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CESR´s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS
BVI response on Consultation Paper, Ref.: CESR/10-108

Dear Mr. Comporti,

BVI[1] gladly takes the opportunity to express its views on CESR's proposed approach to risk measurement and the calculation of global exposure and counterparty risk for UCITS.

General remarks

In general, we appreciate CESR's proposals. The suggested requirements would lead to a uniform understanding of risk measurement methodologies throughout the UCITS area. Today, different regulations apply within the EU. In order to avoid competitive disadvantages it is very important to foster a level playing field among Member States in the area of the risk measurement and the calculation processes.

In Germany, however, the methods and systems used for limiting exposure are not left to the discretion of the investment management companies, but rather are regulated by the Derivative Regulation ("Derivateverordnung"). In

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[1] BVI Bundesverband Investment und Asset Management e. V. represents the interest of the German investment fund and asset management industry. Its 92 members manage currently assets of nearly EUR 1.5 trillion both in mutual funds and mandates. For more information, please visit www.bvi.de.

2004 the Derivative Regulation implemented into German law the provisions of Article 19(1), Article 21, and the derivative-related provisions of Article 22 of the UCITS-Directive (85/611/EEC) as amended by Amending Directives 2001/107/EC (Management Directive) and 2001/108/EC (Product Directive).

Against this background, limitations on the market risk and counterparty risk apply in Germany, as well as special requirements relating to the organisation of management and control systems for the increased risks associated with the use of derivatives. To this extent, CESR's proposals are in line in many points with the German Derivative Regulation.

However, we would like to note that in some areas CESR´s proposals differ from the German standard. Primarily, we request CESR to readjust the following essential points:

- **Boxes 1, 2:** We request CESR to clearly indicate that the commitment approach is only permissible if the use of derivatives is restricted to Futures (Forwards, resp.) and European/American plain vanilla options on single eligible underlying assets. Non-standard derivatives as total return swaps, variance swaps and barrier options and like instruments should clearly not be allowed within the commitment approach.

- **Box 14:** BVI members strictly reject CESR's proposal that the absolute VaR of a UCITS must not be greater than 20 % of its NAV. We suggest that the limit should be left to the discretion of the national supervisory authorities. In case a maximum limit is exceeded, we would like to encourage CESR to implement high level principles which allow a case by case approval by the regulator.

- **Boxes 23, 24:** We do not agree with the proposals regarding prospectus and annual reports disclosures. According to Article 70 UCITS IV Directive, there is no requirement to disclose the method for the calculation of the global exposure or the expected level of leverage and the possibility of higher leverage levels in the fund prospectus. We suggest that only the auditor shall stipulate in the audit report according to Article 73 of the UCITS IV-Directive the method used for each individual UCITS to determine the threshold utilization.

- **Box 26:** BVI members reject CESR´s proposals that exposure to a clearing house should be considered as part of the counterparty exposure limit. If this were the case, it would not be possible to employ such central clearing houses.

Specific comments

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

1. Definition and scope of Global Exposure

1. Do you agree with the proposed Level 3 Guidelines for the definition and scope of global exposure?

In principle, we agree with the proposed guidelines with additional suggestions:

- Currently, an intraday risk calculation is performed when a new trade is done within the portfolio. It should be clarified that without trading activity, a “close of business” calculation is sufficient. Nevertheless, an intraday risk calculation is deemed to be necessary when intraday positions systematically carry a much higher risk than end-of-day positions. Thus intraday calculations of global exposure would lead to high costs and to performance issues.

  In this context, we would like to stress that data setting more than once a day is associated with high administration efforts. Since the valuation of global exposure (VaR or Commitment Approach) is based on a huge static data set (market prices, volatilities correlations, etc.), it is difficult to update this data set more than once a day.

- CESR proposes that VaR (or an equivalent advanced risk measurement methodology) should be used where UCITS ‘*engage in complex investment strategies which represent more than a negligible part of their investment policy, or have more than a negligible exposure to exotic derivatives*’ and that otherwise the commitment approach will be adequate. This represents a move away from the current classification of UCITS as either "sophisticated" or "non-sophisticated" users of derivatives.

  We agree that as standard approaches either the VaR or the Commitment approach should be applied. It should be clearly stated, however, that the commitment approach is only permissible if the use of derivatives (stand-alone and embedded) is restricted to Futures (Forwards, resp.) and European/American plain vanilla

options on single eligible underlying assets. Moreover, non-standard derivatives as total return swaps, variance swaps and barrier options and like instruments should clearly not be allowed within the commitment approach.

We propose to add in Box 1 Point 4 after *'negligible exposure to exotic derivatives the UCITS*' the following sentence '**and where it can be assumed that commitment methodology is not adequately capturing the market risk of its portfolio then UCITS**'.

In conclusion, we support CESR´s approach to create a uniform understanding. In order to avoid disadvantages of competition it is very important to foster a level playing field among Member States in the area of the calculation process when using the commitment approach.

