15 July 2009

Mr. Carlo Comporti
Secretary General
The Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

Dear Mr Comporti

CESR Consultation on Risk Management Principles for UCITS

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

Attached are our responses to the questions posed in the consultation document. Overall, we welcome CESR's proposals and believe they represent a pragmatic approach to many of the issues the industry has been faced with since the Commission Recommendation of 27 April 2004 on the use of financial derivative instruments for UCITS. However, we ask that further consideration be given to the new areas raised by CESR as there is a risk that the outcome could require further clarification. The introduction of UCITS IV and the Management Company Passport requires that interpretations and practices are as aligned as possible between Member States. We understand that CESR will consult again in the autumn, which is welcome given the depth and breadth of the current consultation and the very short time frame allowed for response.

We ask for clarification on whether the advice will be level 2 or 3, as the text suggests level 3 but the title suggests level 2. We also seek confirmation whether the outcome of this consultation will supersede the 2004 Commission Recommendations as stated above. Finally, we note that no cost/benefit analysis has been carried out, nor lead-in times for proposed implementation. We urge that these points be addressed in the next consultation.

If you would like to discuss our response further, please do not hesitate to contact me.

Yours sincerely

Craig Hall
Adviser, Product Regulation

CESR Risk Measurements Consultation

Calculation of Global Exposure using the Commitment Approach

1.1 Context

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

Whilst the definition of global exposure relates to leverage and this works in the context of the Commitment Approach, we question the use of the term in relation to the VaR approach. VaR does not measure leverage, it measures risk. This has been recognised by CESR in some of the paper, but is contradicted in other places. We therefore recommend that global exposure under the Commitment Approach and 'risk exposure' under the VaR approach are kept completely separate.

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

As global exposure is the incremental exposure/leverage generated by the derivative instrument, counterparty exposure does not contribute to this. Furthermore, counterparty risk is already captured in the spread of risk limits (Article 22 (1) and (2) of the UCITS Directive). Including counterparty exposure in the calculation of global exposure would double count the overall exposure to the derivative instrument.

1.2 Scope of the Commitment Approach

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

We agree with the general approach. However, it is not practical to attribute certain instruments and strategies to EPM and other instruments for investment purposes. The use of derivatives must be consistent with the stated investment objectives and risk profile of the UCITS. As an example, if derivatives are used only for hedging/EPM, the cover and exposure requirements should be no different to those used when measuring exposure to derivatives for investment purposes, except in the case of netting.

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?

We agree with this approach in principle, although we would ask CESR to indicate what it considers to be "risk-free" instruments. We believe that leverage can be achieved where the collateral is reinvested into instruments that carry the risk of capital loss, not where the instrument yields a return in excess of the risk-free rate. For example, constant NAV money market funds can produce yields in excess of the risk-free rate when yields are falling.

Furthermore, we seek clarity on the treatment of collateral in relation to cover. If the fund was to lend its securities and receive collateral in return, how would this be

shown (for both asset and cash collateral)? Would CESR be comfortable with the UCITS using the collateral for cover of its derivatives positions?

1.3 Commitment Approach Calculation: General Principles

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

Option 1 does adequately capture the theoretical loss to which the fund would be exposed, but it is, for example, impractical to try to capture an unlimited loss. Furthermore, UCITS should be capturing the risk and volatility of the instruments which contribute to the NAV of the fund. Maximum loss does not capture this. We would therefore recommend Option 2 as the preferred approach. We understand that where deltas are unstable or difficult to calculate (e.g. barrier options), then Option 1 might be more appropriate. However, we also believe that the commitment approach may not be suitable if the delta-adjusted exposure of an instrument cannot be captured.

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

Option 2 has the following advantages:

- it captures the economic exposure (e.g. amount of leverage);
- it recognises that the exposure of opposite derivative trades (e.g. purchased vs written options) are symmetrical; and
- it is workable in practice.

As the delta falls the result will tend to be the same as for 1.

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

We have no suggestions

1.4 Commitment Approach Calculation – Conversion Method

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

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

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

We agree that a non-exhaustive list should be available, but we wish to make two points:

- A list would be helpful if all Member States adopt the methodologies provided in the list. With the imminent arrival of the Management Company passport, it is important that consistency is achieved. This may be achieved through introducing the table at level 2 (with the remainder of the proposals at level

3). However, CESR must ensure that the table provides universally agreeable methodologies and, where appropriate, different options for calculation (which must also be acceptable to all Member States). We also believe that CESR should consider the possibility of reviewing the list on a periodic basis to ensure it remains up to date.

