Response to Consultation Paper (CESR/10-108) - CESR's proposed Guidelines on Risk Measurement and the calculation of Global Exposure and Counterparty Risk for UCITS

Dear Sirs,

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership over 1 350 funds and asset management groups from around the world and a large range of service providers. According to the latest CSSF figures, on 31 March 2010, total net assets of undertakings for collective investment were 1 981 bn euros.
There are 3 516 undertakings for collective investment in Luxembourg, of which 2 149 are multiple compartment structures containing 11 146 compartments. With the 1 367 single-compartment UCIs, there are a total of 12 513 active compartments or sub-funds based in Luxembourg.

According to March 2010 EFAMA figures, Luxembourg's fund industry holds a market share of 27.3% of the European Union fund industry, and according to 2010 PWC/Lipper data, 76.2% 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 express its views on CESR's proposed Guidelines on Risk Measurement and the calculation of Global Exposure and Counterparty Risk for UCITS.

General comments

The measures, drawn up by CESR, intend to harmonise the measurement of risk for UCITS throughout the European Union.

CESR's proposals include detailed monitoring requirements, such as systematic back testing and stress testing. They will also include stricter rules regarding use of the 'commitment approach', an approach generally preferred by long-only managers to calculate their global exposure to risk. (However, considering the point of view of the Luxembourg regulator and more particularly the guidelines provided through the different "risk management" circulars (05/176 and 07/308 more recently), we can say that most (if not all) these requirements were already expressed. More particularly, the systematic back testing and stress testing already constitute strong requirements in the circular 07/308)

ALFI warmly welcomes CESR initiatives aiming to extend coverage and economic soundness of the commitment approach. We nevertheless would like to stress that, in our view, the commitment, by contrast to the VaR approach, is meant to remain relatively straightforward and that the cumulated effect of the guidelines proposed might make the approach too complex. We deem such an outcome to be counterproductive as it might blur the differences between the two approaches to measurement of the global exposure and therefore severe the natural link between the risk profile and the risk measurement methodology. A heavy handed approach

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could also push managers of simpler funds towards a VaR approach or managers of sophisticated funds to unduly arbitrage between the two approaches.

As a result, our members fear that the value at risk (VaR) approach, used mostly by alternative UCITS providers, will be adopted by an increasing number of traditional managers. The compliance costs of UCITS funds look set to rise next year with the introduction of new risk-measurement guidelines. New costs may include IT equipment and tools to analyze risk. Firms will also need to continually feed their systems with data, which will require additional staff that will need to be trained.

Having said that, we think that the level 3 Guidelines should be designed in the way that there is a necessary flexibility for a Management Company to set up its Risk Management which fits to the complexity of the respective UCITS (a long only equity fund does not necessarily request a VaR calculation). If regulations force the industry to a too high standard, the cost of such a standard sophisticated risk management would be a burden in particular small and mid sized asset manager firm.

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 derivate 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 high principles proposed by CESR already.

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. As regards specific consultation questions posed by CESR, we would like to submit the following remarks:

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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?

Although ALFI has some essential concerns we agree with the proposed Level 3 Guidelines for the definition and scope of global exposure. However, we do not see any added value in producing daily figures of global exposure for even the simplest funds such as plain vanilla equity funds. A large majority of ALFI members considers that monitoring of the funds as well as risk figures calculations should be done on a NAV basis frequency.

With regard to the intra-day calculations of global exposure we would like to stress that data set more than once a day is associated with high administration efforts. Since the valuation of global exposure (VaR or Commitment Approach) is based on a huge static data set (market prices, volatilities correlations, etc.), it is difficult to update this data set more than once a day. Thus intra-day calculations of global exposure would lead to high costs and in addition to performance issues.

The required costs to achieve this would probably be very high for all actors of the fund industry and the benefits or extra protection achieved, at best, minor.

