AVIVA INVESTORS

Aviva Investors' response to consultation on CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure

Aviva plc is the world's fifth-largest[1] insurance group and the largest insurance services provider in the UK, is one of the leading providers of life and pension products in Europe and is actively growing its long-term savings businesses in Asia Pacific and the USA. Aviva's main business activities are long-term savings, fund management and general insurance.

Aviva Investors is the global asset management business of Aviva plc, managing assets in excess of £236[2] billion across a range of funds and asset classes. The company operates under a single brand with almost 1,300 employees in 20 locations across North America, United Kingdom, Continental Europe, and Asia Pacific.

General comments

We have the following general comments to make:

- We welcome the consultation as we consider that it is helpful in clarifying some detail.
- We consider that it is important that the concepts of risk management and exposure should be clearly differentiated.
- We are concerned that this consultation, in particular section 2.2, seems to push the choice towards the VaR approach.

Please find below our responses to the specific questions asked.

Responses to questions

Calculation of Global Exposure using the Commitment Approach

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

We consider that article 51(3) may result in VaR being the only method. We want to preserve choice and retain the flexibility to use the commitment approach where it is suitable.

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

No, we do not agree that the counterparty risk involved in an OTC derivative should be considered in the calculation of global exposure. We strongly believe that counterparty risk should be considered separately.

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

We have no specific comments to make.

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?

Yes, we agree that this should be included.

[1] Based on gross worldwide premiums for the year ended 31 December 2008
[2] As at 31 December 2008

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

We consider that option 1 is consistent with the commitment approach.

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

We consider that option 2 is more akin to the VaR approach and therefore using this would be blurring the distinction between the commitment and VaR approaches.

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

We have no specific comments to make.

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

Yes, we consider that an illustrative and non-exhaustive list is helpful. Broadly, yes, we agree with the proposed approach but we consider that there are grey areas in relation to delta adjustments on options and credit default swaps.

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

We have no specific comments to make.

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

We have no specific comments to make.

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

We have no specific comments to make.

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

Yes, we agree with the approach as it relies on counterparty risk being kept separate.

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

If the commitment approach is used, then we consider that the sensitivity approach is not needed. To introduce risk-based measures into the commitment approach seems to blur the two approaches. We consider that the commitment approach does not work if there is high volatility. We believe that the UCITS should have the discretion to judge which approach is appropriate according to the instruments in the particular fund.

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

We have no specific comments to make.

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

We have no specific comments to make.

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

We have no specific comments to make.

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

We have no specific comments to make.

18. Do you agree with the proposals regarding netting?

We do not support the proposals regarding netting. We consider that, for netting to be used, there must be a very strong case in favour and absolutely no doubt that the hedge is "manifest and undeniable". With regard to the second paragraph of section 1.7.1, we are against netting where there are calendar spreads as this assumes zero risk which is not the case.

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

We have no specific comments to make.

20. Do you consider that hedging as described above should be permitted?

We have no specific comments to make.

21. Do you consider that the strong correlation requirement should be further clarified by means of a quantitative threshold e.g. 0.9?

Thresholds rely on historical data and are we therefore consider that they are always dangerous. We prefer to take a more cautious approach and not use thresholds.

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.

Thresholds rely on historical data and are we therefore consider that they are always dangerous. We prefer to take a more cautious approach and not use thresholds.

23. Do you agree with this proposal?

We strongly disagree with the proposal to combine market exposure to an issuer with counterparty exposure to the same issuer in assessing the concentration limits. We believe the Commitment Approach should be used to assess the underlying exposure to the issuer, but the concentration limits should apply separately to counterparty exposure. If we combine the two we would also need to incorporate collateralisation, which would be overly complex and difficult to interpret.

<u>Calculation of Global Exposure using the Value at Risk (VaR) Approach)</u>

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

We agree with the definition of VaR, however, as highlighted it does not capture the extent of the possible loss beyond the stated level. We propose the use of Expected Tail Loss (ETL) in addition to VaR to capture this.

25. Do you agree with the above approach?

Yes, we agree because VaR captures the actual risk of loss in the fund better than a leverage based calculation when more complex instruments are involved.

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?

We consider that stress testing provides additional safeguards for UCITS which use VaR. This should challenge the assumptions that are made in the calculations and VaR model. Stress testing should address historical scenarios. Alternatively, it should test the model using a variety of different data periods, looking at correlations, volatilities and the shape of distribution, even testing the assumption of a normal distribution.