- Some additional instruments which are commonly traded. For example, convertible bonds, interest rate futures, currency options, tranched and unfunded credit options (e.g. unfunded CDOs), interest rate swaptions and equity swaps should be added to the table.

Specific comments on the table

Index future: We believe that the index future should be based on the future price of the underlying asset, not the market value, as the prices of both will differ and the actual exposure is to the index future, not the actual index.
Bond future: We believe that 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 is available as a simpler method of calculation to that of VaR.
Credit default swap: We would like to see a third option – the notional amount of the contract.

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

It is understood that CESR wishes to prohibit the use of the standard conversion methods set out in the table where the FDI does not adequately assess the risks related to that product. However, the Commitment Approach does not assess risk, it assesses leverage. We therefore ask for confirmation that where the FDI commitment basis calculation does not calculate the incremental exposure appropriately, a conservative estimate may be applied. In this instance, we believe it may be more appropriate to use VaR calculations.

1.5 Types of financial derivative instrument which are not included in the global exposure calculation

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

This is an acceptable method. However, issues may arise if the assets in question (those held in the UCITS and those referenced in the TRORS) are only similar, not identical (e.g. a basket of stocks vs. stock market index). In those circumstances a process should be put in place demonstrating significant and stable correlation of those assets. We agree with the approach to cash derivatives.

1.6 Sensitivity approach for derivatives on interest rates in the commitment calculation

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

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

In principle we agree that the sensitivity approach can more accurately assess the exposure to maturities of fixed income derivatives. However, this approach can also be applied to other types of instruments eg credit and inflation derivatives. As the Commitment approach is meant to be simple and easy to understand, we believe it should be optional.

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

We agree with the analysis.

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

The quantitative level depends on the type of the fund and its objectives. The responsibility should therefore be on the UCITS to determine an appropriate level.

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

We have no further comments.

1.7 Commitment Approach calculation: netting & hedging effects

1.7.1 Consideration of netting effects
1.7.2 Considering of hedging effects

18. Do you agree with the proposals regarding netting?

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

We would like to see a precise definition of netting. We believe that netting should be carried out only when there is an elimination of the exposure (i.e. identical contract specifications). Otherwise, there is the possibility of unlimited basis and/or correlation risk which cannot be controlled with the Commitment approach. If the delta-adjusted approach is taken (ie option 2) then the exposure calculation will differ, and netting will not eliminate concentration risk. Furthermore, the concept of hedging is already expressed. If netting is allowed between different contract types, confusion arises as to the difference between netting and hedging.

20. Do you consider that hedging as described above 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?

We believe that hedging should be permitted but do not believe that there should be a strict threshold on correlation as it can be defined in many ways. We would like CESR to provide further guidance on the practices of hedging and netting. We understand that hedging can reduce risk but, for example, the long exposure of Company A and short exposure of Company B (ie a pair trade) can increase risks, whereas those risks when netted should be eliminated. Hedging should not reduce the cover requirements for the UCITS.

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.

We do not believe quantitative limits should apply for the reasons stated in question 21.

1.8 Computation of concentration risk arising from the use of financial derivative instruments

23. Do you agree with this proposal?

We have no further comments.

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

2.1 Definition of VaR

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

We agree with this definition.

2.2 Compliance of the VaR methods with the provisions of Directive 85/611/EC

25. Do you agree with the above approach?

We agree with this approach, subject to our comments under question 1. Technically, global exposure cannot be measured using the VaR approach. We would therefore wish to see a definition for VaR like risk exposure. We also seek confirmation that the VaR figure is to be calculated using the entire portfolio, as opposed to just the FDIs.

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?

As noted above, global exposure cannot be assessed under the VaR approach and we do not believe that consistency with the exposure limit of 200% of NAV is relevant. In terms of additional safeguards for VaR, we believe that stress testing and backtesting are important components in the assessment of risk. These tests should be the subject of regular review. It is important that equally good

governance should be applied by the Manco/UCITS where the VaR function is outsourced. This governance is detailed in the CESR Risk Management Principles.

2.3 Common VaR calculation models

2.4 Input used in the calculation of VaR

2.5 Organisation and means of a UCITS/asset management company using VaR

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?

