efama
European Fund and Asset Management Association

EFAMA Reply to CESR's Consultation Paper on Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

EFAMA[1] welcomes the possibility to comment on CESR's proposals for Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS and congratulates CESR once again for the excellent work.

As a general comment regarding the terminology used throughout the Paper (for example in Box 1, Para.3: "*It is the responsibility of the UCITS to select an appropriate methodology to calculate global exposure*"), EFAMA points out that in many cases the reference to "UCITS" is erroneous and should be modified, or – alternatively – the definitions should be revised. In its Risk Management Principles for UCITS CESR correctly defined the Board of Directors (either of the designated Management Company or of the self-managed investment company) as the entity charged with compliance with the Principles. Similarly, in these Guidelines it should be recognized that in the case of a designated Management Company it is such Management Company that should fulfil the obligations, not the UCITS itself.

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. **2. Do you have any alternative suggestions?**

EFAMA agrees, with the following reservations:

1) Para. 1: some EFAMA members disagree with the requirement to calculate global exposure on at least a daily basis.

[1] EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 42 corporate members approximately EUR 12 trillion in assets under management, of which approximately EUR 7 trillion was managed by approximately 52,000 funds at the end of December 2009. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

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2) Para. 1: a large majority of EFAMA members believes that intra-day calculations should not be required, as they would be very costly due to the data set required and the associated administration efforts. Close of day positions are currently used. If necessary under specific market circumstances, an intra-day assessment (not a calculation) could be carried out.

3) Para. 2 and Para. 5 of Box 1 are inconsistent, as in Para. 2 CESR states that "only those methodologies on which CESR has published level 3 Guidelines" may be considered appropriate, while Para. 5 allows also the use of "any other methodology" to calculate global exposure.

   EFAMA members welcome consistency and harmonization in regulatory approaches. However, defining basic conversion methodologies should not prevent UCITS from employing more advanced and accurate conversion formulas (e.g. sensitivity approach, netting rules) where appropriate. CESR evidenced the need for this flexibility itself, and has fined tuned for instance the netting rules in its "Technical details of the pan-European short selling disclosure regime" (Ref.: CESR/10-453).

   Furthermore, EFAMA members are of the opinion that the use of other methodologies should be allowed, once the methodology has been validated by CESR/ESMA.
   Level 2 Draft implementing measures for UCITS IV currently foresee 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". In order to avoid stifling product innovation, CESR (and later ESMA) should consider setting up a validation process for such new methodologies.

4) Para. 4: There is no definition of terminology such as "complex investment strategies", "negligible part", "negligible exposure" and "exotic derivatives". Such wording is unclear and would cause legal uncertainty. EFAMA members are of the opinion that the determination of the most appropriate methodology and the choice between VaR and the commitment approach should be left to the Management Company, and that it would be very difficult to set thresholds. We therefore suggest to modify the paragraph as follows:

   "A UCITS must use an advanced risk measurement methodology (supported by a stress testing program) such as the Value-at-Risk (VaR) approach when, in the opinion of the

UCITS, the commitment approach is not appropriate to estimate the UCITS' global exposure."

2 Calculation of Global Exposure using the Commitment Approach

2.1 Conversion Methodologies

2.1.1 Standard Derivatives – Embedded Derivatives and Non-Standard Derivatives

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?

General comments:

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.

In discussing futures and options on futures reference is often made 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 is 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.

Numeric examples are useful to provide clarity.

Bond Future

EFAMA disagrees. 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.

We suggest: Use number of contracts * notional contract size * market price of the future in points * price factor. For example, 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 preferred 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

EFAMA disagrees. 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.

Alternative suggestion: 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

Currency Future

EFAMA disagrees. There should be two legs, one of which may be disregarded if in base currency.

Alternative suggestion: Use number of contracts * notional contract size(s)

Equity Future

EFAMA disagrees.

Alternative suggestion: Use number of contracts * notional contract size in units of the underlying equity * local currency price of the underlying equity

Index Futures

EFAMA disagrees.

