EFAMA REPLY TO CESR'S TECHNICAL ADVICE AT LEVEL 2

ON RISK MEASUREMENT FOR THE PURPOSES OF THE CALCULATION

OF UCITS' GLOBAL EXPOSURE

EFAMA[1] welcomes CESR's technical advice to the Commission focusing on risk measurement for the purposes of calculation of UCITS' global exposure. We congratulate CESR for the excellent work and agree with its proposals to a very large extent.

We also agree that the content of this advice should be divided between Level 2 and Level 3 measures relating to UCITS IV, and encourage CESR to limit Level 2 to the principles of risk measurement (with some exceptions we will identify in our comments), leaving the details of the methodology for Level 3. CESR should strike a balance between the flexibility needed to accommodate progress in market practices as well as financial innovation, and, on the other hand, the need for harmonization of risk measurement and a level playing field.

We also believe that CESR should refer for guidance to the Level 3 "Risk Management Principles for UCITS" and maintain coherence with such Principles in its Risk Measurement proposals.

General comments

Regarding the calculation of global exposure using the commitment approach, we would like to point out that it is supposed to be a simpler approach, to be used for less sophisticated funds. Our members therefore invite CESR not to "overload" the methodology.

With respect to the VaR approach, CESR needs to take into consideration in its advice that the basis for VaR calculation of global exposure is the entire UCITS portfolio, not just the derivatives included in it; in other words, VaR represents the total portfolio risk.

Lastly, the move to clearinghouse/CCP clearing of OTC derivatives should be taken into account by CESR with regard to counterparty risk and collateral treatment.

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 44 corporate members about EUR 11 trillion in assets under management of which EUR 6.1 trillion managed by around 54,000 investment funds at end 2008. For more information, please visit www.efama.org.

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Detailed replies

1. Do you agree with the proposed approach in relation to the calculation of global exposure?

EFAMA agrees with the proposed approach in relation to the calculation of global exposure.

2. Should the counterparty risk involved in an OTC derivative be considered in the calculation of global exposure?

No, EFAMA does not believe that the counterparty risk involved in an OTC derivative should be considered in the calculation of global exposure. It is not current market practice to consider risk in terms of both market and counterparty risk, since one OTC contract does not have any more market risk exposure than another identical one. Market risk and counterparty risk represent two different sources of risk and should continue to be managed separately.

3. Do you agree with the proposed approach or can you suggest an alternative approach?

EFAMA agrees with the proposed approach to the scope, with one exception (see answer to Question 4).

4. Do you agree that the incremental exposure/leverage generated through techniques such as repurchase and securities lending transactions should be included in the calculation of global exposure?

EFAMA does not believe that in principle the incremental exposure/leverage generated through techniques such as repurchase and securities lending transactions should be included in the calculation of global exposure, as such transactions usually do not create new market exposure. However, if and when such transactions are structured to create market exposure, almost all EFAMA members believe they should be included in the calculation.

5. Does option 1 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?

Almost all EFAMA members believe that Option 1 does not correctly assess market risk.

6. Does option 2 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?

Yes, almost all EFAMA members believe that Option 2 is appropriate to measure global market exposure, whereas Option 1 measures the maximum potential loss. The use of delta in Option 2 as opposed to just market value is in keeping with industry standards, and allows for a more market-oriented calculation.

Option 2 is also preferable to Option 1 as it allows netting among different positions, thus making possible a global synthetic approach to the UCITS' total commitment on the derivatives market.

7. Do you have any comments or other suggestions regarding other possible measurement approaches?

We have no comments.

8. Do you agree with the proposed approach, in particular the inclusion of a non-exhaustive list of financial derivatives?

EFAMA agrees with the proposed approach, but it is important that the list of financial derivatives remain only illustrative and non-exhaustive, and that the choice of approach (commitment vs. VaR) be left to the UCITS/Management Company. In order to achieve a harmonized implementation and obtain a level playing field among funds in the EU, **EFAMA would prefer to have a list of instruments and the relative conversion methods included in Level 2 measures.**

9. Do you have any alternative suggestions for the conversion method?

Some EFAMA members have put forward the following alternative suggestions:

<u>Index futures</u>: the future price should be used instead of the price of the underlying index. The index future should be based on the forward price of the underlying asset, not the market value, as the prices of both will differ and the actual exposure is to the future, not the actual index.

