

ALFI contribution to the CESR's consultation paper on Risk Managements Principles for UCITS (Ref: CESR/08-616)

I. Introduction

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership over 1 200 funds and asset management groups from around the world and a large range of service providers. According to the latest CSSF figures, on 31 August 2008, total net assets of undertakings for collective investment were 1.9 trillion euros.

There are 3 284 undertakings for collective investment in Luxembourg, of which 1 939 are multiple compartment structures containing 10 765 compartments. With the 1 345 single-compartment UCIs, there are a total of 12 110 active compartments or sub-funds based in Luxembourg.

According to June 2008 EFAMA figures, Luxembourg's fund industry holds a market share of 26.1% of the European Union fund industry, and according to 2008 PWC/Lipper data, 75.4% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

ALFI would like to thank CESR for the opportunity to participate in this consultation on the content.

Overall we warmly welcome CESR's interest in this initiative in this matter and we share CESR's view that sound risk management systems require organisational requirements and specific safeguards and diligences in order to ensure that all kinds of risk are adequately captured particularly in the light of the current market situation and the turmoil in the financial markets. Besides ALFI, the Luxembourg Risk Management Association PRIM has supported the analysis.

In this paper we present short answers to the questions raised by CESR in its consultation paper and some additional comments, which we hope CESR might find helpful. We have included references to relevant pages and paragraph numbers in CESR's paper.

Preliminary remarks

One of the key principles of UCITS is the protection of investors. Consequently, the principles of risk management can truly be seen as a subset of the overall principles to protect investors. As the biggest fund market within Europe, risk management is a key point of regulation for the Luxembourg market. Luxembourg's first regulation regarding UCITS risk management is based on the EU recommendation 2004/383/EC. The CSSF issued a Circular 07/308 in August 2007, on "Guidelines for undertakings for collective investments in transferable securities relating to the use of financial risk management method and the use of financial derivative instruments", which reflects already key aspects of CESR's Consultation Paper. The objective of this Circular is to further clarify how a UCITS should implement its Risk Management Process within the meaning of the Luxembourg regulations.

ALFI is of the opinion that the existing CSSF circulars especially 07/308 reflect in general the principles proposed by CESR already.

ALFI is of the opinion that convergence among competent regulators can be fostered by common principles as a common standard rather than having a rule-based regulatory approach at the level of European legislation. The analysis performed by ALFI is discussed below. In a first chapter general comments are outlined.

In a second part there is rather a more technical discussion of details – with requests for clarification of some wordings and definitions.

II. General Comments

ALFI welcomes clarification of the approach CESR intends to take with regard to the receipt of the risk management process. The Directive requires the risk management process to be sent to the relevant competent authorities. The consultation paper suggests that the competent authority will be approving the risk management process as part of its process for approving the self-managed UCITS or designated Management Company. This perhaps follows on from the attestation CESR requested competent authorities to use during the conversion of funds from UCITS I to III¹. We would not necessarily oppose such an attestation and 'pre-approval' by the regulator, given that the consultation paper later on refers to the risk management process needing to "assess and address **all** risks" as well as adding further detail on the organisation and governance of the process, reporting and monitoring. However, the wording does go further than the Directive so it is important that competent authorities clearly acknowledge this and can therefore rely on the initial risk management process approval in order to avoid multiple approvals by different regulators in Europe.

We think the defined terms need to be looked at carefully. In particular the definition of "Company" states that it is intended to apply to the self-managed investment company or the UCITS designated Management Company. We would welcome clarity throughout the document where reference is made to "the Board of Directors".

For example, in Box 2 the references in 3. and 4. are ambiguous. A strict reading suggests there is no guidance in relation to risk management for the Board of Directors of a UCITS that has designated a Management Company. Is this intended?

