

**ALFI's response to ESMA discussion paper of 22 July 2014 on Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations (ESMA/2014/876)**

Luxembourg, 22 October 2014

Dear Sirs,

ALFI is the representative body of the 2.9 trillion Euro Luxembourg fund industry. It counts among its members not only investment funds but also a large variety of service providers of the financial sector. There are 3,896 undertakings for collective investment in Luxembourg, of which 2,529 are multiple compartment structures containing 12,434 compartments. With the 1,367 single-compartment UCIs, there are a total of 13,801 active compartments or sub-funds based in Luxembourg. 67% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

**Executive Summary**

ALFI welcomes the opportunity to respond to ESMA discussion paper of 22 July 2014 on Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations (ESMA/2014/876). The consultation paper emphasizes on the counterparty risk which has always been treated as a key subject in the context of the UCITS regulation. Changes initiated as part of UCITS III and IV regulations already aligned requirements with the increasing complexity of funds strategies. We also understand that recent changes enacted in the context of the EMIR regulations have been a driving force with important implications that cannot be ignored. Central Counterparties ('CCPs') are now subject to prudential requirements "to ensure that they are safe and sound and comply at all times with the capital requirements".

**1. Do you agree with the working assumptions above?**

Yes, however we expect as well that ESMA will issue some further guidance on centrally cleared OTC in the future (Reference is made to ESMA's Final Report - Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives).

**2. In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA- recognised CCPs for which counterparty risk may not be low? If so, please explain.**

No. One of the overarching purposes of EMIR is to monitor and to reduce risks related to OTC derivative transactions. The new requirements given by Commission Delegated Regulation (EU) No 152/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to standards on capital requirements for central counterparties give enough comfort on the risk profile of CCPs. In the light of this aim we are of the opinion that CCPs should be deemed to be "risk-free" counterparties and therefore be disregarded in the context of this consultation paper regarding calculation of counterparty risk, unless the condition set by ESMA for the CCP are not met..

**3. Do you think that UCITS should apply any counterparty risk limits to ESMA – recognised CCPs? What should be the limits?**

No, we do not believe, for the reason mentioned above, that UCITS apply any counterparty limits to ESMA – recognised CCPs. In our view an ESMA-recognised CCP should be qualified as "risk-free" (please refer to our answer to question 2).

**4. Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.**

No. While EMIR sets minimum standards for segregated accounts, the varieties of such accounts and arrangements differ in certain details.

It is reasonable to consider the differences in the various types of segregation arrangements for the counterparty risk calculation, as they bear different levels of inherent CM default risk. However, globally the rules set to CM under EMIR are highly similar to a broker for exchange traded derivatives. A CM should therefore not be considered for the calculation of counterparty risk provided that recognized client money protection rules or other similar arrangements are in place. Finally looking only at different types of segregation arrangements would have significant implications on the operating model of smaller UCITS (in terms of Asset under Management) using hedging techniques. As cost for segregation could be extremely high, small and midsize UCITS might consider abstaining from using derivatives for hedging purposes and this in turn would increase the risk investors are exposed to (e.g. currency and interest risks).

**5. When assessing the counterparty risk for centrally-cleared OTC derivative transactions, do you think that UCITS should look at other factors than the segregation arrangements? If yes, what are those factors?**

NO. We think that the consideration of the kind of segregation arrangement for calculating counterparty risks should not be the criteria to look at as the same rules as for exchange traded derivatives should apply (please refer to our answer to question 4).

Therefore only a CM which is not protected by 'client money rules' or similar recognized regimes should be included in the counterparty exposure limit.

**6. Do you agree that under an individual client segregation UCITS have a low counterparty risk vis-à-vis the CM for all the assets posted (initial margins, variation margin and excess margin if applicable)? If not, please justify your position.**

No, counterparty risk is reduced close to zero therefore should be deemed as "risk-free" (please refer to our answer to question 4).

**7. Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?**

No. Even though there is still a residual risk with the relevant CM, this risk is considered to be negligible. As the counterparty risk in this agreement is nearly neutralized we see it as appropriate not to impose counterparty risk limits to the CM in this framework.

