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ESMA UCITS Consultation on the review of Eligible Assets for UCITS funds

Summary:

Press release here and call for evidence here

Link to UCITS Eligible Assets Directive UCITS EAD

Questions:

Q16: How would you propose to amend the UCITS EAD to improve investor protection, clarity, and supervisory convergence with respect to the Efficient Portfolio Management (EPM)-related issues identified in the following ESMA reports:

(1) Peer Review on the ESMA Guidelines on ETFs and other UCITS issues (July 2018)
(2) Follow-up Peer Review on the ETF Guidelines; (May 2023)
(3) CSA on costs and fees. (May 2022)

In this context, ESMA is interested in also gathering evidence and views on how to best address the uneven market practices with respect to securities lending fees described in the aforementioned ESMA reports with a view to better protect investors from being overcharged.

ISLA Response:

The International Securities Lending Association (ISLA) would not propose any amendments directly to the UCITS EAD itself, however we would like to take this opportunity to propose changes to relevant guidance, that would increase clarity amongst securities lending market participants, as well as make UCITS more competitive as a global brand.

Firstly, ISLA would like to highlight the Peer Review on the ESMA Guidelines on ETF's and other UCITS issues[1], released in July 2018. As part of the 'Follow Up Actions with NCA's' in point (90), it states that:

'In the context of collateral management, there may be an inconsistency between the [2014] Guidelines and Art. 22(7) of the UCITS Directive which was introduced by the UCITS V Directive. While the Guidelines refer to 'title transfer' and 'other types of collateral arrangement' (such as pledging arrangements) to be permissible for collateral received by the UCITS for its EPM, the text of Art. 22(7) stipulates that the assets held in custody by the depositary are allowed to be reused ***only where the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement****.'*

This can be found in Article 22 (7)d of Directive 2014/91/EU[2], amending Directive 2009/65/EC (UCITS v).

[1] https://www.esma.europa.eu/sites/default/files/library/esma42-111-4479_final_peer_review_report_-_guidelines_on_etfs.pdf
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&qid=1494001122337&from=EN

In addition to this peer review, in 2017, the Securities and Markets Stakeholder group (SMSG) published advice[3] in anticipation of a peer-review of UCITS guidelines compliance. The advice directed at ESMA, was to focus their assessment on NCAs compliance with the guidelines, and list those guidelines that should be the priority for their review on securities lending practices by UCITS.

The advice, in relation to Guidelines for competent authorities and UCITS management companies, released in August 2014[4] states:

'Guideline 43, subparagraph (g) offers guidance with respect to title transfer arrangements; however, this has led to uncertainty among market participants as to the nature of "other types of collateral arrangements" which would be suitable. In particular we note recent developments in securities lending via security pledge rather than title transfer. As some security borrowers might have a preference for pledge structures, an absence of guidance with respect to use of pledge structures may be resulting in UCITS investors being disadvantaged in their securities lending activity. ***Additional ESMA guidance on the use of pledge structures by UCITS could also facilitate UCITS participation in CCP-cleared securities lending****.'*

As local NCAs' legislations are based on UCITS V Article 22(7) and the 2014 ESMA Guidelines, UCITS will be at a significant disadvantage to other lender types, if they are only able to accept collateral under a Title Transfer arrangement, making them less competitive.

UCITS V, Article 22(7), which was updated from the UCITS IV, makes clear that a depositary cannot reuse for its own account the assets of a UCITS that it is holding in custody. However, it further states that it can, however, reuse the assets so long as it meets certain requirements'.

'Title Transfer' and 'Pledging' are only mentioned in UCITS V Art.22 'Obligations Regarding a depositary'.

'Title Transfer' is only referenced in Section 43 (g) of the ESMA 2014 revised Guidelines and 'Pledge' is only mentioned in Section 43 (i):

'g) ***Where there is a title transfer****, the collateral received should be held by the depositary of the UCITS.* ***For other types of collateral arrangement****, the collateral can be held by a third-party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.*

i) Non-cash collateral received should not be sold, re-invested, or ***pledged****.'*

ISLA's market standard legal documentation, the Global Master Securities Lending Agreement (GMSLA), supports both the Title Transfer (GMSLA 2010)[5] and Security interest over collateral (GMSLA 2018)[6] i.e., 'Pledge' structures.

