efama

European Fund and Asset Management Association

EFAMA Reply to CESR's Consultation Paper on Risk Management Principles for UCITS

EFAMA[1] is grateful for the possibility to comment on CESR's Consultation Paper on Risk Management Principles for UCITS. We agree that risk management plays a crucial role in the protection of UCITS investors and in the fulfillment of UCITS managers' fiduciary duties, and therefore support CESR's initiative.

EFAMA broadly agrees with CESR's approach in this Consultation Paper, but we have some general and some detailed comments.

General Comments

CESR should clarify its use of the expression "risk management". CESR's paper refers to "risk management", although it mostly describes the function of "risk controlling" or "risk monitoring", which is much narrower and covers only part of risk management. Risk management is an integral part of investment management and includes investment decisions by the investment manager, for example regarding asset allocation or the setting of risk tolerance limits. We recommend that CESR introduce this distinction and modify the language of the paper to clarify the concepts (see also our comments regarding Para. 7). EFAMA believes that this paper should focus on risk monitoring, its organization and execution, as well as its independence from the investment management function.

EFAMA believes two important concepts must always be taken into account when discussing risk management: materiality and proportionality. First of all, a careful analysis of all possible risks in view of their materiality to the UCITS must lead to the identification of the material risks to be managed by the risk management process. Secondly, the measures foreseen by the risk management process must be proportionate to the characteristics of the UCITS' investment strategies, as well as to the size and complexity of the activities and organization of the management company.

[1] **EFAMA** is the representative association for the European investment management industry. EFAMA represents through its 24 member associations and 42 corporate members about EUR14 trillion in assets under management of which EUR7.3 trillion managed by around 52,000 investment funds at end June 2008. For more information, please visit www.efama.org.

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Specific Comments

Definitions
For EFAMA it is important to clarify that the references to "Board of Directors" are to the Board of Directors of the designated Management Company or of the self-managed investment company, and not to the Board of the UCITS (except in the case of the self-managed SICAV, where the Board coincides with the UCITS Board). To this effect, a definition of "Board of Directors" should be included.

Furthermore, the definition of "Outsoucer" used by CESR is requires modification. The party to which a Company may delegate performance of risk management activities is the **Outsourcee**, while the Outsourcer is delegating party.

RISKS RELEVANT TO UCITS

EFAMA welcomes CESR's acknowledgment in Para. 9 that only some operational risks also affect investors' interests, and should be considered within the scope of this document. We wish to stress that only relevant or material risks should be taken into account by the risk management process, and that CESR should therefore be consistently referring only to material risks throughout the paper.

PART 1 – SUPERVISION

Box 1: Supervision by competent authorities
Although we agree that risk management should be considered by the competent authorities during the process of UCITS authorization, EFAMA strongly believes that this cannot lead to a re-assessment of the risk management process each time a new UCITS is authorized, which would be overly burdensome for the industry and further slow down the UCITS licensing procedure. When licensing a new UCITS, the appropriateness of the risk management process should be considered, but the initial risk management approval for the management company should be relied upon and multiple approvals should be avoided.

Furthermore, such an assessment is not included in Art. 4 of the UCITS Directive, which regulates the authorization of UCITS, and therefore such an obligation would exceed the requirements of the UCITS Directive.

With regard to Para. 5, EFAMA also believes that the language should be aligned with Box 1 and the risk management process should not be "assessed" by the competent authority in the process for licensing the UCITS, but rather "considered".

In Para. 6, we suggest the following modifications (see our comments above): "Material changes to the risk management process should be provided to the regulator."

PART 2 - GOVERNANCE AND ORGANIZATION OF THE RISK MANAGEMENT PROCESS

Box 2: Definition of roles and responsibilities
EFAMA agrees in principle with CESR's proposal.

However, in reference to Paragraphs 1 and 2 in Box 2, CESR should acknowledge that the risk management process as well as its documentation, formalisation and traceability should be proportionate to the nature, scale and complexity of the Management Company's activities (see Para. 2 of Box 3), in order to avoid undue burdens on small and mid-sized companies.

Furthermore, EFAMA is of the opinion that a separate "risk management policy" document is not necessary, and that the risk management process can continue to be duly documented within existing organizational rules and procedures. The last sentence in Para. 2 ("The corresponding documents will be referred to as 'risk management policy'") should therefore be deleted, and the reference to the "policy" in Para. 3 should be modified into "risk management process".

With regard to Para. 7, in the first sentence the reference to the risk management policy should be removed and the sentence should read: "In particular, with respect to its organisation and functioning, **the process** should:".

With regard to Para. 7 (c), we refer to our general comments regarding the definition of "risk management", and reiterate that risk management is not just risk controlling. Instead of referring to the "risk management and investment management <u>processes</u>", the text should refer to the "risk management and investment management **functions**".

