



European Securities and
Markets Authority

Final report

Revision of the provisions on diversification of collateral
in ESMA's Guidelines on ETFs and other UCITS issues



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Acronyms used

ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
NCA	National competent authority
OTC	Over-the-counter
UCITS	Undertaking for Collective Investment in Transferable Securities



I. Executive Summary

Reasons for publication

In December 2012, ESMA published the guidelines on ETFs and other UCITS issues (ESMA/2012/832) (hereafter the guidelines). Since the entry into force of the guidelines on 18 February 2013, ESMA has been asked by stakeholders on numerous occasions to reconsider its position on the requirements on collateral diversification (paragraph 43(e) of the guidelines) on the basis that they have a significant adverse impact on UCITS's collateral management policies. Stakeholders drew particular attention to the consequences for money market funds that place cash into reverse repurchase agreements.

On 20 December 2013, ESMA published a consultation paper (ESMA/2013/1974) in which the Authority set out proposed amendments to paragraph 43(e) of the guidelines.

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Annex I of this final report sets out ESMA's position on collateral management by UCITS. The guidelines in Annex I modify the rules on collateral diversification in paragraph 43(e) of the existing guidelines and introduce some further consequential changes.

Next steps

The guidelines in Annex I of this report will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines.

II. Feedback statement

Questions

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?

1. Respondents to the consultation unanimously welcomed ESMA's initiative to reconsider its position on collateral diversification. In their view, the existing diversification rules limit the extent to which UCITS, and in particular UCITS Money Market Funds (UCITS MMFs) and UCITS Short-Term Money Market Funds (UCITS ST MMFs), may enter into reverse repurchase arrangements. In return this has a detrimental impact on the return for investors and complicates the liquidity management of UCITS.
2. However, while agreeing on the principle that UCITS MMFs and UCITS ST MMFs should be able to receive collateral up to 100% of their NAV in securities referred to in Article 54(1) of the UCITS Directive, the majority of respondents suggested that this possibility should be granted to all UCITS and not be limited to UCITS MMFs and UCITS ST MMFs.

ESMA's response: Taking into account the feedback received, ESMA decided to apply the specific approach for collateral received in the form of government securities to all UCITS rather than limiting it to UCITS MMFs and UCITS ST MMFs.

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.

3. Respondents to the consultation generally did not believe ESMA should introduce additional safeguards for government bonds received as collateral.

ESMA's response: ESMA considered carefully the comments made by stakeholders, most of whom did not see a need for additional safeguards. However, in light of the decision to allow all UCITS to be fully collateralised in securities referred to in Article 54(1) of the UCITS Directive, ESMA took the view that it was appropriate to introduce additional disclosure requirements for those UCITS intending to make use of this flexibility. In particular, ESMA decided to require such UCITS to communicate in the prospectus their intention to take advantage of the tailored rules on diversification and to list the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral beyond the 20% limit. To complement this, a disclosure requirement has also been introduced in the UCITS' annual report.

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

4. Respondents to the consultation expressed mixed views on ESMA's proposal to diversify the government securities across at least six different issues. Some stakeholders supported the proposal while other objected to it and asked ESMA to remove the reference to a minimum number of issues.

5. Other respondents suggested a diversification limit of 20% per issue. In their view, such a limit would in practice result in UCITS receiving at least six different securities because it is not operationally feasible to have five different issues of exactly 20% of the NAV.
6. ESMA was also asked to clarify whether possible haircuts should be taken into account when calculating the diversification limit. Indeed, if haircuts were to be included this would mean that UCITS that apply haircuts to the collateral received would have to receive securities from other issuers for the proportion that exceed 100% of the NAV.

ESMA's response: While noting the comments made about the operational challenges that could be posed by the requirement to diversify the collateral across at least six issues, ESMA decided that it was important to ensure alignment with the provisions of Article 54(1) of the UCITS Directive.

On the issue of haircuts, meanwhile, ESMA adapted the guidelines so as to refer to UCITS being “fully collateralised” in government securities in order to avoid situations in which, following the application of haircuts, UCITS would be required to receive securities from other issuers for the proportion exceeding 100% of the NAV.

Finally, ESMA considered it appropriate to introduce a transitional provision with respect to both of the additional disclosure elements of the revised provision on collateral diversification (i.e. regarding information in the prospectus and annual report).

Annex I – Cost benefit analysis

1. Introduction

1. Pursuant to Article 16 of the Regulation establishing ESMA¹, ESMA is empowered to issue guidelines and recommendations addressed to competent authorities or financial market participants with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervision, and to ensuring the common, uniform and consistent application of Union law. The same article obliges ESMA to conduct open public consultations regarding the guidelines and recommendations and to analyse the related potential costs and benefits, where appropriate. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.

2. Policy options

2. When developing the consultation paper, ESMA identified the following two options for amending the rules on the diversification of collateral.

