28 May 2010

CESR
11-13 avenue de Friedland
75008 PARIS
FRANCE

Dear Sir/Madam,

CESR/10- 108:   Consultation paper - CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

We welcome the opportunity to comment on the proposals made in the paper. Please find our detailed comments attached below.

We look forward to hearing from you if there is any clarification that you would find useful on the points we have raised.

Yours sincerely

pp Karen Bowie

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Adviser, Product Regulation

CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

> 1. Do you agree with the proposed Level 3 Guidelines for the definition and scope of global exposure?
>
> 2. Do you have any alternative suggestions?

Box 1, paragraph 1 states that UCITS should, where necessary, also carry out intra-day calculations. We are not aware of any commercially available intra-day risk system. All available systems use end of day positions. However, we acknowledge that there is a need for intra-day assessment of risks during extreme market conditions. We recommend the box refer to intra-day assessment rather than calculation.

Box 1, paragraph 5 suggests that "any other methodology" can be used to calculate global exposure whereas paragraph 2 states that "a UCITS may consider appropriate for the calculation of global exposure only those methodologies on which CESR has published level 3 Guidelines." This appears inconsistent and clarification is required as to what other methods are appropriate, if any. We note that the draft level 2 implementing measures state that "Member States may allow management companies to calculate global exposure by using the commitment approach, the value at risk approach or other advanced risk measurement methodologies as may be appropriate."

It is important that there is regulatory consensus as to the approaches to be used and consistent standards and interpretation of regulations across jurisdictions. In particular, there should be clarification as to the point at which VaR rather than Commitment is used. "Negligible" should be clarified or removed as it is too vague to be helpful.

We also question the use of the term "global exposure" in relation to the VaR approach. VaR measures "risk" and not "leverage". We recommend that references be to "global exposure" under the Commitment Approach and "risk exposure" under the VaR approach.

> 3. Do you agree with the proposed conversion methodologies for the different types of financial derivative instrument?
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> 4. Do you have any alternative suggestions?
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> 5. Do you find the numeric examples useful in providing further clarity?
>
> 6. In particular, do you consider that the use of the market (or notional) value of the underlying reference asset for a credit default swap is appropriate? Do you have any alternative suggestions?

The numerical disclosures do provide clarity but are complex in places. The commitment approach should be a simple process but the examples include complex (exotic) derivatives. We would normally expect a UCITS with exposure to these (complex) instruments to use the VaR approach. On the other hand, for a simple UCITS, a simple commitment approach should be appropriate.

It is important that the examples provide universally agreed methodologies and, where appropriate, different options for calculation (which must also be accepted by all Member States). We also believe that the list should be reviewed on a periodic basis to ensure it remains up to date. However, the list should not be so prescriptive that it becomes additional rules.

In discussing futures and options on futures, industry risk professionals often refer to the tick value method. A tick is the smallest movement in the price of a future for which variation margin will be paid and the tick value is the amount of margin that is paid for a one tick movement on one contract. In the calculation methods set out below we use the factor 'cash value of one point'. The relationship between a tick value and the cash value of one point is tick value / tick size in points = cash value of one point. The tick value method should be a recognised methodology as it may be preferred to applying contract size, because the tick value method corrects the overstatement which arises in interest rate futures but produces identical results for other types of future and option on future.

The notional values calculated below are in the local currency of the instrument and should be converted into base currency equivalent using the spot or forward rate as appropriate.

Comments on specific numerical examples:-

Bond Future

We disagree with the usage of the price of the cheapest to deliver. Using the price of the cheapest to deliver is computationally complex, as it requires selection of one among a changeable list of cheapest to deliver bonds. The apparent gain in accuracy is eliminated by the inaccuracy of subsequent netting, hedging and sensitivity processes. Calculating the cheapest to deliver will be difficult as the cheapest asset can change on a daily basis (or even continuously).