2. Do you have any alternative suggestions?

One BVI member considers that for some structured funds there might be the need for a tailor made risk management approach to capture the global exposure of a fund adequately. It seems advisable to give the industry and the regulators the possibility to agree on internal models for selected funds which might fit better to limit the global exposure and thus to protect the investors interests. Further comments to the internal model for structured funds are given below - see the answers to Questions 56 et seq.

2. Calculation of Global Exposure using the Commitment Approach

2.1 Conversion Methodologies

2.1.1 Standard Derivatives – Embedded Derivatives and Non-Standard Derivatives

3. Do you agree with the proposed conversion methodologies for the different types of financial derivative instrument?

In addition to the proposed conversion methodologies for the different types of financial derivative instrument we have some suggestions:

- Conversion formula for futures (Bond Futures, Interest Rate Futures and Currency Futures) should be:

  number of contracts × notional contract size × **future price**

In our view, it is not easy to identify the "*market price of the cheapest-to-deliver reference bond*" because the bond could be subject to variation. Insofar, it would not make sense taking "*market price of the cheapest-to-deliver reference bond*" into account. The future price simplifies the conversion formula for futures.

- CESR might check if for the conversion of warrants the formula should be:

  number of shares/bonds × market value of underlying reference instrument × delta × **notional**

- As an alternative to the approached conversion of Plain Vanilla Fixed/Floating Rate Interest Rate and Inflation Swaps (herein "market value of underlying") we suggest the following conversion methodology:

  Market value **of swap**

- Aas an alternative to the approached conversion of Forward Rate Agreement (herein "notional value") we suggest CESR the following conversion methodology: **Market value**

Our members are uncertain what the following statement is supposed to mean: '*A derivative providing leveraged exposure to an underlying index, or indices that embed leveraged exposure to their portfolio, must apply the standard applicable commitment approach to the assets in question.*' We would appreciate if CESR could give an example and additional guidance.

As mentioned above (Q 1), conversion formulas for non-standard derivatives as total return swaps, variance swaps and barrier options as these instruments should clearly not be allowed within the commitment approach.

4. Do you have any alternative suggestions?

At the moment, we do not have alternative suggestions.

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

The numeric examples are useful.

6. In particular, do you consider that the use of the market (or notional) value of the underlying reference asset for a credit default swap is appropriate? Do you have any alternative suggestions?

We consider the value of the underlying reference asset **not appropriate** to assess CDS in the commitment methodology, as it would disregard the interest rate risk of the position. Furthermore, within the commitment approach, only hedging should be acceptable, and all CDS protection positions should conservatively be counted "Zero".

2.1.2 Types of financial derivative instruments which may be excluded from the global exposure calculation

7. Do you agree that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation? If you do not agree please explain your answer. 8. Do you consider that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for the UCITS?

We think that all (derivatives) positions should be included in the calculation of global exposure, as it may occur that a combination of derivatives positions has only incremental exposure at one point in time (where it may be argued to skip it from the exposure calculation), whereas at a later point in time it might bear a certain financial risk which is then incorrectly disregarded. The examples given do only partially reflect zero risk circumstances, as they e.g. do not explain why the positions bear no basis risk. In our view, some of the largest failures of risk management policies (e.g. ENRON) were made possible because it was accepted to disregard certain positions in the risk calculation of global exposure.

2.1.3 Netting and Hedging

9. Do you agree with the proposed definitions of netting and hedging? 10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure? 11. Do you have any alternative suggestions?

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

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

14. Do you agree with the examples provided where hedging is not possible? In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

First of all, we would like to note that it would be difficult to implement netting and hedging criteria in the IT systems. In practice, a risk controlling function usually will not be able to determine whether a fund manager is in fact trying to generate additional alpha by using netting and/or hedging strategies. The result would be that in most cases netting and hedging positions could not be offset against each other.

- **Netting**

In relation to netting, CESR's proposals are more restrictive than the current guidelines. CESR proposes that netting may only apply where derivatives relate to the same underlying asset.

We partially agree with the netting criteria. Netting of positions should only be allowed if the derivatives positions are 1:1 identical. A term spread (different maturity dates, mentioned under 5.) should not be included, as it would leave the UCITS with the term spread risk.

If a UCITS holds long security positions and an index derivative to hedge the market risk, it should be allowed to net these positions under the precondition that the securities are constituent of the index (even if hedging is allowed).

- **Hedging**

Similarly, the conditions permitting hedging to reduce global exposure are more prescriptive than at present. In our view, hedging should be allowed if the correlation between the underlying assets is sufficiently high (e.g. > 80%).

We agree with the hedging criteria and examples. In particular, we agree that beta hedging should not be taken into account when calculating global exposure. However, it should be clarified that beta hedging is allowed as

stated in para. 20, 2nd bullet point, where the strategy complies with the aforementioned criteria in Box 5 point 6. In this context, we request CESR to clarify what is meant by '*highly correlated*' under para. 20 and how that can be proved.

