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Dear Mr. Cardia,

Allianz Global Investors would like to thank CESR for the opportunity to participate in this consultation. Overall we warmly welcome CESR's technical advice to the European Commission focusing on risk measurement for the purposes of calculation of UCITS' Global Exposure as an additional step towards introducing greater supervisory consistency. The further development of UCITS Risk Management as well as a consistent implementation of the respective regulations across the EU member states is crucial for assuring one of the main goals of UCITS – i.e. an adequate protection of the investors.

Allianz Global Investors Europe with its Management Companies in France, Germany, Italy, Ireland, London and Luxembourg welcomes the clarification on some technical aspects concerning UCITS risk limitation – in particular the global exposure calculation and details on counterparty risk. Furthermore Allianz Global Investors is of the opinion that the general risk principles issued by CESR in 2009 will support the aim to harmonise the risk management for a UCITS and fosters a more consistent implementation to become a truly Single Market of regulated investment funds in Europe.

We fully understand that CESR is asked to consider carefully perceived needs to modernize the legislation regarding Risk Management. The current financial crisis has indeed underlined the importance of this work and it should be a joint goal of regulators and the industry to keep and protect the high reputation of UCITS. At the same time this is a very difficult task, not only because we all needed to learn that the unexpected does happen. In light of the financial crisis we are of the opinion that risk management and in particular the various risk limitations shall not be viewed as single limitations – we rather understand risk management as an overall approach which asks the Management Companies to implement adequate measures to assure the protection of the investors. In order to provide best in class risk management expertise across Management

Companies belonging to the same group, we would welcome specific acknowledgement by CESR that it understands the benefits sub-delegation to a centre of expertise might bring in this regard.

The recent crisis has revealed that a focus on the Global Exposure calculation can not prevent a UCITS of being exposed to risk. The ABS/MBS crisis with inter alia the liquidity risk issue as well the related valuation issues have shown clearly, that an overall risk management is of utmost importance for the fund industry.

Last but not least we would like to ask CESR in its advice also to bear in mind potential indirect consequences of its work to the success of UCITS outside Europe. Using our Luxembourg hub as a platform for the global distribution of our funds we experience in our daily business that the UCITS risk management regulation is of particular interest for all the regulators outside the European Union as well. There is a huge interest to understand and learn more about the risk management principles given by CESR as well as to understand in detail technical aspects inter alia concerning the global exposure calculation using a Value at Risk methodology. Even if it is true to have in the focus a harmonised regulation assuring a high level of protection for investors in the Single market, it would make sense to consider that the risk management needs for cross-border distribution is likewise an important aspect which needs to be considered carefully in the course of further development of the UCITS risk management system.

Yours sincerely,

Markus Miederhoff

General Counsel Europe

Thomas Nummer

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I. Calculation of Global Exposure using the Commitment Approach

1.1 Context

Article 51(3) of the new UCITS Directive provides that:

"A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio.

The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions. This shall also apply to the third and fourth subparagraphs."

Global Exposure is understood to be a measure of the incremental exposure and leverage generated by a UCITS through the use of financial derivative instruments. A UCITS cannot have global exposure greater than its NAV. A UCITS total risk exposure may not exceed 200% of its NAV on a permanent basis (excluding potential increase of overall risk exposure by means of temporary borrowing of up to 10% of UCITS' NAV), which means that the global exposure of a UCITS may at most be doubled through the use of financial derivative instruments.

Given that the counterparty risk associated with over-the-counter (OTC) financial derivative instruments is specifically limited for a given entity through the provisions of article 52(1) and given that the global exposure relating to financial derivative instruments is, anyway, limited to 100% of the UCITS' NAV through the provisions of Article 51(3), the global exposure concept can be reduced to its market risk dimension.

Questions

1. Do you agree with the proposed approach in relation to the calculation of global exposure?
2. Should the counterparty risk involved in an OTC derivative be considered in the calculation of global exposure

Answer ALLIANZ GLOBAL INVESTORS :

1) Yes, we agree.

2) No, Counterparty risk should not be included. The GE in this regard should be reduced to the Market Risk/Commitment only, as it is interpreted as incremental exposure and leverage generated primarily through FDI. Since Counterparty risk is considered by specific limitations (max 10 %/5% per counterpart as well as within the 20 % group limitation) one should furthermore consider adequately liquidity risk in the RM process – but likewise to counterparty risk we do not see liquidity risk being part of the GE monitoring (however, another important part of an overall risk management).

1.2 Scope of the Commitment Approach

The Commitment Approach, in compliance with the rules hereafter, is appropriate for measuring the global exposure laid down by Article 51(3) of the new UCITS Directive. The calculation process has to be applied to all the positions in financial derivative instruments, whether used as part of the UCITS' general investment policy or as part of techniques and instruments (efficient portfolio management). Only those positions on financial derivative instruments that, at the level of the UCITS, generate incremental exposure are included in the calculation.

If transferable securities or money market instruments embed financial derivative instruments that qualify as embedded derivatives according to the provisions of Article 51(3) of the new UCITS Directive, Article 10 of Directive 2007/16/EC and point 23 of CESR's guidelines concerning eligible assets for investment by UCITS, then the global exposure, issuer concentration and leverage calculation rules apply to the embedded FDI element. A UCITS therefore needs to be able to separate embedded FDI from the host instrument in order to meet regulatory requirements.

If UCITS are authorised to avail themselves of repurchase transactions or securities lending transactions in order to generate additional leverage through the reinvestment of collateral, these transactions must be taken into consideration for the determination of the global exposure. The calculation process has to include any reinvestment of collateral in financial assets that yield a return greater than the risk-free rate.

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

Answer ALLIANZ GLOBAL INVESTORS :

Yes, we agree with the proposed approach. Assets incl. in a Securities lending scheme remain in the portfolio records (for accounting and risk analysis purposes) and thus are included in the GE calculation.

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?

Answer ALLIANZ GLOBAL INVESTORS :

In principle ALLIANZ GLOBAL INVESTORS agree that the incremental exposure/leverage generated through techniques /instruments such as repos and sec. lending should be included in the calculation of a GE - as it is a core principle of UCITS RM.