Alternative suggestion: Use number of contracts * cash value of one point * price of the future in points. For example, the S&P/MIB future has a value per point of EUR 5. The current price is 30,595. The commitment of a long position in 30 contracts is 30 * EUR 5 * 30,595 = EUR 4,589,250.

Plain Vanilla Bond Option

A majority of EFAMA members disagree.

Alternative suggestion: Use number of contracts * cash value of one point * local currency price of the underlying in points * delta.

Plain Vanilla Equity Option

A majority of EFAMA members disagree.

Alternative suggestion: Use number of contracts * number of underlying shares per contract * price of the underlying share in local currency * delta.

Plain Vanilla Interest Rate Option

A majority of EFAMA members disagree.

Alternative suggestion: Use number of contracts * cash value of one point * underlying index level in points * delta.

Plain Vanilla Currency Option
A majority of EFAMA members disagree.

Plain Vanilla Index Options
A majority of EFAMA members disagree.

Alternative suggestion: Use number of contracts * cash value of one point * price of the underlying index in points * delta.

Plain Vanilla Options on Futures
A majority of EFAMA members disagree.
Alternative suggestion: Use number of contracts * cash value of one point * price of underlying in points * delta.

Plain Vanilla Swaptions
EFAMA agrees.

Warrants and Rights
We disagree and suggest that rights should be excluded as they are not normally treated as derivatives. Similarly low exercise price options (LEPO) should be excluded, as their market value is similar to their exposure value.
Alternative suggestion: For warrants use number of warrants * number of units of the underlying per warrant * price of one unit of the underlying * delta.

Plain Vanilla Fixed/Floating Rate Interest Rate and Inflation Swaps
EFAMA disagrees. Notional is the best basis for matching a swap and a hedged instrument.
Alternative suggestion: Use notional value of the fixed leg. Choice of the fixed leg determines the sign to be used in netting and hedging - receive fixed is long, pay fixed is short.

Currency Swap
EFAMA agrees.

Cross currency Interest Rate Swaps
EFAMA agrees.

Basic Total Return Swap
EFAMA agrees.

Non-basic Total Return Swap
EFAMA agrees.

Single Name Credit Default Swap
A majority of EFAMA members disagree.
Alternative suggestion: Use notional value. For the purposes of netting and hedging, buy protection = negative notional = short. Sell protection = positive notional = long.

Contract for Differences
EFAMA agrees.

FX forward
We agree with the calculation method. However, there are particular problems arising from cross FX transactions which require consideration. In a cross FX, say a USD/GBP forward in a fund with a base currency of EUR, the risk factor is the USD/GBP exchange rate and the exposure should be the notional value. The methodology of splitting the instrument into two legs creates initially exposures to two exchange rates, USD/EUR and EUR/GBP. The same double count may arise in currency swaps, cross currency interest rate swaps and plain vanilla currency options. We recognise that netting procedures, particularly in the currency of the short leg, may subsequently reduce this double count to a single count. However, in moving foreign exchange exposure from one foreign currency to another a cross hedge arguably does not meet the global exposure definition of incremental exposure and on this basis cross hedges could be totally excluded from global exposure calculations.

The basic formula for FX forwards should be notional value of the currency leg(s).

Forward rate agreement

EFAMA disagrees.

Alternative suggestion: We recommend using the notional of the fixed leg. The fixed leg determines the sign of the exposure, which is needed for netting and hedging purposes.

Convertible bonds

EFAMA disagrees. Arbitrage will keep the market value of the bond and that of the underlying equity roughly in line. There is no conversion to the equity without elimination of the bond, hence this instrument does not create significant incremental exposure.

Alternative suggestion: Exclude convertible bonds from global exposure calculations.

Credit linked notes

EFAMA agrees.

Partly paid securities

EFAMA disagrees. Treat this as a physical.

Warrants and Rights

We agree with the calculation method for warrants. We would suggest that rights should be excluded as they are not normally treated as derivatives. Similarly low exercise price options (LEPO) should be excluded, as their market value is similar to their exposure value.