In accordance with Box 5 point 6, hedging arrangements may only be taken into account when calculating global exposure if they offset the risks linked to some assets and, among other things, if they should be efficient in stressed market conditions. We request CESR to clarify what is meant by '*efficient and stressed market conditions*' and how that can be proved.

2.1.4 Efficient Portfolio Management Techniques

15. Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques? 16. Do you have any alternative suggestions?

In principle, we agree with CESR´s proposals with some suggestions.

CESR proposes that any leverage generated by the reinvestment of collateral through repos or securities lending, in addition to leverage generated through derivatives, is taken into account when measuring global exposure.

The assumption of the reinvestment in cash seems to be a theoretical case. The use of Repo is made to get liquidity in case of redemptions.

Stock borrowing does not lead to additional Global Exposure. The UCITS gets collateral to mitigate risks and collateral is not being reinvested as far as it is safekept on a hedged account.

We would like to suggest that borrowing and lending does in general not create Global Exposure.

2.1.5 Sensitivity Approach

17. What are the advantages and disadvantages of each methodology? 18. Which methodology do you consider more appropriate? Please give explanations and indicate whether additional safeguards should be included.

19. In the last step of Option 1, the total amount is multiplied by 12.5. Do you consider that (i) this takes due account of the sensitivity of the UCITS and (ii) that this is in line with the commitment conversion methodology (e.g. conversion of the derivative into the market value of the equivalent position in the underlying assets)?

20. Under option 2 the target sensitivity of the UCITS can be longer than the sensitivity of the derivative while the equivalent underlying position is relatively small. This can result in high levels of leverage within the UCITS. Please provide views on the additional safeguards that could be introduced to mitigate this risk.

In our view, both methodologies are complex to implement and suffering from the discretionary choice of the buckets. There is no big discrepancy between both methodologies. Altogether, our members cannot give an advice which option is more appropriate without practical assessment.

With regard to the Basel II Directive, there is an advantage for the 1st approach. Additionally, a disadvantage of the 2nd methodology can be seen in the fact that the target duration may be defined quite arbitrarily. On the other side, Option 2 is easier to calculate as the duration is not required.

Independently, it is not clear if the sensitivity approach is part of the commitment approach and if calculation of interest exposure is mandatory or optional to the algorithm described above in the commitment approach.

In comparison with par. 58 bullet point 1 (minimum requirement of six maturity segments), the question might be raised if four buckets are sufficient. At this point CESR might consider aligning the commitment approach with the VaR approach or vice versa.

In our view, an additional safeguard could be a scenario analysis (stress test) which simulates the twist of the interest rate curve.

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

3.1 General Principles and general requirement

21. Do you agree with the general principles outlined for the use of VaR?

Yes, we agree. In this context, we request CESR to clarify that the limit can be an absolute limit (%/EUR) or a relative VaR limit (%).

Referring to **para. 42**, the VaR limits should always be set according to the defined risk profile. In particular, CESR considers that there might be circumstances where, giving the agreed risk profile, the UCITS should set a VaR limit that is lower than the regulatory threshold for ensuring consistency between the VaR limit and the risk profile. In practice, some BVI members set a VaR limit that is equal to the regulatory threshold whereby they give an additional limit (e. g. leverage stresstest limit) in order to achieve a lower risk profile. It should be possible to perpetuate this method.

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

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

In principle, we agree.

One of our members suggests that for commensurability reasons it might be better to use the relative VaR for all portfolios. It should be possible to define a leverage free benchmark for an absolute return UCITS according to the fund's profile. Possibly, the leverage free benchmark has to be changed more often. This should be no problem if the process is being well documented.

Another member proposes to introduce a third approach next to 'Relative VaR' and 'Absolute VaR' to calculate the leverage: This means that the VaR of the UCITS is calculated in a first step including all positions (Global exposure with Derivatives) and after that in a second step including all securities and cash but excluding derivatives (Global Exposure without Derivatives). The leverage of the portfolio is the ratio between both VaR figures and the Global Exposure of the portfolio shall not exceed twice the VaR of the Global Exposure without Derivatives. This approach would make live much easier regarding data-requirements, investing and desinvesting and also backtesting. This approach measures the leverage much better than the relative approach as there are no deviations between fund and benchmark.

3.3 Relative VaR approach

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

Yes, we agree.

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

In principle, we agree with the proposed criteria for the reference portfolio. However, we have the following suggestions:

- **Box 11 Point 2, 1st Bullet point:**

In our view, the restriction regarding embedded derivatives seems to be problematic: For example, for a currency hedged portfolio the unhedged index is not appropriate as a reference portfolio. The currency hedged index is not free of derivative components. Further examples are ABS Indices or convertible bond indices, which might contain derivative components, but are in accordance to the fund's risk profile. Therefore from our point of view, certain exceptions should be permitted. In this case, the reference portfolio should be a convertible bond index, even though it comes along with embedded derivatives.

