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**European Securities and Markets Authority**
**103, rue de Grenelle**
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# AFG's response to the ESMA'S discussion paper on calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity given by the ESMA to express the French asset management's opinion on the calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations.

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.
Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.
AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

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

AFG considers that the above paragraphs 1 to 8 present a good definition of the scope more than assumptions. We understand that it is a reminder of the rules seen from the side of ESMA.

**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.**

AFG considers that all the ESMA-recognised CCPs do not present a unique or similar risk profile. We make distinction between CCPs recognised by ESMA which have the bank status and the others. AFG sees a real advantage in CCPs that are registered as credit institutions or banks because they have a direct access to central bank liquidity. Furthermore, these CCPs can have a higher size of capital and guarantee funds and also a stricter regulation on risks than other CCPs.

Overall, AFG considers that CCPs recognized by ESMA present a very low counterparty risk even if some seem to be safer than others.

AFG would also like to remind that legislators have decided the compulsory move to compensation precisely within the objective of a sharp counterparty risk reduction. Thus, AFG believes that it is the responsibility of local or European supervisors to make sure that CCPs present a very high level of financial and operational stability.

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

AFG supports ESMA's position that ESMA-recognised CCPs do not present a significant counterparty risk and considers that there should be no limit on this marginal risk.

**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.**

Yes, AFG believes that the assessment of counterparty risk vis-à-vis the CM and the client should ideally distinguish between the different types of segregation arrangements. The individual client segregation with regard to other types of segregation enables UCITS to have assets and positions legally and operationally separated from the assets and positions of other CM's clients in CCP accounts. This allows UCITS to recover their assets directly from CCPs without the risk to be impacted by CM's default.

At the advanced stage, AFG considers that CCPs and clearing members should publish their prices for individual client segregation very rapidly and thus enable checking that concrete offers are made on reasonable commercial terms as required by EMIR regulation.

However, since individual client segregation offers are not yet mature and do not appear competitive for some of our AFG members, the latters are also currently assessing other means to be protected from CM counterparty risk in other types of segregation arrangements such as gross omnibus where initial margin would be transferred in property to the CCP by the CM and excess margin would be segregated in an account under client money rules at the CM.

**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?**

The risk assessment of CCPs requires a close examination of their rules, their financial situation, the diversity of their members, their access to central money, the default waterfall …

However the key factor to determine counterparty risk is the type of segregation that determines the split between the counterparty risk existing on the CCP (very low) and the CM.

Moreover, the European regulation shall take into account the UCITS obligation to have the capability to close out at any time their positions.

**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.**

AFG agrees on the fact that UCITS have a zero counterparty risk vis-à-vis the CM under individual client segregation.

However, the definition of "individual client segregation" under EMIR regulation is imprecise and can therefore lead to different interpretations across European countries and/or CCPs. For AFG, "individual client segregation" means a cash and securities account of a clearing member opened for the account of a UCITS or a UCITS compartment within the CCP. This structure offers real portability to the UCITS.

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

AFG does not consider it necessary to apply a counterparty risk limit to the CM under individual client segregation. For the AFG members it is clear that individual segregation implies that all assets will be deposited with the CCP and that none will be kept by the CM, including excess margin. It raises the question of haircuts that the CM may ask for on top of the level of collateral required by the CCP. We consider that the CM is not entitled to haircuts in case of total individual segregation.

**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?**

AFG considers this scenario as extremely improbable if the level of segregation is properly negotiated and documented. In case of individual segregation, the CCP knows the final clients and have identified their assets and positions. A second CM has normally been identified as a backup in case of a defaulting primary CM. Thus, the CCP will try to transfer the derivative positions to the backup CM and, in the improbable case where it is not possible, the derivative positions will be liquidated.

**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.**

AFG considers there is the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs. The distinction between derivatives should be made between centrally cleared or non-centrally cleared derivatives.

In order to avoid disturbing the existing processes for ETDs, AFG considers that a phase in period of at least 24 months after the application date of the requirements for centrally cleared OTC derivatives in terms of counterparty risk should be granted to market participants and then the same time limit before imposing new counterparty ratios to UCITS.