Box 3: The risk management function
In Para. 1 of Box 3 the reference should be to unit<u>**(s)**</u>, (not unit), as used in Para. 7(a).

In Para. 3 of Box 3 the reference to the risk management policy should be deleted. Instead of "policy and procedures", we suggest that CESR refer to the "**risk management process**".

In Paragraph 8 of the explanatory text, EFAMA recommends replacing "…expertise needed to be accountable for the responsibilities" with "…expertise needed to **discharge the duties**".

Para. 10 should make a distinction between the risk management functions which are the responsibility of the investment manager, and the risk monitoring or controlling, to be carried out by the risk management function.

The reference to "IT structures" in Para. 9 is unclear. We would suggest stating that "the risk management function should employ sound processes, professional expertise and adequate **risk management techniques and systems**".

In Paragraph 14 of the explanatory text, EFAMA would like to see reflected the very important principle of proportionality expressed in Para. 2 of Box 3, in order to avoid undue burdens on small and mid-sized companies. The term "guarantee" ought to be replaced by "**ensure**".

Paragraph 15 of the explanatory text: EFAMA suggests the deletion of the last sentence, as in some cases an appropriate appraisal is embedded in the investment process on a dynamic basis, while in other cases an appraisal at intervals (for example once a day) is sufficient. In some cases, a dynamic appraisal is not even feasible. The frequency of appraisal should be at the discretion of the Management Company.

Box 4: Outsourcing
Para. 1 Box 2: EFAMA fully agrees that it should be possible to outsource risk management. However, it would be better to state that the Management Company retains "***primary*** responsibility"for the effectiveness and appropriateness of the risk management process, rather than "***full*** responsibility".

Para. 2 Box 4: The reference to "the appropriateness of its operations and conditions" should be replaced with "the appropriateness of its operations and **risk management process**", as "conditions" is unclear. The requirement that procedures should be established for the "assessment of the Outsourcer's governance, technical and business environment" is very broad, and we suggest clarifying it by adding "to the extent this is material to the quality of outsourced activities".

Para. 20 of explanatory text: The reference to "Outsourcer" should be changed to "Outsourcee" (see our comments on the definitions).

PART 3 - IDENTIFICATION AND MEASUREMENT OF RISKS RELEVANT TO THE UCITS

Box 5: Identification of risks relevant to the UCITS
Para. 1 Box 5: "All risks" is too broad. The sentence should read: "The risk management process should assess the risks **material** to the UCITS"

Para. 2 Box 5: For consistency, also in Para. 2 the reference should be to "**material**" risks, not "relevant" risks . We also suggest eliminating the reference to the risk management "policy" (see our comments to Box 2), replacing "all possible risks" with "material risks", and modifying Para. 2 as follows: "**The risk management function should identify the material risks affecting the UCITS according to the methods and principles defined by the risk management process of the Company**".

Explanatory text: see our general comments regarding the lack of distinction between "risk management" and "risk controlling" or "risk monitoring".

Para. 22 of the explanatory text - EFAMA suggests modifying the sentence as follows: "The risk management process should regard as relevant the material risks that stem from the investment **strategy and profile of the UCITS** and the valuation process" (the reference to the manager's trading style should be removed).

EFAMA disagrees with CESR's allocation of functions in Para. 23 of the explanatory text: the responsibility for the overall risk management process is lies with the Board of Directors, which is also in charge of identifying the risks and defining the overall risk profile of the fund. The risk controlling function should provide the ongoing monitoring and report to the Board.

Para. 24 of the explanatory text: EFAMA would appreciate a clarification of the meaning of the last part of the sentence ("…without being bound by the use of a specific risk management model…").

Box 6: Risk measurement techniques
Please see our general comments on proportionality at the beginning of this reply.

Para. 1 of Box 6: The reference to the "risk management policy" should be deleted (see our comments to Box 2). The sentence should read: "The Company should specify …".

In reference to the explanatory text, we suggest deleting the wording "more or less sophisticated in terms of meaning and methodology" in Para. 26, as well as the text in parenthesis in Para. 28 "(higher risk profile UCITS may need more complex measures than low-risk profile ones)", as such language is too vague and undefined. EFAMA fully agrees with the fact that the choice of the risk measurement framework should be proportionate to the risk characteristics of the UCITS, although for the purpose of these Principles we do not see the need to specify further details.

EFAMA disagrees with the last sentence in Para. 28, which could be interpreted in an overly prescriptive way – especially the statement "…consider the use of market-leading market solutions" – for management companies utilizing adequate in-house solutions.