Moreover, there is no clear distinction between "derivative-free" and "leverage-free" (see explanatory text para. 45 and para. 51 vs. Box 11 Point 2 Bullet point 1). Basically, derivatives should be allowed as part of the comparable asset portfolio as long as

a) they do not cause additional leverage in the comparable asset portfolio (refer to the rules applied for calculating commitment under 2.1.2 and 2.1.3) and

b) help creating a better fit to the risk profile of the fund.

Inter alia, derivatives should be allowed in order to replicate leverage free and eligible indices (for instance commodity indices). Other examples could be: funds that deal significantly with volatility (eg. volatility swaps), credit spreads (eg. CDS), or commodities which could have as a benchmark component a volatility index (eg. VIX), a basket of CDS (eg. ITRAXX), or a commodity index (eg. IPD).

- **Box 11 Point 2 Bullet point 2**

If a UCITS pursues a long/short strategy, the reference portfolio may consist of physical short positions despite the fact that the UCITS is only allowed to hold short positions via derivatives. If the risk/return profile of the UCITS changes frequently it may also be permissible to use the relative VaR method if measures are implemented to accommodate the reference

portfolio accordingly. In this case, it is still possible to measure against a reference portfolio (e.g. -100 <-> + 100, including neutral exposure).

Furthermore, we think that long only reference portfolios are adequate for long/short strategies, e.g. 130/30 strategies. See attachment (Benchmarking 130/30 strategies) for details and analysis.

25. Do you have any alternative suggestions?

One of our members suggests that ex Ante Tracking Error and Expected shortfall (CVAR) should be permitted as alternatives.

3.4 Absolute VaR approach

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

Yes, we agree.

3.6 VaR approach: Quantitative requirements
3.6.1 Calculation Standards

27. Do you agree with the calculation standards proposed for the VaR approach?

BVI members strictly reject CESR's proposal that the absolute VaR of a UCITS cannot be greater than 20 % of its NAV. It should be possible to increase the limit beyond 20%.

It would be highly problematic to provide an absolute limit of 20% for VaR (99 %, 20 days) ≅ Max (VaR(99 %,1 day) = 4,47%, as the absolute VaR approach may also be appropriate for strategies, which – in volatile market phases – may comprise a higher risk, even without applying derivative components.

Therefore, we suggest that the limit should be left to the discretion of the national supervisory authorities. In case a maximum limit is exceeded, we would like to encourage CESR to implement high level principles which allow a case by case approval by the regulator.

Independently, it should be made very clear that dynamic scaled risk models (that lead to shorter observation periods but provide much better results in volatile markets) concur with the calculation standards.

Finally, the prescribed criteria for the calculation of absolute VaR (99 per cent confidence level, 20 business day holding period, historical observation period of at least 1 year) are broadly consistent with the current provisions outlined by the German financial regulator. Insofar, we agree with those standards.

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

Yes, we agree. We especially appreciate the flexibility in the choice of parameters. In the first step, retention of the German standard parameters (99% confidence interval, 10 days holding period) is desirable.

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

Yes, we agree with the rescaling method. The examples are useful.

30. Do you have any alternative suggestions?

We do not have any alternative suggestions.

3.6.2 Risk Coverage

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

CESR proposes that the VaR model takes account of general market risk, specific market risk, idiosyncratic risk and event risk. This macro level review is a new requirement. The entity responsible for measuring risk for the UCITS has to ensure that the qualitative backtesting requirements are fulfilled. Event or default risk is an integral part of the VaR calculation (e.g. via credit spreads) so that no clear separation seems to be possible.

With regard to the definitions, please see our answers to the questions 54f.

3.6.3 Completeness and accuracy of the risk assessment

32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

Yes, we agree.

3.6.4 Back Testing

33. Do you agree with the proposals regarding back testing of the VaR model? 34. Do you have any alternative suggestions?

In general, we agree with the proposals regarding back testing of the VaR model. Apparently, CESR's proposals are in line with current German regulatory requirements. However, we have additional suggestions:

- We do not agree with the upscaling factor, as it could be in volatile markets that the number of outliers increases in such periods. Furthermore, an upscaling factor does not help to get a better view about the UCITs risk. If an upscaling factor will be implemented, one has to be aware that it must be implemented in the portfolio itself and the mirror portfolio in the relative VaR.

- CESR's view on the admissability of dirty and clean back testing methods should be expressed more explicitly.

- As information of the authorities on a yearly basis is common practice in some of the actual regulations (see for example Luxembourg regulation as of today) we consider that the restriction to quarterly information should not be mandatory.

- The suggested approach ("unconditional coverage") may appear too simplistic to adequately identify model issues, i.e. counting the number of days on which the realized portfolio loss is greater than the VaR forecast. In particular, the approach may induce questioning or/and rejecting sound models while failing to identify a bad model.

- **Box 17 point 6 last sentence:** In our view, it should be up to the UCITS to define the measures to improve the VaR model and take appropriate actions and not to the regulator to change the methodology. However

the UCITS/Management Company has to disclose the measures taken to the regulator.