In addition, some of our AFG members are also currently assessing other means to be protected from CM counterparty risk in other types of segregation arrangements such as gross omnibus where initial margin would be transferred in property to the CCP by the CM and excess margin would be segregated in an account under client money rules at the CM.

**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?**

AFG considers that it is not a satisfactory solution to assess on a case by case basis the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk.

AFG believes that it is the responsibility of local or European supervisors to make sure that CCPs present a very high level of financial and operational stability.

**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.**

Generally, AFG agrees that, under an omnibus client segregation, UCITS have a higher counter-party risk vis-à-vis the CM than under an individual client segregation.

However, some of our AFG members are currently investigating various routes with CMs, negotiating conditions and provisions under an omnibus segregation scheme and make sure that 1/ initial margin are transferred to CCP, 2/ excess margin are posted at the CM under an account protected by client money rules.

**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?**

AFG considers that an "omnibus client segregation" is an account of a clearing member within a CCP opened for its clients.

AFG agrees that UCITS should be subject up to a certain extent to counterparty risk limits to the CM under omnibus client segregation. We believe that they should apply those limits to the amount of collateral posted to the CM if not transferred in property to the CCP and if not

protected at the CM by client money rules. Usually initial margin and variation margin are transferred to the CCP while excess margin (in cash or collateral) are posted at the CM.

AFG believes that setting the counterparty risk limit to 50% is an adequate measure.

The limits should be given by the European regulator on a general basis and not on a case by case basis.

**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.**

Please refer to AFG's answer to question 9.

In order to avoid disturbing the existing processes for ETDs, AFG considers that a phase in period of at least 24 months after the application date of the requirements for centrally cleared OTC derivatives in terms of counterparty risk should be granted to market participants and then the same time limit before imposing new counterparty ratios to UCITS.

**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?**

AFG considers that the other types of segregation which do not offer to UCITS an identical security as the individual client segregation should be subject to counterparty risk limits.

In that matter, AFG encourages ESMA to closely analyse the different types of contractual arrangements that CCPs and CM can offer and the other types of segregation models that may also offer a good level of protection.

AFG members strongly call for clarity regarding the qualification of the types of segregation of each CCP on an ESMA register, which is a prerequisite to applying any distinctive limits based on the segregation.

The limits should be given by the European regulator on a general basis and not on a case by case basis.

**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.**

Please refer to AFG's answer to question 9.

In order to avoid disturbing the existing processes for ETDs, AFG considers that a phase in period of at least 24 months after the application date of the requirements for centrally cleared OTC derivatives in terms of counterparty risk should be granted to market participants and then the same time limit before imposing new counterparty ratios to UCITS.

**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.**

AFG agrees that UCITS should treat OTC derivative transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply counterparty risk limits to CMs. However, the limits should be different depending on the location of the CCPs: if it seems obvious to apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs for "exotic CCPs", it should be reasonable to apply less restricting limits for non EU CCPs with similar standards to those of European regulation.

The limits should be given by the European regulator on a general basis and not on a case by case basis. Some of our members insist that an impact assessment should be conducted before introducing such counterparty ratios especially to CCPs clearing ETDs.

**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.**

AFG considers that ICAs should be treated in an equivalent manner as a direct clearing arrangement and it would make sense to apply to ICAs the same limits applicable to the different segregation models envisaged for direct clearing arrangements.

AFG would like to alert regulators on the risk of unavailability of CMs capacity to onboard small asset managers. It is thus supposed that for those players ICAs could prove to be the only solution to respect the compensation obligation.

**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?**

Yes, this can be the case when the client of the CM uses an omnibus account with it. In such instances, the counterparty risk limits should depend on the offer of CMs able to clear certain contracts.

If you need any further information, please don't hesitate to contact Eric Sidot (e.sidot@afg.asso.fr) or myself (e.pagniez@afg.asso.fr).

Sincerely Yours,

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Vice Director General