1.3 Commitment Approach Calculation: General Principles

For a given position in a financial derivative instrument, the Commitment Approach calculation converts the position into the equivalent position in the underlying asset of that derivative. The above mentioned conversion process is to be implemented for all financial derivative instruments with the exception of those positions specifically mentioned below.
The total commitment arising from the use of financial derivative instruments equals the sum, in absolute terms, of the individual commitments corresponding to the individual positions in financial derivative instruments, after taking due consideration of any netting and hedging effects according to the rules laid down hereafter. Financial derivative instruments that comply with the netting and hedging criteria may be disregarded from the total commitment calculation.
For positions on financial derivative instruments having a limited loss payoff function, like long positions on plain vanilla options or protection buyer CDS positions, two calculation methods were discussed within the Technical Working Group on risk measurement:

- Option 1: UCITS may refer to a risk-based approach and the maximum theoretical loss may be used as reference amount for the commitment calculation. This would mean that for a long position on an equity call, the exposure amount would come down to the market value of the option contract (for example, a UCITS is long 1 call contract on share xyz with the current MV of the option at €4, then the exposure would equal €4, and if the MV tomorrow was €5, the exposure would be €5 etc.) or for a protection buyer CDS contract the sum of the premiums to be paid during the lifetime of the contract.
- Option 2: UCITS convert the position into the equivalent position adjusted by the delta (which takes into account the likelihood of settlement) in the underlying asset.

CESR wishes participants in the consultation process to assess the relevance of the proposed options.

Questions

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

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

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

Answer ALLIANZ GLOBAL INVESTORS :

In general one needs to consider the leverage/exposure generated by a FDI and thus we are of the opinion that option 2 might be in most cases an appropriate approach – however, there might be alternative approaches fit better for some specific instruments – such deviation for the general guideline (equivalent position adjusted by the delta) needs to be explained in the RMP and disclosed to the responsible authority.

1.4 Commitment Approach Calculation – Conversion Method

UCITS shall convert the positions in financial derivative instruments into the equivalent positions in the underlying asset by taking the market value of the underlying asset or, if appropriate and conservative, the notional of the financial derivative contract.
This conversion method shall be applied to all the financial derivative instruments (with the exception of those specifically mentioned below) for which the use of the market value of the

underlying asset leads to an adequate and accurate exposure amount with regard to the specific risks relating to that product.
In illustrating the Commitment Approach calculation, CESR considers it appropriate to provide an illustrative and non-exhaustive list of financial derivative instruments with the corresponding conversion method. For these products, CESR considers that the use of the market value of the underlying asset leads to an adequate and accurate exposure amount with regard to the specific risks
relating to these products:

Plain Vanilla Equity option: market value of the underlying asset adjusted by the option's delta, i.e., number of contracts x number of shares x underlying price x delta

Plain Vanilla Bond option market value of the underlying asset adjusted by the option's delta, i.e., principal x underlying price x delta

Plain Vanilla Warrant market value of the underlying asset adjusted by the warrant's delta, i.e., number of contracts x number of shares x underlying price x delta

Index future market value of the underlying asset, i.e., number of contracts x value of 1 point x index level

Bond future market value of the underlying asset, i.e., number of contracts x notional x market price of cheapest-to-deliver adjusted by conversion factor[1]

Forward FX principal (i.e. market value of underlying asset) of the forward contract – normally viewed as the market value of the currency leg of the FX contract

Interest rate swap notional of the swap contract (fixed leg)

Credit default swap protection seller: market value of the underlying asset
protection buyer: option 1: sum of premiums to be paid during lifetime of contract / option 2: market value of the underlying asset (see discussion re this measurement technique in paragraph 1.3)

Total Rate of Return Swap[2] 1) for the basic TRORS contract market value of the underlying asset (respectively notional)
2) for non-basic TRORS contract: sum (in absolute terms) of the market value of the underlying asset of both legs (respectively the notional for both legs)

A UCITS is not permitted to use the calculation method set out above in the case of financial derivative instruments for which the conversion of the position in the financial derivative instrument into the equivalent position in the underlying asset by taking the market value of the underlying asset (or, if appropriate and sufficiently conservative, the notional) does not provide for an adequate and accurate assessment of the risks relating to that product. Financial derivative instruments that do not qualify for the standard conversion method are, for instance, digital options (or binary options), barrier options, variance swaps or more complex options with a highly volatile delta.
In this case, if a conservative estimate of the commitment amount can be applied, the UCITS may do so. With regard to these products the commitment amount could, for instance and if possible, equal the maximum potential loss that could arise from the position. For binary options that would mean that, instead of the delta weighted market value of the underlying asset, the maximum potential loss should determine the commitment amount. (Please note that for some financial derivative instruments, such as binary "asset or nothing" options, it may be impossible to compute a maximum potential loss and an alternative conservative approach must be adopted.)

However, as this approach does not take into account the sensitivity to market movements, it should be used only if these investments represent an ancillary part of the UCITS investments, and do not impact significantly the level of risk of the UCITS.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

We agree in principle with the proposal. Luxembourg ManCos have received guidance from CSSF in the circular 07/308 – appendix 1 lists the calculation methods and ALLIANZ GLOBAL INVESTORS welcome in principle the methods laid down an adequate way to harmonize the calculation the commitment approach. Furthermore we welcome the idea of an illustrative non-exhaustive list for the most common FDI.

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

Answer ALLIANZ GLOBAL INVESTORS :

No, we think its favourable to have a standardised conversion approach and think the conversion approach fits for fund manager who do not invest too much in complex FDIs. However, we see the challenge coming from non linear risks which are potentially not captured adequately in the RM – i.e. we propose funds having high exposure to complex FDI with significant impact to the overall fund risk profile, one should apply adequate measures - e.g. a VaR calculation.

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

Answer ALLIANZ GLOBAL INVESTORS :

No, as indicated above regulators such as CSSF has given guidance in a non-exhaustive list of financial derivatives.

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

Answer ALLIANZ GLOBAL INVESTORS :

We do see a challenge for funds with high exposure in complex FDIs (non linear risks) to use a commitment/leverage approach. In such a situation one should rather use another/more adequate calculation method to monitor the GE.

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

Where the use of a derivative does not result in any incremental exposure for the UCITS the underlying exposure is not included in the commitment calculation. For example, a TRORS, the purpose of which is to swap the total return of a financial asset held in the UCITS portfolio for the total return of another financial asset, need not be taken into consideration for the purpose of the calculation of the total commitment when the swap in question does not subject the UCITS to the market risk of the asset held and when it does not include either leverage clauses or other additional risks as compared to a pure and simple holding of the reference financial asset. This reasoning can be extended to cases in which the performance swap involves several assets or even the entire portfolio. CESR considers that there is no incremental exposure arising from such a use of the TRORS as there is simply a substitution of the exposure of another financial asset for the exposure on a financial asset directly held in the UCITS portfolio. As a consequence, if a TRORS exchanges the exact performance of assets held by the UCITS against other assets, for the purposes of calculating the commitment of the UCITS, those assets, the performance of which is exchanged, are replaced in the portfolio by the performance of those received. For example, TRORS that do not provide incremental exposure or leverage (i.e. exposure is created on an un-leveraged basis) as calculated using the commitment approach will not have to be taken into account in the commitment approach calculation process.
Another example that could be considered is where a UCITS holds financial derivative instruments and cash, the derivative instruments concerned are not considered to generate incremental global exposure (leverage) up to the value of such cash positions. UCITS that employ cash-equivalent instruments that generate an investment return (e.g. money market instruments) must calculate their global exposure in the normal manner.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

We agree with the approach.