Variance swaps

We have no comment.

Volatility swaps

We have no comment.

Barrier (knock-in knock-out) Options

Our initial reaction is that applying maximum delta is more indicative of a stress scenario than of an attempt to estimate the current market value of underlying exposure. We can identify some cases in which use of the maximum delta is actually inappropriate. For instance in the case of down-out-puts (which are embedded derivatives in bonus certificates) it is possible to find maximum deltas of the order of 10,000% shortly before the maturity of the option, and higher values can arise.

Alternative suggestion: In our opinion UCITS should be given the discretion to use the maximum economic exposure as the commitment value when this is considered appropriate.

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 use of the notional value would be easier to apply, particularly in the case of basket CDS. A CDS provides default protection for a specified notional amount of the reference security. However, in matching both the CDS and the reference instrument, or similar instruments of the same issuer, should be quantified in terms of notional in base equivalent.

2.1.2 Types of financial derivative instruments which may be excluded from the global exposure calculation

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?

EFAMA agrees, but many EFAMA members support the following exception: in the context of first bullet point, cash equivalents (money market instruments) and risk-free assets (high quality bonds) should also be considered as eligible.

2.1.3 Netting and Hedging

9. Do you agree with the proposed definitions of netting and hedging?

EFAMA largely agrees, with the following exceptions in Box 5:

- In Para. 4. the use of hedging and netting arrangements to reduce commitment on derivatives is not allowed if the UCITS uses a conservative calculation of their commitment value, rather than an exact calculation. EFAMA disagrees, and recommends that it should be allowed, as a conservative approach would normally be more prudent and should not be penalized. Furthermore, the principle of allowing conservative imprecision when measuring against maximum limits is well established and is actually applied by this guideline.
- In Para. 5: EFAMA suggests replacing the words "same cash security" by "same UCITS eligible underlying" and to delete the text in brackets.
- In Para. 6, second bullet point: we suggest deleting "verifiable" for clarification purposes.
- In Para. 6, fourth bullet point should be revised as follows: "they should relate to the same asset class;" should be replaced by "they should relate to the same asset class or the same underlying risk". For example, FX hedging of exposure from holding units of another fund should be taken into account.

EFAMA also believe that CESR should include a statement regarding the treatment of derivatives (for example currency forward contracts) applied at share class level, to clarify that they can be netted as well.

10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure?

EFAMA agrees in principle, but stresses that in respect of hedging, the term "offsetting" is inappropriate, as hedging does not always aim to offset a specific risk. Sometimes only risk reduction is desired (e.g. partial hedging or using a derivative with a high correlation to the assets/risk factor to be hedged/reduced).
Some of our members, however, believe that hedging arrangements should be accepted as a risk reduction/reduction of global exposure as long as the derivative used for hedging purposes has high correlation with the underlying asset.

11. Do you have any alternative suggestions?

Please see above.

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?

EFAMA agrees.

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?

A large majority of EFAMA members agree with CESR's examples, while some believe that it might be appropriate to take beta-hedging strategies into account.

2.1.4 Efficient Portfolio Management Techniques

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?

EFAMA agrees, except for the treatment of repo and reverse repo transactions mentioned in paragraph 23 of the explanatory text.

A further use of some repo (or reverse-repo) collateral as underlying to a new repo transaction does not create any new risk as such. There is no reason to add those securities to the global exposure calculation; only the collateral obtained in that 2nd repo transaction might possibly create risk if reinvested in risky assets, as mentioned in Para. 1 and 2.

Example:

1. **First reverse repo transaction**: UCITS pays 100, receives stocks for 100 and commits to selling the same stocks for 100 at maturity date.

=> no market risk related to those stocks

2. **Second repo transaction**: UCITS sells stocks for 110, receives cash for 110 and commits to buy same stocks for 110 later-on.