The monitoring of global exposure needs to be adjusted to the risk profile. The industry has already methods in place to determine the sophistication of a fund and hence the appropriate methodology to calculate the global exposure. Our only concern with devolving more power to the management company on this decision is that there could be greater variability amongst management companies in the approach taken for similar funds, and we can anticipate that some will favor the cheapest option where possible, as opposed to the most appropriate risk management approach.

Furthermore, we believe in the necessity of a formalized self assessment in order to select the appropriate risk measurement methodology but items to consider are scattered throughout the Board of Directors (Conducting Persons).

With regard to Box 1 Point 4 we propose to add after 'negligible exposure to exotic derivatives the UCITS' the following sentence 'or have more than a negligible exposure to exotic derivatives, or where the commitment approach doesn't adequately capture the market risk of the portfolio, then UCITS must use'.

2. Do you have any alternative suggestions?

For some structured funds there might be the need to have a tailor made risk management approach to capture the global exposure of a fund adequately – we are of the opinion that the VaR approach in combination with to so called cover rule shows already the need for using a combination of methods/risk tools in order to capture the requirements of the global exposure limit (market risk and leverage limit) sufficiently. In light of that it is advisable to give the industry and the regulators the possibility to agree for selected funds on internal models which might

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fit better to limit the global exposure and thus to protect the investors best. However, having said that, we fully agree that as standard approaches either the VaR or the commitment approach should be applied.

Further comments to the internal model for structured funds are given below - please see our answers to the questions 56 et. seq.

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?

In general we agree with the most points of the proposed conversion methodologies for the different types of financial derivative instrument. Nevertheless we would like to urge CESR to take the following critical issues into account:

- Box 2, 3. Bond Future:
Why is it given that only the cheapest to deliver bond can be used for calculating the commitment approach for bond futures? Why not directly future's price?
In our opinion it should be still possible to use also a synthetic reference bond with the price of future. The main issue in that point is to get the right issuer and this is independent from using cheapest to deliver bond or synthetic bond. In the case of plain vanilla bond options the usage of cheapest to deliver bonds isn't given, too.

- Box 2, 3. Currency Future:
In this case the factor "notional contract value of currency leg(s)" should be considered, too. Otherwise it would be inconsistent to the method for plain vanilla currency options and FX forwards.

- Box 2, 3. Leveraged exposure to indices with embedded leverage
We would appreciate if CESR takes into consideration the leveraged exposure to indices or indices with embedded leverage. If this would not be considered in the commitment approach, the UCITS might be able to produce leverage without any limitation. (One member pointed out that they agree with the view of the CESR in order to take into account any leverage due to a leverage indices like an ETF on the return equal to twice the return of the DAX30 for example, in order to not circumvent the rule of UCITS III.)

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- Box 2, 4. Credit Linked Notes:
We think that for Credit Linked Notes the commitment should be the market value of the Credit Linked Note position for every reference asset. A Credit Linked Note of 1.000.000,- EUR market value on bonds from issuer A and B should therefore have a commitment of 1.000.000,- EUR in issuer A and 1.000.000,- EUR in issuer B summing up to an overall commitment of 2.000.000,- EUR for the Credit Linked Note position.

- Box 2, 5. Barrier Options:
We do not agree to the methodology for barrier options using the maximum delta. This is actually not a marked-to-market view, but rather a stress scenario view. In some cases we consider the use of the maximum delta as not effective. E.g. in case of down-out-puts (which are embedded derivatives in bonus certificates) the maximum delta can rise up to infinity; in the event of a very short remaining time to maturity, when the underlying is near the barrier. Hence a UCITS would be unable for to invest in certificates like bonus certificates. In our opinion when investing in barrier options (directly or embedded) the VaR approach should be used in general.

Furthermore, we would appreciate if CESR includes the following conversion methodology for Digital Options:

Number of contracts * actual value of the digital option

(Operational comments for Variance and Volatility Swaps: the determination of the currently implied volatility for the calculation of the commitment might be difficult in practice.)