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

For interest rate related financial derivative instruments that only expose the UCITS to general interest rate risk, UCITS may use a sensitivity-based approach instead of the standard Commitment Approach. The aim of the sensitivity approach is to have a more risk-based approach to interest rate instruments than the standard approach proposed in paragraph 1.4. Indeed, there is a much larger range of risk and volatility between interest rate instruments of various maturities than there is between two different equity indices: the sensitivity of a 20-year bond can indeed be 80 times bigger than the sensitivity of a three-month money-market instrument. The sensitivity approach allows UCITS to take this particular feature of interest rate instruments into account.
Under this method, the commitment related to a financial derivative instrument is calculated in a similar way to the one used in the standard method (market value of the underlying asset or notional), except that the amount is multiplied by the ratio between the sensitivity (or modified duration) of the financial instrument and the maximum sensitivity of the portfolio.

 The standard definition of the sensitivity (or modified duration) of a financial instrument is equal to the opposite of the derivative of the market value of that financial instrument with respect to the interest rate, divided by the value of the instrument.

 The maximum sensitivity for a UCITS is equal to the higher of the following two values, as specified in the full prospectus: the absolute value of the maximum sensitivity and the absolute value of the minimum sensitivity. For instance, if the sensitivity interval mentioned in the prospectus is [-2; 4], the maximum sensitivity will be 4. If it is mentioned [-3; 1], the maximum sensitivity will be 3. As some UCITS may not disclose a sensitivity range in their prospectus, a default mechanism sensitivity should be defined and used only for UCITS that do not disclose a sensitivity range. This default maximum sensitivity should be conservative (low), as a situation where a UCITS has incentives not to disclose its sensitivity range to take a higher level of risk without appropriate investor disclosure would not be acceptable.

For example, the commitment of an interest rate swap is the sum, in absolute terms, of the individual commitments of the two legs, measured by the product of the notional of the contract and the ratio between the sensitivity of the leg and the maximum sensitivity. For an interest rate option, the calculation is similar, except that it takes into account the delta of the option.
This method allows the use of a risk-weighted approach to interest rate instruments, considering their specific nature; however, it does not take into account other risks that can be contained in such instruments such as credit risk. Therefore the exposure to credit derivatives cannot be taken into account through this approach and the standard approach proposed in the commitment paper should in such a case be maintained.
The value of derivatives calculated using this sensitivity approach is added to the value of all other positions in the portfolio using the commitment approach to calculate the UCITS' overall global exposure.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

Yes we agree.

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

Answer ALLIANZ GLOBAL INVESTORS :

Given the complexity of such a sensitivity approach we would suggest that its use should be optional.

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

Answer ALLIANZ GLOBAL INVESTORS :

see answer above

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

Answer ALLIANZ GLOBAL INVESTORS :

We are of the opinion that GE should focus on market risk/exposure and thus we would regard default risk rather as a subtype of credit risk and it should be handled separately (however, in the existing issuer risk calculation standards used in the market there is no consideration of default probability)

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

Answer ALLIANZ GLOBAL INVESTORS :

The convexity effects should be taken into consideration if a fund has significant exposure towards secondary risks; especially in some non-trivial cases (e.g. convertible bonds, options on interest-rates).
(Furthermore one should keep in mind that the commitment approach focus on the risk concerning the use of derivatives – i.e. there is not a GE monitoring of all assets in a portfolio – ABS/MBS papers which have contributed to the GE of a fund significantly were not considered in the GE at all.)

1.7 Commitment Approach calculation: netting & hedging effects

When proceeding to the calculation of the Commitment Approach, UCITS may benefit from netting and hedging effects and as such the global exposure calculation may be reduced appropriately for derivative instruments that meet the criteria.
The consideration of netting and hedging effects, as further described hereafter, can only be done for equivalent amounts of commitment, which means that if pursuant to the consideration of the netting or hedging effects, there remains a residual global exposure position on financial derivative instruments (e.g. over hedging), then the UCITS must include this residual exposure when calculating the global exposure.

In all cases, the application of any netting or hedging should not result in the UCITS neglecting obvious and material risks, and so the only allowed purpose of these transactions shall be to reduce the market risk of the portfolio. Specifically, the consideration of netting and hedging effects must not ignore positions on financial derivative instruments that are aimed at implementing specific investment strategies (example: long/short strategies, straddle strategies) designed to generate additional returns to the fund that, from a risk perspective, are not neutral for the UCITS. In such situations, the netting or hedging of these instruments is forbidden.

1.7.1 Consideration of netting effects

Netting can be done between financial derivative instruments and between financial derivative instruments and security positions (for instance stocks, debt securities).
Netting between long and short positions on financial derivative instruments is possible provided that they refer to the same underlying asset, regardless of the contracts' due date (for instance long call position and short call position on same underlying asset).
Netting between financial derivative instruments and assets held directly by a UCITS is possible provided that the two positions refer to the same underlying asset (for instance long cash position on share xyz and synthetic short position on share xyz).

1.7.2 Considering of hedging effects

CESR is considering whether it is appropriate to permit UCITS to hedge positions in derivatives against related security positions. In these circumstances positions in financial derivative instruments that are solely used for the purpose of hedging partially or totally the market risk (general and specific market risk) relating to positions of the UCITS may be netted against the related security positions provided that through the use of such derivatives an undeniable and manifest risk reduction at the level of the portfolio can be observed. For illustration purposes, one could think of a UCITS concluding bond future contracts to hedge the general interest rate risk relating to its positions on debt securities.
UCITS that want to benefit from such hedging effects must be able to demonstrate that the prices of both the positions to be hedged and the financial derivative instrument always move in opposite directions and demonstrate a strong and negative correlation in all market conditions. This would prohibit, for example, hedging a long equity portfolio with a stock index if the equity basket and the index have not been adequately chosen to maximise the risk reduction deriving from the hedging, or to hedge a long equity portfolio of natural resource companies with a short investment in a commodity index.

Questions

18. Do you agree with the proposals regarding netting?

Answer ALLIANZ GLOBAL INVESTORS :

We agree with the proposals regarding netting.

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

Answer ALLIANZ GLOBAL INVESTORS :

No additional comments.

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

Answer ALLIANZ GLOBAL INVESTORS :

Yes, provisional other metrics than correlation, such as Betas between assets, are involved so as to compute the degree of hedging that can be achieved or the relative weight of both components to have an efficient hedging. The regulation should not concentrate purely on a high numerical correlation coefficient.