We agree with paragraphs 2.3 and 2.4.

In relation to paragraph 2.5, we make the following observations:

- The unit calculating the VaR (ie operating the VaR model) should be organisationally separate from the portfolio management and marketing/distribution units.
- If the VaR model is maintained by such an independent unit, the testing and back-testing by the UCITS is sufficient to discharge the independent review. No further independent testing of the model should be required.
- If the VaR model is maintained by a potentially conflicted unit (such as portfolio management), then an independent validation is required.
- The VaR model should be seen as a risk control tool and as such does not necessarily have to be part of the portfolio management process. The VaR model should however be tested against models used in the portfolio management process on a regular basis.
- The portfolio management process should at all times be aware of the results of the VaR model.
- Liquidity risk is not provided for in the VaR analysis, which assesses market risk. We recommend the reference to liquidity risk in this context is removed. Liquidity risk should be reviewed and assessed in other ways.

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

Yes

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

It should be noted that currently not all Competent Authorities review and assess VaR models. We are aware that backtesting is reported to the authorities in Germany and Luxembourg, but we would like to understand what CESR expects from Competent Authorities in regard to the risk management process.

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

We do not believe that Competent Authorities should have to approve the actual VaR models. They should review the risk management process and ensure that the UCITS/Management Company is well equipped to understand the VaR model and its construction.

2.6 Definition of the relative VaR

2.7 Limits of the relative VaR approach and proposed safeguards

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

We agree with the approach, except that the calculation of global exposure (which should be risk exposure) should equal the VaR of the UCITS divided by the VaR of the reference portfolio and it should not exceed 2.

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?

We 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. However, we ask for clarification on the definition of "long/short" strategy, since the proposal specifically excludes the use of a long-only benchmark for such strategies. The industry definition of a "long/short" strategy is one that would have either a net long or short directional bias. We would like clarification as to whether a "market neutral" fund is also regarded by CESR as a "long/short" strategy.

If such an approach is taken for 130/30 funds, this seems to imply that these funds could not have a long-only reference portfolio. In practice the VaR of 130/30 funds tracks the VaR of the relevant market index (e.g. S&P 500, MSCI Europe, etc.) and effectively they consist of a long-only equity portfolio and a 30/30 market neutral portfolio. If a reference portfolio is constructed for a 130/30 fund, presumably this would be 130% long and 30% short, which would fail to meet the requirement that the absolute sum of the long and short positions must be equal to 100% of the NAV.

If the conclusion to be drawn from the above is that the definition of a reference portfolio is not possible for 130/30 funds, then they would have to be treated as absolute VaR funds. This is not appropriate and would be detrimental to the ongoing viability of this type of fund as the VaR is so close to that of its benchmark, which has been as high as 35% VaR in the recent stressed market conditions.

Benchmarks which contain derivatives by nature (eg commodity indices and convertible bond indices) should be allowed.

Finally, the requirement of the 99% confidence interval over 20 days should apply to relative VaR as well as absolute VaR. Currently, this has not been specified in the chapter on relative VaR.

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

We believe that where VaR is in relation to a benchmark, the UCITS/Management Company should asses the appropriateness of different methods (e.g. active VaR, relative VaR) in relation to the types of strategies employed by the UCITS.

Active VaR is a close relation to tracking error - it looks at the 99%tile on the distribution of the differences between the fund and benchmark ie dividing the 99 percentile loss of the fund by the 99% loss of the benchmark.

In a number of strategies, Active VaR has a number of advantages over the relative VaR for long-only and 130/30 funds that have the usual portfolio benchmark e.g. FTSE 100 or 0-5 year gilt. These include:

- the fund will behave roughly in line with the portfolio e.g. under a rel VaR approach an equity fund may have a VaR only twice that of a given bond fund, but may behave in a very different manner;
- as tracking error is already in extensive use by fund managers it is likely to be more accepted by them in the investment process.

2.8 Definition of Absolute VaR

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

As previously stated, we understand the global exposure in terms of VaR to be the actual risk of loss (ie the risk exposure).

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

We agree with the proposals, but CESR has not provided examples or reasons for the use of different numbers of days to assess VaR, e.g. is it the length of time it would take to liquidate a portfolio (ie the assets' liquidity), whether the fund manager is likely to do so, etc?

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

We do not believe stricter criteria are required.