Risk Management or Risk Monitoring

Risk Management in an integral part of investment management and responsibility for calculating the risk in a portfolio and managing the level of risk must rest with the investment manager. What UCITS requires, and what this document should address, is how Risk Monitoring independent of the investment management

¹ CESR's guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives (2001/107/EC and 2001/108/EC) CESR/04 – 434b, Annex
"(...the name of the authority in question...) is content, that (...the name of the management company in question...), which is the management company for (...name of the UCITS in question...), has in place an appropriate risk-management process as required by Article 21, paragraph 1, of the amended Directive.

function should be organised and executed. This includes the setting of risk limits, which are appropriate to the risk profile of the fund, the independent calculation of the risk exposure, the reporting and escalation of breaches of limits and the monitoring of actions taken to bring the funds back within those limits.

The use of the expression Risk Management to include both of these processes can be confusing and we would suggest trying to reword some of the sections where this occurs.

III. Technical Analysis CESR Consultation Paper 08/616 "Risk Management Principles for UCITS"

Definitions

Senior Management:

ALFI thinks that reference should also be made to the self-managed investment company article (Article 13a), because the defined term 'Company' is used.

Board of Directors and Senior Management:

We are unsure as to the definition of these two terms which are used throughout the document. Also when "Board of Directors" is used it is not clear whether this is always intended to refer to the Board of the SICAV or to that of the designated Management Company where one exists. In Luxembourg reference is often made to the 'Conducting Person' or 'Dirigeant' as being responsible for Risk Management and for reporting to the Board as required. We would suggest that CESR should take this approach into account.

Outsourcer:

CESR defines "Outsourcer" as a third party to which a Company may delegate the performance of risk management activities. ALFI is of the opinion that if a company outsources the risk management activity to another body, it is the company that is the "outsourcer" and that other body carries out the outsourced activity. In the event the aforementioned definition is used, this could lead to confusion, as this definition is ambiguous.

Risks Relevant to UCITS

Operational Risk (paragraph 2, 8 and 9):

Operational risks are generally not relevant to investors and are unlikely to materialise into capital losses or poor investment performance, as the Management Company would make good any losses of this nature to investors. At the end of this discussion paragraph 9 clarifies this issue to a certain extent. However, is the wording in paragraph 9 sufficient in making this point clear enough?

Market Risk:

ALFI suggests completing the definition of market risk as follows: “risk that arises from fluctuations in values of, or income from, assets or in interest or exchange rates”.

Furthermore a key element of UCITS risk management is not to limit the fund's exposure to market risk but to limit the fund manager's ability to increase the market exposure via active fund management – i.e. the potential leverage generated by the fund manager needs to be limited rather than the market risk (systematic risk) as such. We think the limitation of leverage might be highlighted a bit clearer.

Proposed Level 3 Measures

General principle:

Addendum ii) ALFI would propose as general principle instead of “the identification and measurement of risk management process” the following wording: the identification, limitation and measurement of risks relevant to the UCITS.

Box 1: Supervision by competent authorities

ALFI would like to refer to its general comments. In addition, if the Management Company passport provisions are included in the UCITS IV package of change, this aspect of the guidance will need to be reconsidered.

Paragraph 4:

In the statement it is mentioned that the companies should comply with conditions on risk management at “all times”. With regard to the market turbulence on 11 September, ALFI proposes an alteration of the wording as the following: under “normal” market conditions.

Furthermore it might be of help if CESR would clarify what the word “conditions” means?

Paragraph 5:

How do the regulations envisage that the assessment will be conducted by the competent authorities at the time of licensing the UCITS? In Luxembourg the management companies are currently only required to re-submit our risk management process to the CSSF if there are changes needed to address the risks associated with the new UCITS. Does CESR envisage that a submission of the risk management process would be required with each UCITS?

We would see this adding to the time to market of a new sub-fund if the risk management process had to be submitted and approved for each new sub-fund. We understand that the competent authority needs to approve the risk management process of a Management Company and there will be – as outlined above – a re-submission in the event of material changes to the risk management process.

How will subsequent monitoring be handled, by the UCITS / Management Company auditors or by regulatory visits? We would recommend that this be part of the requirements of the Long Form Report (based on CSSF circular 02/81) conducted by the auditors on an annual basis.

Box 2: Definition of roles and responsibilities

Paragraph 7:

Paragraph 7 basically states that a risk management process should be appropriately documented. So far ALFI agrees with CESR's proposal. We welcome that internal risk management/policies should be supplemented by supervisory principles and thus being both parts of the overall risk management system and not seen separately.