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

Answer ALLIANZ GLOBAL INVESTORS :

No. The decision on quantitative figures should be further clarified (and this is not achieved properly by the simple mean of the correlation level. Indeed, correlations of 0.9 have not the same statistical relevancy whether they have been computed with a long or a short time-series). However, this does not necessarily mean that regulation needs to be defined in that detailed level – alternatively, industry associations might come up with best practice standards assuring that there is a 'best practice' applied by ManCos, which of course have the ultimate responsibility to assure adequate protection of the investors.

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.

Answer ALLIANZ GLOBAL INVESTORS :

Pls see our comment above – instead of having a regulatory defined threshold we propose to have the flexibility to implement adequate measures at the level of the industry which can be used by a ManCo as best practice guideline.

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

The Commitment Approach, as detailed above, must be used by the UCITS to determine the issuer concentration limits arising from the use of financial derivative instruments in all cases. In addition, issuer concentration risk must include any counterparty risk associated with the same issuer in respecting the UCITS limits.

Questions 23. Do you agree with this proposal?

Answer ALLIANZ GLOBAL INVESTORS :

In general we do agree with the approach to use same calculation principles (i.e. delta adjusted positions – conversion method) for the issuer limitation as well. However, as indicated in the discussion above (answer 16), it might be worth considering instead of purely the market value of a security the default risk as part of issuer risk – otherwise one limits an issuer with high credit ratings (AAA) likewise to an issuer with low credit worthiness 10 % (if government 35%) of the NAV.

By applying the conversion approach to e.g. derivatives having government issues as an underlying (such as Bund, Boble futures) in a commitment approach as well as in the issuer calculation without considering the default risk, it appears sometimes difficult for fixed income funds to used such futures for their duration management efficiently. Thus, it might be worth to discuss whether one could adjusting the standard commitment approach with a default probability factor to calculate some issuer risk more adequately (in particular concerning fixed income futures such as Bund considered in the government exposure.

Definitions

1. Total Rate of Return Swap (TRORS) - See Sections 1.4 and 1.5

The basic TRORS contract is defined as a bilateral contract between a total return payer and a total return receiver whereby the total return payer pays the total return of a reference asset (i.e., short position on reference asset) and receives from the receiver of the total rate of return (i.e., long position on reference asset), in principle, a floating rate payment (for instance LIBOR) plus a spread.
The non-basic TRORS contracts as those where, instead of the floating rate payment leg, the TRORS refers to a fixed rate payment or to the total return of another reference asset.

2. Market Risk

Market risk includes both general market risk and specific market risk.

3. Delta factor

The delta factor presented in the option conversion formulae measures the sensitivity of the option price with regard to the underlying asset (e.g. bond, equity) price change. It describes numerically how similar the option behaves to the underlying asset. If the delta is close to zero, the option will hardly respond to movements in the underlying asset, which means the option does not behave like the underlying asset. If, on the other hand, the delta approaches unity, the option moves one-for-one with the underlying asset and so behaves very much like it.

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

2.1 Definition of VaR

VaR measures the worst expected loss at a given confidence level (probability) over a specific time period under normal market conditions. For example if the VaR (1 day, 99%) of a UCITS equals $4 million, this means that, under normal market conditions, the UCITS can be 99% confident that a change in the value of its portfolio would not result in a decrease of more than $4 million in 1 day. This is also equivalent to saying that there is a 1% probability (confidence level) that the value of its portfolio could decrease by $4 million or more during 1 day, but the level of this amount is not specified (i.e. it could be catastrophic).
Market practice in UCITS over the last number of years suggests that there are 2 main approaches to using VaR, namely the relative and absolute VaR measurement approaches. These are more fully described in paragraphs 2.6 and 2.9 below.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

In general we agree with the definition – although some formal comments from our side:

We consider the terminology "expected" to be misleading since VaR is not mathematically defined as an expected value, but as a quantile metrics. One could rephrase it such as : "Given a predefined confidence probability level p, and a specific time period T, VaR is defined as the theoretical cumulated loss amount over period T that will be exceeded with a probability (1-p)"exceeds the VaR is (1-p)"

Furthermore the wording 'normal market conditions' is not defined and thus it might be an idea to have a wording such as 'stable market conditions'. The assumption is that the market conditions will be quite similar to the conditions at the VaR calculation during the specific time period.

We like the example which helps to 'translate' the VaR concept into a figure – to show the influence of the parameter to the final VaR, it might be worth having a matrix showing the different VaR results by simply changing the parameter (99% vs 95% - 10 days vs 20 days etc)

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

It is important to stress that Article 51(3) of the new UCITS Directive requires that "A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio." While the commitment approach calculates global exposure as a percentage of NAV (and clarifies the extent to which the UCITS is in compliance with the limit set out in Article 51(3) of the new UCITS Directive), VaR does not calculate global exposure in the same way; it measures the probability of risk of loss rather than explicit leverage levels. It is also important to note that Article 51(3) of the Directive also states that "the (global) exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions". Such wording envisages a risk-measurement methodology such as VaR as the VaR calculation explicitly respects these criteria.

Nonetheless, it is possible that when using VaR, a UCITS may generate higher levels of leverage than that which would be allowed were the same positions measured using the commitment approach. However, while the commitment approach might be more precise in measuring leverage (or global exposure) on a conservative basis, VaR is a better measure of market risk and, thus, might be more adequate to fulfil the requirements set out in the Risk Management Principles paper e.g. adequate assessment of market risk and in particular concentration and interaction of risks. Given the above, it is important to consider how VaR enables a UCITS to comply with the requirements of the UCITS Directive and whether any additional requirements concerning the calculation of total leverage generated by the UCITS through derivatives should be considered. It is indeed clear that strategies such as 200% long and 200% short strategy on equities could meet all requirements for using a VaR approach (especially for the absolute VaR limit) while clearly generating a global exposure greater than 100% of NAV through derivatives (as calculated using the commitment approach).

Questions 25. Do you agree with the above approach?

Answer ALLIANZ GLOBAL INVESTORS :

We are of the opinion that a VaR approach is more suitable to measure the potential market risk inherent in an UCITS portfolio - which is exposed to a certain extent to complex FDIs - than the commitment approach although its main objective is not the measurement of leverage. Furthermore one should highlight that a VaR should consider all portfolio holdings instead of focusing on FDIs only.

But it has to be taken into account that the VaR measurement only relates to the market risk and does neither include liquidity nor counterparty risk as proposed in article 51 (3). We think that 'one size fits all needs approach/figure' is not possible and thus a VaR figure to monitor the market risk of a fund plus additional measures to capture counterparty risks, liquidity risk, adeqauate cover risk etc. might be a solution to achieve the overall regulatory goal – i.e. to protect the investors of a UCITS adequately.

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?

Answer ALLIANZ GLOBAL INVESTORS :

To have a consistent approach to the 200 % NAV exposure a relative VaR limitation is preferable. Furthermore the VaR approach should be complemented by stress tests which do give further information about the risk behaviour of a fund under not 'normal' market conditions and give information about the degree of non linear risk pattern of a fund.

