centre for UCITS funds with more than €1 trillion in UCITS assets domiciled in the country. Accordingly, developments in the UCITS arena are of particular importance to the Irish industry.

The IFIA welcomes the publication of, and the opportunity to comment on, ESMA's consultation on the revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues (the Guidelines). We also appreciate ESMA's willingness to revisit aspects of the Guidelines that have proved challenging to the industry. The willingness to engage and provide solutions to real issues affecting the industry demonstrates the effective role ESMA can play in addressing potential problems in an appropriate manner.

We have responded, in detail below, to the questions in the Consultation Paper and we remain at ESMA's disposal for further discussion on these issues. However, we want to highlight the core themes of our response. As a major domicile for Money Market Funds, Ireland is acutely aware of the challenges that the proposed collateral diversification rules present to Money Market Funds. We fully appreciate why the focus of ESMA's consultation is on alleviating the challenges posed to Money Market Funds, however, we have always believed that the strength of the UCITS framework has been the uniformity of the rules across all fund types. For this reason, as we explain below in more detail, we are of the view that any changes to collateral diversification rules should apply to all UCITS funds.

SPECIFIC RESPONSES

Q1) Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of money market funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

Yes, we believe strongly that ESMA should revise the rules for the diversification of collateral received by UCITS however we do not believe that there is a valid distinction between UCITS that take the form of Money Market Funds and other forms of UCITS. The issues that ESMA has identified in the context of Money Market Funds (cost of implementation and credit quality concerns) apply equally to all forms of UCITS and, while we note that ESMA considered extending the scope of the review contained in this consultation paper to other forms of UCITS and decided against it, we urge ESMA to reconsider this, as the issue is creating real problems and concern for managers of all types of UCITS. We believe that extending the revision proposed in this consultation to all types of UCITS is appropriate, proportionate and would resolve the credit quality issues facing UCITS managers in this respect, while also reducing costs for investors without diluting the security which the collateral requirements are designed to provide.

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 fund types and strategies. Applying different rules in respect of issues that are common to all UCITS funds could potentially lead to confusion for investors and diminish a significant strength of the UCITS brand.

Additionally, the wording of the proposed derogation as it currently stands in both Option 1 and Option 2 provides that the relevant funds "may receive collateral up to 100 % of their net asset value 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."

Given that certain UCITS may, in fact, be over-collateralised (i.e. collateral represents more than 100% of NAV), to ensure such UCITS would not be deemed to be in technical breach of the Guidelines, we suggest that an appropriate amendment be made to the current form of wording of the proposed derogation to address this anomaly, e.g. in the context of Option 1:

"By way of derogation from this sub-paragraph, UCITS that comply with the definition of Money Market Funds and Short-Term Money Market Funds of the guidelines on a common definition of European money market funds (Ref. 10-049) may **be fully collateralized** by 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.

Separately, there are two other issues in relation to collateral diversification that we bring to ESMA's attention at this time and request that ESMA consider them as part of the same review of the requirements in this respect:

Exception for newly-established UCITS.

We believe that it is appropriate to extend the six month derogation from the UCITS standard diversification requirements provided for in the UCITS Directive to cover the collateral diversification requirements contained in the Guidelines too. The reasons for the derogation contained in the Directive are well established and understood and the same reasons apply equally to the diversification of collateral. Therefore the extension of the derogation to cover collateral diversification in the first six months of a UCITS' authorisation is a logical and sensible step.

Exception for small UCITS.

The practical implications of the collateral diversification requirements currently contained in the Guidelines is that a UCITS which receives collateral for 100% of its NAV (such as a Structured UCITS or other form of UCITS which enters into a single total return swap to implement its investment policy) must hold collateral from at least six different issuers. For UCITS which have a small NAV and wish to use high quality government securities as collateral this presents problems because such government securities are typically only sold in units of €50,000 or more. This means that it is not possible for a UCITS with assets of less than €300,000 to meet this requirement and we therefore request a de minimis exception from the collateral requirements of the Guidelines to facilitate UCITS in this or similar positions.

Q2) Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.

It is important to bear in mind the purpose of collateral received by a UCITS is to mitigate counterparty risk rather than to prevent excessive concentration of investments. Should a counterparty default, of critical importance is that the collateral is of good credit quality and sufficiently liquid to enable the UCITS to realise the collateral in the market.

Given the nature of government bonds and on the basis that such securities meet all other criteria for use as collateral (e.g. high quality, liquid, traded on regulated market, priced daily etc), we argue that there should not be **any** specific issuer limit applied on the basis that such an additional requirement does not provide any benefit or additional protection to the investor in the UCITS.

A UCITS is already obliged to ensure that in respect of government bonds utilised as collateral, the collateral conditions (over and above the relevant issuer limits) are met in accordance with the provisions of paragraph 43 of the Guidelines and must disclose the details of its collateral policy to investors in its documentation according to paragraph 47. We believe that these are sufficient safeguards for collateral in the form of government debt and encourage ESMA to remove any issuer diversification requirements in relation to government bonds held as collateral and not impose any issue diversification requirements either (see further response to Q3 below).

Q3) Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

We note the selection of the "six issue" minimum diversification test is similar to a UCITS investment concentration rule. However, as mentioned in previous submissions on the purpose and use of, collateral in a UCITS context, we do not believe that UCITS investment concentration rules are relevant when it comes to determining minimum standards for collateral. The purpose and use of collateral is not about protecting the investor against being over exposed to a particular asset/asset type, it is a form of protection against counterparty exposure. Accordingly, we do not agree that the standard to be applied to collateral diversification is the UCITS investment concentration rules.

As noted above, for collateral to fulfil its purpose to mitigate counterparty risk it is more important that the collateral is of good credit quality and is readily realisable in the market. We do not believe that for government securities it is necessary to impose a strict requirement in relation to number of issuers (as mentioned above in our response to Q2) or to any minimum number of issues within the collateral pool (as is being suggested in the proposed derogation).

However, if ESMA does not agree with this assessment and wishes to retain the amended form of wording suggested within the consultation, we feel that the draft wording needs to be amended to provide clarity in relation to the following points:

- It is not clear from the current draft wording whether the 6 issue requirement only applies when 100% of NAV is collateralised from a single issuer, or when any value > 20% of NAV is collateralised from a single issuer.
- Currently, the 6 issue requirement is drafted in terms of % of collateral and not NAV, which appears to be inconsistent with the general issuer diversification test (% of NAV) i.e. seems to be drafted in terms of collateral received from each counterparty.