4. Do you have any alternative suggestions?

As a general comment, we would like to mention that UCITS using non-linear instruments (i.e. structured products or options) should rather use another methodology than commitment.

5. Do you find the numeric examples useful in providing further clarity?

Yes, almost all ALFI members find the numeric examples useful in providing further clarity. However, for barrier option we do not agree to the methodology (see answer to question 3).

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?

We consider the use of the contract's notional value is an appropriate methodology for a credit default swap. Prior to using the method for global exposure calculation,

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CESR should first determine whether it is in favor of protecting the buyer side or the seller side. In the case of protecting the seller side, the absolute value of the contract's notional value is the proper way to calculate the global exposure while the sum of the premiums to be paid seems to be more appropriate when dealing with protecting the buyer side (short the risk).

As a consequence, the use of the contract's notional value should be limited to the protection seller (long the risk). In the case of the protection seller, the absolute value of the contract's notional value (eventually minus recovery rate amount is the proper way to calculate the global exposure) should be used.

As an example, a UCITS holding the bond and purchasing the CDS protection, would at all times generate no marginal exposure and therefore no commitment.

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

In principle a large majority of ALFI members agrees that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation. However, we understand that the effects of holding derivatives and cash is the same as holding assets (synthetic replication) but we believe it is odd and inappropriate to consider such a position shouldn't generate any commitment as this could potentially open the door to mis-representation of strategies and risk profiles. Specifically, the impact of combining cash or cash assets and derivatives on the global exposure is already and, in our opinion, better addressed through hedging/netting guidelines.

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?

ALFI considers that the examples properly reflect circumstances which do not result in incremental exposure for the UCITS.

2.1.3 Netting and Hedging

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

In principle ALFI members agree with the proposed definitions of netting and hedging.
We would as well appreciate if CESR could further clarify on point 4 of box 5 what in detail specifies an exact calculation versus conservative calculation.

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

We agree with the proposed criteria.

11. Do you have any alternative suggestions?

We have no further suggestions.

12. Do you agree with the examples provided of strategies where netting is possible?

In principle we agree with the examples provided of strategies where netting is possible. However with regard to different maturities CESR's wording suggests that the classification of a trade would be necessary in order to define the proper monitoring. We think that this surely would be impracticable and not without considerable effort feasible. In any case, we would like to suggest using a residual risk approach (absolute value) as global exposure of none fully/netted positions.

13. Do you agree with the examples provided where hedging is possible?

Yes, ALFI agrees with CESR's examples.

14. Do you agree with the examples provided where hedging is not possible?

In principle ALFI agrees with CESR's examples although we don't fully agree with item 21 first example of the explanatory text. In case of an equity portfolio which in order to hedge positions, goes short in any diversified market index (or in a basket of the same portfolio); hedging should be accounted for netting purposes.

In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

Almost all ALFI members do not agree with the examples. In case the hedging purpose can be clearly demonstrated by the management company it might be appropriate to take the so-called beta-hedging strategies into account when calculating global exposure.

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?

Almost all ALFI members agree with the proposed approach.

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16. Do you have any alternative suggestions?

No further suggestions.

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.

We would like to encourage CESR to propose a set of high level principles instead of defining detailed technical standards. In addition ALFI members agree that Option 1 is not as intuitive as Option 2.

Option 2 should scale using a 10 year equivalent sensitivity. We are not sure that the scaling of 12.5 is relevant or intuitively justifiable. As a general comment, we believe that this approach is too complex and we are not sure if it provides clear and distinctive added value compared to the current approach.
However, we agree with the principle that netting of positions which are close to each other on the yield curve should be possible.

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?

Yes, we agree with the general principles outlined by CESR.

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

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

Yes, the majority of our members agree.

3.3 Relative VaR approach

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

Yes, we agree.

