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BEAMA response to CESR Consultation Paper on Global Exposure for UCITS

Consultation Paper CESR/10-108 - CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

BEAMA welcomes the opportunity to reply to CESR's Consultation Paper "CESR's Guidelines on Risk Measurement ant the Calculation of Global Exposure and Counterparty Risk for UCITS" (CESR/10-108).

As a general remark, we would like to remind CESR one of the characteristics of the Belgian market for UCITS, namely that structured UCITS account for a large proportion of the product offer to retail consumers.

General remark

Due to the limited period of consultation and the very technical nature of the material involved, the association has organized an extra survey among its members around some topics. This enabled the association to reach out to some practitioners/specialists in the field. The answers of these respondents are brought together by way of a global answer from BEAMA.

In view of the above mentioned characteristics of the Belgian market, we emphasize the answer to the text pp. 50-51 on specific guidelines for structured UCITS.

Specific remarks, following the document of CESR

Re Box 1:

For most of the "low turnover" UCITS (to be defined) a daily exposure calculation should not be mandatory. It is probably more efficient to have a lower frequency spending more time on the accuracy and especially on the analysis by independent Risk Management. (Use is more important than pure formal calculation)

(one respondent)

Re Box 2:

For options and Credit Default Swaps, i.e. all asymmetric products the proposed exposure calculation does not look correct. Instead the risk exposure when selling (the options or the protections in case of CDS) should be higher than for the buyer of those derivatives.

In the explanatory text: normally a CDS is on an issuer and not on a specific bond. That is unclear in the text on single name CDS.

On question 3: seeing the above we do not agree with the proposed conversion methodology for options (buyer) nor for CDS (protection buyer).

Also for CDS, by taking the reference asset market value for measuring the risk exposure, it lowers the risk exposure when credit is deteriorating which should not be the purpose.

(one respondent)

Re Box 4:

Respondent B noted on question 7:

Yes, but the type described in Box 4 is too strictly defined: "cash" in the first condition should be extended to money market instruments, deposits, and high-quality debt instruments

Respondent A noted on question 8:

Yes, provided that the "substitution" create an exposure compliant with the fund rule/investment policy without any additional leverage.

(two respondents)

Re Box 5:

Explanatory text – Netting

In case of an index, the component of the index offsetting a position in the portfolio (direct or indirect through another derivative) should also be taken into account

(one respondent)

Re Box 7 and 8:

Question 18: preferred option is option 2 although both methods are rather complex where probably a pure modified duration approach would be easier and more efficient (with some additional constraints on the leverage in order to avoid multiple positions).

(one respondent)

Re Box 9:

Agree with the general principles but think the explanatory text 42. should be fully part of the principle.

Generally on the VaR related rule it should be clearer that CESR are speaking about ex-ante calculation.

(one respondent)

Re Box 11:

Question 23: yes generally but the use of relative VaR for Long/Short funds can be questioned.

(one respondent)

Re Box 14:

If it is agreed that the general principle should be reinforced (see above remark on Box 9) then no absolute VaR limit should be imposed. If the limit of 20% is removed (and that is the suggestion here) then further disclaimer should be foresee for compartment without benchmark on the level of expected VaR or VaR triggers.

This limit of 20% is questionable when there are non-sophisticated funds using no derivative instrument with clearly higher VaR because of the market they are investing in.

(one respondent)

Re Box 22:

Point 1 is OK for a pure internal risk management point of view but for funds having selected the VaR approach, the only external measure should be the VaR. Otherwise, calculating the leverage for external purpose means that the two approaches are imposed for those funds.

(one respondent)

Re Box 23:

Point 3 is too vague and as mentioned re Box 22 this should not be imposed for funds having selected the VaR.

Answer to question 42 and 43: no not really considering the above.

(one respondent)

Re Box 24:

Answer to question 44: no as the complexity of the concept will only create an illusion of transparency and not a real transparency.

(one respondent)

(pp. 50-51): CESR's initial views on specific guidelines for structured UCITS

Respondent B noted to **Question 56**. *(Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?)*

Yes. We prefer the approach described under 4(b) on p. 51, because the investor has assumed the risks involved in the strategy described in the prospectus and the KII. During the life of the fund, the most relevant risk is not achieving the pre-defined payout by not observing the following portfolio management guidelines:

- swap contract(s) and prospectus must correspond with each other;
- deviations between the notional of commitments towards the investors and the notional amount of the swap contract must be subject to tight spreads;
- interest flows generated by the investments must be in line primarily with the interest flows that are to be ceded to the counterparties of the swap.
- the issuer and/or counterparty risks of the investments must meet certain criteria.

(one respondent)

Respondent B noted to **Question 57**. *(If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.)*

We are in favour of the approach described under 4(b) on p. 51 and not any type of commitment approach, because the investment strategy is elaborated on beforehand and the investor knows from the start which market parameters will influence the payout and in what way. The pre-defined output for customers is a core element in the product proposition (and especially with capital protected funds) and is transparent.