2.3 Common VaR calculation models

A variety of models exist for estimating VaR. Each model has its own set of assumptions, its advantages and drawbacks. Common models include the parametric (variance-covariance) model, the historical simulation model and the Monte Carlo simulation model.

As every approach has its advantages and drawbacks, the choice of model must depend on the investments strategies and financial instruments used in the UCITS, and remain the responsibility of the UCITS. For example, a UCITS could choose to carry out a parametric VaR rather than a Monte Carlo VaR or use other methodologies based on e.g. volatility if it judges that the UCITS' market risks are adequately taken into account by this methodology.

2.4 Input used in the calculation of VaR

The UCITS must use input that best fits with the strategies and the behaviour of markets. The length of the data history used in the calculations has to be suitable. In particular, it must make a prudent decision between the need to take into account extreme situations and the importance of overweighting recent events. The observation period should be at least one year, this period may be shortened or recent events overweighted during extreme market conditions. Whatever the data used and the calculation of parameters, the UCITS has to test the models used in order to check that all parameters are well calibrated.

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

The risk management unit with responsibility for the VaR calculation should be independent of the units in charge of managing and marketing the UCITS. The UCITS should use VaR methods that are consistent with best market practices and are also in accordance with CESR guidelines on risk management principles for UCITS.

The model used must be internally validated by the UCITS by a function which is independent from that responsible for building the model. The model must be adequate and effective, integrated into the investment process of the UCITS, based on suitable back testing. UCITS should ensure that the VaR models used capture adequately all the risks linked to the portfolios and take into account all the cash and derivative instruments in the portfolio. It must develop documentation on the VaR models used, describing the operating principles of the models, the methods used to validate the models, the validity range of the models and the monitoring of the implementation.

The UCITS must carry out a complete and rigorous stress testing programme to identify events or factors which could substantially affect the portfolio's level of risk. The stress tests must be based on quantitative criteria (concerning market and liquidity risks) and provide for qualitative criteria. The UCITS must record and analyse the results of all calculations carried out in order to check that the models measure satisfactorily the UCITS' risks, which means in particular that performance tests must be run to check that the variations of UCITS' NAV are consistent with the measurements of risk (back testing), in accordance with CESR's paper on risk management principles for UCITS. If it appears that the back testing results reveal a too high percentage of exceptions, the UCITS must review the VaR model and make appropriate adjustments. Where the back testing results give rise to consistently inaccurate estimations and an unacceptable number of exceptions competent authorities reserve the right to apply stricter criteria to the use of VaR.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

In general we agree with the approach outlined in the paragraphs 2.3, 2.4 and 2.5.
However, it might be challenging to have beside the (risk) department being responsible for building the model another independent department in the same ManCo which can internally validate the model in detail (very difficult in terms of technical equipment and technical skills).
We think that it might be the role of internal audit or compliance function to assure an independent check of the set up of the risk management function in general and the risk model used in particular.
Furthermore we do agree on the need for liquidity stress test (asset and liability side) but it is in our view not part of the GE discussion but rather an additional aspect to be considered in an overall rm approach.
If a ManCo has delegated the calculation of risk figures to a third party, it is in our view the responsibility of the ManCo to perform independent controls concerning the validity of the risk model used by the service provider.

28. Do you have any comments or suggestions?

Answer ALLIANZ GLOBAL INVESTORS :

We do agree on the need for liquidity stress test (asset and liability side) but it is in our view not part of the GE discussion but rather an additional aspect to be considered in an overall rm approach.

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

Answer ALLIANZ GLOBAL INVESTORS :

We consider it is essential to calculate VaR daily. Daily data are required to undertake accurate back-testings and ensure the effectiveness of risk monitoring.

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

Answer ALLIANZ GLOBAL INVESTORS :

For assessment purposes one should take into account the nature and volume of FDIs being used by the UCITS (significant amount of FDIs with non-linear pay-offs might be difficult to capture in delta normal approach). In addition a transparent back testing procedure should be in place and the results should be disclosed to the competent authority approved the UCITS.

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

Answer ALLIANZ GLOBAL INVESTORS :

In principle we agree that the competent authority should approve the model – as part of the RMP approval process) – however, the regulator can be supported by technical experts of the audit firms being in charge of the fund's audit – such an audit result needs to be disclosed to the regulator in a sufficient detail level. Furthermore the fund's auditor should asses the model on a regular basis.

2.6 Definition of the relative VaR

Under the relative VaR approach, the calculation of the global exposure of the UCITS follows these steps:

- Calculate the VaR of the UCITS' current portfolio (which includes derivatives): different methods may be used to this end, see above for more details on VaR calculation methods;
- Calculate the VaR of a reference portfolio (which will be a non-leveraged derivative-free portfolio): the consistency with the VaR method and parameters used to calculate the VaR of the UCITS must be ensured;
- Check that the VaR of the UCITS is not greater than twice the VaR of the reference portfolio in order to ensure a limitation of the global leverage ratio of the UCITS to 2.

The global exposure equals to (VaR UCITS – VaR Ref Portfolio) / VaR Ref Portfolio x 100, and is less than 100%.

2.7 Limits of the relative VaR approach and proposed safeguards

The use of a relative VaR approach may require additional safeguards to ensure consistency with the global exposure limit as stated by the UCITS Directive. Indeed:

- The Value at Risk may not be an adequate tool to assess the leverage if the VaR itself does not capture all the risks of the UCITS:
- The reference portfolio must be appropriately chosen.

To illustrate this last bullet point, the following example can be used of a UCITS that would:

- invest 100% of its net assets in European stock market,
- take additional synthetic positions of 120% long positions and 120% short positions on European stock markets.

Then a simple calculation of the global exposure through the commitment approach may, in most cases, come to a 240% global exposure. However, depending on the selected VaR method (historical, Monte-Carlo) and the market data (ex: recent historical variations of the stock value), the VaR of the global portfolio may, as data are combined together, happen to be smaller than twice the VaR of a European stock market benchmark.

Another limit of the relative VaR approach is that the VaR for some reference portfolios may be quite high: the VaR of sectoral benchmarks in emerging countries can be very high, and thus allow for a very high risk allowance when doubled and, in some cases, this may be greater than local thresholds used by Member States for absolute VaR calculations.

A relative VaR method does not strictly limit the leverage of the strategies, as it allows UCITS to double the risk of loss under a given VaR model and not to double the exposure. However, it creates a clear link between the risk of loss of the reference portfolio and the risk of loss of the UCITS, and the similarity of risks between the reference portfolio and the UCITS' portfolio should prevent the UCITS using highly leveraged strategies. But as previously mentioned, the calculation of leverage does not replace risk management measures. Hence, the use of the relative VaR approach does not exempt UCITS from establishing appropriate risk management measures and limits.