24. Do you agree with the proposed criteria for the reference portfolio?

There is no clear distinction between "derivative-free" and "leverage-free" (see explanatory text item 45 and 51 vs. Box 11 point 2.1). Basically derivatives should be allowed as part of the comparable asset portfolio as long as (a) they do not cause additional leverage in the comparable asset portfolio (refer to the rules applied for calculating commitment under 2.1.2 and 2.1.3) and (b) help to create a better fit to the risk profile of the fund. Inter alia derivatives should be allowed in order to replicate leverage free and eligible index (for instance commodity indices). Other examples could be: funds that deal significantly with volatility (e.g. volatility swaps), credit spreads (e.g. CDS), or commodities could have as a benchmark component a volatility index, a basket of CDS (e.g. ITRAXX), or a commodity index (e.g. IPD). In light of the above one member mentioned that 130/30 like strategies should be allowed to use a long only benchmark.

25. Do you have any alternative suggestions?

We don't have any alternative suggestions.

3.4 Absolute VaR approach

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

Yes, we agree.

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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?

We think this should be left to the discretion of the national supervisory authorities. However, we do not agree with the proposed approach of setting a strict maximum VaR of 20%. We would like to encourage CESR to implement high principles which allow a case by case approval of the regulator in case a fund needs a higher risk budget. We feel that the existing CSSF guidance as outlined in 07/308 gives on the one hand side a clear limit which fits for most of the funds, however, it gives – based on clear principles - the opportunity to offer investors a fund with a higher risk budget (Funds using a comparable asset as relative limit did show in the past sometimes higher than 20 % VaR. A too strict limitation on the absolute VaR limit might lead asset managers to use inadequate relative VaR limitation). All in all, for most funds a 20 % absolute VaR limit is acceptable.

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

Yes, we agree.

There was one member mentioning that empirical and academic evidence suggest that the adjustment factor between volatility and VaR, or between VaRs, should imply an indicator which reflects the texture of the tail of the distribution. This could incidentally lead to the replacement of the square root adjustment factor by another, more appropriate, law., i.e. the proposed framework as stated in page 32 is a rule of thumb and one needs to consider it's limitation adequately.

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

Yes, we agree.

30. Do you have any alternative suggestions?

We do not have any alternative suggestions, except view expressed on question 28.

3.6.2 Risk Coverage

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

Yes, 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 with Box 16 and the explanatory text.

In light of that we are of the opinion that it is the responsibility of each management company to conduct adequate/critical reviews, on a qualitative basis, of the advantages/drawbacks of the used risk model.

3.6.4 Back Testing

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

Yes, we agree. However, the suggested approach to report on a quarterly basis if a overshooting as defined by the paper for the most recent 250 business days happens might cause a burden for the industry – i.e. we would recommend to have a yearly information to the competent authorities (at calendar year end) – for the case the senior management deems it appropriate – such a reporting including an analysis should be done during the period (in other words: We favor an approach where a systematic yearly reporting is provided to the competent authorities along with a more regular monitoring and a systematic communication to the management when the outliers ratio are too high.
Furthermore, the suggested approach ("unconditional coverage") may appear too simplistic to adequately identify model issues, i.e. counting the number of days on which the realized portfolio loss is greater than the VaR forecast. In particular, the approach may induce questioning or/and rejecting sound models while failing to identify a bad model.

34. Do you have any alternative suggestions?

Box 17 point 6 last sentence: it should be up to the UCITS to define the measures to improve the VaR model and take appropriate actions and not to the regulator to change the methodology. However the UCITS/Management Company has to disclose the measures taken to the regulator.

3.6.5 Stress testing

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35. Do you agree with the proposals regarding the VaR stress testing programme?

In general ALFI agrees with the approach outlined in the paper. However, the challenge for the asset managers in performing stress tests is to adequately analyze and implement measures for the UCITS, i.e. plausibility test of model as well as direct implications on the investment strategy (e.g. risk reduction).