Under the GMSLA Pledge, the Lender transfers ownership of the borrowed securities to the Borrower outright (as it would have done under the title transfer version). The collateral provided by the Borrower is, however, not transferred to the Lender outright. Instead, collateral securities are transferred to a secured account with a third-party custodian, and the Borrower grants security of the

[3] https://www.esma.europa.eu/sites/default/files/library/esma22-106-265_smsg_securities_lending_report.pdf
[4] https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf
[5] https://www.islaemea.org/gmsla-title-transfer/
[6] https://www.islaemea.org/gmsla-security-interest/

posted collateral in favour of the Lender. It is important to note that the GMSLA Pledge agreement does not permit the Lender to rehypothecate or re-use the collateral.

Additionally, as part of the Peer review on the Guidelines on ETFs and other UCITS issues conducted in July 2018, it was noted in ESMA's report at time of release, that '*One NCA [DE] confirmed that under its current legal framework as well as its internal and external guidance,* ***other collateral arrangements than title transfer arrangements, such as pledging arrangements, are permissible****.'*
Germany has since, in 2021, removed this provision, as although the guidelines mention 'other types of collateral arrangement', 'pledged collateral' is not explicitly referenced. This clearly demonstrates interpretational challenges around the Guidelines. ISLA believes it would be helpful to include defined terminology and provide examples for 'other types of collateral arrangements' such as Pledge.

There has been increased demand for use of pledge structures in recent years, as a result of the Basel III implementation. This is driven by the borrowers' desire for a more capital efficient structure achievable through providing collateral by way of security interest (where a borrower remains the owner of the collateral, even though it is the subject of security) rather than by way of transferring ownership outright to the lender.

It is important to note the Pledge structure is not intended to replace the existing Title Transfer, that is referenced in the guidelines. That document would therefore continue to be available for use between parties who prefer to deal with collateral on a title transfer basis.

Under the Basel III regime, investment funds such as UCITS, when they serve as counterparties to SFTs with banks and broker-dealers, are captured as unrated entities under the Capital Requirements Regulation, with a risk weight of 100%. The European Commission and the co-legislators have thus far set a transitional arrangement for unrated entities, such as UCITS, whereby institutions that use an Internal Ratings Based (IRB) approach, would be able to apply a preferential risk weight of 65% to exposures that have a probability of default of less than or equal to 0.5%. As a result, the risk-weighting for securities-lending arrangements with funds will rise dramatically for banks, disincentivising such activity, despite the fact that UCITS are heavily regulated for investor protection purposes and are regarded as financially sound.

Use of the GMSLA Pledge agreement potentially enables borrowers to benefit from the better treatment for regulatory capital, as the borrower retains a property interest in the collateral assets and is not exposed to the same risk of non-return of excess collateral by the lender. Therefore, the borrower may be considered to not be taking any exposure to the principal lender, and this potentially eliminates the risk weighted assets and leverage exposure for the borrower, thus making UCITS a more attractive source of supply for borrowers if they are able accept collateral by way of Pledge.

Allowing UCITS to accept collateral by way of pledge, increases the attractiveness of UCITS as a source for borrowing, without reducing the levels of investor protection and without introducing additional risk to underlying investors. The GMSLA 2018 Security Interest over collateral 'Pledge' document, is widely used across the market and recognised by ESMA in other pieces of legislation, such as SFTR.

ISLA proposes that ESMA confirm Security Interest over Collateral structures 'Pledge' as an acceptable type of collateral arrangement as per 43(g) of the ESMA 2014 Guidelines. ISLA has assumed in our interpretation of the guidelines, that ESMA provides for the possibility of other collateral arrangements with the proviso that the collateral be held by a third-party custodian who is unrelated to the collateral provider and is subject to prudential supervision. Confirmation of this from ESMA via updated guidelines, would be hugely beneficial to market participants. ISLA would then propose NCAs review their local legislation, within their respective jurisdictions to align their national rules accordingly.

Secondly, with regards to the Follow-up Peer Review on the ETF Guidelines;[7] issued in May 2023 and the CSA on costs and fees[8] issued in May 2022, ISLA would like to note the following with regards to securities lending fee splits.

Due to their large portfolios of liquid assets, UCITS offer an ideal supply of in-demand securities, usually through the intermediation of a securities lending (SL) agent. When a SL agent is employed, the direct and indirect costs associated with their services is deducted from the total revenue generated from this activity. The appointment of an SL agent by the UCITS is a commercial arrangement between the parties, and there are often differences in service levels which are agreed depending on the SL agents service offering and the UCITS lending parameters. The appointment of an SL agent will be subject to negotiation between the parties based on varying factors.

