ASSOGESTIONI
associazione del risparmio gestito

Milan, 31 May 2010

CESR
11-13 Avenue de
Friedland
75008 Paris

Your Ref.: CESR/10-108
Our Ref.: 370/10

Re: Response to the CESR consultation on CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.

Assogestioni, the Italian association of asset management companies, welcomes the opportunity to comment on CESR's Consultation Paper on guidelines at level 3 on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS .

Here below the Association responds to the consultation document.

1. Definition and scope of Global Exposure

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?

We agree with the proposed Level 3 Guidelines but we suggest to modify the sentence of the second paragraph of the box 1. as follows: "*a UCITS may consider appropriate for the calculation of global exposure ~~only~~ those methodologies on which CESR has published level 3 Guidelines".*

We believe that it is should be responsibility of the UCITS to regard as compliant also other methods that rely on techniques that are consistent with the principles set in the Guidelines.

2 Calculation of Global Exposure using the Commitment Approach

3. Do you agree with the proposed conversion methodologies for the different types of financial derivative instrument? 4. Do you have any alternative suggestions? 5. Do you find the numeric examples useful in providing further clarity? 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?

6. Do you have any alternative suggestions?
As indicated in par. 1, it appears that gross and net commitment could be determined using the market value of the equivalent position in the underlying asset or the notional value of the derivative contract, where the latter is more conservative.

In the last point of par. 2, the criteria that could be used for the calculation of commitment are defined where it states that "*The calculation... must be based on an exact conversion of the financial derivative position into the market value of an equivalent position in the underlying asset*". The same limitation is also set in par. 4 of Box 5. Netting and Hedging: "*If the UCITS uses a conservative calculation rather than an exact calculation of the commitment... hedging and netting arrangements cannot be taken into account to reduce commitment on the derivatives involved*".

Assogestioni asks such sentences to be deleted as we do not consider appropriate to exclude netting or hedging arrangement when a UCITS uses a conservative calculation rather than an exact calculation of the commitment.

For the conversion method of Bond Future, but more generally for all futures, we ask to use the future price instead of the market price of the CTD. This method, besides being easy to adopt, reflects the practice used in markets as well as being included in the Commission recommendation on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS) where in 3.2.2 Technical precisions it indicates that:"*...the conversion of forwards, futures and swaps positions should depend on the precise nature of the underlying contracts. In the case of simple contracts, the marked-to-market value of the contracts will usually be relevant.*"

In the table below, there are commonly used methodology that we regards as compliant with the rules and should be included in the list:

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

ASSOGESTIONI
associazione del risparmio gestito

	CESR	Assogestioni
Bond Future	number of contacts * notional contract size * market price of the CTD	number of contracts * notional contract size * market price of the future
Interest Rate Future	number of contracts * notional contract size	number of contracts * notional contract size * market price of the future *(spot exchange rate, if the underlying is not in the base currency of the fund) or number of contracts * notional contract size * (100-t(100-market price of the future))/100 where t=period basis on the contracted rate of deposit. Example for Euribor 3 months, t = 0.25
Currency Future	number of contracts * notional contract size	number of contracts * notional contract size * market price of the future *(spot exchange rate)
Equity Future	number of contracts * notional contract size * market price of underlying equity share	number of contracts * notional contract size * market price of the future
Index Future	number of contracts * notional contract size * index level	number of contracts * notional contract size * market price of the future
Plain Vanilla Bond Option	notional contract value * market value of underlying reference bond * delta	notional contract value * market value of underlying reference bond (clean price) * delta
Plain Vanilla Currency Option	notional contract value of currency leg(s)[1]* delta Where any currency derivative has 2 legs that are not in the base currency of the fund, both legs must be taken into account in the commitment calculation	number of contracts* notional contract size in not base currency * spot exchange rate * delta *Not base currency vs not base currency* - number of contracts* notional contract size in not base currency (a) * spot exchange rate * delta - number of contracts* notional contract size in not base currency (b) * spot exchange rate * delta