36. In particular do you agree with the proposed quantitative and qualitative requirements?

Yes, we agree.

37. Do you have any alternative suggestions?

In general ALFI members agree.

Furthermore a few members suggest a stress-testing program to approach the shareholders structure as well, i.e. to complement the stress-tests that are performed at the level of assets. That is, we would encourage investment funds to perform stress-testing at the level of shareholders to simulate important redemptions and analyze the potential answer that can be given by selling-off the assets.

3.7 VaR approach: Qualitative requirements

38. Do you agree with the proposed tasks under the responsibility of the risk management function?

Yes, we agree in general.
However we understand that for the case the global exposure is calculated with a VaR approach there is no additional calculation of the leverage of the UCITS. We think that a VaR approach combined with the cover rules are more adequate to limit and thus monitor the global exposure of a fund. An additional monitoring of the leverage using the commitment method is not considered adequate for a UCITS using VaR approach.

39. Do you agree with the requirements regarding model testing and validation?

A review of the risk models should take place on a regular basis. Thus we agree that an independent oversight needs to be established, but we believe that this is already captured sufficiently by internal and external audits. Furthermore, we are of the opinion that as long the risk controlling function fulfils all the relevant criteria concerning the independence, the technical model validation should stay within the risk controlling function to avoid costly duplication of work.

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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?

No, almost all ALFI members believe with regard to Box 22 point 1 that the VaR approach sufficiently covers the monitoring of leverage in derivatives. In addition CESR should take into consideration that its proposals regarding the monitoring of leverage causes additional administrative burden and will probably not reflect positively on perceived quality of VaR models. It seems also redundant as a high leverage should be captured by VaR or at least within the stress testing programs. We are of the opinion that the cover rules – discussed in chapter 5 – are also an additional safeguard to prevent the UCITS from an inadequate global exposure, i.e. we would recommend including chapter 5 into this section.

3.8.2 Disclosure

a) Prospectus

41. Do you agree with the proposals regarding prospectus disclosure?

No, we do not agree. Information about the method used for the calculation of global exposure as well as the level of leverage might be difficult to understand for investors in mutual funds. We worry about some level of confusion, especially as the KID makes use of the SRRI to inform the investor of the level of risk taken.

42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?

No, we do not agree. The KID (SRRI) is more effective and up-to-date than a VaR figure in the prospectus (see question 41). As the leverage may frequently change over time especially under different market conditions we don't see any added value for investors in giving a rough estimated expectation of leverage and do frequent changes to the prospectus when leverage changes in major dimensions over time.

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

We disagree because the proposed method of calculating leverage is not consistent with the commitment approach and does not give a valid estimate of the 'leverage' in the portfolio (e.g. Interest Rate Swaps notional amount are not indicative of the inherent leverage of such a position).

As outlined above we do not agree that the leverage should be calculated and published. If CESR expects the industry to do so costs for a UCITS will increase significantly as when using a sophisticated VaR approach a more or less non-

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sophisticated approach to calculate the leverage is needed, too. VaR in conjunction with stress testing should be adequate.

b) Annual reports

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

We disagree since the investor should receive consistent information to compare UCITS. This is part of KID discussion. Please refer to questions 41-43.

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?

In general ALFI agrees with the proposals in Box 25. At a high level, collateral management is the function responsible for reducing credit risk in unsecured financial transactions. Collateral is used to provide security against the possibility of payment default by the opposing party in a trade. However, collateral management has evolved rapidly over the past 15-20 years with increasing use of new technologies, competitive pressures in the institutional finance industry, and heightened counterparty risk from the wide use of derivatives, securitization of asset pools, and leverage. As a result, collateral management now encompasses multiple complex and interrelated functions, including repos, tri-party / multilateral collateral, collateral outsourcing, collateral arbitrage, collateral tax treatment, cross-border collateralization, credit risk, counterparty credit limits, and enhanced legal protections using ISDA collateral agreements.