One method is to use number of contracts * notional contract size * market price of the future in points * price factor.

e.g. A Bund future has a contract size of EUR 100,000. If 177 contracts are held and the current price is 115.96 the commitment is:

177 * EUR 100,000 * 115.96 / 100 = EUR 20,524,920.

The same result may be obtained by the following calculation, which is consistent with that applied to interest rate and index futures: number of contracts * cash value of one point * market price of the future in points.

The Bund future has a cash value of one point of EUR 1,000. Applying this method the commitment is:

177 * EUR 1000 * 115.96 = EUR 20,524,920.

Where price is quoted on a yield basis, as in Australian bond futures, use number of contracts * notional * fair value of the underlying.

For example, a fund is long 1094 contracts of Australian 3 year bond futures, which are quoted on a yield basis. The futures price is 98.31, corresponding to a yield of 100 − 98.31 = 1.69%. The notional per futures contract is AUD 100,000 and the coupon is 6%. Using the formula published by the Sydney Futures Exchange the underlying value per futures contract comes out at AUD 112,556.05. The commitment is thus 1094*AUD 112,556.05 = AUD 123,136,318.70.

Interest Rate Future

The formula should take into account the future price.

It is also worth noting that the calculation 'change in value divided by percentile price movement equals effective market exposure' is a useful tool for assessing the appropriateness of methods of calculating the exposure from linear instruments. This test indicates that using contract notional overstates the exposure four or twelve fold depending on whether the duration is a quarter or a month. Overstatement will give rise to use of one month interest rate futures to hedge away exposures in the zero to two year bucket at minimal expense in terms of duration impact. It should therefore be permissible to use the tick value method mentioned above.

For this, one would use number of contracts * cash value of one point * index level in points.

For example, a fund is long 80 contracts of a 90 day Sterling interest rate future. The value per point is GBP 1,250 and the current price is 95.16. The commitment is 80 * GBP 1,250 * 95.16 = GBP 9,516,000

Other comments on specific numerical examples:-

Index future: The formula should be based on the future price of the underlying asset, not the market value, as the prices of both will differ and the actual exposure is to the index future, not the actual index.

Currency future: The formula should take into account the future price.

Plain Vanilla Currency Option: Netting arrangements should be acceptable as both currency legs must be taken into account in the commitment calculation.

FX Forward: This should also refer to the footnote on page 8 on foreign currency legs for consistency

Embedded Derivatives: The sentence in paragraph 4 should be clarified to say that the method should apply only to the embedded derivative element. For example,

certain "plain vanilla" convertible bonds may not create any additional exposure. Some Exchange Traded Funds could also be considered to embed a derivative.

> 7. Do you agree that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation? If you do not agree please explain your answer
>
> 8. Do you consider that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for the UCITS?

Boxes 3 and 4 seem to follow the criteria for Efficient Portfolio Management and should be labelled as such. This section appears to exclude Delta One notes from the calculation. Please clarify that this is the case.

The section bullet point in Box 4 seems to introduce an element of judgment into the process.

> 9. Do you agree with the proposed definitions of netting and hedging?
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> 10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure?
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> 11. Do you have any alternative suggestions?
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> 12. Do you agree with the examples provided of strategies where netting is possible?
>
> 13. Do you agree with the examples provided where hedging is possible?
>
> 14. Do you agree with the examples provided where hedging is not possible? In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

Netting should be carried out only when there is the elimination of the exposure i.e. identical contract specifications.

The netting and hedging arrangements generally seem to introduce the potential for judgment – the commitment approach should be a simple process that can be easily automated without any requirement to exercise judgment. Complex netting and hedging requirements will mean that VaR will be increasingly used across the industry as it will become a simpler method to implement, which could result in increased levels of leverage.

Box 5, paragraph 2 and paragraph 5. We believe that netting arrangements should be taken into account only when the due date of the contracts are the same. There

could be incremental exposures that are not taken into account if the contracts' have different due dates.