- Option 1:

Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its 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, 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 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. Such 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 collateral received.

Option 2:

Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its 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, UCITS may receive collat-

¹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010.

eral 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. Such 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 collateral received.

3. The likely economic impacts

3.1. Costs

Option 1: Under option 1, UCITS that do not comply with the definition of Short-Term Money Market Funds or Money Markets Funds of the guidelines on a common definition of European money market funds (Ref. 10-049) should ensure a minimum diversification of collateral of 20% of their net asset value per issuer of collateral.

Option 2: Under option 2, UCITS that do not receive as collateral 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 should ensure a minimum diversification of collateral of 20% of their net asset value per issuer of collateral.

The scope of option 2 is wider than the scope of option 1. Indeed, option 2 applies to all UCITS receiving a certain type of collateral whereas option 1 is limited to UCITS that comply with the definition of Short-Term Money Market Funds and Money Market Funds (as set out in the guidelines on a common definition of European money market funds). However, the wider scope of option 2 could increase the risk of UCITS holding collateral that is less diversified.

3.2. Benefits

Option 1: Option 1 introduces the possibility only for Short-Term Money Market Funds and Money Market Funds to receive collateral up to 100% of their net asset value that takes the form of 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. Option 1 would retain the benefits of the diversification principle for the wider universe of UCITS, while recognising the specific collateral management practices of UCITS that take the form of money market funds (MMFs). In particular, Option 1 would have a positive impact for denominated Short-Term Money Market Funds and Money Market Funds that enter into reverse repurchase agreements as a form collateralised deposit because no issuer diversification would be necessary.

Option 2: Option 2 introduces a derogation for collateral that takes the form of 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. UCITS may receive up to 100% of their net asset value in such collateral without applying any issuer diversification. Option 2 would place fewer constraints on UCITS in general in terms of collateral management because no issuer diversification would be necessary if the collateral takes the form of government securities. This option would also address the potential adverse consequence of the current guidelines, namely that UCITS would be forced not to accept collateral that would generally be considered to be of high quality simply to meet the 20% issuer limit. Option 2 would have a particularly positive impact for Short-Term Money Market Funds and Money Market Funds that enter into re-



verse repurchase agreements as a collateralised deposit because no issuer diversification would be necessary.

4. Policy choice

ESMA considered the feedback received from stakeholders in determining its final policy choice as reflected in the revised guidelines. In particular, ESMA assessed carefully the benefits of option 2 that were identified by respondents to the consultation, such as giving all UCITS access to relatively safe and liquid collateral in the form of government securities.

ESMA also considered the costs of option 2, including the potential consequences of UCITS (not only UCITS in the form of MMFs) holding less diversified portfolios of collateral. ESMA sought to mitigate this potential cost by prescribing additional disclosure to investors and potential investors of the UCITS' intention to make use of the higher limit for collateral in the form of government securities. This cost is further mitigated by ESMA's decision to maintain a diversification requirement in terms of a minimum number of issues and a cap of 30% for any individual issue.



Annex II – Guidelines

I. Scope

Who?

1. These guidelines apply to competent authorities.

What?

2. These guidelines apply to UCITS management companies and UCITS taking the form of investment companies.

When?

3. These guidelines apply from [2 months after publication of translations].

II. Purpose

4. The purpose of these guidelines is to provide a workable framework for the management of collateral received by UCITS in the context of OTC financial derivative transactions and EPM techniques. These guidelines complement the ESMA guidelines on ETFs and other UCITS issues that entered into force on 18 February 2013².

III. Compliance and reporting obligations

Status of the guidelines

5. This document contains guidelines issued under Article 16 of the ESMA Regulation³. In accordance with Article 16(3) of the ESMA Regulation competent authorities must make every effort to comply with the guidelines.
6. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices.

Reporting requirements

7. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication of these guidelines by ESMA. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.

² http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

³ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

IV. Diversification of collateral received in the context of OTC financial derivatives transactions and EPM techniques

8. Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is 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. This derogation does not affect the other criteria for collateral management as set out in paragraphs 41 to 47 of the guidelines.
9. The UCITS' annual report should contain details of the following in the context of OTC financial derivative transactions and efficient portfolio management techniques:
 - a. where collateral received from an issuer has exceeded 20% of the NAV of the UCITS, the identity of that issuer; and
 - b. whether the UCITS has been fully collateralised in securities issued or guaranteed by a Member State.
10. UCITS that exist before the application date of these guidelines are not required to comply with the provisions relating to the prospectus transparency on collateral diversification until the earlier of:
 - a) the first occasion after the application date of these guidelines on which the prospectus, having been revised or replaced for another purpose, is published; and
 - b) twelve months after the application date of these guidelines.
11. Requirements to publish information in the report and account of an existing UCITS do not apply in respect of any accounting period that has ended before the application date of these guidelines.