There is a risk that some UCITS might be tempted to build the reference portfolio in a way that "games" the calculation of the relative VaR. In order to ensure that UCITS do not use relative VaR to generate excessive leverage the following additional requirements are proposed:

- The reference portfolio must not contain financial derivatives or embedded derivatives to avoid any leverage inside the reference portfolio itself; if short positions are used in the reference portfolio, then the absolute sum of long and short positions must be equal to 100% of the NAV of the UCITS.
- The reference portfolio must have a risk profile that is very close, if not identical, to the UCITS' portfolio. The UCITS' portfolio must be scaled back to an unleveraged reference portfolio which must be consistent with the investment objectives and policies of the UCITS (as provided in the fund rules and the prospectus). It must also adhere to the investment limits (but not necessarily to the issuer limits) set out in the UCITS Directive). For the avoidance of doubt, a long-only benchmark cannot be used as a reference portfolio for a long/short strategy, since it would not entail a similarity of the risk profiles of the reference and UCITS portfolios.
- The reference portfolio can be based on a combination of unleveraged market indices that is consistent with the investment strategy, it can also be inferred from a target allocation, an asset allocation observed over the recent period, or a statistical analysis of the market risks of the portfolio. Where a choice must be made between different

reference portfolios, the portfolio with the lower potential market risk level must be chosen. For the avoidance of doubt, this implies that an emerging markets index cannot be used as a reference for a portfolio invested in less volatile markets.
• If the modifications of the risk/return profile of the UCITS portfolio are very frequent or the definition of a reference portfolio is not possible, the relative VaR method should not be used.
• The UCITS must maintain a written procedure detailing the selection and approval of the reference portfolio.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

Taking into account the limitation of the VaR approach in the measurement of the leverage (see comments under 2.2.) we are of the opinion that the relative VaR approach is an adequate limitation of the GE of a UCITS.

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?

Answer ALLIANZ GLOBAL INVESTORS :

The proposed 3 step relative VAR approach is in our view in principle an adequate approach to compare the risk of a portfolio against its benchmark, though it is not fully adequate to limit the global exposure.

However, in a few details one probably should think about exceptions of a reference portfolio for UCITS using long/short strategies and commodities or convertibles (or any other financial Instrument which includes by nature FDIs). Examples:
- Clarification that allowed convertible bonds indices are eligible as reference portfolio is needed.
- Clarification that allowed commodity indices are eligible as reference portfolio is needed.

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

Answer ALLIANZ GLOBAL INVESTORS :

no further comment

2.8 Definition of Absolute VaR

The alternative VaR methodology that a UCITS can adopt is the absolute VaR approach. This, in simple terms, limits the percentage VaR that a UCITS can have relative to the NAV. Given that

this measure is not referenced to a derivative-free portfolio as used in the relative VaR method, it is important that the absolute VaR limit is suitably conservative and reflects the existing non-derivative limits applied to UCITS when considering the risk of loss of, for example, the default of an issuer. Given that VaR measures the worst expected loss at a given confidence level (probability) over a specific time period under normal market conditions, it is proposed that absolute VaR with a 99% confidence level over a 20 working day holding period must not exceed 20% of the UCITS net asset value. This 20% limit can be equated to the 20% risk of loss on issuer-concentration.

The threshold is defined for a specific time period and a given confidence level but these two last parameters are scalable either upwards or downwards. The UCITS can use other parameters and the VaR limit can be scaled to the particular time period and confidence level chosen. In that case, the UCITS must convert the regulatory VaR threshold into a new one based on the chosen parameters by supposing the UCITS returns are independent and normally distributed[3] and using the following concordance table.

Confidence level	Coefficient of normal distribution
99%	2.326
97.5%	1.96
95%	1.645
90%	1.282

$$VaR(y\%) \approx coeff(y\%)/ coeff(x\%) \times VaR(x\%)$$

For example, if the UCITS uses a probability of 95% in its own processes, it can convert it using the coefficient of normal distribution: VaR(99%) ≈ 2.326 / 1.645 x VaR(95%).

In the same way, it is possible to move from a time period to another one by using the square root of the time:

$$VaR(x \text{ days}) \approx \sqrt{x} / \sqrt{t} \times VaR(t \text{ days})$$

For example, VaR(5 days, 95%) ≈ VaR (20 days,95%)/ √4.

Consequently, the regulatory absolute VaR constraint is equivalent to the following one:

VaR (95%, 5 working days) ≈ 1.645 / 2.326 / √4 x VaR (99%, 20 working days). ≤ 7% x NAV

The competent authority must not authorise a UCITS to go beyond these limits.

The UCITS may fix a lower threshold if it estimates that it is more appropriate considering its strategy and its risk profile.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

We are of the opinion that in principle the relative VaR limitation is the preferable approach – however, not always conceptually and technically easy to apply. However, if a funds can demonstrate that a absolute limitation is adequate (since above mentioned shortcomings/challenges of the rel. limitation is given) and such a limit fits to the overall risk profile of a fund, one should accept absolute VaR limitations as well (pls see our comment below).

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

Answer ALLIANZ GLOBAL INVESTORS :

To apply 20 % as standard for all funds is not possible – thus, one should define absolute risk limitations which depend on funds asset class and which should be defined within the responsibility of the ManCo and disclosed to the responsible regulator. The limit definition is therefore highly specific and should not be predetermined by regulatory requirements. The risk Assessment in the Management company is a suitable place.

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

Answer ALLIANZ GLOBAL INVESTORS :
see comment above

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

Absolute VaR measures potential loss rather than leverage. There is a risk that the use of the absolute VaR method could result in UCITS strategies using high levels of leverage with an inadequate risk management system that does not take into account fat tail risk. In addition, non sophisticated investors may not be able to understand the precise risk profile generated by the strategies.

UCITS that engage in arbitrage strategies, where the mixture of long and short strategies leads to fat tails (adverse movements of both long and short legs) but low VaR, may incorporate high levels of leverage. It is recommended that UCITS, resorting to leveraged arbitrage strategies while measuring their global exposure with absolute VaR, take appropriate additional measures to monitor their risk profile (use of stress-testing, CVaR or other methods able to detect the potential impact of low-probability market events). Investors should also be provided with sufficient information about the existence of leverage risk and the corresponding level of risk taken by the UCITS on the respective long and short legs. Under these conditions, the use of the absolute VaR method might result in the UCITS taking exposures that would not be consistent with the application of the commitment approach; this situation is justified by the fact that by using a more sophisticated and sensitive risk management system (VaR, completed by additional risk management measures), the UCITS may be authorised to take into account, through the VaR method, the risk-reduction effects of highly-correlated long and short positions.