<u>Bond futures</u>: the calculation should be on the same basis as the index future i.e. number of contracts X notional X future price. Calculating the cheapest to deliver will be difficult as the cheapest asset can change on a daily basis (or even continuous). It must be noted that the Commitment approach should be a simpler method of calculation than VaR.

<u>Credit Default Swaps</u>: reference notional

10. Are there other types of financial derivative instruments which should be included in the paper?

Some EFAMA members believe that other commonly used instruments should be included in the list, such as:

- Convertible bonds - Conversion method: use of market value
- Interest rate futures - Conversion method: number of contracts X contract size X future price

- Currency options - the notional amount in a foreign currency can be translated into the fund's reference currency, taking into account the delta of the option
- Cross options (other than currency options) – the two legs should be considered separately (similarly to forwards)
- Currency swaps – Conversion method: notional as it is exchanged
- Swaptions
- Options on futures
- A kind of swap commonly used for structured funds where the receiving leg is a plain vanilla equity option and the paying leg is a floating rate payment -Conversion method: the same as for a plain vanilla equity option: market value of the underlying asset adjusted by the option's delta, i.e., number of contracts x number of shares x underlying price x delta.

11. Are you aware of any type of financial derivative instrument where global exposure cannot be calculated using the commitment approach?

EFAMA members are not aware of any other type of commonly used financial derivative instrument where global exposure cannot be calculated using the commitment approach. However, we agree with CESR (see page 7) that for some less common derivatives the commitment approach cannot be used.

12. Do you agree with the approach regarding TRORS and derivatives with cash or an equivalent position?

EFAMA agrees with CESR's approach.

13. Do you agree with the proposed use of the sensitivity approach?

EFAMA agrees with the proposed sensitivity approach.

14. Do you consider that this should be compulsory for these types of derivative or optional for UCITS?

Almost all EFAMA members believe its use should be optional for UCITS.

15. Do you agree with the analysis of the sensitivity approach described?

EFAMA agrees with CESR's analysis.

16. What quantitative level would you consider appropriate for the default sensitivity?

Default sensitivity levels should be set by the UCITS and for each fund, on the basis of a careful risk assessment.

17. Do you have any additional comments or suggestions on this approach?

We have no further suggestions.

18. Do you agree with the proposals regarding netting?

Almost all EFAMA members agree with the proposals regarding netting.

19. Do you have any additional comments and/or proposals?

No, we do not have additional comments.

20. Do you consider that hedging as described above should be permitted?

Yes, a large majority of EFAMA members believe that hedging should be permitted.

21. Do you consider that the strong correlation requirement should be further clarified by means of a quantitative threshold e.g. 0.9?

22. Can you suggest a possible threshold e.g. for the minimum correlation between stock baskets? Please justify your answer based on relevant market data.

No strict quantitative thresholds should apply. A decision on thresholds must be left to the discretion of the UCITS/Management Company, as its level depends on how each fund is structured, the selected instruments and market conditions. In case these parameters do not fit the commitment approach, VaR should be used. A standardized setting of regulatory binding correlation limits would not improve the commitment approach.

23. Do you agree with this proposal?

Yes, a large majority of EFAMA members agree in principle with the proposals regarding computation of concentration risk. However, the proposal should be understood as relating to the 20% issuer concentration rule, not to the 5/10% issuer limits. Finally, the computation methodology should be part of Level 3 measures.

24. Do you agree with this definition? Do you have any alternative suggestions?

EFAMA agrees with CESR’s definition of VaR. However, we believe that it should be expressed in terms of percentage/basis points (as per current usage), not in cash amounts.

25. Do you agree with the above approach?

Yes, EFAMA agrees with CESR’s approach.

26. What additional safeguards (if any) are necessary for UCITS which use VaR to calculate global exposure to ensure consistency with the total exposure limit of 200% of NAV?