**8. To what extent do you think that the liquidation of derivative positions by a CCP in respect of a defaulting CM (and the associated market risk) is a significantly likely scenario that should be taken into account by the UCITS?**

It seems to be a rather theoretical scenario as the default of a CM seems to be unlikely due to a strict regulation and its robust capital resources required. And even if there would be a default event on a CM, the positions of the UCITS are liquid by their nature, so that their liquidation by the CCP at fair value shouldn't cause an issue.

Effectively, only the potential market movement over the period after default until final settlement might have an impact. We believe that in practice this period is likely to be very short and hence the materiality of possible price changes seems to be minor. As accurately estimating of cumbersome and the benefits will likely not outweighs the cost, we believe that this scenario should not be considered further.

**9. Do you agree that UCITS should apply the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs? If not, please justify your position**

No. It seems reasonable to believe that under segregation regimes UCITS should not calculate any counterparty risk provided that adequate client money protection rules are in place.

**10. Notwithstanding the choice of segregation model, do you believe that the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk should be assessed on a case-by-case basis?**

No. CMs are subject to the same regulations and, thus, to the same standards. The risk limits, if any, should be the same. Risk limits on a case-by-case basis would also open regulatory arbitrary opportunities for the market. Risk limits should be standardized for UCITS consistent to the current counterparty risk regime. Besides economic value added of a case-by-case assessment appears in our opinion not to outweigh the involved administrative burden.

**11. Do you agree that, under an omnibus client segregation, UCITS have a higher counter-party risk vis-à-vis the CM than under an individual client segregation? If not, please justify your position.**

Yes. Nevertheless while referring to client money protection rules it might not be necessary to take it into account for the counterparty risk (please refer to our answer to question 4).

**12. Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus client segregation? If yes, do you agree that UCITS should apply those limits to the amount of collateral posted to the CM (i.e. initial margin, variation margins and excess collateral if applicable)? What should be the limits?**

No. Even though certain counterparty risk exists, it is hardly possible to quantify it. It is not possible to quantify it in a reasonable and accurate manner due to the individual cases and complexity how and how different the omnibus accounts are managed by each entity. See as well our answer to question 4.

**13. Do you agree that UCITS should be subject to the same counterparty risk limits to CMs under omnibus client segregation for both OTC derivatives and ETDs? If not, please justify your position.**

No. It seems reasonable to believe that under segregation regimes UCITS should not calculate any counterparty risk provided that adequate client money protection rules are in place.

**14. Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangement? What should be the limits and the criteria for setting them?**

The question seems to be too generic; different types of segregation are possible. The handling strongly depends on the type of the segregation. Please refer to the well-developed scenarios already provided in ESMA consultation document and in particular section IV.III.

**15. Do you agree that UCITS should be subject to the same counterparty risk limits applying to the CM under these other types of segregation arrangement for both OTC financial derivatives and ETDs? If not, please justify your position.**

Relevant counterparty risk limit should continue to apply unless specific measures aimed at mitigating risks are put in place. Typically, instruments with an individual client segregation may be subject to more flexibility (being disregarded from the calculation providing that client money protection rules are in place). However, a reasonable and sound approach would be to apply the same counterparty risk limit. The rationale behind this view is linked to the fact that any logic derived from the type of segregation arrangement would have considerable implications (rising costs, increasing complexity of the operational model, putting small and mid-size UCITS at risk with more constraints, influencing investment strategies). As exposed above, the current approach should continue to apply and for any further information, please also refer to the answer to question 4.

**16. Do you agree that UCITS should treat OTC derivative transactions cleared by non - EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.**

No, we believe that for the sound functioning of the (global) financial markets it's important to stress the mutual recognition of non-EU-CCPs. Non-EU and EU-CCPs are subject to stringent requirements.

**17. Do you agree that ICAs should be considered equivalent to direct clearing arrangements and that the same limits envisaged for the different segregation models in a direct clearing arrangement should apply to an ICA? If not, please justify your position. No. The Client via which the ICA takes place is a quite usual counterparty. According counterparty risk limit rules should, therefore, apply.**

**18. Do you believe there might be circumstances under ICAs where UCITS have an exposure to the client of the CMs? If yes, what are those circumstances and do you think that UCITS should be subject to counterparty risk limits applying to the clients of the CMs? What should be the limits?**