Additionally, UCITS may hold assets where the risk profile cannot be adequately captured by the computation of an absolute VaR. Structured securities, credit-linked financial instruments or financial derivative instruments designed to limit the maximum loss at a given confidence level are examples of such assets. In these circumstances, it is advised that the use of absolute VaR should be forbidden unless appropriate additional risk management methods (such as stress-testing) ensures that both the maximum loss and the sensitivity to market movements in adverse conditions are consistent with the result of an amplification of market movements by a factor lower than 2 (maximum leverage).

In addition, there should be a requirement that the marketing of UCITS that exhibit a potentially high level of leverage should include specific due diligences and procedures from the person or entity in
charge of marketing the UCITS in order to ensure a good understanding of the specificities of the UCITS' risk profile by their clients or potential clients.

Questions

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?

Answer ALLIANZ GLOBAL INVESTORS :

We are of the opinion that stress testings and adequate disclosures as part of an enhanced investor information in the prospectus (maybe also in the KII) should be in principle standards applied for a UCITS having an absolute VaR limitation.

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?

Answer ALLIANZ GLOBAL INVESTORS :

As mentioned in Q38 it is adequate to have further information concerning leverage risks for the investor but there is in our view no need for specific marketing provisions. However, it might be worth to have an exchange of arguments within CESR working groups may be helpful (concerning KII).

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

Answer ALLIANZ GLOBAL INVESTORS :

CESR risk principles have laid down that an overall rmp is required and that the individual rm should fit to each fund.
A UCITS has to demonstrate (beside the VAR and other risk limitations) that the fund meets its payment and delivery obligations coming from FDIs (cover rules). Furthermore there is the general need to have sufficient liquidity in the funds – i.e. UCITS RM asks for an overall rm approach and thus it remains in the responsibility of the ManCo to assure adequate procedures to capture the risk of a UCITS. Since UCITS risk profiles are quite different, there is no standard for additional safeguards

III. OTC Counterparty Risk Exposure

3.1 Background and Introduction

Article 52(1) of the new UCITS Directive states that "the risk exposure to a counterparty of the UCITS in an OTC derivative transaction may not exceed:
10% of its assets when the counterparty is a credit institution referred to in Article 50 (1) (f), or
5% of its assets, in other cases."
Additionally, Article 52(2) confirms that "a UCITS may not combine:

- investments in transferable securities or money market instruments issued by,
- deposits made with, and/or
- exposures arising from OTC derivative transactions undertaken with a single body in excess of 20% of its assets."

The Commission Recommendation[4] clarified the requirements in relation to the calculation of counterparty risk exposure. The Recommendation states that "the exposure per counterparty in an OTC (should be) measured on the maximum potential loss incurred by the UCITS if the counterparty defaults and not on the basis of the notional value of the OTC." In calculating this exposure, UCITS are recommended to use the mark-to-market approach, including an add-on methodology to reflect the potential future exposure[5].
A recent PWC comparative analysis[6] noted that there is a lack of consistency in, inter alia, the calculation methodology for OTC counterparty risk across Member States. The report also details some of the different counterparty risk methods used by those Member States who have provided guidance in this regard.

3.2 OTC counterparty risk calculation methodology

Counterparty risk exposure measures how much a UCITS could lose if their OTC counterparty defaults. The additional safeguards required by the UCITS Directive that mitigate this risk exposure (such as daily valuation of OTC contracts, independent verification of such valuations, the requirement that OTC contracts are fully liquid and requirements on the credit quality of the OTC counterparty) should be taken into account in determining an appropriate methodology for calculating counterparty risk exposure across all Member States.

Due to the existence of these compensating controls and requirements in the UCITS Directive, CESR considers that the "add-on" for future credit exposure is not necessary as this inflates the risk exposure in a subjective manner. CESR also proposes that the use of risk-weightings should not be permitted. This approach greatly simplifies the calculation of counterparty risk while also recognising that the amount calculated represents the full current amount at risk.
It is therefore recommended that the counterparty risk associated with the use of OTC financial derivatives should be calculated as the positive MTM of the OTC contract.
A UCITS may net OTC exposures with the same counterparty in order to ensure adherence to the 5% or 10% limits. It is recommended that that netting positions with the same OTC counterparties be permitted provided legally enforceable (by the UCITS) netting agreements are in place. It should also be understood that the netting rules are only applicable to all OTC contracts with the same counterparty and not to any other exposures the UCITS may have to the counterparty.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

We agree that the calculation method as part of the overall counterparty process needs to be harmonised – and at the level of ALLIANZ GLOBAL INVESTORS we agree in particular to the proposal not to have the third step of the calculation approach – i.e. the use of risk-weightings should not be permitted.

We agree to the proposed calculation method – i.e. just to consider the p/l as counterparty risk. However, if CESR tends to include beside the p/l an add-on factor, one should harmonise the add-on calculation method across the EU countries.

42. Can you suggest an alternative method?

Answer ALLIANZ GLOBAL INVESTORS :

We do not see an alternative approach which would fit into the UCITS risk framework. If add-on would be recommended by legislation/regulation we would be in favour of a fixed factor (e.g. 10% to the unrealised P/L) regardless the instrument and the maturity of the contract – this would reduce the complexity in the calculation method.
(The add on approach is already a simplification of a monte carlo simulation. The different values for the add on are the direct results of this simplification.)

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

Answer ALLIANZ GLOBAL INVESTORS :

To assure an adequate counterparty risk management the rm function needs to have a deep understanding how to mitigate risk and thus, the rm function needs to understand the netting possibilities based on standardised agreements such as ISDA.

In principle, we do agree to the netting procedures outlined above. However, for us it is not clear why there should be no netting with other exposures the UCITS has with a counterparty, as long as sufficient netting-agreements are in place. Furthermore we are of the opinion that the rm function needs to be involved in a proper due diligence (approval process) of counterparties.

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

Answer ALLIANZ GLOBAL INVESTORS :

We do not believe that additional netting rules should apply.

3.3 Treatment of collateral received

Collateral may be used to reduce counterparty risk exposure once the prudential collateral rules in Directive 2006/48/EC are applied and that the collateral:

- is marked-to-market on a daily basis and exceeds the value of the amount at risk;
- is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
- is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party;
- can be fully enforced by the UCITS at any time.

It is recommended that these four principles identified above should be respected, with a strong view that the liquidity of any collateral received is of paramount importance. It is clear that a majority of Member States impose collateral rules by identifying the specific instruments that can be used as eligible collateral, while the Commission Recommendation uses principles as opposed to identifying specific instruments. Therefore it is proposed to develop a detailed set of regulatory principles which would provide a more robust and flexible approach, and that these principles would need to be more detailed than those set out in the Commission Recommendation.