=> no market risk as long as cash is not reinvested (ordinary treatment of repo according to Para. 1 and 2 of box 6)

3. **Unwind of operations**:

Second repo unwinds via UCITS receiving stocks and paying 110 (no PnL related to stocks MtM).
First repo unwinds via UCITS selling the same stocks for 100 (no PnL either).

=> no PnL even if stock's price has moved.

2.1.5 Sensitivity Approach

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.

The two CESR options are judged technically complex by EFAMA members. However, a large majority of EFAMA members would consider Option 2 as more appropriate.

Indeed, the large majority of EFAMA members considered the option 1 methodology too cumbersome, not in line with actual practice and therefore costly to implement if required, confusing as mixing commitment and VaR approaches, and finally not used for actual global exposure calculation purposes, therefore not supported by the asset managers.

Option 2 is considered a more accurate method because it considers the actual sensitivity of interest rate derivative instruments when computing the global exposure. Although Option 2 is more in line with the current risk management practice, EFAMA members highlight that the choice should be offered to UCITS to:

- either apply the proposed buckets under point 1 of Box 8 and the correlation factors under point 7 of Box 8

- or apply buckets with different periods based on observed correlations and sorted either by maturity or duration, in which case the netting as proposed under point 7 of Box 8 would not be necessary.

In all cases, the buckets should be made by currency because of the different interest rates per currencies.

In practice, UCITS perform duration adjustments based on the « DV01 » (Dollar value per basis point) of a fixed income security or interest rate/bond derivative instruments.

Principle: Debt securities are netted with interest futures based on duration. For this purpose, the « hedging potential » of the bonds and the « hedging power » of the futures is calculated and expressed in « DV01 » (Dollar value per basis point).

Example:

Below the assets to be hedged, assuming that the assets belong to the same duration bucket:

Debt Sec		Market value	duration	weighting	weighted dur.
CALCIPAR SA FLTG RATE NTS 01/JUL/2014 EUR50000 .	EUR	501'500.00	0.26	0.07613287	0.019794546
CENT EURO MEDIA FRN GTD SNR 15/MAY/2014 EUR'REGS .	EUR	200'500.00	0.45	0.03043797	0.013697085
AMERICAN EXPRESS CR 3.62500 13/OCT/2009 .	EUR	3'903'908.00	2.14	0.59265347	1.268278435
MORGAN STANLEY GLBL NT 4.375% DUE 01/MAR/2010 .	EUR	1'981'260.00	2.49	0.30077569	0.748931468
		6'587'168.00		1	2.050701534

The hedging potential for this fund (DV01) is the (market value x weighted duration) / 10,000.

Ex.: (6,587,168 x 2.050701534) /10,000 = 1,350. 83

Interest rate future position:

Description		contract size	No. of contracts	conversion factor	Duration
EURO-SCHATZ FUT Sep07	EUR	100'000.00	76	0.975468	1.799

The hedging power of the future (DV01) is the (contract size x holdings x conversion factor x duration) / 10,000.

Ex.: (100,000 x 76 x 0.975468 x1.799) /10,000 = 1,333.70.

The hedging ratio is therefore 1,333.70/1,350.83 = 99%.
In consequence the contribution of the future towards market risk is approx. 1% !

Duration or maturity buckets

In order to consider the correlation between the durations of assets to be hedged and the derivative positions, the UCITS should determine itself which buckets are meaningful. The buckets could be either based on maturity buckets or on duration buckets as both methods have:

- Equally strong advantages: looking at the correlation between bonds and futures within a maturity bucket is more transparent and straight forward to compute, while looking at the correlation between bonds and futures within a duration bucket is more directly related to the duration hedging objective.

- No particular disadvantages (they are both similarly exposed to the danger of correlation breaking down within a bucket)

UCITS should be able to choose the size of their relevant duration or maturity bucket, as the strength of the correlation between the relevant bonds and futures cannot be the sole factor to determine the relevance of a bucket because:

- the validity of "buckets" has to be estimated in light of the fund specific risk profile (the duration management of a fund which simply wishes to reduce the overall fund duration wouldn't need to be as thin/expensive as the duration management of a fund which aims to be exposed to a specific duration tranche or has guidelines to maintain its duration under a specific range).