2.9 Additional safeguards to mitigate the risks related to the use of the absolute VaR approach

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?

We agree that the proposed safeguards are sufficient.

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?

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

High levels of leverage do not necessarily equate to high levels of risk, although if the leverage is purposefully used to increase returns and volatility, an increase in leverage would be reflected in the VaR figure. We therefore believe that there should be no avoidance of UCITS engaging in leverage providing that the systems and controls of the risk management process, and the techniques and models employed to monitor risk, are sufficiently robust. For marketing purposes, it would be helpful for the investor to understand the extent to which the UCITS engages in leverage.

3 OTC Counterparty Risk Exposure

3.1 Background and Introduction

3.2 OTC counterparty risk calculation methodology

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

Whilst we agree that the Counterparty reduction factor should be removed, we do not see the logic to remove the add-on for future credit exposure. CESR refers to inflating 'the risk in a subjective manner'. Our observations are:

1. Risk is based on subjective and objective criteria – e.g. scenario testing is wholly subjective.
2. The add-on is a conservative approach and will provide extra safeguards for the UCITS. It also fairly differentiates derivatives and their underlying exposures in a simple and transparent manner.
3. Paragraph 2.2, first paragraph, refers to article 51(3) relating to future market movements which should be taken into account when calculating exposure. Whilst counterparty exposure does not relate directly to future market movements, it is still a subjective increase of risk, which is acknowledged in the UCITS Directive.

42. Can you suggest an alternative method?

We believe that MTM plus add-on is the most appropriate methodology.

43. Do you agree with the approach for netting arrangements?
44. Do you consider that additional netting rules should apply?

Whilst we agree that legally enforceable netting arrangements should reduce the counterparty exposure, we are considering with members whether the exposure should be extended to cover any set-off provisions. We are consulting members on this point and we ask that CESR, too, consider the merits of such an approach.

3.3 Treatment of collateral received

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?

The Credit Support Annex (CSA) will specify the type of collateral received and transferred. CESR suggests that this collateral should be exposed to only negligible risk. It is entirely possible that a corporate bond fund, for example, would only pass corporate bonds as collateral to the OTC counterparty. It is therefore possible for the OTC counterparty to stipulate it will transfer only corporate bonds to the UCITS under the terms of the CSA. If this is the case, the collateral could be exposed to higher risks than cash or government bonds. If the UCITS must ask for these lower risk assets, then the difficulty and cost in dealing with an OTC counterparty could rise.

In relation to the first bullet point of paragraph 3.3, if a UCITS chooses to engage in the passing of collateral, it is done to reduce counterparty risk. In certain circumstances and at certain times, the risk may be eliminated, but any amount that is not eliminated should simply contribute to the counterparty risk exposure rules. We therefore recommend that the bullet point is re-written to "is marked-to-market on a daily basis".

We do not believe that there should have to be diversification of the collateral, given the other high-level principles.

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

We agree with the principles based approach but suggest that the collateral received should not be connected to the OTC Counterparty as correlation of an OTC Counterparty and another bank's commercial paper could be highly correlated (as witnessed over the past two years).

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

We are of the view that collateral received by a fund either by way of title transfer or by way of security, must be in addition to being eligible collateral in terms of the type of collateral agreed between the parties also be eligible assets within the meaning of the Eligible Assets Directive.

Under a collateral arrangement by title transfer, collateral is transferred outright to the fund immediately on delivery of the collateral. In the case of a collateral arrangement by way of security, in the event of a default by a counterparty, unless

the counterparty has paid its obligations in full, the UCITS is entitled to exercise immediately the powers under the agreement (including the power to sell the collateral). Upon enforcement, in both cases, the collateral becomes scheme property including for the purposes of valuation as the collateral is no longer subject to offset by an obligation to transfer back. It therefore seems to us that any collateral received must be an eligible asset.

3.4 The treatment of collateral passed

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?

We agree that the **net** exposure to the counterparty (ie the difference between the collateral and the MTM value of the derivative – not the actual collateral passed). should be included in the 5%/10% counterparty limit (and, where appropriate aggregated with the issuer concentration limit of 20%).

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

3.5 Counterparty limits

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

We believe that further work should be carried out on the use of credit default swaps and letters of credit as a means of mitigating counterparty risk.

4 Sophisticated/Non-Sophisticated UCITS

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

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

We agree with this proposal.