The following are examples of the different services typically provided to UCITS:

Service level:

- Bespoke client reporting: Some lending agents may offer reporting in accordance with the clients' ESG guidelines or regulatory reporting such as SFTR.
- Coverage of penalties under the Settlement Discipline Regime of the Central Securities Depositary Regulation (CSDR).
- Transaction costs may be passed to the underlying lender or be absorbed by the lending agent.
- A more comprehensive service level generates higher costs for the lending agent, which in turn may be passed to the UCITS.

ISLA agrees that all costs and charges should always be communicated to the UCITS in a clear manner allowing full transparency.

Return generation:

- Securities lending is an over-the-counter market activity with lending fees reflecting the bespoke structure of the individual loan transaction and can vary by the type of securities on loan, type of collateral and duration of the loan.
- Investor outcomes in securities lending programs vary significantly and limiting or capping the percentage fee the lending agent can charge, may restrict investment in technology and hinder the innovation necessary to deliver the best outcomes for underlying investors.

Risk Management:

- Most investors' primary consideration when engaging in securities lending, is risk management.

[7] https://www.esma.europa.eu/sites/default/files/2023-06/ESMA42-111-7570_Follow-up_Peer_Review_on_Guidelines_on_ETFs_and_other_UCITS_issues.pdf
[8] https://www.esma.europa.eu/sites/default/files/library/esma34-45-1673_final_report_on_the_2021_csa_on_costs_and_fees.pdf

Considerable expertise and resource are expended to protect underlying investors.

- Levels of protection offered, such as a borrower default indemnification may come at an additional cost. This is an extra safeguard, benefitting UCITS in the event of a borrower default where a shortfall between the value of the collateral and the cost to repurchase the loaned securities, would be covered by the lending agent.

Similar to fees for other investment management services, securities lending fees are negotiated between the relevant parties, taking into consideration a number of factors. It is imperative that securities lending transactions be treated in the same manner as other capital markets products, which permit costs to be negotiated commercially between the relevant parties.

It is also important to note, that there are various models in the market that ESMA should be aware of, when considering securities lending:

- Direct Lending – Where an asset manager appoints an in-house securities lending agent or affiliate. The in-house lending agent acts on behalf of the UCITS and lends their securities directly to borrowers.
- Custodial Agency Lending - Most large custodian banks offer agency lending services for their custody clients. In this model, the custodian of the UCITS is appointed as lending agent to lend UCITS' securities to borrowers.
- Third Party Lending - A lending agent other than the UCITS' custodian (or depositary) is appointed to lend the UCITS' securities.

ISLA would like to note that SL agents providing a lower cost for their services does not directly result in higher securities lending returns for the UCITS. There is no direct correlation between the two, as performance of the SL agent in generating returns can vary.

Lastly, in 2020, the reporting of securities finance transactions, including securities lending came into force under the EU's Securities Finance Transaction Regulation (SFTR) which has substantially increased transparency of the securities lending activity conducted by UCITS to regulators, including the disclosure of borrowing fees.

ISLA endorses transparency in the disclosure of fees deducted from the gross securities lending income as well as returns generated for investor portfolios. ISLA encourages regular reviews of securities lending arrangements and believe that in order to provide maximum protection to underlying investors, there must be choice; this will help to support a commercially viable securities lending market for UCITS and allow them to maintain their ability to earn revenue for the benefit of their underlying investors.

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Q17: Would you see merit in linking or replacing the notion of EPM techniques set out in the UCITS Directive and UCITS EAD with the notion of securities financing transaction (SFT) set out in the SFTR[9]? Beyond the notions of EPM and SFT, are there any other notions or issues raising concerns in terms of transversal consistency between the UCITS and SFTR frameworks?

ISLA Draft Response:

ISLA would **not** propose replacing the notion of EPM techniques set out in the UCITS Directive and the UCITS EAD with the notion of securities financing transactions as set out in SFTR, as Efficient Portfolio Management techniques are not limited to SFTs and constitutes a much broader range of activities for example, the use of derivatives, within the parameters of Art. 11 of the EAD.

Although it is widely accepted that securities lending is one of the most common forms of EPM techniques, it is important to acknowledge that EPM does still exist for funds that do not engage in securities financing. Neither the Directives nor the ESMA Guidelines provide for an exhaustive list of techniques and instruments that are to be considered as EPM.