- the validity of the buckets may break down during stress conditions and should therefore rather be re-evaluated when required rather than fixed in stone.

3 Calculation of Global Exposure using the Value at Risk (VaR) Approach

3.1 General Principles and general requirement

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

EFAMA agrees.

3.2 VaR Approaches – Relative VaR and Absolute VaR – The Choice

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

EFAMA agrees with Box 10, but we disagree with the suggestion in Para. 45 and 46 of the explanatory text that the benchmark of a fund used for performance measurement should be systematically used as reference portfolio.

The aim of the relative VaR approach is to limit the market risks caused by derivative instruments, not to limit the incremental risk of a portfolio.

In respect of benchmark constrained funds or funds having minimal tracking errors from the benchmark, such an approach is recommendable from a practical angle as the maintenance of the benchmark portfolio in a VaR system may be less cumbersome than the maintenance of a reference portfolio. However, if a fund is benchmark unconstrained or its tracking error is set to a level where the fund´s incremental risk must be higher than the benchmark portfolio´s incremental risk in order to achieve its performance target, the relative VaR using the benchmark would be inappropriate, given the difference in the incremental risks of the respective portfolios. A UCITS could "breach" the relative VaR limit even without the use of derivative instruments.

3.3 Relative VaR approach

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

EFAMA agrees.

24. Do you agree with the proposed criteria for the reference portfolio?
25. Do you have any alternative suggestions?

We disagree. It should be possible to use as a reference portolio benchmarks including derivatives or embedded derivatives (for example convertible bond indices, volatility indices, the CDS iTRAXX) when such benchmarks are created by generally accepted index providers, are published and generally available.

Furthermore, some EFAMA members believe that some discretion in the choice of the composition of the reference portfolio should be allowed, as long as the approach is more restrictive than the approach suggested by CESR. The UCITS should have the possibility to use as reference portfolio the actual UCITS portfolio, but without derivative instruments and without trying to replicate all risks in the reference portfolio. The advantage of such an approach is that it would be easier to implement, while being more conservative and restrictive.

3.4 Absolute VaR approach

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

EFAMA agrees.

3.5 Minimum requirements for VaR approach

3.6 VaR approach: Quantitative requirements

3.6.1 Calculation Standards

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

A large majority of EFAMA members agrees.

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

A large majority of EFAMA members agrees.

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

We find the examples very useful.

30. Do you have any alternative suggestions?

No.

3.6.2 Risk Coverage

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

We agree.

3.6.3 Completeness and accuracy of the risk assessment

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

We agree.

3.6.4 Back Testing

33. Do you agree with the proposals regarding back testing of the VaR model?

34. Do you have any alternative suggestions?

A large majority of EFAMA members agrees. Some, however, disagree and suggest that the frequency requirements are too prescriptive. The UCITS should retain discretion to adapt the frequency of calculation (e.g. on the basis of market conditions), perhaps with a minimum frequency (quarterly).

Some members believe that a quarterly reporting (Box 17 – Para. 6) would be too burdensome and propose a yearly requirement instead.

3.6.5 Stress testing

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?

A large majority of EFAMA members agrees.

In Para. 1 of Box 19 CESR requires that the stress tests should cover "all risks which affect the value or the fluctuations in value of the UCITS to any significant degree". Some members believe that the wording "significant degree" should be clarified, and wonder how "all risks" could be covered. "Those risks … not fully captured by the VaR model" should also be clarified, limiting them to those that are reasonably foreseeable.

3.7 VaR approach: Qualitative requirements

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?

EFAMA mostly agrees with CESR's proposals. Many EFAMA members, however, are concerned by the model validation requirements in Para. 3 of Box 21, which would seem to require a burdensome and costly duplication of functions within the Management Company. It should be sufficient that the independence of the internal risk management function be guaranteed, although internal and external audits could also provide validation.

The paragraph should be modified as follows: "Following initial development, the model should undergo a validation by ***a party independent of the portfolio management function…***".