Almost all EFAMA members consider that stress tests could be used as additional safeguards within the general framework of risk measurement to estimate the potential loss under non-normal market conditions. However, it should be noted that the VaR methodology and total exposure limits expressed as a percentage of NAV are different concepts.

27. Do you agree with the approach outlined in paragraphs 2.3, 2.4 and 2.5?

28. Do you have any comments or suggestions?

Yes, EFAMA agrees, with one exception:

The requirement that “The model used must be internally validated by the UCITS by a function which is <u>independent</u> from that responsible for building the model.” (Para. 2.5) is overly burdensome and impracticable. Models should be internally validated by means of backtesting, and cannot be validated by another unit within the UCITS/Management Company, as this would require a complete duplication of the Risk Management function.

From Box 7 of “CESR’s Risk management Principles for UCITS” and from the following explanatory text, it is clear that the management of model risk should remain internal, and that validation should be carried out by the risk management function. Para. 38, for example, states: “*The quality of risk model-based forecasts should be demonstrably assessed. Essentially, the risk management function should run documented tests to verify that model-based forecasts and estimates correspond, with the appropriate confidence level, to the actual values of the relevant risk measures (back-testing).*”

29. Do you consider that VaR should be calculated at least daily?

Almost all EFAMA members agree that VaR should be calculated at least daily.

30. What type of criteria should competent authorities take into account in an assessment of the VaR Models?

We believe that the following criteria could be taken into account by competent authorities to assess VaR models:

- Backtesting results
- Model failures
- Quality of data input
- Nature and volume of the financial derivative instruments used.

31. Do you consider that VaR models should be approved by competent authorities?

No, almost all EFAMA members consider that VaR models should not be approved by competent authorities. While we fully agree with an assessment by competent authorities, approval should remain the responsibility of the UCITS/Management Company. According to Box 1 in CESR's "Risk Management Principles for UCITS", "*The adequacy and effectiveness of the risk management process should be considered by the competent authorities as part of the process for licensing the UCITS/Company, and subsequently supervised on an ongoing basis.*" On the contrary, "*the risk management policy is approved, reviewed on a regular basis and, if necessary, revised <u>by the Board of Directors</u>.*"

Models need to be adjusted on an ongoing basis. Flexibility is therefore needed, both to keep them updated, and to avoid significant delays in the launch of new funds.

32. Is the proposed 3-step relative-VaR approach adequate to limit the global exposure of a UCITS?

EFAMA members agree with the proposed 3-steps approach, but wish to point out that the result should be expressed as an absolute ratio. For example, the formula should read as follows:

The global exposure equals to

absolute [(VaR UCITS – VaR Ref Portfolio) / VaR Reference Portfolio] x 100

and should not be a negative number. The current formula (as stated in the third bullet point in Para. 2.6) could lead to a negative ratio.

33. Do you consider that the proposed limitations on the reference portfolio constitute reasonable and adequate safeguards to ensure that the relative VaR method does not result in the UCITS taking excessive risk or leverage?

Yes, a large majority of EFAMA members agree that the proposed limitations on the reference portfolio constitute reasonable and adequate safeguards, and that a long-only benchmark can be used, but an exception should be made for convertible bond and commodity indices as they do not introduce any leverage.

34. What additional safeguards (if any) do you consider necessary?

Almost all EFAMA members believe that stress tests could be considered as additional safeguards within the framework of risk measurement.

35. Can the absolute VaR be considered as an appropriate way of measuring global exposure?

Yes, EFAMA members believe that absolute VaR can be considered as an appropriate way of measuring global exposure. However, we recommend specifying the same confidence level and holding period for both absolute and relative VaR (they are currently proposed by CESR only for absolute VaR). Such definition would foster a harmonized implementation and a level playing field among funds.

Some of our members disagree with CESR's proposed requirement that the absolute VaR should not exceed 20% of the UCITS NAV, which they deem to be too low.

36. Do you consider that the proposed thresholds are suitable? Can you suggest other thresholds?

Yes, almost all EFAMA members consider that the proposed thresholds are suitable.