		The delta must be corrected for the sign appropriate and both legs must contribute positively to the calculation of the commitment
Plain Vanilla Option on future	Number of contracts * notional contract size * market value of underlying asset * delta	number of contracts* notional contract size *market price of the future * delta
Plan vanilla fixed/floating rate interest rate and inflation swaps	market value of underlying (the notional value of the fixed leg may also be applied)	market value of fixed leg involving the payment at maturity of notional or the notional value of the fixed leg
Single Name Credit Default Swap	market value of underlying reference asset or the notional value	| +/-notional value + market value of the contract | or notional value
Basket Credit Default Swap	-	| +/-notional value + market value of the contract | or notional value
FX forward	Notional value of currency leg(s)	notional value of currency leg(s) * spot exchange
Credit linked notes	Market value of underlying reference assets(s)	market value of credit linked note

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

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?
We agree on the exclusion from global exposure calculation of derivatives which do not result in incremental exposure.

9. Do you agree with the proposed definitions of netting and hedging? 10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure? 11. Do you have any alternative suggestions? 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?
In general we agree with definition of netting and hedging, but as mentioned before in answer 3,4,5,6 Assogestioni asks to delete sentences that exclude to make netting or hedging arrangement when a UCITS uses a conservative calculation rather than an exact calculation of the commitment.

In relation to hedging arrangement, one criteria indicates that combinations of trade on financial derivatives should refer to the same asset class. We ask to clarify if the criteria also cover the possibility of making hedge arrangement with the underlying assets of a UCITS. This would also allow funds that invest primarily in other funds, if possessing sufficiently detailed and updated information on the composition of the target UCITS, to make hedge arrangements.

Duration hedging could be made to reduce duration risk also on corporate bond portfolio. We ask to modify the example in par. 20 as follows:

"*A portfolio management practice which aims to reduce the duration risk by combining an investment in a long-dated bond with an interest rate swap or at reducing the duration of a UCITS bond portfolio* ***(also corporate bond portfolio)*** *by concluding a short position on bond future contracts representative of the interest rate risk of the portfolio (duration hedging).* "

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 agree with the proposal.

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 inline 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.
We suggest option 1 because the methodology is consistent with the Basel II Accord.

<u>3 Calculation of Global Exposure using the Value at Risk (VaR) Approach</u>
21. Do you agree with the general principles outlined for the use of VaR? 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?
In general we agree with the proposed approach but we have some alternative suggestions.

We propose also a different measure of Relative VaR to capture the empirical correlation between UCITS returns and Reference Portfolio returns that in the formula outlined in the paper are not necessarily reflected.

Relative VaR = VaR (UCITS Returns – Reference Portfolio Returns)
i.e. VaR (delta returns).
max Relative VaR = 2*Absolute VaR of Reference Portfolio

We ask to modify the criteria indicated for the reference portfolio when a UCITS uses as reference portfolio a well known benchmark whose underlying is also composed of embedded derivatives such as convertible bonds. In this case we deem not strictly necessary to transform the benchmark in a leverage free benchmark. More generally, if the benchmark used as reference portfolio is sufficiently diversified and is published in an appropriate manner, it could be used even if it contains embedded derivatives.

26. Do you agree with this description of absolute VaR? 27. Do you agree with the calculation standards proposed for the VaR approach? 28. Do you agree

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

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? 31. Do you agree with the requirement regarding the risks which should be taken into account in the VaR model? 32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

We agree with the proposals.

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

We agree with the proposals except of point 6..

The task of a back testing is to measure the model accuracy in estimating VaR at 1% probability level, therefore we expect that the model errors are 'around' 1% of the number of observations, i.e. daily realized portfolio returns. If the number of observations (returns) is very large, errors tend to be very near to 1%, if the number of observations is small, errors can be lower than 1% or higher than 1% without automatically implying that the model is inaccurate. We must therefore use a statistical test for assessing if the percentage of errors we got in the back testing is or not 'statistically' different from 1%. One of the these tests, well known and largely used by public regulators [1], is the binomial test discussed by Kupiec (1995) and Lopez (1999)[2].