3.8 VaR: Additional safeguards and disclosure

3.8.1 Additional safeguards

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

Most EFAMA members disagree and believe that the VaR approach is either sufficient, or even superior.

Additional safeguards such as stress tests are sufficient, and shortfalls perceived in current exposure measurement could be addressed by innovation within the stress testing process. Cover rules are also mentioned by some as an additional safeguard.

3.8.2 Disclosure

a) Prospectus

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?

Most EFAMA members disagree with the proposals. Some agree partially, only with the disclosure of the method of calculation of the global exposure – and even in this case it is suggested that it might be appropriate not to distinguish between relative or absolute VaR, so that a switch between the two would not require an update to the prospectus.

Investors are likely to be misled by the leverage figure, as they associate it with incremental market exposure – although leverage does not equate to higher risk. However, CESR's proposed definition disregards whether the derivatives increase or decrease market exposure. As illustrations of the potential impact of this approach (a) a US equity fund consisting solely of common stocks would be correctly portrayed as unleveraged, but a clone in which all foreign exchange risk had been eliminated by hedging to base would be reported as 100% leveraged, (b) among accounts using VaR, a 200% long/short market neutral fund structured with total return swaps would be reported as having the VaR of a bond fund and 400% leverage, and (c) hedged share classes would be reported as leveraged. These conceptual differences would certainly confuse investors.

Furthermore, there is concern that these disclosures in the prospectus will be too difficult to understand for investors, and the belief that the SRRI in the KID is more adequate. It is also feared that the disclosure of levels of leverage will require frequent changes in the prospectus, which will cause significant costs.

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

EFAMA members disagree with the methodology in Para. 3 of Box 23. CESR's proposals that "leverage should be calculated as the sum of the notionals of the derivatives used" would see derivatives used for hedging as contributing to the portfolio's leverage (see our reply to Q42). Furthermore, CESR's proposal is not consistent with the commitment approach and does not provide an accurate estimation of leverage.

b) Annual reports

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

A majority of EFAMA members agree. Some disagree, as such information is not considered useful to investors. The level of detail of the information required by Para. 2 and 3 of Box 24 is unclear and therefore a concern. Among the objections to the proposal: a) it is deemed inappropriate to disclose internal limits; b) the publication for an absolute VaR fund might render it ineffective as a cap on market exposure, as there would be a tendency to increase limits to reduce the risk of breaches; c) VaR is only one of a range of available risk measures and often is secondary to other risk measures employed by the portfolio manager; d) the high and low levels of VaR for some funds may vary considerably over time reflecting different market conditions.

4 OTC Counterparty Risk Exposure

4.1 Collateral

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?

EFAMA agrees, with some exceptions:

1) first bullet point of Para. 1 of Box 25 (collateral liquidity): it is suggested that the level of liquidity required should also be conditional to the haircuts accepted as collateral.
2) Regarding the fourth bullet point of Para. 1 of Box 25 (correlation), some EFAMA members believe that the monitoring of the correlation should be left to the discretion of the UCITS;
3) in the fifth bullet point of Para. 1 of Box 25 (collateral diversification), EFAMA members do not see the need for diversification if the collateral received is of very high quality. They invite CESR to reconsider the need for diversification in that case, and in particular propose the deletion of diversification by country as a requirement, as long as the collateral is of very high quality;

4) in the last bullet point of Para. 1 of Box 25 ("collateral cannot be sold, re-invested or pledged") an exception must be made for cash, for which reinvestment is necessary in order to generate the yield expected by the counterparty for OTC derivatives. In securities lending, compensation is also earned by reinvesting the cash collateral and sharing the yield with the collateral giver. Principles could be set for the reinvestment possibilities. Collateral should be allowed to be reinvested in money-market funds.

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?

No, a large majority of EFAMA members do not consider them useful. They believe that it should be sufficient to specify that the UCITS should satisfy itself that the haircuts are adequate. Furthermore, haircuts are set by market standards/counterparties and imposing a higher standard would simply render UCITS uncompetitive in markets such as that for securities lending.

