AFG’s response to the Bank for International Settlements’ public consultation on revisions to the Basel III leverage ratio framework

Investment funds (UCITs and AIFs)’ concerns about potential impact of absence of recognition of non-cash collateral and limited recognition of cash collateral for the purpose of determining Leverage Ratio

We are writing to you to express potential concern regarding aspects of the determination of exposure measure of OTC-derivative contracts within the calculation of Leverage Ratio.

In particularly, we are concerned that absence of recognition of non-cash collateral could:

- Undermine funds and asset managers’ ability to hedge risks and investment objectives on behalf of their investors;
- Undermine use of derivative contracts for risk management purposes within mandates,
- Prevent assets managers acting on behalf of funds and mandates from being able to use derivatives on a cost-efficient basis, or indeed at all.

The key benefit of application of Basel III regulation to market participants should be the reduction of risk.
Most of our funds and mandates represent a relatively low level of systemic and counterparty risk: French Highly regulated investment funds (UCITS, AIFs) are subject to stringent counterparty risk limits in particular due to EU fund regulations.

We believe that the impacts to European investors and the European fund industry restricting recognition to cash collateral only could be significant.

Derivatives allow asset managers to hedge risks on behalf of their clients in a way that is tailored to the risk profile of their portfolios and mandates.

Under current arrangements, counterparties entering into derivatives transactions

- Calculate their exposure on a T+0 basis, at end of day, when books close.
- Call for variation margin during day T+1 (when the counterparties have reconciled their portfolios and agreed the margin call).
- Collect Variation Margin – cash or securities - T+2 or T+3 (T+2 is typical for high quality government bonds e.g.).

The implementation of the proposed regulation with absence of recognition of non-cash collateral would be hardly manageable. Even for cash collateral, proposed amendment to consider for netting only cash collateral exchanged in T+1 in the morning would be hardly manageable.

Such requirement could prevent investment companies from hedging risks at all. At best, it would require the development of techniques, such as pre-funding cash VM in segregated accounts at custodians, to facilitate posting of VM by T+1 which would increase operational complexity and may not be worth deploying, given the impact for the end investor.

Apart from the impact of setting up these accounts, it would diminish funds’ ability to invest in financial instruments generating a return to their investors. A similar argument could be made regarding non-cash collateral, where settlement cycles and the cost of repo of eligible collateral (where possible) would call into the question the operational feasibility and cost basis for hedging.

In addition, use of cash collateral only would be conflicting with the ESMA Guidelines on ETFs and other UCITS issues, which have the effect of restricting recourse to repo services for the purpose of posting of collateral on derivative transactions. UCITS regulation limit short-term credit to 10% of a fund’s Net Asset Value, so to the extent Repo services are used by UCITS, it is for the purpose of fund redemption requests only.

If firms cannot post or collect collateral within the time and parameters set out under Basel III regulation for the purpose of recognizing collateral as reducing derivative exposure, they may have limited access to non-cleared derivatives market.

The BCBS-IOSCO Working Group on Margin Requirements for non-centrally cleared derivatives, in particular that Working Group’s March 2015 report, does not require VM to be settled T+1. Rather,
it simply says that 'covered entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin (i.e. a zero threshold) on a regular basis (e.g. daily).

We therefore question the necessity of the level of stringency imposed within Basel III regulation and potential impact for our clients.

Additionally, it creates an unbalanced playing field for actors that already have regulatory restrictions limiting their ability to manage cash collateral (for instance UCITS funds). This will drastically limit their capacity to use the derivatives markets to manage their risks.

Consequently, we therefore urge the Basel Committee to consider asset managers limited ability to access to cash collateral on large part of funds and mandates they manage and assess potential impact absence of recognition of non-cash collateral in the functioning of derivatives market when making their decision.

Yours sincerely,

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,

Eric Pagniez