37. What are your views on the application of stricter criteria to difference types of asset classes e.g. bonds, equities?

No, EFAMA does not consider that stricter criteria are necessary or appropriate.

38. Do you consider the proposed safeguards, such as the use of appropriate additional risk management methods (stress-testing, CVaR) and the disclosure of the level of leverage, are sufficient safeguards when the absolute VaR method is used in the context of arbitrage strategies or complex financial instruments?

Yes, almost all EFAMA members agree such safeguards are sufficient, but their use should be at the discretion of the UCITS/Management Company.

39. Should UCITS using strategies that are potentially highly leveraged under the absolute VaR method be subject to specific marketing provisions, either at the level of the UCITS (minimum initial investment) or during the marketing process?

No, we do not believe that UCITS using strategies that are potentially highly leveraged under the absolute VaR method should be subject to specific marketing provisions. Firstly, it will be difficult to define "highly leveraged", and secondly marketing provisions are already subject to MiFID and national regulation. No minimum initial investment should be required – and such a provision is not foreseen either in the UCITS Directive or in MiFID – but appropriate disclosure must be provided to investors and distribution must follow MiFID rules. Furthermore, in our opinion marketing provisions do not fall under the scope of this consultation paper.

40. Can you suggest alternative safeguards and/or requirements to avoid UCITS engaging in strategies which generate high levels of leverage?

EFAMA does not have any further suggestions and maintains its position that a robust risk management is essential.

41. Do you agree with the proposed method for calculating counterparty exposure?

Yes, a large majority of EFAMA members agrees with CESR’s proposed method for calculating counterparty exposure.

42. Can you suggest an alternative method?

Some EFAMA members do not agree with CESR. They propose different approaches, some suggesting to remove the counterparty reduction factor while maintaining the add-on for future credit exposure, while others support the use of the 'mark to market' approach used to measure the credit risks associated with derivative contracts in Annex III of European Parliament and Council Directive 2000/12/EC [risk weighting * (positive MTM + (notional * add-on percentage)), maintaining the risk weighting.

43. Do you agree with the approach for netting arrangements?

EFAMA agrees with CESR’s approach, but we disagree with the restriction of netting only with OTC contracts with the same counterparty. We believe that netting of OTC derivative positions and other positions between the UCITS and the same counterparty should be permitted, provided that legally enforceable (by the UCITS) netting agreements are in place. In this regard, we refer to Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, that also applies to UCITS (Art.1, (2), (c), (v)) and that explicitly recognizes close-out netting provisions (Art.7), regardless of the nature of the positions.

44. Do you consider that additional netting rules should apply?

No, EFAMA does not consider that additional rules are necessary.

45. Do you agree with the proposed approach to agree a set of principles in relation to acceptable collateral to reduce counterparty exposure? Do you have alternative suggestions?

Yes, EFAMA members agree with the proposed approach.

46. Do you consider that rather than following principles based approach specific instruments that can be used as eligible collateral should be indentified?

A large majority of EFAMA members believe it would be useful to identify instruments that can be used as eligible collateral, but such a list must be non-exhaustive.

47. Should collateral be UCITS compliant in terms of asset eligibility and diversification?

A large majority of EFAMA members believes that collateral should be UCITS compliant in terms of asset eligibility, but not in terms of diversification.

48. Do you agree that collateral passed to a derivative counterparty should be included in the either the 5%/10% OTC counterparty limit or the 20% issuer concentration limit?

Yes, almost all EFAMA members agree that the net collateral passed to a derivative counterparty should be included in the 20% issuer concentration limit, but only with regard to the overcollateralization.

49. Do you have any other suggestions as to how such collateral passed should be treated?

No other suggestions.

50. What areas of further work should be carried out with regard to this?

EFAMA believes that further work should be carried out on the use of credit default swaps as a means of mitigating counterparty risk.

51. Do you agree with the proposal to abandon the use of the term sophisticated and nonsophisticated UCITS?

52. If you object to this proposal could you please provide reasons for this view?

Yes, EFAMA agrees with CESR's proposal to abandon the use of the term sophisticated and non-sophisticated UCITS.

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