4.2 Counterparty/issuer Concentration

As a general comment, it seems that counterparty risk and issuer concentration have been confused in Box 26. They are subject to different requirements and should be dealt with separately.

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?

No, EFAMA believes that the exposure to a clearinghouse should be considered equal to zero. Commission Recommendation 2004/383/EC of 24 April 2004 states that derivative trades performed on an exchange with a clearing house that meets the requirements of Recommendation 5 are free of counterparty risk. Given the possibility that for some derivatives only a single clearinghouse might be set up, it would also be impossible to meet the exposure limits.

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?

Most EFAMA members agree. However, if the margin is cash (the normal case), it should be included under the deposit limit, not under the counterparty limits.

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?

Most EFAMA members agree, but it must be taken into account that exposures to a counterparty through stock-lending or repurchase agreements are reduced by collateral. Furthermore, some of our members point out that the Directive only refers to risk exposure to "a counterparty of the UCITS ***in an OTC derivative transaction***", and that CESR's proposals are therefore exceeding the legal requirements.

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

Most EFAMA members agree that in most cases a UCITS position exposure should be calculated using the commitment approach. However, there are specific circumstances where it is not possible to use a suitable commitment approach for a particular derivative or derivative structure (see Para. 8 on page 12 of CESR's paper); for instance, when the delta is very volatile because, for example, the level of a security approaches the strike of a barrier option or because of other circumstances. Level 3 Guidelines should specify that in such cases the Management Company can use an alternative approach (for example VaR).

Other EFAMA members are of the opinion that the counterparty exposure should be calculated using the mark-to-market approach, including an add-on methodology reflecting the potential future exspoure.

5 Cover rules for transactions in Financial Derivative Instruments

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

EFAMA agrees.

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

No.

6 Glossary of Terms

54. Do you agree with the proposed definitions?

EFAMA agrees, with the following exceptions:

1) In the definition of "General market risk", the reference to interest rates should be deleted and the definition should read as follows: "*Risk of loss arising from changes in the general level of market prices*";
2) In the definition of "VaR", the word "maximum" should be deleted and the definition should read as follows: "*VaR is a measure of the potential loss to the UCITS due to market risk*."

55. Do you consider that CESR should provide other definitions in these guidelines? Do you have any suggestions for other definitions?

A very large majority of EFAMA members do not consider it necessary.

CESR's initial views on specific guidelines for structured UCITS

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?

Structured funds are a very important and growing category of investment funds, and according to EFAMA statistics, as of 31 December 2009 guaranteed/protected funds in Europe[2] had EUR 203 Billion in assets under management. It is important that they be accommodated under the UCITS framework, as otherwise they would be created under other legal wrappers providing less investor protection and transparency (for example as structured products under the Prospectus Directive or as banking products).

First of all, we believe that CESR should differentiate among structured funds. For many of them (for example CPPI funds) there is no need to adopt a different approach. For a specific subcategory of structured funds, however, we agree that there are issues that require a different approach.

The UCITS restrictions are designed to protect investors who (i) invest in a dynamic structure, (ii) may subscribe at any time, (iii) have invested with an uncertain payoff, and (iv) may take that payoff at any time in the future.

[2] UCITS as well as UCITS-equivalent funds.

In the structured funds discussed in the paper investors (i) have selected a static structure, (ii) generally invest at the beginning of the life of the fund, (iii) expect a defined payoff, and (iv) expect that payoff at a defined future date.

We would define such funds as "**Funds with predefined payoffs**", a subcategory of structured funds.

Modification of the structure in reaction to intervening passive breaches will put attainment of the investment objective at risk. Such funds often benefit from external guarantors. The guarantors themselves rely on the static nature of the structure in giving that guarantee, and modification in reaction to passive breaches could also potentially deprive investors of the protection of the external guarantee.