We do not agree with CESR that operational risks in general are non-quantifiable. We suggest therefore deleting the wording "such as operational risks" from Para. 31. We would also delete the examples at the end of Para. 31 "(e.g. risks attached o the technical features … UCITS performance)", as they should not be included in the principles.

Box 7: Management of model risk concerning the risk measurement framework
Box 7, Para. 2: the word "continuous should be replaced by "**ongoing**".

Para. 33 of the explanatory text: EFAMA suggests the following modification: "Back-testing should be carried out separately for every **relevant** technique used in the risk management framework", as back-testing is not relevant to all techniques.

Box 8: The link between risk measurement and asset valuation
In reference to Para. 2 of Box 8 and in particular to Para. 40 of the explanatory text, EFAMA agrees that the risk monitoring/measurement function should support the valuation process. This support, however, should take the form of participation in the management company's valuation committee, not of imposing its pricing assumptions and models on the valuation function.

The valuation function should exercise its activities independently of the risk monitoring function, and should be responsible for choosing the most appropriate pricing source or valuation model. Risk monitoring should not be the only factor in the choices regarding valuation.

At the same time, the risk monitoring/measurement function should use prices selected on the basis of the criteria set by the valuation function, so as to maintain consistence within the company.

We suggest adding at the end of Para. 39 the wording "**where available**", as actual comparable trades might not be available.

PART 4 – MANAGEMENT OF RISKS RELEVANT TO THE UCITS

Box 9: Risk management procedures
EFAMA believes that the language of Para. 1 of Box 9 should be modified to better define the role of the Board of Director as follows: "The Board of Directors should **approve the product and** risk profile of each UCITS managed by the Company **prior to its launch**."

The function of the Board of Directors should not be to define such product and risk profile by itself, but to approve it and bear responsibility for it, after it has been defined.

Para. 2 should be similarly modified: "The risk management procedures should ensure that the actual level of the risks incurred by the UCITS remain consistent with its **product and** risk profile as **approved** by the Board of Directors."

For consistency reasons, the terminology "**product and** risk profile" should be used in Paras. 41 and 42 as well.

Box 10: Risk limits system
Para. 1 of Box 10: EFAMA suggests the following modification: "The risk management policy of the Company … measures used to monitor and control the relevant **quantifiable** risks", as non-quantifiable risks clearly cannot be subject to a limit system. The same addition of "**quantifiable**" should be made to the first sentence of Para. 45.

In Para. 45, EFAMA does not believe that it is necessary or even feasible for every transaction to be taken into account <u>immediately</u> into the calculation of the corresponding limits for all risks, and the word should therefore be deleted. The reference in the second sentence of this paragraph should be to "all **material** risks to which a limit can apply".

Box 11: Effectiveness of the risk management process
EFAMA believes that that the requirement in Box 11 of a "prompt" correction of the portfolio in case of breaches to the risk limit might not necessarily in the best interest on UCITS investors. CESR should recognize that corrective action should be discussed and agreed with the investment management function, and the appropriate

timing of corrective action has to be evaluated according to the best interests of the UCITS and its investors.

EFAMA agrees with the fact that the risk management process should allow warnings to be generated so that appropriate corrective measures may be taken on a timely basis to prevent breaches. However, in our opinion the second sentence of Para. 48 and the entire Para. 49 should be deleted, as the use of specific risk assessment measures and in particular of stress testing should be left to the discretion of the management company. Furthermore, such details seem to be too prescriptive for these principles.

PART 5 –REPORTING AND MONITORING

Box 12: Reporting to the Board of Directors and the Senior Management
EFAMA recommends deleting the reference to the risk management policy (see our comments on Box 2). The second sentence of Para. 1 of Box 12 should read: “The terms, contents and frequency of this reporting should be defined.”

In Para. 2, we do not believe that it is possible to outline “expected breaches”, a reference to which should therefore be deleted.

As discussed in our comments to Box 11, the word “prompt” in Para. 2 is inappropriate. It would be sufficient for CESR to refer to “appropriate action”.

In Para. 3 we would again replace the word “defined” with “**approved** by the Board of Directors ”(see our comments regarding Box 9).

Box 13: Monitoring of the risk management process
EFAMA disagrees with CESR’s proposal in Para. 1 of Box 13 that – besides the Board of Directors – also the “Supervisory Function” should receive written reports from the risk management function on a periodic basis. It should be sufficient for the Board of Directors to receive such reports, and such Supervisory Function is in any case not required in all Member States.

In Para. 3, we believe that the reference to “internal or external independent oversight” is too unclear. The paragraph should therefore be modified as follows: “The risk management process should be subject to appropriate **review by the Company’s internal or external auditors**”.

We hope our comments will be of assistance and remain at your disposal for any clarification.

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23 October 2008