Additionally, the concept of a securities financing transaction as defined in SFTR, Regulation (EU) 2015/2365 under Article 3(11) is as follows:

a) a repurchase transaction;
b) securities or commodities lending ***and securities or commodities borrowing transaction****;*
c) a buy-sell back transaction or sell-buy back transaction;
d) a margin lending transaction;

Under SFTR, both securities lending and securities borrowing are defined as an 'SFT', however, UCITS funds are only able to lend their securities and are not currently able to borrow, therefore it would not be appropriate to replace the notion of EPM with SFT on this basis.

ISLA would see merit in ESMA acknowledging in the UCITS EAD or guidelines, that under SFTR, there is a reportable field (field 20) that provides an indication of whether the collateral in an SFT is subject to a Title Transfer collateral arrangement or a Security Financial Collateral Arrangement i.e., a Pledge, which is a well-established and recognised structure for securities financing transactions. For transversal consistency between the two frameworks, ISLA would further encourage recognition from ESMA of this type of collateral arrangement. UCITS that could potentially engage in securities lending, and accept collateral by way of a pledge, would also be mandated to report under SFTR, to the respective NCA, as is done today with securities lending transactions involving title transfer.

[9] https://eur-lex.europa.eu/eli/reg/2015/2365/oj

Q18: Apart from the definitions and concepts covered above, are there any other definitions, notions or concepts used in the UCITS EAD that may require updates, further clarification or better consistency with definitions and concepts used in other pieces of EU financial legislation, e.g., MiFID II, EMIR, Benchmark Regulation and MMFR? If so, please provide details on the issues you have observed and how you would propose to clarify or link the relevant definitions or concepts.

ISLA Draft Response:

ISLA would like to further reiterate, in addition to our responses to questions 16 & 17, that we encourage ESMA to acknowledge the use of Security Interest over Collateral 'Pledge' as an additional form of collateral arrangement, as well as Title Transfer. This is because the EU's Uncleared Margin Rules under EMIR, have already introduced the concept of UCITS being able to accept collateral in other ways that are not via Title Transfer. This concept should be brought across in the context of UCITS engaging in securities lending transactions.

UCITS which enter into uncleared OTC derivatives are subject to an obligation under EMIR to exchange collateral to mitigate the risks of one of the counterparties defaulting on their obligations. The exchange of collateral must comply with detailed requirements set out in Commission Delegated Regulation (EU) 2016/2251 (the Margin RTS). All UCITS are required under the Margin RTS to exchange variation margin (VM), which protects counterparties against exposures related to the current market value of their OTC derivatives. UCITS which have larger derivatives portfolios (i.e., UCITS which have an aggregate month-end average notional amount of uncleared OTC derivatives of 8 billion EUR or more) are also required to exchange initial margin (IM), which protects counterparties against potential losses that could stem from movements in the market value of the OTC derivatives occurring between the last exchange of VM before the default of a counterparty and the time that the OTC derivatives are replaced or the corresponding risk is hedged.

The Margin RTS does not explicitly require counterparties to use title-transfer collateral arrangements or security interest collateral arrangements, such as pledges to meet the requirements to exchange VM or IM, however, both types of collateral arrangements can be used to meet the requirements in the Margin RTS relating to VM and both are used in practice (although title-transfer collateral arrangements are more prevalent).

In contrast, it is commonly accepted in the market that title-transfer collateral arrangements cannot meet the more stringent requirements in the Margin RTS for IM. In particular, the Margin RTS requires that IM must be protected from the default or insolvency of the collecting counterparty. This cannot be achieved using a title-transfer collateral arrangement as the collateral becomes part of the proprietary assets of the collecting counterparty and, therefore, would not be protected from the default or insolvency of the collecting counterparty. Therefore, in practice, UCITS which are subject to the obligation to exchange IM must use security interest collateral arrangements such as pledges to comply with the IM requirements in the Margin RTS.

The UCITS Directive permits UCITS to use both OTC derivatives and securities lending arrangements for efficient portfolio management ("EPM"). ISLA proposes that there should be consistency between both types of EPM techniques as to the permissible ways in which UCITS can accept collateral. Given that UCITS are permitted to accept collateral subject to security interest arrangements such as pledges, to meet their obligations under the Margin RTS for uncleared OTC derivatives and, as a practical matter, have to accept collateral under such arrangements if they are subject to the requirement to exchange IM, it should also be possible for UCITS to accept collateral under security interest collateral arrangements (such as pledges) where this relates to their securities lending activities.