3.6.5 Stress testing: General Provisions/Quantitative Requirements/ Qualitative Requirements

35. Do you agree with the proposals regarding the VaR stress testing programme? 36. In particular do you agree with the proposed quantitative and qualitative requirements? 37. Do you have any alternative suggestions?

In general, we agree with the proposals regarding the VaR stress testing programme with the following remarks:

- Converse stress tests, as proposed in **Box 18,** are difficult to implement in practice and generate very few useful results for the risk management process. Therefore, this requirement should not be implemented to the Risk Management Directive in general.

- The challenge for the asset managers in performing stress tests is to adequately analyse and implement measures for the UCITS, i.e. plausibility test of model as well as direct implications on the investment strategy (e.g. risk reduction).

3.7 VaR approach: Qualitative requirements

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

In principle, we agree with the proposed tasks under the responsibility of the risk management function. However we understand that for the case the global exposure is calculated with a VAR approach there is no additional calculation of the leverage of the UCITS. We consider that a VaR approach combined with the cover rules (cf. paragraph 5) would be adequate to limit and thus monitor the global exposure of a fund. An additional monitoring of the leverage using the commitment method is not considered adequate for a UCITS using VAR approach.

Furthermore, it is sufficient that the Senior Management approves the task by the risk management function for validating and implementing for each UCITS a documented system of VaR limits consistent with its risk profile, given that it follows general rules approved by the Board of Directors. In our view, a one to one approval of the Board of Directors is not necessary.

Finally, we consider that the detailed requirements concerning tasks by the risk management function will result in additional cost.

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

We agree, provided that the independent model validation can be performed by e.g. the fund auditor. A review of the risk models should take place on a regular basis. Thus we agree that an independent oversight needs to be established. Certainly, we believe that this is already captured sufficiently by internal or external audits. Validation of risk models by a third party functionally separated from risk management function is not necessary as long as a standard risk software solution is used and the processes are reviewed by internal and/or external audit and this review is adequately documented.

Furthermore, one BVI member is of the opinion that as long the risk controlling function fulfils all the relevant criteria concerning independence, the technical model validation should stay within the risk controlling function in order to avoid costly duplication of work.

3.8 VaR: Additional safeguards and disclosure

3.8.1 Additional safeguards

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?

With regard to Box 22 point 1, CESR proposes that a fund measuring global exposure using VaR should carry out additional monitoring of leverage where VaR does not adequately cover the monitoring of risk. This leverage monitoring overlay is a new requirement and this would require huge amounts of work, and will probably not reflect positively on perceived quality of VaR programs.

Moreover, this leverage monitoring seems redundant as a high leverage should be captured by VaR or at least within the stress testing programs.

Stress tests are more appropriate to analyze tail risks. We consider that the cover rules would also be an additional safeguard to prevent the UCITS from an inadequate global exposure.

Finally, we agree with the proposals regarding the use of other risk measurement methods.

3.8.2 Disclosure

a) Prospectus

41. Do you agree with the proposals regarding prospectus disclosure? 42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus? 43. Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?

BVI members strictly reject CESR's proposals that the UCITS should disclose in its prospectus the method used for the calculation of the global exposure (i. e., commitment approach, relative VaR or absolute VaR) and the expected level of leverage and the possibility of higher leverage levels.

According to Article 70 of UCITS IV Directive, the prospectus shall only mention if transactions in financial derivative instruments are authorized, in which case it shall include a prominent statement indicating whether those operations may be carried out for the purpose of hedging or with the aim of meeting investment goals, and the possible outcome of the use of financial derivative instruments on the risk profile. **There is no requirement to disclose the method for the calculation of the global exposure or the expected level of leverage and the possibility of higher leverage levels in the fund prospectus.**

Furthermore, information about the method used for the calculation of global exposure as well as the level of leverage might be difficult to understand for investors in investment funds. We are concerned about the risk of confusion, especially as the KID makes use of the SRRI to inform the investor of the level of risk taken. The leverage information may be misleading, especially when calculated in the proposed form.

In our view, the KID information (SRRI) should be sufficient because it is more effective and up-to-date than a VaR figure in the prospectus (ref Q 41). As the leverage may frequently change over time, especially under different market conditions, we do not see an added value for investors in giving a rough estimate on leverage. Moreover, it should be sufficient to revise the prospectus in case of switching from absolute VaR to relative VaR approach or when leverage changes in major dimensions over time.

According to German Derivative Regulation, we suggest that the auditor shall stipulate in the audit report according to Article 73 of the UCITS-IV-Directive the method used for each individual UCITS to determine the threshold utilization.

Finally, we do not agree that the leverage should be calculated and published. Especially, a leverage definition using the gross notional exposure (Q 43) is misleading and should not be used. If CESR expects the industry to do so, costs will increase dramatically as when using a sophisticated VaR approach, a more or less non-sophisticated approach to calculate the leverage is needed, too. VaR in conjunction with stress testing should be adequate.

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

b) Annual reports

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

No, we do not agree. In our view, the KID is the means of choice to inform the investor in an ongoing and up-to-date manner. We disagree since the investor should receive consistent information which enables him to compare various UCITS. Please refer to our answers on questions 41 - 43.