---

[1] S. Campbell 'A Review of Backtesting and Backtesting Procedures' FED Staff Working Papers 2005

[2] This is a test of unconditional accuracy. In order to test the hypothesis that VaR forecasts are unconditionally correct, we propose to use the binomial test discussed by Kupiec (1995) and Lopez (1999). The test is based on the following likelihood ratio statistic:

$$LR(\alpha) = 2\left[\ln\left(\alpha^{*n}\left(1-\alpha^{*}\right)^{N-n}\right) - \ln\left(\alpha^{n}\left(1-\alpha\right)^{N-n}\right)\right]$$

where, in our case, α = 1%, N is the sample size (250 daily observations), n is the number of times portfolio returns exceed VaR estimates, and α^* = n/N . This statistic is asymptotically distributed as a $\chi^2(1)$.

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

According to this test, using a sample of 250 daily returns, if we have 2 overshooting we can accept the hypothesis that 2 overshooting are not (statistically) different from 2,5 overshooting (1% of 250 daily returns) with a significance level of 74,2% (see table). Therefore 2 overshooting is in the allowed range, as well as, for example, 3 overshooting.

Errors	p-Value
0	
1	27,8%
2	74,2%
3	75,8%
4	38,1%
5	16,2%
6	5,9%
7	1,9%
>7	0,5%

In the case of 4 overshooting we can accept the same hypothesis at a significance level of 38,1%, still a very high level of significance. Typically are accepted value with significance level up to 5% or even 1%.

Therefore we propose to set a limit of (at least) 6 overshooting as threshold for accepting the model accuracy. Note that also zero overshooting is refused by the test.

Furthermore, to foster a level playing field among Member States and avoid that same authorities can apply stricter criteria while others do not we ask to modify point 6. as follows:

The UCITS senior management and ~~where applicable~~ the UCITS competent authority should be informed at least on a quarterly basis, if the number of overshootings for

---

The null hypothesis is $\alpha=\alpha^*$. The p-Value measure the probability of refusing the null hypothesis. Low p-Value means low probability of considering accurate a model which is not.

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

each UCITS for the most recent 250 business days exceeds ~~4~~ 6 in the case of a 99% confidence interval. This information should contain an analysis and explanation of the sources of 'overshootings' and statement of what measures if any were taken to improve the accuracy of the model. ~~The competent authority may take measures and apply stricter criteria to the use of VaR if the 'overshootings' exceed an unacceptable number.~~

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? 37. Do you have any alternative suggestions?
We agree with the proposals.

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?
We agree in general with the proposed tasks under the responsibility of the risk management except that the risk management function should be responsible to monitor the level of leverage when use VaR approach (see also answer 40).

We do not agree also with the requirement regarding model validation.

We do not deem necessary to undergo a generic validation of the model by an independent party of the building process in order to maintain a risk management policy proportionate to the nature, scale and complexity of the Company's activities and of the UCITS it manages.
It is the responsibility of the Senior management to approve and review the risk management policy, including the model used; it is also its responsibility to decide if the model should be validated by an independent party.
The request for an independent assessment leads to an unjustified increase in costs because it involves alternatively either creating a validation function within the company with the same skill set as the risk management function or outsourcing the function to a third party (or an additional party if the risk management function is already outsourced). In both cases the company would incur a significant organizational cost not always necessary in consideration of the fact that risk management function is independent from asset managers and the risk measurement arrangements as well as techniques used to develop the model must be adequately documented and validated on an ongoing basis.

