Counterparty risk

Risk management policy for collateral

RSK/RCS/RDC

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General context

- The ESMA guidelines published on 18 December 2012 (*) provide new constraints for securities received as collateral. These include constraints on liquidity, issuer quality, absence of a high correlation and asset concentration.

- These guidelines apply immediately to new European-compliant funds and will apply to all compliant funds (except those with a “grandfather” clause) by February 2014.

- This document details the revised risk management policy for collateral to take account of the regulatory changes.

- This document specifies the general selection principles to be made for OTC operations in order to comply with the new constraints.

(*) the ESMA 2012/832 guidelines are available on *www.esma.europa.eu*

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Counterparty risk

- The counterparty risk measures the cost of replacing a counterparty for OTC operations (repos, securities borrowing/lending or derivatives).

- This cost represents the amount that a portfolio could lose if the counterparty defaults when the positions with that counterparty cannot be replaced at identical market prices to those contracted with the initial counterparty.

- If this cost is negative (the operation may be replaced on more favourable terms for the fund), no loss is recorded and the counterparty risk is considered to be nil.

- The counterparty risk is a function of the market price of the OTC positions contracted with an individual counterparty (aggregated or assessed individually depending on whether they are negotiated under a netting agreement), incremented by the risk of the position deteriorating in the time needed to put a new operation in place in the event of default by the initial counterparty (add-on) and reduced by the guarantees received (collateral).

- As referred to in Article 52 of Directive 2009/65/EC, the counterparty risk (*) is limited to 10% (**) of the net asset value of UCITS funds generally and/or those compliant with European standards.

(*) excluding “add-on”

(**) the limit is reduced to 5% if the counterparty is not a credit institution of an OECD or EEA country.

Counterparty analysis

- In order to minimise the default risk on OTC operations, AMUNDI only deals with a limited number of financial institutions selected from among the leading market counterparties.

- The counterparties are continuously monitored by a dedicated credit and counterparty risk management team; this team reports to the Risk Department and is therefore totally separate from the Front Office.

- Counterparty analysis, like issuer analysis, is primarily based on operational profile (country, activity, strategy and business model, risk management and management's track record), and financial profile (revenues, profitability, balance sheet, liquidity, capital).

- This team has access to the counterparties at financial presentations and one-to-one meetings with senior management. In order to build their opinion, the analysts can refer to the top three rating agencies, broker and investment bank research, Bloomberg and/or Reuters databases and economic news feeds.

Selection and approval of counterparties

- The analysis of a new counterparty starts with a Front Office request (fund managers or dealers) with the agreement of the head of the trading desk.

- If the opinion is positive, the credit risk team submits the request for approval to the Amundi Credit Committee. Approval may be granted for one or more types of contracts: forex, securities borrowing/lending or repos, OTC derivatives (options, swaps, credit derivatives, etc.).

- If the credit committee approves the counterparty, a credit-equivalent limit is set and applies to all portfolios. The limit may be revised at any time.

- The committee may ask for additional specific constraints in terms of guarantees etc.

- Following the committee's approval, the legal department negotiates the necessary agreements with the counterparty - framework agreements (ISDA, EMA, GMSLA, GMRA etc.) and corresponding annexes (e.g. Credit Support Annex, Collateral Annex).

- The credit risk team has drawn up the applicable rules for collateral; these have been approved by the committee and define certain clauses (minimum trigger amount, eligible assets, haircuts, cross-default clauses, etc.).

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OTC operations and eligible collateral

- The following table shows the classes of securities received for each type of OTC operation.

OTC operation	Types of collateral received
Securities lending	Equities/Bonds/ETFs/Cash
Short-term reverse repos	Bonds
Long-term reverse repos	Equities/Bonds/ETFs
Short-term repos	Cash
OTC derivatives	Equities/Bonds/Cash

- The ESMA guidelines of 18 December 2012 provide new constraints for the management of collateral whether it is in securities or cash.

- The new constraints on non-cash collateral concern its liquidity, valuation, issuer quality, and the concentration of the assets received.

- The constraints on cash collateral concern the nature of authorised reinvestments.

Securities as collateral: liquidity and valuation

- Article 43 (a) of the ESMA guidelines states that "any collateral received other than cash should be **highly liquid** and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation"

- Article 43 (b) states that "collateral received should be **valued on at least a daily basis** and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place"

- Amundi applies these principles through the following constraints:

Capital base / capitalisation	A minimum capital base or capitalisation is required
Type of securities	Exclusion of illiquid securities
Geographic region	Regions are defined by asset class and management style
Permitted currencies (cash)	Only major currencies

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Securities as collateral: issuer quality

- Article 43 (c) of the ESMA guidelines states that “collateral received should be of **high quality**”.

- The notion of high quality is not defined in the ESMA guidelines.

- Amundi has set constraints in terms of ratings and maximum maturity. These limits are defined by type of OTC operation.

- If there is a difference in the rating given by the three main rating agencies, the lowest rating should be used.

- In addition to the constraints on issuer quality, Amundi excludes from eligible collateral any security whose issuer is under a legal ban.

- In particular, issuers domiciled in countries under embargo or involved in the manufacture or trade of anti-personnel mines and cluster munitions are not allowed (in compliance with the Ottawa and Oslo Conventions) .

Securities as collateral: correlation

- Article 43 (d) prohibits **a high correlation**: “the collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty”.

- In the event of a counterparty default, it is possible that the holder of securities issued by that counterparty will not recover the capital it invested.

- Accordingly, prudence dictates that securities issued by the counterparty or any other entity in the issuer group are not eligible to be received as collateral.

Securities as collateral: asset concentration

- Article 43 (e) states that "collateral should be sufficiently diversified in terms of country, markets and issuers".
- The Article introduces a new concentration ratio per issuer. No single issuer of the securities received as collateral is allowed to exceed **20% of the fund's net assets.**
- However, no limit is defined in the guidelines regarding concentration by country.
- Nor is the notion of markets defined in the guidelines.

- In this context, Amundi applies the following constraints:

Market concentration	Amundi does not apply any constraint in terms of market concentration pending regulatory clarification on this point.
Country concentration	A maximum limit per country as a percentage of the fund's net assets.
Issuer concentration	Application of the new ESMA rule of a maximum of 20% of the fund's net assets per issuer.

Securities as collateral: haircut policy

- Article 46 of the ESMA guidelines now requires UCITS to put in place a clear haircut policy for the collateral received by the UCITS.

- A haircut is a percentage deducted from the market value of the securities received as collateral. It is intended to reduce the risk of loss if the counterparty defaults.

- Despite margin payments made, the cash lender receiving securities as collateral continues to run a risk that is a function of the counterparty and the evolution of the market price of the collateral.

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- The haircut is therefore an additional security to reduce the risk of loss in the event of the default of the counterparty lending the securities.

- Levels of haircuts by asset class are determined using risk indicators that take account of the volatility of the assets in normal and stressed market conditions.

Cash collateral

- Article 43 (j) of the ESMA guidelines states that collateral received in cash must be:
  - placed on deposit
  - invested in high-quality government bonds
  - invested in reverse repo transactions that can be unwound at par at any time
  - invested in short-term money market funds

- Article 44 states that “re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral”.

- In particular, the 20% per issuer constraint applies to reinvestments of the cash collateral received.

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