Comment by

Union Asset Management Holding AG

on the

Interim Report of the FSB Workstream on Securities Lending and Repos

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Volksbanken Raiffeisenbanken
cooperative financial group

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Dear Sir or Madam,

Union Investment welcomes the opportunity to comment on the Interim Report of the FSB Workstream on Securities Lending and Repos (WS5).

Union Asset Management Holding AG is the parent company of the Union Investment Group. The Union Investment Group, based in Frankfurt/Main, Germany, was founded in 1956, and is today one of Germany's leading asset managers for retail and institutional clients with more than 180 billion Euro assets under management. Union Investment offers a wide range of investment solutions in various asset classes and investment styles: equity, fixed-income, money market, alternative investments and quantitative structured funds.

We appreciate the efforts undertaken by FSB in order to develop a policy recommendation on Securities Lending and Repos. Nevertheless we want to take the opportunity to comment on some of the issues.

After reviewing the WS5's Interim Report, we have the impression that in Germany regulated investment funds and their managers especially are already subject to a very strict regulation of securities lending (in comparison to the regulation in other European countries). The German provisions regarding securities loan transactions were introduced by the Second Financial Market Development Act ("Zweites Finanzmarktfoerderungsgesetz") in 1994 as it was a motive of the German legislator to establish an additional source of income for the investors of regulated investment funds while preventing those investors from any additional risk (cf. BT-Drs.[1] 12/6679, pages 37, 79-80). These provisions proofed in practice, most provisions have been remained nearly without any amendments – even when moved via the Investment Modernization Act into to the todays Investment Act (Investmentgesetz) in 2004.

Therefore, we believe that WS5 should consider the German legislators long-term experiences regarding the existing regulation when developing a respective policy recommendation. Besides the above, we believe that at some parts, the Interim Reports should be subject to amendments.

Please find our specific comments below.

Yours sincerely

Schindler Dr. Zubrod

[1] „BT-Drs." means document of lower house of the German parliament ("Bundestagsdrucksache").

I. Motives of the Borrower for Security lending transactions

Besides the motives of borrowers for entering into securities loan transactions already mentioned (Section 1 of the Interim Report) borrowers also use securities loan transactions for hedging purposes: If it has entered into a put option as option seller (Short Put) and the price of the underlying decreases, the borrower may borrow and sell the underlying in order to limit the losses arising from the Short Put. In that case it would re-deliver to the lender the security it has received from the buyer of the Short Put.

II. Section 2.4 of the Interim Report (Forth key driver for repos)

The demand for Repos is also to be seen from the perspective of a regulated investment fund as the pledgee under a repo.

According to the European Market Infrastructure Regulation ("EMIR") and the current market practice, regulated investment funds will be forced to provide cash collateral either in the clearing process or for OTC derivatives not being subject to any clearing obligation. Differing from other Financial Counterparties (as defined in Art. 2 para. 8 of EMIR), regulated investment funds respectively their managers are prohibited from forwarding any cash collateral received (e.g. regarding OTC derivatives or security loan transactions) as their own collateral contribution to a third party. It is the nature of an investment fund, that liquidity is either to be invested or to be maintained for the redemption of fund units. Already in front of this background, cash collateral can only be obtained via loans or repos.

Furthermore regulated investment funds are subject to regulatory as well as contractual investment restrictions. As the ESAs contemplate the limitation of assets being eligible collateral regarding OTC Derivatives not cleared by a CCP (cf. Q34/35 of the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (JC/DP/2012/1)), it is likely that the manager of a regulated investment funds might be additionally forced transforming assets not being eligible collateral into cash collateral via repos in order to remaining able to hedge existing market risks via OTC derivatives.

III. Section 2.5 of the Interim Report (fifth key driver for repos)

The last paragraph, stating that one asset manager enters into security loan transactions as lender in order to gain liquidity for collateralizing OTC derivatives should be deleted as it gives a wrong picture of the market practice and regulations (at least in Germany).

According to Sec. 54 para. 2 Sentence 2 of the German Investment Act ("Investmentgesetz"), with respect to securities loan transactions cash collateral received by the regulated investment fund can only be booked to bank account or can be invested either directly or indirectly into money market instruments (Sec. 4.2.3.4 of the Interim Report reflects this regulatory background correctly). As set out in Sec. 27 para 1 of the German Investment Act, the custodial bank, supervising the asset manager, has to care for the presence of sufficient and effectively transferred collateral subject to Sec. 54 of the German Investment Code.