Credit risk exists in any transaction which is not executed on a strictly cash basis. An example of credit-risk free transaction would be the outright purchase of a stock or bond on an exchange with a clearing house. Examples of transactions involving credit risk include over the counter (OTC) derivative deals (e.g. swaps, swaptions, credit default swaps, CDOs) and business-to-business loans (e.g. repos, total return swaps, money market transactions, term loans, notes, etc.). Collateral of some sort is usually required by the counterparties in these transactions because it mitigates the risk of payment default. Collateral can be in the form of cash, securities (typically high grade government bonds or notes, stocks, etc.).
Collateral is typically required to wholly or partially secure derivative transactions between institutional counterparties such as banks, broker-dealers, hedge funds, and lenders.

ALFI members welcome CESR's idea of not imposing an exhaustive list of eligible instruments for collaterals, but rather to define fundamental and high principles for collateral. ALFI members believe that the global financial crisis has highlighted the

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need to make the financial system more robust, stable and transparent. Exceptional and largely unforeseeable circumstances – in which previously highly liquid markets such as commercial paper became largely illiquid - lie behind the problems experienced by the industry in recent months.

We concur with CESR's liquidity principles as set out in Box 25 that any collateral posted must be sufficiently liquid. We also agree that "stale prices" should not occur. Nevertheless we would like to stress that such occurrence is not always within the control of the UCITS. A liquid instrument may become illiquid at a certain point in time. Thus, rather than impose a prohibition, we recommend introducing an obligation to impose mitigation measures in order to avoid UCITS holding collateral with stale prices.

We would like to encourage CESR to define the correlation between OTC counterparty and collateral. Collateral issuer credit quality, correlation with OTC counterparty and collateral diversification should be considered by the Management Company in a consistent manner. Single guidelines for each of the three dimensions should be avoided. What about an OTC counterparty being a credit institution posting collateral issued by another highly-rated credit institution? Usually, there is a high correlation between both entities. The proposed wording by CESR would not allow such scenario. For example, OTC counterparty with a high credit quality posting AAA OECD government bonds should not need to diversify, as this would significantly increase the cost to bear by investors.

We fear that the proposed collateral diversification rule might counteract an efficient portfolio management. We would like to stress that collateral solely represents a security that is relevant in the case of counterparty's default. It would be therefore appropriate to provide principles based on the consideration of a combination of the quality of the collateral and of its diversification (very high quality of collateral with few or no diversification requirements and vice versa). This would reflect the consideration of the risk of a concurring default of the counterparty and the collateral issuer. It should be clear that collateral diversification rules should only apply **"if"** there is an obvious risk.

We do see a challenge for UCITS to fully enforce collateral. Therefore, we suggest to impose an obligation to keep collateral (posted in favor of a UCITS) in segregated accounts (one account per sub-fund).

We have strong reservation regarding the proposal to prohibit UCITS to re-invest collateral. In order to take into consideration the additional risk that UCITS are exposed to; UCITS should be allowed to re-invest cash-collateral received from counterparty under the condition that the additional market risk is reflected in the global exposure calculation (calculation methodology to be defined). In particular, where a UCITS accepts cash collateral, it must be in a position to re-invest the money in order to generate the yield which an OTC counterparty usually expects for cash collateral.

We would like to draw CESR's attention to the fact that it is not in general possible to trace if the collateral is subject to a re-hypothecation by the counterparty.

46. Do you have any alternative suggestions?

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ALFI member deem further clarifications on the role of the depositary/custodian bank in case collaterals are held with the depositary/custodian and in case collateral are held with other parties than the depositary/custodian as useful for the industry.

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?

ALFI considers indicative haircuts as very useful for the fund industry. For the valuation of the collateral presenting a significant risk of value fluctuation, UCITS should apply prudent discount rates. In this context it is to be noted that collateral in a currency other than the currency of exposure should also be the subject of an adjustment for risk of currency mismatch.