Box 5, paragraph 4. This states that where a UCITS uses a conservative approach rather than an exact calculation for each derivative, netting and hedging arrangements cannot be taken into account to reduce commitment on the derivatives involved. We would argue that a conservative approach would normally be more prudent and it does not make sense that netting and hedging arrangements cannot be used in those circumstances. We recommend that UCITS using a conservative calculation should be able to use netting and hedging arrangements too.

Box 5, paragraph 6. We suggest removing "verifiable" from the second bullet point to aid clarification. In addition, "the same asset class" should be changed to "the same underlying risk" in the fourth bullet point i.e. hedging arrangements can take place where they relate to the same underlying risks.

We also recommend the inclusion of additional guidance as to the treatment of derivatives used to hedge specific share classes.

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15. Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques?

16. Do you have any alternative suggestions?

We suggest that an alternative title to this section should be considered as, for example, Sale & Repurchase Agreements are not an EPM technique per se.

Further clarification is required as regard the "risk free return" as not all short dated domestic sovereign debt can be classified as risk free in the current economic climate.

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17. What are the advantages and disadvantages of each methodology?

18. Which methodology do you consider more appropriate? Please give explanations and indicate whether additional safeguards should be included.

19. In the last step of Option 1, the total amount is multiplied by 12.5. Do you consider that (i) this takes due account of the sensitivity of the UCITS and (ii) that this is in line with the commitment conversion methodology (e.g. conversion of the derivative into the market value of the equivalent position in the underlying assets)?

20. Under option 2 the target sensitivity of the UCITS can be longer than the sensitivity of the derivative while the equivalent underlying position is relatively small. This can result in high levels of leverage within the UCITS. Please provide views on the additional safeguards that could be introduced to mitigate this risk.

Both methodologies are very complex and most generally available models will not be able to cope with these calculations. As noted above, the commitment approach should be a simple process which can be easily automated. A simpler approach would be to use VaR instead.

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21. Do you agree with the general principles outlined for the use of VaR?

Yes, although the VaR limit should be an "internal" limit and there should be no requirement to disclose this in the Prospectus or in the Risk Management Process Document.

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22. Do you agree with the proposals regarding the choice of the VaR approach?

23. Do you agree with the proposed approach regarding the use of the relative VaR?

24. Do you agree with the proposed criteria for the reference portfolio?

25. Do you have any alternative suggestions?

Active VaR is a sensible approach as it is a close relation to tracking error and has a number of advantages over relative VaR for long-only and 130/30 funds. Funds with a relative VaR of 2 could be excessively risky and very highly leveraged.

Certain market indices that include embedded derivatives and derivatives should be acceptable such as indices on convertible bonds or volatility indices.

With regard to relative VaR approach we suggest that, to avoid confusion, the relative VaR formula provided in Box 11 should be specified to be more consistent with the text:

VaR UCITS / VaR Reference Portfolio <= 2

Although this definition of Relative VaR is appropriate, we believe the Committee should *also* consider allowing the more common definition of Relative VaR ("RelVaR").

RelVaR measures risk by calculating the potential loss of deviations of the UCITS in respect to its Reference Portfolio. Or alternatively, the volatility of the UCITS return relative to the Reference Portfolio.

RelVaR is calculated as the VaR of a combined portfolio comprised of a long position in the UCITS portfolio and short position in the reference portfolio.

RelVaR = VaR (UCITS – Reference Portfolio)

The advantage of this definition is that it is more closely aligned with how benchmarked UCITS Fund Managers typically manage their funds and are monitored. Investors also frequently think of fund risk in these terms. For example, it is common also to express RelVaR, scaled to one standard deviation and a one year holding period, as *ex ante* tracking error.

All the qualitative and quantitative VaR requirements would remain unchanged, although back-testing could be defined in terms of relative performance.

The maximum VaR could be defined in a similar manner as the existing formula in Box 11. That is, the ratio of RelVaR to the VaR on the Reference Portfolio could be constrained to 100%.

The advantage of permitting this approach would be closer integration between the regulatory approach and day-to-day risk management.

