



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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**Feedback Statement on CP84 –
Consultation on the adoption of ESMA’s
revised guidelines on ETFs and other
UCITS issues**



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Introduction

1. On 28 July 2014 the Central Bank of Ireland (the “Central Bank”) published Consultation Paper CP84 *Consultation on the adoption of ESMA’s revised guidelines on ETFs and other UCITS issues* (“CP84”). The closing date for comments was 17 October 2014 and 5 responses were received.
2. CP84 relates to the adoption of ESMA’s revised Guidelines on ETFs and other UCITS issues (the “revised Guidelines”).
3. The Central Bank highlighted some concerns which it had regarding the revised Guidelines, particularly the ability for all UCITS to derogate from the collateral diversification requirement where 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.
4. The Central Bank set out its proposal to implement the revised Guidelines in a modified manner which it believed addressed the concerns which it raised.
5. Respondents were asked to comment on the Central Bank’s proposal.

Feedback on questions posed in CP84

Question 1: Do you agree that the concerns of the Central Bank outlined in this paper are valid?

6. While some respondents understood the concerns raised by the Central Bank, all believed that these did not warrant the approach proposed by the Central Bank. One respondent stated that the revised Guidelines embed collateral management in the UCITS risk management process including stress testing. These requirements will ensure that a UCITS takes appropriate action in the event of deterioration of sovereign collateral held by the UCITS.
7. Several respondents commented that the revised Guidelines had been consulted upon and the concerns raised by the Central Bank had already been considered as part of that process. ESMA had made its determination on the matter and the Central Bank should not seek to revisit this.
8. Several respondents also commented that if the Central Bank proceeded with its proposal, UCITS in Ireland would be subjected to additional requirements which did not apply in other jurisdictions. This would create an uneven playing field and put Ireland at an unnecessary competitive disadvantage.
9. One respondent noted that collateral management processes are highly automated. The Central Bank’s proposal would require significant manual intervention in this process which would be more inefficient, cumbersome and expensive.

Central Bank: While the Central Bank rejects the arguments regarding gold plating and also that the other guidelines are sufficient mitigants, it agrees that the proposed rule can be clarified. Accordingly, the Central Bank is revising the rule based on the formulation set out in the ESMA (CESR) guidelines which apply to UCITS money market funds (‘MMFs’) (ESMA/2014/1103). The revised rule will require that the threshold applied by a UCITS in their credit assessments of collateral issuers is the standard which applies to investments by a UCITS MMF. The revised rule is set out in Appendix I and has been inserted into the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1))(Undertakings for Collective Investment in Transferable Securities) Regulations 2015 (the “Central Bank (UCITS) Regulations 2015”).

Other provisions set out in CP 84, as regards matters which should be taken into consideration in a credit assessment process and also practice which should be followed when there is deterioration in credit quality, have been retained but in the form of guidance.

Question 2: Do you consider that the Central Bank should implement the ESMA guidelines but limit the derogation to UCITS MMFs?

10. Respondents did not agree with limiting the derogation to UCITS MMFs. They commented that the revised guidelines had already been consulted upon by ESMA. ESMA decided not to limit the derogation to UCITS MMFs and the Central Bank should accept this approach. This would ensure a consistent approach across all Member States.

Central Bank: The Central Bank queried whether it was appropriate to permit all UCITS to derogate from the collateral diversification requirements. In particular, it had concerns about how a UCITS management company would manage collateral of deteriorating credit quality in stressed market conditions.

Following careful consideration, the Central Bank has decided to address its concerns through imposing rules regarding the determination of ‘high quality’. These are set out in paragraph 3 of Schedule 3 of the Central Bank (UCITS) Regulations 2015. They are supplemented with guidance which sets out the Central Bank’s expectations regarding how a responsible person should act where a UCITS is holding collateral of deteriorating quality.

Question 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?

11. Respondents did not agree with the proposed rule to be included in the UCITS Rulebook. They considered that the revised guidelines already implement a number of safeguards that apply to all collateral including government bonds and therefore no further safeguards were required.
12. One respondent commented that the proposed rule would add further difficulty for a UCITS manager in making a determination of what ‘high quality’ means as each of the items to be assessed are themselves undefined and open to interpretation. This respondent also believed that several of the provisions of the proposed rule were ambiguous and unclear. Some respondents queried whether the 20% limit should apply on a Net Asset Value basis instead of a percentage of the total collateral held.

Central Bank: Taking into account the feedback received, the Central Bank has decided upon an alternative means to mitigate the risks it has identified. The proposed rule has been revised based on the formulation set out in the ESMA (CESR) guidelines which apply to UCITS MMFs. It builds upon the existing obligation on the responsible person to perform a credit assessment as set out in Regulations 69(1)(a) and 69(1)(aa) of the EC (UCITS) Regulations 2011. It expands this obligation by identifying a specific credit quality threshold. If this threshold is breached, the requirement for a new credit assessment will be triggered.

Appendix I

Conditions for Collateral Received by a UCITS

The conditions for the receipt of collateral by a UCITS, to which *Regulation 24*¹ refers, are:

1. 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 its pre-sale valuation. Collateral that is received should also comply with the provisions of Regulation 74 of the EC (UCITS) Regulations 2011.

2. Valuation

Collateral that is 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.

3. Issuer Credit Quality

Collateral received should be of high quality. The responsible person shall ensure that:

- (i) where the issuer was subject to a credit rating by an agency registered and supervised by ESMA that rating shall be taken into account by the responsible person in the credit assessment process; and
- (ii) where an issuer is downgraded below the two highest short-term credit ratings by the credit rating agency referred to in (i) this shall result in a new credit assessment being conducted of the issuer by the responsible person without delay.

4. Correlation

Collateral received should be issued by an entity that is independent from the counterparty. There should be a reasonable ground for the responsible person to expect that it would not display a high correlation with the performance of the counterparty.

5. Diversification (Asset Concentration)

- (i) Subject to subparagraph (2), collateral should be sufficiently diversified in terms of country, markets and issuers with a maximum exposure to a given issuer of 20 per cent of the net asset value of the UCITS. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20 per cent limit of exposure to a single issuer.
- (ii) 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 6 different issues, but securities from any single issue should not account for more than 30 per cent of the UCITS’ net value. UCITS that intend to be fully collateralised in securities issued or guaranteed by a Member State

¹ This is a reference to Regulation 24 of the Central Bank (UCITS) Regulations 2015.

should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies or guaranteeing securities which they are able to accept as collateral for more than 20 per cent of their net asset value.

6. 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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