Point. 3 should be deleted, in particular "*~~Following initial development, the model should undergo a validation by a party independent of the building process for ensuring that the model is conceptually sound and captures adequately all material~~*

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

~~*risks. This validation process must also be carried out following any significant change to the model. A significant change could be related to the use of a new product by the UCITS, the need to improve the model following the back testing results, or a decision taken by the UCITS to change certain aspects of the model in a significant way*~~".

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods? 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?
In general we agree that the use of some strategies or the risk profile of some assets cannot be adequately captured by the computation of VaR. The UCITS should therefore take appropriate measures to monitor its risk profile.

We believe that the information displayed in the prospectus should be consistent with the process used by Company to identify, measure and monitor the risk. With reference to UCITS that use a VaR approach, we do not agree to indicate the leverage as the definition of leverage itself. Normally a UCITS chooses VaR methodology for the calculation of global exposure when the commitment approach is not appropriate.

For the presentation of the risk profile of the investment, included the risk related to derivatives, we suggest to public an explanation regarding the methodology used to calculate the global exposure and the limit set by UCITS.

44. Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?
In general we agree to give a synthetic disclosure regarding the VaR methodology without going in too much technical details. We do not agree on giving information on the lowest, the highest and the average utilization of the VaR limit during the financial year. This details do not add transparency for the investor and could be misleading. Regardless the method of calculation (VaR or commitment approach), in the annual report the result of the management techniques should be disclosed and not the compliance with global exposure parameters.

<u>4 OTC Counterparty Risk Exposure</u>
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

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

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?
We agree with the proposals and we do not regard it as useful to include examples of minimum haircuts for different asset classes. The decision regarding the appropriate quantitative level for haircuts should be the sole responsibility of the management company.

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?
We do not agree that exposure to a clearing house should be considered as a part of the counterparty exposure limit. The use of a clearing house reduce to a negligible part the risk of counterparty default thanks to safeguarding system such as membership requirements, margins, clearing house shareholders' equity.

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?
We agree with the proposal.

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?
We agree that only net exposure to a counterparty generated through a stock-lending or repurchase agreement should be calculated within the OTC counterparty limit. Where net exposure is understood as the amount receivable by the UCITS minus any collateral provided to UCITS custodian. These net exposures must be taken into account for the calculation of the counterparty limit and not for the calculation of issuer limit (5,10, 40% rule). On page 18 of the document is clarified that there is no incremental market risk due to the fact that the securities act as collateral.

Regarding the position exposure to the underlying assets of financial derivative instruments in transferable securities, the text should be modified as follows:
" *This provision does not apply in the case of:*
- *index-based financial derivative instruments provided the underlying index is one which meets with the criteria set out in Article 53(1) of the Directive:*
- *future on notional bonds exchanged in regulated markets*
- *financial derivatives on interest rates or foreign exchange rates or currencies.*"

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it

51. Do you agree that a UCITS position exposure should be calculated using the commitment approach?
We agree with the proposal.

5 Cover rules for transactions in Financial Derivative Instruments
52. Do you agree with the proposed cover rules for financial derivative instruments? 53. Do you think there should be further restrictions on the assets held by the UCITS as cover?
We agree with the proposal, but we think it's useful to provide some practical examples relating to cover proposed cover rules for financial derivative (i.e: listed or not listed financial derivative instrument provides for physical delivery of the underlying financial instrument, financial derivative instrument cash-settled, foreign exchange forward).

6 Glossary of Terms
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?
We suggest to change some definition as follows:
- General market risk: risk of loss arising from changes in the general level of market price ~~or interest rate~~.
- Value at Risk (VaR): Var is a measure of the ~~maximum~~ potential loss to the UCITS due to market risk....

We remain at your disposal for any request of clarification or further comments on the content of our reply.

The Director General

00186 Roma Via in Lucina,17 Tel. 06 6840591 Fax 06 6893262 20121 Milano Via Andegari,18 Tel. 02 361651.1 Fax 02 361651.63 info@assogestioni.it www.assogestioni.it