The following set of high-level principles is therefore recommended:

- Liquidity – any collateral posted must be sufficiently liquid in order that it can be sold quickly at a robust price that is close to pre-sale valuation. Collateral should normally trade in a deep liquid marketplace with transparent pricing. Additionally collateral with short settlement cycles are preferable to long settlement cycles as assets can be converted into cash more quickly.
- Valuation – collateral must be capable of being valued on at least a daily basis and the possibility of “stale prices” should not be allowed. An inability to value collateral through independent means would clearly place the UCITS at risk, and this would also apply to “mark to model” valuations and assets that are thinly traded.
- Issuer credit quality – as collateral provides secondary recourse, the credit quality of the collateral issuer is important. This may involve the use of haircuts in the event of a less than “very high grade” credit rating. It should be reasonable to accept collateral on assets that exhibit high price volatility once suitably conservative haircuts are in place.
- Correlation – Correlation between the OTC counterparty and the collateral received must be avoided.
- Collateral diversification (asset concentration) – there is an obvious risk if collateral is highly concentrated in one issue, sector or country.
- Operational and Legal risks – collateral management is a highly complex activity. As such, the existence of appropriate systems, operational capabilities and legal expertise is critical.
- Collateral must be held by a third party custodian which is subject to prudential supervision not related to the provider or is legally secured from the consequences of a failure of a related party;
- Collateral must be fully enforced by the UCITS at any time.
- Collateral cannot be sold or pledged.

While it is clear that the above principles need more analysis and rules (for example specific haircuts), the benefit of such an approach would be to allow a flexible regulatory approach that would assist both home regulators and industry participants. It can also be argued that the role of collateral is as a risk mitigator and the question of whether such collateral should be UCITS compliant is not relevant.

Questions

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?

Answer ALLIANZ GLOBAL INVESTORS :

We do agree with the implementation of eligibility criteria as to the collateral and we estimate that the set of principles will develop a more consistent approach across Europe.

However, one should analyse the recommendations/principles given by CESR carefully – a too strict diversification requirement and having (in principle) not the possibility to pledge collateral might be not adequate. But we do agree that risk management needs to assure that all risks related to the collateral management needs to considered appropriately in the counterparty risk management.

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

Answer ALLIANZ GLOBAL INVESTORS :

We think that it makes no sense to limit eligible collateral to certain instruments since that leads to an unnecessary loss of flexibility and may lead to higher costs of collateral.

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

Answer ALLIANZ GLOBAL INVESTORS :

We do not think that a diversification comparable to UCITS concentration limits is necessary (in particular when cash only or AAA-sovereign bonds are of utmost quality are given as collateral). Concerning eligibility using a prudent approach with appropriate haircuts and the already mentioned high level guidance there should be no need to define eligible assets for collateral.

3.4 The treatment of collateral passed

Although Article 32 of the new UCITS Directive requires that the assets of the UCITS is entrusted to the depository for safe-keeping, it is clear that market practice requires collateral or margin to be passed by the UCITS in respect of a derivative transaction (whether exchange traded or OTC). Such passing of collateral represents a portion of the assets of the UCITS legally passing from the UCITS depository to the derivative counterparty (although the UCITS still bears the market and credit risks associated with such collateral). The UCITS Directives and Commission Recommendation are silent on this point.

It was agreed that the provision of collateral may form part of a derivative contract permitted by Article 50(1)(g) of the new UCITS Directive and is therefore not in conflict with Article 32.

It is clear that an exposure is created that represents a risk-of-loss to the UCITS (i.e. the loss of the collateral in the event of, say, a bankruptcy). It was therefore agreed that any collateral passed should be captured on a net basis (in the case of over-collateralisation) either in the issuer-concentration limit of 20% (Article 52(2)) or in the 5%/10% OTC counterparty limit.

Questions

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?

Answer ALLIANZ GLOBAL INVESTORS :

It depends on the way the collateral is provided. If the collateral is only pledged to the OTC counterparty there is no need to include the net part in the overall counterparty exposure. If the collateral is completely transferred and there is a mismatch (over collateralization), adding the mismatch to limits makes sense.

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

Answer ALLIANZ GLOBAL INVESTORS :

For us it makes no sense to add the ‘overcollateralization’ to the limits for single OTC-transactions since the collateral might be provided and received on an UCITS – counterparty level and not per transaction.

3.5 Counterparty limits

It is recommended that more work is needed on the components of derivative transactions which should be included in the issuer concentration limit of 20%. This is particularly important in the case of potential netting transactions (for example between the cash security and the derivative contract) or where credit derivatives are used (such as bought credit protection on an issuer). Robust requirements are envisaged to ensure that no possibility for abuse or misinterpretation exists.

Questions

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

Answer ALLIANZ GLOBAL INVESTORS :

No comment.

Sophisticated/Non-Sophisticated UCITS

The Commission Recommendation introduced the concept of sophisticated and non-sophisticated UCITS depending on the methodology used to calculate global exposure. In general non-sophisticated UCITS were recommended to use the commitment approach and sophisticated UCITS may use the VaR statistical approach.

Different practises have evolved in Member States regarding both the use of commitment versus VaR approaches and the distinction between a sophisticated and non-sophisticated UCITS. No common definition has emerged, for example some competent authorities define certain financial derivatives as sophisticated or complex, others consider the overall investment strategy and the majority of competent authorities do not provide any guidance in this area. This has resulted in confusion among industry participants (including investors) regarding these terms.

In general the decision regarding the methodology used to calculate global exposure is a matter for the UCITS. This decision is not so much based on the distinction between sophisticated or non-sophisticated but rather on the choice of the most appropriate methodology given the UCITS strategy and types of derivatives used.

It is proposed that provided proper safeguards and parameters are introduced governing the use of both the commitment and VaR approaches used to calculate global exposure the terms sophisticated and non-sophisticated have no relevance and should be abandoned.

Questions:

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

Answer ALLIANZ GLOBAL INVESTORS :

Since we have seen the challenges for the Luxembourg industry due to the need of classification of funds we agree to have no formal categorization into sophisticated and non-sophisticated. Hence, we agree with the abandon of these terms especially for the communication to the investors, as they only confuse and cannot be used as comparative between different UCITS.

We welcome the clarification that the choice of the approach is a decision of each UCITS itself. Only the UCITS can – as part of its risk assessment - define which approach is the most appropriate one. Regulators should give guidance concerning the requirements for each approach as described, but instrument based decisions or any other automatism made from regulators shall be avoided because of resulting inflexibilities (one single instrument in a small percentage to the UCITS NAV shall not force the UCITS to use the VaR approach, if the risk of these instrument have been analysed and the UCITS concluded, that the commitment approach captures all relevant risks. However we understand that the calculation approaches for each fund should be disclosed to the competent authority. We have seen that inter alia the Irish approach where the decision was left to the rm department with a regular review of the

regulator and the depositor seems to ba decent approach. Basically it should include different criteria such as type of instruments / long or short / maximum exposure / hedging or speculative /

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

Answer ALLIANZ GLOBAL INVESTORS :

no objection – see comment above

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