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26. Do you agree with this description of absolute VaR?

Yes

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27. Do you agree with the calculation standards proposed for the VaR approach?

28. Do you agree with the proposals regarding setting different default parameters and rescaling?

29. Do you consider the examples for the rescaling of parameters are useful in providing further clarity?

30. Do you have any alternative suggestions?

Please clarify the appropriate frequencies and periods of risk-factor observations. Ten years of monthly returns may be appropriate. One year of monthly returns would not. Quarterly updates are too infrequent. For a one year data series, we recommend daily updates.

Evidence of 'fat-tails' show losses greater than 2.326 standard deviations happen more than 1% of the time. Publishing this parametric statistic as a 99% confidence interval would be misleading.

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31. Do you agree with the requirement regarding the risks which should be taken into account in the VaR model?

Yes

> 32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

Yes

> 33. Do you agree with the proposals regarding back testing of the VaR model?
>
> 34. Do you have any alternative suggestions?

The recommendations do not take into account the UCITS holding period. For example, for UCITS with a high turnover, 1 day is acceptable. However, for UCITS with a longer holding period, a longer period may be acceptable.

Given a lack of clean back testing data, the requirements are too prescriptive and more flexibility is needed where 'dirty back testing' is used as there may be valid explanations for 'overshootings'. It is understood that most countries use 'dirty back testing'.

Paragraph 5 indicates that if the back testing reveals a high percentage of "overshootings", this should give rise to "adjustments" to the model. It is not clear what if any adjustments are meant by this. By their nature, VaR models will over/undershoot - the backtesting merely proves that at any point in time the level of volatility used in the model is not precise.

It would be helpful if guidance is given on the way(s) in which back testing may be carried out where relative VaR is being used.

> 35. Do you agree with the proposals regarding the VaR stress testing programme?
>
> 36. In particular do you agree with the proposed quantitative and qualitative requirements?
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> 37. Do you have any alternative suggestions?

The proposed requirements state that the stress tests should cover "all risks which affect the value or the fluctuations in value of the UCITS to any significant degree". "Significant degree" should be clarified. We would also question how "all" risks could be covered? In addition, the requirements do not cover relative stress testing in relation to relative VaR.

"Those risks which are not fully captured by the VaR model used" also requires clarification. We would suggest that some concept of the reasonably foreseeable risks should be included.

38. Do you agree with the proposed tasks under the responsibility of the risk management function?

39. Do you agree with the requirements regarding model testing and validation?

Box 21, paragraph 1. Please explain what is meant by "validation"? Also, the risk management function does not "control" the fund VaR limits as such, it monitors them. Compliance systems within the investment function should provide controls.

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?

We disagree that leverage should be calculated as the sum of the notionals of the derivatives used (Box 23). This does not appear to take into account, for example, derivatives used for hedging. Other than for the most simple of UCITS, leverage calculated as the sum of notionals will not be a meaningful risk measure.

41. Do you agree with the proposals regarding prospectus disclosure?

42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?

43. Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?

We have no objections in disclosing the method used for the calculation of the global exposure although we would query the need to disclose the calculation methodology.

As mentioned above, we do not agree with the method described to calculate leverage, and do not believe that the expected level of leverage should be disclosed in the prospectus as this is likely to be misleading and cause confusion for investors. A fund with a higher leverage may not necessarily be riskier.

If leverage were to be calculated and disclosed, the concept would require a more detailed definition; in particular, one which attempts to provide some form of risk scalar or pivot point(s) to enable the meaningful aggregation of risk within and across asset classes.

For example, within fixed income, two positions with the same notional exposed to a three month interest rate and ten year interest rate have vastly different risk exposures. Aggregating across multiple asset classes (equity, dividends, credit, currency etc) exacerbates the problem. Internal VaR limits should also not be disclosed. These are no different to internal limits for issuer exposure.

> 44. Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?

We have no objection to this, but further clarification is required in respect of the information required in Box 24, paragraph 2 i.e. the level of detail required in relation to the reference portfolio and in respect of Box 24, paragraph 3.