Since the “practice” reported from one individual asset manager does neither reflect the market practice nor the regulatory framework applying to regulated investment funds, in order to avoid any wrong impressions, WS5 should delete this paragraph or at least clarify the specific country which allows that practice.

IV. Section 3 of the Interim Report (Location within the shadow banking system)

WS5 should consider and mention under (iii) that in particular German regulated investment funds are subject to a strict regulation which only allows the re-investment of cash collateral into low risk money market instruments (cf. our remarks under III.). Those reinvestments are in the interest of the investors:

The recipient of cash collateral is obliged to pay interest on the amount received. The payment of interest reduces the income from the securities lending fee. Investing cash collateral into short term money market instruments reduces the financial burden of the interest payment obligations.

With respect to (iv) WS5 should consider and point out (e.g. via a foot note) that not all market participants are allowed to participate in “collateral upgrading services” via securities loan transactions. As stated above (cf. III of our remarks), German regulated investment funds, respectively their managers, are not allowed to forward collateral received from securities lending as own collateral contribution to a third party. Furthermore, as also stated in Sec. 4.2.4 of the Interim Report, regulated investment funds are not allowed entering into securities loan transaction as borrower.

V. Section 4.2.1.2 of the Interim Report (Counterparty concentration limits)

When the possibility of securities loan transactions was introduced in Germany in 1994, the first draft of the Second Financial Market Development Act (“Zweites Finanzmarktfoerderungsgesetz”) included fix haircuts on collateral (10% for cash collateral, 20% for bonds, 40% for stocks). Those fix haircuts have been replaced by the todays concentration limits. The German legislator deemed it likely that a regulated investment fund respectively its manager would be unable to find a borrower at all if fix haircuts in the mentioned range would apply (cf. BT-Drs. 12/7918, page 115). Since the Second Financial Market Development Act (“Zweites Finanzmarktfoerderungsgesetz”) of 1994, regulated investment funds have to ensure a 100% collateralization of the value of the securities lent and shall ask the borrower for a collateral surplus being customary in the particular market. The German legislator combined this model with concentration limits, because it feared that allowing a lower collateralization might lead to a short-term under-collateralization (cf. BT-Drs. 12/7918, page 115). The concentration limits comply with those determined in the UCITS Directive.

According to Sec. 54 para. 4 of the German Investment Act (“Investmentgesetz”), the manager of a regulated investment fund is obligated to report immediately to the German supervisory authority BaFin if the value of the collateral received from the borrower decreased below the value of the securities lent. Therefore, the German Supervisory Authority should have obtained long-term experiences on the frequency of those events respectively the German regulation of securities loan transactions.

VI. Section 4.2.2 of the Interim Report (Liquidity risk)

We can confirm that it is the common practice that securities are lent without a fix maturity and each party is entitled to terminate the security loan transactions at any time.

Differing from the current wording of Sec. 4.2.2 of the Interim Report, in Germany UCITS are only allowed to agree on a fix maturity (up to 30 days) of securities loan transactions at a total of 15% of the NAV. The German legislator has set this limit of 15% to mitigate the liquidity risk (cf. BT-Drs. 12/6679, page 80).

Therefore, WS5 should consider in Sec. 4.2.2 that in Germany restrictions on the maturity of securities loans transactions do not only apply to money market funds. WS5 should further consider that in Germany the liquidity risk is also being mitigated by a limit on the volume of securities loan transactions having a fix maturity.

VII. Section 4.2.3.1 of the Interim Report (Minimum levels of margins and haircuts)

Besides the UK, also Germany has adopted provisions by which exposures of regulated investment funds arising from securities loan transactions must be 100% collateralized at all times (cf. our remarks under V.). Therefore, WS5 should also mention Germany in Section 4.2.3.1, second bullet point.

VIII. Section 4.2.3.2 of the Interim Report (Eligibility criteria on acceptable collateral (eligible collateral))

According to Sec. 54 para. 2 of the German Investment Act ("Investmentgesetz") regulated investment funds are allowed to accept cash collateral as well as security collateral, including money market instruments. Bonds are only eligible collateral if they would also be accepted by the ECB or the German Federal Bank as collateral. Stocks are eligible collateral if they are admitted to trading on a regulated market. Any correlation between the borrower and the issuer of the security collateral must be avoided.

We believe that if WS5 recommends a policy in this regard, it should also consider shares in UCITS as eligible collateral.