Addendum 7d:

As outlined before one should clarify that Board of Directors should refer to the BoD of the Management Company, where one has been designated, or the BoD of the SICAV if self-managed.

Box 3: Risk Management Function

ALFI is of the view that in Box 3 Paragraph 2 further clarity is needed on what is considered to be "proportionate" in relation to the independence of the risk management function.

Paragraph 8:

ALFI agrees with the proposal in Paragraph 8 and has no comment on the requirement that a risk management function must be adequately resourced, but we would like to bring attention to the fact, that an adequate risk management function should be adequately funded.

Paragraph 9:

Concerning Paragraph 9 clarification of wording is needed. We suggest to replace "IT structures" with "risk management systems" - in order to be coherent with the wording in Directive 85/611/EC.

Paragraph 10:

If risk management is, as mentioned in paragraph 10, only responsible for identification, monitoring and measurement it clearly raises the question who has responsibility for **managing** risks.

Paragraph 11:

We agree fundamentally with Paragraph 11, however the wording "of the company" should be inserted after "Board of Directors". Some national regulations require the reporting line of risk management to be to the Conducting Persons, this is not in conflict with the CESR proposal that risk management should provide regular reports to the BoD. It perhaps raises the question that where we are dealing with a

self-managed SICAV who employs the risk management function, is the SICAV expected to have their own risk management staff in the same way they have their own conducting persons.

Paragraph 12:

Regarding paragraph 12, ALFI would like to reiterate once again its comments made above under point III, it is rather difficult to understand the differentiation being made between BoD and Senior Management.

Paragraph 13:

We totally agree with paragraph 13, except that it shouldn't be a degree of separation, but rather a complete separation.

Paragraph 14:

Furthermore, ALFI would like to know, with regard to paragraph 14, under which conditions CESR considers it is acceptable not to have a separate risk management function. Could this role being fulfilled by a Conducting Person or Director in the case of a 'small' self-managed SICAV?

Paragraph 15:

ALFI reiterates its position that if risk management is the only responsible for identification, monitoring and measurement who has responsibility for managing risks.

Box 4: Outsourcing

ALFI generally agrees with the CESR's proposal but with the regard to Box 4, paragraph 2 we would suggest to change the wording of the last sentence from "...operation and conditions" to "...operation and risk management process."

Paragraph 17:

Regarding paragraph 17, ALFI would like to reiterate once again its above-mentioned comments and insert "of the company" after "Board of Directors".

Box 5: Identification of risks relevant to UCITS

We suggest in view of box 5, paragraph 1 to soften the wording here by stating that the risk management process aims at identifying, assessing and mitigating the risks directly related to the UCITS. The wording "all" is difficult in this context.

Paragraph 22:

In relation to Paragraph 22 ALFI suggest amending “trading style” to “investment strategy and profile” (alternatively use the wordings tactical and strategically asset allocation)

Paragraph 23:

Concerning the identification of risks relevant to the UCITS mentioned in paragraph 23 it is important to be clear as to the responsibilities of a company (as defined) and the Board of Directors of a company that has designated a Management Company. So, for clarity we suggest the following rewording “...whose advice should therefore help the Board of Directors of the company to provide a meaningful description to the fund of the risk profile of the UCITS which should be included in the prospectus and amended as necessary.”

Paragraph 24:

With regard to paragraph 24, ALFI believes that the Luxembourg regulator (CSSF) has specified to use VaR as the general internal model to monitor the level of risk in a sophisticated UCITS. Since a VaR concept does not appear to be the best risk monitoring approach for all UCITS, CESR's proposal would seem to provide a more flexible wording – which we welcome.

Paragraph 27:

We generally agree with paragraph 27. More of a challenge is where a Management Company manages third-party funds or risk management is outsourced as to how they integrate systems.

The statement regarding the IT system is that the tools/systems may need “to be integrated”. The independence in which risk managers operate is in general well defined, but to our point of view, the independence of IT systems is rather important. We are not in favour of fully integrated systems: i.e. systems used to control (ex-post) should not be the same as system used to manage portfolios (ex-ante).