4. OTC Counterparty Risk Exposure

4.1 Collateral

45. Do you agree with the proposals in Box 25? In particular, do you consider that the proposed criteria for the acceptability of collateral to reduce counterparty exposure are appropriate?

In principle, we agree with CESR's proposals.

At a high level, collateral management is the function which is responsible for reducing counterparty risk in unsecured financial transactions. Collateral is used to provide security against the possibility of payment default by the opposing party in a trade. Examples of transactions involving credit risk include over the counter (OTC) derivative deals (e.g. swaps, swaptions, credit default swaps, CDOs) and business-to-business loans (e.g. repos, total return swaps, money market transactions, term loans, notes, etc.). Collateral of some sort is usually required by the counterparties in these transactions because it mitigates the risk of payment default. Collateral can be in the form of cash, securities (typically high grade government bonds or notes, stocks, etc.).

BVI members welcome CESR's idea of not imposing an exhaustive list of eligible instruments for collaterals, but rather defining fundamental and high principles for collateral.

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

We would like to encourage CESR to define the correlation between OTC counterparty and collateral. Collateral issuer credit quality, correlation with OTC counterparty and collateral diversification should be considered by the Management Company in a consistent manner. Single guidelines for each of the three dimensions should be avoided.

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

be clear that collateral diversification rules should only apply "**if**" there is an obvious risk.

Regarding the proposal to prohibit UCITS to re-invest collateral, BVI members hold differing views. On the one hand and under stringent governance, reinvestment of collaterals should be permitted (like reinvestment of cash in cash products). On the other side and in order to take into consideration the additional risk that UCITS are exposed to, UCITS should be allowed to re-invest cash-collateral received from counterparty under the condition that the additional market risk is reflected in the Global Exposure calculation (calculation methodology to be defined). In particular, where a UCITS accepts cash collateral, it must be in a position to re-invest the money in order to generate the yield which an OTC counterparty usually expects for cash collateral.

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

46. Do you have any alternative suggestions?

We deem further clarifications on the role of the depositary/custodian bank in case collateral is held with the depositary/custodian and in case collateral is held with other parties than the depositary/custodian useful for the industry.

47. Do you consider that it would be useful to include some examples of minimum haircuts for different asset classes? Do you have a preference on what these haircuts might be?

Yes, we consider that it would be very useful to include examples of haircuts for different asset classes.

For the valuation of the collateral presenting a significant risk of value fluctuation, UCITS should apply prudent discount rates. In this context, it has to be noted that collateral in a currency other than the currency of exposure should also be subject to adjustment for risk of currency mismatch.

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

4.2 Counterparty/issuer Concentration

48. Do you agree that exposure to a clearing house should be considered as part of the counterparty exposure limit? Do you have any alternative suggestions?

No. BVI members reject CESR´s proposals that exposure to a clearing house should be considered as part of the counterparty exposure limit. Exposure to a clearing house must not be considered part of the counterparty exposure. Otherwise, it would not be possible to use such central clearer. The ultimate motivation for an OTC clearer is to exclude credit risk. The setup for the clearing house has to be free of credit risk (through collateral and margining processes).

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

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

We expect that the introduction of Central Clearinghouses, as planned by global regulators in the case of CDS, will meet the above-mentioned criteria. However, it should be possible to exceed 10% exposure with one central clearing house.

49. Do you agree that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit? Do you have any alternative suggestions?

No. Exchange Traded Derivatives are not part of the above mentioned constraint. Moreover, it should be possible to exceed 10% margin exposure per broker (depending on investment strategy).

50. Do you agree that exposures to a counterparty generated through stock-lending or repurchase agreements should be included in the OTC counterparty exposure limit? Do you have any alternative suggestions?

We agree with the approach proposed by CESR although the wording of the UCITS Directive solely refers to "*risk exposure to OTC counterparty* **in an OTC derivative transaction**…". BVI members are of the opinion that there is no clear legal basis for this approach.

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

BVI members agree that the exposure should be calculated using the commitment approach.

However, to calculate the ratio of 5/10% a securities equivalent is required. Furthermore, other methods for calculating position exposure should be possible as well.

5. Cover rules for transactions in Financial Derivative Instruments

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

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

As further restriction or guidance, a general definition of highly liquid assets should be given.

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

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

6. Glossary of Terms

54. Do you agree with the proposed definitions? 55. Do you consider that CESR should provide other definitions in these guidelines? Do you have any suggestions for other definitions?

In general, we agree with the proposed definitions. However, some definitions have to be specified, especially:

- **Specific Risk:** The definition of specific risk is not sufficient. Default risk may be added here.

- **Idiosyncratic Risk:** Definition is not sufficient.

- **Event Risk:** It will not be necessary to define “event risk”. Back testing-outliers caused by downgradings or defaults are infrequent and can be analysed and reported manually. Stresstesting the market risk is performed by shifting the spread curves. After that it would be redundant to stresstest also the Event Risk.