Funds with predefined payoffs can respect the UCITS restrictions and guidelines at inception, but the fund profile may, over time, diverge from the standard guidelines

The required standard guidelines for Global Exposure and Issuer Concentration are an issue for Funds with predefined payoffs at inception, but not more than for any other UCITS. They can put in place payoffs (or "formulas") that comply with the requirements, and indeed most of the classical payoffs comply with them.

Global Exposure is in general not an issue since they tend to have a low leverage, below 1 in general. Issuer Concentration is also in general manageable, because their payoffs are either based on indices or on a diversified portfolio of securities.

However, Funds with predefined payoffs must be managed to provide a predetermined payoff at maturity of the fund, and the UCITS does not have much flexibility to follow the restrictions, being obliged to achieve the predetermined formula that has been promised to investors. In the process, passive infringements are possible.

For example, the payoff may depend on some conditions related to some specific securities. The UCITS will enter into barrier options and, if the value of the security is close to the strike of such option and if the maturity is close, the delta of such option can be very important and volatile, and lead to an infringement of the Global Exposure limit (even with a VaR methodology).

A Fund with a predefined payoff based on a diversified portfolio of securities can also have a problem, over time, to meet concentration limit. For example, if one security of the formula goes up very much while the others stagnate, there could be overexposure to this security.

It is important to note that the other limits, such as counterparty risk limits, can be fully respected at any time by appropriate means (collateral, reset of derivatives etc.).

EFAMA proposes that Funds with predefined payoffs should be permitted to remain in passive breach of some restrictions and limits, in order to provide the predefined payoff and thus fulfill their obligations to investors. Should such a breach occur, the UCITS would be required to disclose it in its prospectus (in full) and in the KID (in a concise way).

Regarding CESR's criteria, we have the following additional comments:

The fund is passively managed and structured to achieve a pre-defined payoff
We agree, but the term "passively managed" should mean that the manager, at all times, (i) will have to respect the predefined payoff, without any right to change it, and (ii) must ensure the required payoff can be met, in practice through derivatives. This should of course not prevent the manager from actively managing his relations with derivatives counterparties, actively entering and unwinding derivatives, changing counterparties, managing counterparty risks, managing inflow and outflows etc.

The fund has a final maturity date not exceeding 9 years
EFAMA does not believe that it is necessary to define a maximum maturity date.

The fund is not open to new subscriptions
EFAMA members do not believe it is necessary to close the fund to new subscriptions, as long as adequate disclosure is made to investors of the breach, and certainly not if the fund is not in breach of restrictions.

The prospectus contains full disclosure regarding the investment policy, underlying exposures and pay-off formulas. It should also contain information on leverage levels and the specific risks associated with investing in such a fund.
EFAMA agrees with the requirement of full disclosure to investors of investment policy, payoff formulas and risks. For the reservations by most of our members regarding leverage disclosure, please see our answers above.

The final predefined payoff is guaranteed by a credit institution located in the OECD or by entity subject to prudential supervision or investors capital on maturity is guaranteed by a credit institution located in the OECD or by an entity subject to prudential supervision

Not all structured funds or funds with a predefined payoff include a formal guarantee. In fact, less and less funds do so, due to the low interest rates level. It would be very restrictive to limit such funds to capital guaranteed funds. Investors would have a protected downside but at the price of a very limited possible upside, especially if the maturity is limited to 9 years. Very few formulas would therefore make sense and investors would be extremely restricted in their choice. Structured notes would therefore replace UCITS, at the detriment of investor protection and transparency.

The requirement for a capital guarantee should therefore be deleted. Capital protection and capital guarantee should not be confused.

Similarly, capital guarantee and payoff guarantee should not be confused. Predefined payoffs may be linked, for example, to the prices reached, at some predetermined dates, by shares that belong to a predetermined basket.

Furthermore, EFAMA is of the opinion that it would be too restrictive to limit to credit institutions the eligibility as a guarantor. We agree that other entities subject to prudential supervision could issue guarantees, for example insurance companies and MiFID firms.

We remain at your disposal should you require any clarification.

Peter De Proft
Director General

31 May 2010