If VaR numbers are published, they will be used by investors to compare products. This is only of value where the VaR models and parameters are comparable. In the light of this, we question the value of such disclosure.

> 45. Do you agree with the proposals in Box 25? In particular, do you consider that the proposed criteria for the acceptability of collateral to reduce counterparty exposure are appropriate?
>
> 46. Do you have any alternative suggestions?
>
> 47. Do you consider that it would be useful to include some examples of minimum haircuts for different asset classes? Do you have a preference on what these haircuts might be?

As regards the correlation between the OTC counterparty and the collateral received, the requirements need to recognise that conditions can change.

Collateral should be allowed to be re-invested in, for example, money market funds.

The examples of minimum haircuts are generally not feasible as they are subject to market standards and conditions and set by counterparties.

> 48. Do you agree that exposure to a clearing house should be considered as part of the counterparty exposure limit? Do you have any alternative suggestions?
>
> 49. Do you agree that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit? Do you have any alternative suggestions?
>
> 50. Do you agree that exposures to a counterparty generated through stock-lending or repurchase agreements should be included in the OTC counterparty exposure limit? Do you have any alternative suggestions?
>
> 51. Do you agree that a UCITS position exposure should be calculated using the commitment approach?

Box 26 is confusing and appears to have muddled Counterparty Risk and Issuer Concentration which are subject to different requirements. The two subjects should

be dealt with separately. It would also be helpful if the explanatory text included explanation of counterparty risk provisions.

We do not agree with the first bullet point in Box 26, paragraph 1. Commission Recommendation 2004/383/EC of 24th April 2004 makes clear that derivative trades performed on an exchange with a clearing house that meets the requirement of Recommendation 5 are free of counterparty risk.

Exposure to a counterparty through stock lending and repurchase agreements are reduced by collateral.

Counterparty risk should be calculated using the mark-to-market approach. The above mentioned Commission Recommendation clarified the requirements in relation to the calculation of counterparty risk exposure and stated that "the exposure per counterparty in an OTC (should be) measured on the maximum potential loss incurred by the UCITS if the counterparty defaults and not on the basis of the notional value of the OTC." In calculating this exposure, UCITS are recommended to use the mark-to-market approach, including an add-on methodology to reflect the potential future exposure.

In relation to Q 51, if CESR means that for issuer concentration purposes, the calculation of the underlying of derivatives should be carried out using the conversion methodologies set out in the commitment approach, we agree.

52. Do you agree with the proposed cover rules for financial derivative instruments?

Yes

53. Do you think there should be further restrictions on the assets held by the UCITS as cover?

The proposed cover rules are adequate and should ensure that a UCITS will be capable of meeting its commitments from derivative transactions.

54. Do you agree with the proposed definitions?
55. Do you consider that CESR should provide other definitions in these guidelines? Do you have any suggestions for other definitions?

In relation to global exposure, the text "... or the market risk of the UCITs portfolio" should be deleted. The global exposure definition will then be appropriate for the commitment basis of calculations.

A new definition of "Risk Exposure" is needed that covers VaR (as per our comments in response to questions 1 and 2)

There is no definition of leverage in the glossary, although it is defined at box 23, paragraph 3. However, leverage is meaningless for bond funds and (as mentioned in response to question 39) the definition at box 23, paragraph 3 is not consistent with the commitment basis of calculating exposure.

The words "maximum" should be removed from the definition of "Value at Risk" as VaR does not measure the maximum loss but estimates the likelihood that the loss will exceed a certain amount.

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56. Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?

57. If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.

58. Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach

59. Can you suggest any additional criteria?

We agree that the types of funds described can use an approach that differs from the standard approach to measuring global exposure.

However, we would highlight that not all capital protected funds include a formal guarantee. There are also a number of actively managed structured funds. We propose that an alternative title to this section is considered as not all types of structured funds are considered in these proposals. The title should reflect the narrow definition and criteria used within the section.