- Additional, a general definition of **highly liquid assets** should be given.

ANNEX: CESR´s initial views on specific guidelines for structured UCITS

56. Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?

No. In our view, there should be made no distinction in the calculation of global exposure. More important from our point of view is the existence of an adequate and sufficient monitoring process – developed on a case by case basis – to secure the communicated payoff structure.

Independently, we welcome the discussion on the global exposure calculation for some structured funds. However, the criteria for defining structured funds – inter alia having a predefined maturity – seem to be too strict. There are also funds with a structured/passive investment approach aiming to generate a clearly described pay-off which does not have a

maturity – i.e. the definition of structured funds should be defined more broadly. However, we think that not only passively managed funds should be able to benefit from the possibility to have a different calculation approach. In this case, we kindly ask CESR to define alternative risk measurement principles acceptable for actively managed structured funds.

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

The approach is sufficient to avoid that NAV becomes negative in such structured funds.

The rationale of max loss approach would be the special features of these products (e.g. known pay-off, defined maturities and passively managed with no changes in the life-time of the fund). Also, we are of the opinion that the VaR approach, esp. Monte Carlo VaR, is an adequate risk measurement approach for such structured products.

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

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

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

59. Can you suggest any additional criteria?

No, we cannot suggest any additional criteria.

For structured funds it should be considered if global exposure is an adequate way to limit the risk. In certain market situations it is possible for structured funds that the VaR is higher than twice the VaR of the benchmark. In this case there is no chance to reduce the risk without changing the payoff function of the fund. But the payoff function is stated in the prospectus and hence, in our opinion this limit breach should not cause any transaction which distorts the payoff function. The most important thing

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

We hope that our suggestions will help CESR in refining its guidance on risk measurement and the calculation of global exposure and counterparty risk for UCITs. We remain at your disposal for any questions or further clarification.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

(signed)
Alexander Kestler

(signed)
Peggy Steffen

Enclosure

STANDARD &POOR'S

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Benchmarking 130/30 Strategies

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- The proliferation of 130/30 products has raised interesting questions in terms of how they should be benchmarked. The use of leveraged long and short positions renders them different, at least at first blush, to traditional long only products.
- In this paper, we explore various benchmarking options for such strategies and evaluate them against a set of principles for a good benchmark.
- Based upon our evaluation, we suggest that while 130/30 strategies may be structurally different from long only managers, traditional long only market benchmarks are still appropriate for these strategies.

Introduction

Short extension strategies, which relax the traditional long only constraint for active managers and allow a greater expression of active views, have seen considerable growth in interest and assets in the recent past. While the short or leveraged long positions in such strategies typically range from 20% to 40%, 30% is the most widely used figure. Therefore, "130/30 strategies" have become synonymous with short extension strategies.

As is well known by now, the theoretical underpinnings for 130/30 strategies lie in the "Fundamental Law of Active Management," first proposed by Grinold (1989). It laid out a framework that defined a manager's risk adjusted value add (information ratio, IR) as a function of the manager's skill (information coefficient, IC) and the number of active decisions (breadth, N) to apply that skill.

$$IR = IC \times \sqrt{N}$$

Clarke, de Silva and Thorley (2002) built upon that idea by adding a third variable – the degree to which manager is able to implement his ideas (transfer coefficient, TC). This variable reflects the ability of the manager to express his ideas given investment constraints.

$$IR \approx TC \times IC \times \sqrt{N}$$

One of the most important constraints imposed on active managers is the long only constraint. The impacts of this constraint are magnified by the structure of most market benchmarks which are top heavy and therefore limit the expression of negative opinion for a vast majority of stocks.

The proliferation of 130/30 products has raised interesting questions in terms of how they should be benchmarked. The use of leveraged long and short positions renders them different, at least at first blush, to traditional long only products. In this paper, we explore various benchmarking options for such strategies and evaluate them against a set of principles for a good benchmark.

What is a Good Benchmark?

The Merriam-Webster English Dictionary defines a benchmark as "**a**: a point of reference from which measurements may be made **b:** something that serves as a standard by which others may be measured or judged **c:** a standardized problem or test that serves as a basis for evaluation or comparison." While this is not really a technical definition, it provides a simplistic gut-check on appropriateness of an index as a performance benchmark. In the world of performance measurement of funds, more granular requirements of performance benchmarks have been specified. Bailey (1992a) lays out six key principles of a good benchmark. These principles, which are required reading for prospective charter holders of the CFA Institute, are widely recognized among performance analysts. The six principles are:

- **Unambiguous:** The names and weights of securities constituting the benchmark are clearly delineated.
- **Investable:** The option is available to forgo active management and simply hold the benchmark.
- **Measurable:** The benchmark's return can be calculated on a reasonably frequent basis.
- **Appropriate:** The benchmark is consistent with the manager's style.
- **Reflective of current investment opinions:** The manager has current investment knowledge (be it positive, negative, or neutral) of the securities that make up the benchmark.
- **Specified in advance:** The benchmark is constructed prior to the start of an evaluation period.