(one respondent)

Respondent B noted to **Question 58**. *(Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach.)*

Re first bullet of point 5, p. 51 →

<u>(1) The fund is passively managed and structured to achieve a pre-defined payoff; and</u>

The interpretation of CESR is too strict: this would mean "that the portfolio composition is selected at the launch of the fund and remains in place until maturity, with no changes allowed over the life of the fund."

It should be possible to rebalance the assets due to redemptions, risk-speading limits, prospectus requirements, internal risk framework, market trends. We propose the following definition: "the management of the fund portfolio is aimed exclusivily at achieving a pre-defined payoff".

We also propose that the payoff must be achieved on a pre-defined date and would add the following to the definition: "the management of the fund portfolio is aimed exclusivily at achieving (a) pre-defined payoff(s) on (a) pre-defined date(s); and"

Re second bullet of point 5, p. 51 →
(2) The pre-defined payoff is based on a calculation formula relating to the performance of financial instruments or other financial parameters; and

OK

Re third bullet of point 5, p. 51 →
(3) The fund has a final maturity date not exceeding 9 years; and

We don't see the sense of having a maximum maturity. What matters is that the maturity is fixed.

We propose the following: "The fund has a final maturity date."

Re fourth bullet of point 5, p. 51 →
(4) The fund is not open to new subscriptions; and

This condition seems superfluous to us. A fund can be organised in such a way that subscriptions are possible without harming the existing investors. Moreover, if there are only redemptions, the counterparty of the swap could be tempted to price the option rather low. It is also worth mentioning that the portfolio is rebalanced upon the net movement of subscriptions and redemptions.

However, new subscriptions can be subject to considerable downward commitments. If the estimation of CESR is that this is not opportune, new subscriptions should be not be allowed.

Re fifth bullet of point 5, p. 51 → (5)
The prospectus contains full disclosure regarding the investment policy, pay-off formulas and a framework of eligibility criteria of the underlying exposures. It should also contain information on leverage levels and the specific risks associated with investing in such a fund.

OK

We would put "and" after point (5), because point (6) also looks important to us.

Re sixth bullet of point 5, p. 51 →
(6) The final pre-defined payoff is guaranteed by a credit institution located in the OECD or by entity subject to prudential supervision; or

We don't understand this so clearly. If the meaning is that the fund cannot be its own counterparty, we agree. It is essential that the pre-defined payoff be guaranteed by one or more derivatives agreements. If the fund were to be its own counterparty, it would have to engage in the necessary hedging operations to achieve the "pre-defined payoff" and to assume the relevant market risk: that cannot be the intention. Thus, the fund should conclude swap agreements with one or more counterparties. We would re-word this point as follows: "The final pre-defined payoff must be based on one or more OTC derivative agreements."

Re seventh bullet of point 5, p. 51 →
<u>(7) Investors' capital on maturity is guaranteed by a credit institution located in the OECD or by an entity subject to prudential supervision; or</u>

Capital guarantee is not a constituent of the concept: we propose that it should be deleted.

Re eighth bullet of point 5, p. 51 →
<u>(8) Capital protection on maturity is obtained through investments in deposits, debt securities of high quality such as debt securities issued by an entity subject to prudential supervision and registered in a Member State of the EEA or debt securities issued or guaranteed by a Member State of the EEA.</u>

Capital protection is not a constituent of the concept: we propose that it should be deleted.

However, Capital protection could be seen as a precaucionary measure, because it leads to a decrease of the commitment of a structured fund. If CESR tends do keep the "commitment" and/or "VaR" approach, then we strongly suggest to follow the 4b) approach of page 51 at least for capital protected funds (which then would receive an alternative approach). If necessary without allowing secondary subscriptions.

(one respondent)

Respondent B noted to **Question 59***. (Can you suggest any additional criteria?)*

No.

(one respondent)

Respondent C noted to the **Questions 56-59** (concerning *CESR's initial views on specific guidelines for structured UCITS*)

In case of structured UCITS with a pre-defined maturity, the general principle to calculate and satisfy the ***maximum global exposure*** <u>AT ALL TIMES</u> during the life of the product, might be usefully complemented by other approaches. It can be argued that after the initial phase of the launch of the product (commercialization and initial hedge), the next phases require a different treatment.

In this view it was suggested that a combination of

(a) The management of the maximum loss of non-payment of the protected capital at the end date, by way of a (bank) term deposit or fixed interest debt paper through the principal of spreading the exposure over several counterparties and/or debt paper lines; and
(b) The monitoring of the counterparty risk in order to manage the maximum loss of non-payment of the pre-defined pay-off by way of collateral arrangements;

would better handle the ***relevant exposure*** during the remaining life of the product.

With respect to (b), the existing guidelines for add-on methods as referred to by CAD Dir 2000/12/CE can be followed in order to include the 'replacement cost', the 'future risk' and the 'quality of the counterparties'.

(one respondent)

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BEAMA, 31 May 2010.