IX. Section 4.2.3.3 of the Interim Report (Restrictions on the re-use of collateral / re-hypothecation)

In Germany, regulated investment funds and their managers have limited possibilities to re-use collateral. According to Sec. 54 para. 2 of the German Investment Act ("Investmentgesetz"), the re-use is limited to cash collateral received. Cash collateral can be deposited on cash accounts of the custodial bank, or if the custodial bank agrees on blocked cash accounts of certain credit institutions. Furthermore, cash collateral can be invested directly or indirectly (reverse repo) into certain money market instruments. Such is summarized correctly under Section 4.2.3.4 of the Interim Report (we do not understand the difference between Sections 4.2.3.3 and 4.2.3.4. Maybe it would make sense to merge the two Sections of the Interim Report).

We believe that WS5 should consider in its policy recommendation that cash collateral is only being provided against the payment of interest. If the lender would not being entitled to re-use the cash collateral at least in the manner described above, depending on the market interest rate, receiving cash collateral could decrease the lending fee. Therefore, a ban of any re-use would set an incentive for the lender, not to accept cash collateral at all.

From our perspective, money market investment funds are also a save investment and the redemption of fund units takes place in a timely manner. On top, in comparison to bank deposits and the related default risk, a higher grade of diversification is reached. Therefore also money market investment funds or at least qualifying money market funds (cf. Art. 18 para 2 of Directive 2006/73/EC) should be eligible asset regarding the re-use of cash collateral received.

X. Section 4.2.4 of the Interim Report (Transparency (Disclosures))

As mentioned above (cf. III of our remarks), the manager of a regulated investment fund is obligated under German law to report immediately to the German supervisory authority BaFin if the value of the collateral received from the borrower decreased below the value of the securities lent.

Besides, the custodial bank supervises that sufficient collateral has been posted in a legally valid manner.

As any possible exposure from securities loan transactions and repos would also to be considered by the UCITS in the combination limit (total exposure regarding one market participant through all kinds of transactions) of 20% of the NAV, the default risk, if any, is being limited and we do not see any need for additional reporting requirements on a transaction basis (if the latter is looked at by WS5).

XI. Section 5.1 of the Interim Report (Lack of transparency)

For the reasons provided above (cf. X. of our remarks), we believe that the limited benefits of reports on a transaction basis, if any, do not justify the costs of implementing and running of a reporting system considering repos and securities loan transactions. Instead, WS5 should consider in its recommendation how securities loan transactions can be made same safe all over Europe, as they are under the German regulation, existing and proofed for many years.

The risks arising from repos are limited too and therefore do not cause higher transparency needs. At the beginning of each transaction, the sum paid to the pledgee under a repo equals the value of the securities provided to the other party. Counterparty risks only arise as far as the value of the securities provided increase or decreases or in case of payments of the relevant securities issuer. WS5 mentions in its Interim Report that in most cases repos take place on a short term basis (cf. Sec. 1 of the Interim Report). Master Agreements being basis for those transactions, consider the collateralization and an appropriate minimum transfer amount. Any remaining risk is to be considered when calculating the total exposure regarding one market participant, which is limited to 20% of the NAV (please see above).

Therefore, we believe that transparency requirements which are currently implemented under EMIR, are not required with regards to repos and securities loan transactions.

XII. Section 5.4 of the Interim Report (Potential risks from fire-sale of collateral assets)

WS5 highlights that fire-sales of less liquid assets may harm the market. As asset manager, we are only accepting highly liquid securities for the collateralization of securities loan transactions. For the benefit of our investment funds' investors, it is important that collateral could be realized as soon as possible, if required. According to article 46 of EMIR, CCPs shall only accept highly liquid collateral. We believe that the reason for that provision in EMIR fosters the same motive, we follow when negotiating eligible collateral for the benefit for our investment funds' investors.

Compared to the estimated volumes of collateral requested by CCPs for the collateralization of OTC derivatives, the volume of collateral requested for securities loan transactions seems to be minor. With regards to EMIR we expect that any further limitations on the eligibility of collateral possibly set out by ESMA (with regards to OTC derivatives not being clearing-eligible) will much stronger increase the risks from fire-sales for the market than the realization of collateral posted with regards to securities loan transactions and repos could ever do.

For that reason, we believe that it would be justifiable not to consider the described risk with regards to securities loan transactions and repos.

XIII. Section 5.6 of the Interim Report (Shadow banking through cash collateral reinvestment)

As far as WS5's statement shall also apply to regulated investment funds, we do not share WS5's assumption that reinvesting cash collateral received from securities lending means subjecting the portfolio to credit and liquidity risks. If no reinvestment takes place, the investors of the portfolio anyway are subject to the default risk of the credit institution maintaining the cash account. Liquidity risks can only realize, where the asset manager reinvests cash collateral without maintaining a liquidity management in this regard.