27. Do you agree with the approach outlined in paragraphs 2.3, 2.4 and 2.5?

Yes, we agree with the approach outlined.

28. Do you have any comments or suggestions?

We think the approach is sensible. We consider that the VaR principle and concept works well. It is the implementation that is the key area and the robustness of the VaR model is of paramount importance.

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

Yes, we do consider that VaR should be calculated at least daily.

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

Criteria should include the ability to model extreme events (most model do not) and the ability to stress test models, for example, by changing the data period used.

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

We do not oppose this but we would question the practicality of this being a requirement in terms of the competent authorities' resources and their willingness to approve providers' offerings. In addition, such a proposal would have to be subject to full Cost Benefit Analysis.

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

We do not support the use of relative VaR because it is not a logical way to control global exposure. The selected reference portfolio may itself be highly volatile, and this method allows significantly greater scope to take risk than the absolute VaR limit being set at 20% as it is in Luxembourg. Relative VaR is a useful risk management tool but should not be used to limit exposure.

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 do not support the use of relative VaR. However, if it is used, the proposed limitations are too restrictive. To have a risk profile "identical to the reference portfolio" effectively rules out all but index tracking funds.

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

The use of absolute VaR is more effective to limit exposure than relative VaR. However, it should not be unreasonably constrained.

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

We have no specific comments to make.

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

We strongly disagree with the proposed thresholds. We do not approve of the use of the table of confidence levels and coefficients of normal distribution because of the use of normal distribution. We consider that there are some circumstances where this is acceptable but if the expected return distribution is clearly skewed or fat-tailed then the model should reflect this.

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

We do not consider that different criteria are necessary for different types of asset class since the volatility of asset classes is inherently built in. Furthermore, we do not consider the square root of time assumption to be robust.

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?

Yes, we consider the proposed safeguards are appropriate.

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?

We consider that UCITS' risk should be appropriately communicated, but in our view, marketing provisions should be outside of the scope of this consultation.

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

We have no specific comments to make.

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

Yes, this seems reasonable.

42. Can you suggest an alternative method?

We have no specific comments to make.

43. Do you agree with the approach for netting arrangements?

Yes, this seems reasonable.

44. Do you consider that additional netting rules should apply?

Theoretically, we are in favour of additional netting rules but we are unsure how this could work given that other instruments are unlikely to be covered by the existing ISDA.

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?

Yes, we support the use of principles in this context. We believe the principles should provide clarity as to the impact on collateral of the inclusion in the counterparty ISDA of payment of Independent Amounts, which effectively increase the counterparty risk exposure. Payment of independent amounts has not historically been expected on UCITS funds but we would like clarity as to whether making such payments would breach the collateral requirements for the UCITS. Similarly we would like to confirm whether giving the counterparty the right to close out any position in the event of a significant decline in NAV is consistent with the UCITS requirements to have global cover at all times.

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

No, we do not support the use of a list of specific instruments. We consider that the guidance is already sufficient specific.

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

We consider that liquidity is the key consideration for collateral and we do not consider that diversification is paramount.

48. Do you agree that collateral passed to a derivative counterparty should be include in the either the 5%/10% OTC counterparty limit or the 20% issuer concentration limit?

No, we do not agree that the collateral should be included because it is effectively unrealised P&L on the transactions with the counterparty. If this approach is taken, this would limit what can be undertaken with that counterparty and may even increase the level of risk.

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

Our concern lies where there has been agreement to pass the collateral but it is in transit i.e. the risk that it will not be delivered.

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

We have concerns in relation to basis risk i.e. making sure that the protection purchased does in fact cover what is required. We are also concerned that there is some level of counterparty non-performance risk.

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

We have a neutral view on the use of the terms. However, we are very concerned about the risk that abandoning the use of these terms might be misinterpreted as abandoning the requirement to choose the commitment or VaR-based approach to calculating exposure. It must still be clear that a decision must be made to select the appropriate approach and that this must be documented.

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

We do not object to the proposal as long as it is made very clear that abandoning the use of these terms does not mean abandoning the requirement to choose the commitment or VaR-based approach to calculating exposure. We are concerned that there might be confusion between the parameters used in the Risk Management Process, which may be volatility, trading error, VaR or other, and the method for calculating exposure.