Paragraph 28:

It is interesting that CESR does not seem to be proposing the route of ‘sophisticated’ or ‘non-sophisticated’ funds other than mentioning that different techniques will be required for ‘high-risk’ or ‘low-risk’ UCITS. However, we disagree with the last sentence regarding the consideration of market-lead solutions as it can be read to be overly prescriptive, especially for management companies that use adequate in-house solutions.

Paragraph 31:

We disagree that all operational risks are non-quantifiable. CESR is really excluding Operational Risk except where it has a direct bearing on the UCITS performance. However, a Management Company should have decent operational risk management procedures in place.

Box 7: Management of model risk concerning the risk management framework

We understand that this box should only apply to sophisticated funds. Otherwise a clearer differentiation between non-sophisticated and sophisticated funds is needed.

Paragraph 33:

Back testing should be carried out for sophisticated funds; i.e. change 'every technique' to 'complex technique'

Paragraph 35-38 (scenarios):

Every scenario defined by risk management is subjective. Thus it is quite impossible to construct a set of "perfect" scenarios able to cover the all range of possibilities. It should be easier to impose some basic scenarios (as it is the case for banks) rather than leaving them free to choose.

The tools used for stress testing are also subject to some conditions:

- How is the multi-co linearity between sub-scenarios are taken into account?
- What are the limits of the stress testing tools?
- Are they the same as the Risk Management tools (and by the way certainly out of the scenario conditions?)

Box 8: The link between risk management and asset valuation

Addendum to Box 8 Paragraph 2:

European legislation asks for a risk management having a responsible role in the valuation of OTC derivatives. CESR's approach is broader in terms of scope (illiquid assets, structured securities and complex derivatives). However it is not stated that the risk management function is responsible for the valuation, rather that risk management "provides appropriate support". We welcome that CESR clarifies that not only the valuation of OTC derivatives needs to be in the scope of risk management but also the increasingly complex valuation processes for other instruments. But we understand the role of risk management not being responsible for the valuation of the instruments in scope as such.

Paragraph 39:

For clarity, we suggest adding that the risk manager should not be involved in the detailed calculations mentioned. We also propose including on the end of the paragraph 'where available', as actual comparable trades are not always available.

Paragraph 40:

We are not absolutely clear on this. We consider there could be potentially significant issues in complying with this. We would appreciate seeing some practical examples from CESR.

Box 9: Risk management procedures

The following words should be added at the end "...with the risk profile as defined by the Board of Directors and included in the fund's prospectus appropriately."

We wonder whether this box should clarify the different requirements of sophisticated and non-sophisticated funds.

Box 10: Risk limits system

Paragraph 43:

We would distinguish here between "hard" regulatory limits – i.e. which will not be defined by the Management Company and "soft" internal limits and warnings. As a consequence the internal limits/warnings should be indicative and allow for adjustment and warning for internal purposes only (and not commitment to investors).

Paragraph 46:

Following on from the above comment, we suggest inserting the word "regulatory" before "limits".

Box 11: Effectiveness of the risk management process

Clarification should be added that this applies to **active** breaches to the regulatory part of the risk limit system only. An overly strict rectification procedure for all limit breaches (internal as well as regulatory limits) is not necessarily in the best interest of the investors. Active breaches of regulatory/external limits should be corrected immediately whereas passive breaches should be reduced in the client's interest.

Paragraph 48:

Furthermore taking action on the basis of potential issues identified by stress testing needs further thought.

Box 12: Reporting to the Board of Directors and Senior Management

We regret that the paper does not provide greater clarification on reporting to the investors.

See general comment. There is no guidance here on the company reporting to the fund's Board of Directors in cases where the UCITS has designated a Management Company.

Addendum Box 12 Paragraph 2:

We would suggest replacing “expected breaches” by “warnings”.

Box 13: Monitoring of the risk management process

ALFI shares the general view of CESR, that the risk management function should conduct periodical assessments and that the BoD and Supervisory Function should receive on a periodical basis a written report.

We do however support CESR's view, although are we correct in our understanding that CESR is proposing that an external auditors report - to the competent authority as well the Board of Directors of the Management Company - on the adequacy of the Risk Management function should be set up?