Some indicative examples on haircuts would therefore be very useful.

The definition of haircuts is usually subject to market standards and guidelines and should be therefore left to the UCITS. On the other hand, we would like to encourage CESR to propose high principles for indicative haircuts. In addition, we would welcome if CESR clarifies which levels should be applied to thresholds of collateral and minimum margin calls.

4.2 Counterparty / issuer Concentration

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?

Provided that the clearing house complies with the following three conditions, we understand that all transactions on derivative financial instruments executed on a market could be excluded from the calculation of the use of counterparty risk limitations:

- backing by an appropriate completion guarantee;
- daily valuation of the market values of the positions on derivative financial instruments; and
- making margin calls at least once a day.

ALFI members expect that the introduction of Central Clearinghouses, as planned by global regulators in the case of CDS, will meet the above-mentioned criteria.

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?

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Almost all ALFI members consider it to be valuable to define first of all the used terms:

A **margin** is collateral that the holder of a financial instrument has to deposit to cover some or all of the credit risk of his counterpart.

The **initial margin requirement** is the amount required to be collateralized in order to open a position.

The **variation margin** or **maintenance margin** is not collateral, but a daily payment of profits and losses. Futures are marked-to-market every day, so the current price is compared to the previous day's price. The profit or loss on the day of a position is then paid to or debited from the holder by the futures exchange. This is possible, because the exchange is the central counterparty to all contracts, and the number of long contracts equals the number of short contracts. Certain other exchange traded derivatives, such as options on futures contracts, are marked-to-market in the same way.

To ensure that the seller of an option can fulfill his obligation upon exercise of the option, he has to deposit collateral. This premium is equal to the premium that he would need to pay to buy back the option and close out his position.
ALFI considers that the passed variation margins to a broker are usually equal to the unrealized loss on a derivative position that a UCITS has with this broker. In the case of a default of the broker, the UCITS doesn't lose more than it would lose, should the contract be closed on the UCITS initiative and re-opened with another broker (transaction costs and spreads excluded).

Therefore, ALFI does not agree with CESR's approach, that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit. In respect to the variation margin, the margin is already the liability to the broker. In respect to the initial margin, the margin is the collateral the UCITS delivers to the broker. As mentioned above only over-collateralization must be taken into account in calculating the counterparty risk exposure. In this case the question is, if there could be any over-collateralization if the UCITS pays initial margin? In our opinion there is no over-collateralization.

We would appreciate to get more examples and more detailed definitions of margin, broker etc.

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?

ALFI agrees with the approach proposed by CESR - although the wording of the UCITS directive solely refers to "risk exposure to OTC counterparty in an OTC derivative transaction…". Some ALFI members understand that there is no clear legal basis for this approach.

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

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ALFI wants to draw CESR's attention to the specific situation where a UCITS has to use a specific bond future for duration management. By applying the commitment approach for calculating the concentration limits, a UCITS may not be able to manage duration efficiently, as the bond future would expose the UCITS to an issuer risk which may quickly go beyond the regulatory limit.
Thus, it might be worth to discuss whether one could adjust the standard commitment approach with a default probability factor to calculate some issuer risk more adequately (in particular concerning bond futures having a "cheapest-to-deliver" government bond as underlying).

5 Cover rules for transactions in Financial Derivative Instruments

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

Yes, ALFI agrees with the proposed cover rules for financial derivative instruments. As mentioned under 3.8.1 we would see cover rules as an additional safeguard to the VaR approach – for a fund using a commitment approach we are of the opinion that this is inherently included and thus no separate cover rule needs to be applied.

In addition, a member argued that it might be good to have a closer link between the cover rules monitoring and the liquidity risk management process that each UCITS will have to put in place (see CESR's document 09/963 Box 4 point 3. page 106).

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

No, ALFI members consider there should be no further restrictions; however, the UCITS should perform an appropriate assessment regarding the liquidity level of the assets held in order to ensure that they can be converted into cash on very short notice at a price corresponding closely to the current valuation of the financial asset on its market.

6 Glossary of Terms

54. Do you agree with the proposed definitions?

ALFI members in general agree with CESR's proposed definitions.

However, one member advocated to reformulate the definition of VaR which as stated gives rise to potential problem of interpretation. In particular, we deem the terminology "maximal potential loss" to be inappropriate. We would reformulate the

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VaR definition as "VaR (1D,99%) is a threshold whose magnitude will be *reached and exceeded* by daily mark-to-market losses with 1% probability".

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

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Specific risk should cover the idiosyncratic risk and the event risk.
In contrast, Specific market risk covers two general types of risks, systematic or market risk and specific or non systematic risks. Unlike systematic or market risk, specific risk can be diversified away by adding more securities to the portfolio.

In addition, we suggest to extend the glossary of terms to incorporate also the following notions, to whom definitions should be provided:

- Currency leg (pages 9 and 12)
- Client money rules (page 45)
- Structured UCITS (page 50)
- Leverage (page 5)

Additionally, we deem important to provide explicit definitions for the following notions:

Back-testing

➔ Back-testing is the process of evaluating a strategy, theory, or model by applying it to historical data. (In the context of the VaR: Backtesting is a statistical testing framework that consists of checking whether actual trading losses are in line with VaR forecasts.

Stress-testing

➔ Stress testing is a form of testing that is used to determine the stability of a given system or entity. (More specific: Stress-Testing is a process to identify and manage situations that could cause extraordinary losses.

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?

ALFI welcomes the discussion on the global exposure calculation for some structured funds. However the criteria for defining structured funds - inter alia having a predefined maturity- seems to be too strict. There are also funds with a

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structured/passive investment approach aiming to generate a clearly described pay-off which does not have a maturity – i.e. the definition of structured funds should be defined more broadly.

We agree that such funds asking for an alternative calculation method should have a structured investment approach which – however, we think that not only passively managed funds should be able to benefit from the possibility to have a different calculation approach.

We kindly ask CESR to define alternative risk measurement principles acceptable for such structured funds.

57. If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.

The approach is sufficient to avoid that NAV becomes negative in such structured funds.
The rationale of max loss approach would be the special features of these products (e.g. known pay-off, defined maturities and passively managed with no changes in the life-time of the fund).
As a general comment, we are fine with all the criteria as specified but believe that they only focus the approach on a subset of structured funds with passive investment strategies.

We kindly ask CESR to define further alternative risk measurement principles acceptable for actively managed structured funds.

58. Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach

We do not agree with the too strict criteria since this will limit the possibility to have beside the VaR/commitment approach another approach to calculate the global exposure to just a very limited range of funds.

The limitation of the fund maturity date to 9 years is not appropriate as a general investor safeguard. Such limitation should be considered on a case-by-case basis depending on the exact structure of the fund and disclosed to the investors. See our general comment above.

59. Can you suggest any additional criteria?

No – we think it might be good to analyze the possibility to give derogation to the standard approaches further.
For structured funds it should be contemplated if global exposure is an adequate way to limit the risk. In certain market situations it is possible for structured funds that the VaR is higher than twice VaR of the benchmark. In this case there is no chance to reduce the risk without changing the payoff function of the fund. But the payoff function is stated in the prospectus and hence in our opinion this limit breach

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should not cause any transaction which distorts the payoff function. The most important thing regarding the risk of structured funds is to keep the payoff function, because this is the amount the investor expects to achieve, and to ensure that the NAV could not be less 0. In our opinion sufficient and appropriate safeguards for this are the coverage rules and the limitation of counterparty and concentration risk. Compliance of the payoff function should be monitored regularly, too.

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