Using these principles, we evaluate various benchmarking options for 130/30 funds.

130/30 Indices

As the 130/30 fund market has grown, several 130/30 indices have been launched. Prominent among the providers of such indices are Standard & Poor's and Credit Suisse. Murphy (2007) and Lo and Patel (2007) provide details on construction of the S&P 500 130/30 Strategy Index and the Credit Suisse 130/30 Index, respectively.

The construction of these index portfolios falls into three basic steps:

- Identify a market benchmark, such as S&P 500 or Russell 3000, as the universe.
- Establish a set of factors for identifying attractiveness (or lack thereof) of universe constituents, and combine these factors into a composite scoring algorithm.
- Use the output of the algorithm to sample or re-weight index constituents with appropriate risk controls. Risk controls are applied to beta, deviations from benchmark weights or degree of short extension.

It may be difficult to reconcile the notion of an index with a rules-based portfolio that represents, on a daily or real time basis, the outcome of an active investment strategy. Equity indexation has traditionally covered whole markets or market segments that have distinguishable characteristics as asset classes. The overriding feature of such broad indices is that they attempt to provide representation of their respective market or segment.

Increasingly, index providers offer narrower subsets of whole market segments, sometimes with components of active management. If such "strategy" indices provide sufficient transparency for interested parties to understand and replicate the exposure they provide, then there are benefits to the investment community because such exposure can be offered through linked investment products at a lower cost than comparable active management products. In fact, strategy indices are probably the fastest growing segment of the index market, and comprise a majority of exchange traded funds (ETFs) by count in the U.S. market. 130/30 indices clearly fit in the strategy index category.

Strategy indices require a subtle, but significant, shift in the mindset of investors. What has heretofore been called "passive" investment, that is, gaining index exposure through index-linked products, takes on a new meaning in light of these new index offerings. With this new meaning comes both opportunity and risk, and while strategy indices offer passive exposure to a particular investment strategy, investors must make an active choice in determining how such exposure fits within the context of their overall portfolio. Exhibit 1 provides an example of the equity index continuum in the U.S.

Exhibit 1: Example of the equity index continuum

Representative Indices	***Strategy Indices***		
Beta	**Beta Plus**		**Alpha-Seeking**
Market Exposure	**Alternatively Weighted Market Exposure**	**Enhanced Index**	**Analyst Recommendations**
S&P 500	Equal Weight S&P 500	S&P 500 130/30 Strategy Index	S&P U.S. Stars Index

Source: Standard & Poor's

A number of empirical factors have been investigated as alpha sources in literature over the last three decades. Chan, Karceski and Lakonishok (1988) provide a detailed summary of these factors, which they divide into five categories – accounting factors, technical factors, macroeconomic factors, statistical factors and the market factor. Since the turn of the century, quality of the accounting based factors and interaction of the empirical factors has also been well-researched in financial literature. (For example, see Figelman (2007) and Cornell and Landsman (2003).) But no set of factors used in 130/30 indices can claim to capture a broad consensus in identifying stock mispricing. There also is no constraint upon 130/30 managers to use a purely quantitative investment process and there may well be more qualitatively oriented 130/30 portfolios in the future than we find today. Therefore, 130/30 indices violate one of the key principles of a good benchmark – appropriateness.

Manager Universes

Manager universes, which are comprised of median or average returns of a peer group of funds, are widely used by investment consultants in selecting funds, and by fund management companies in advertising performance. However, the use of such benchmarks is questionable. Bailey (1992b) identifies several conceptual shortcomings and the survivorship bias issue as key problems in using such universes as benchmarks. The conceptual problems involve the peer universe not being reflective of the investment style or portfolio risk of a particular fund. The survivor bias issue involves the universe median returns being over-stated because under-performing funds which were merged or liquidated are typically removed from the database.

In terms of the qualities of a good benchmark, the above problems suggest manager universes may not meet appropriateness or measurability criteria. Furthermore, as a practical matter, the manager universe violates the investability criteria since it is not possible to invest in all constituent funds.

Conceptual shortcomings and survivorship bias aside, there is a more practical issue with using peer universes to evaluate 130/30 managers. Since the concept is fairly new, most of the funds have been launched in the last few years. The count of funds to comprising such a universe is fairly small as well, rendering the composites statistically unreliable. For instance, a search of U.S. active extension products in Nelson's institutional fund database as of March 2008 revealed only 20 products, most of which have launched in 2006 and 2007. This is shown in Exhibit 2. It will take a few more years and launch of quite some more funds for 130/30 manager universes to be meaningful.

Exhibit 2: U.S. Equity Short Extension Products in Nelson's Institutional Funds Database as of March 2008

Firm Name	Product Name	Benchmark	Starting Year
Credit Suisse Asset Management, LLC (US)	Short Extension	S&P 500	2007
Northern Trust Global Investments	Northern Trust Quant 130/30 Core Equity	Russell 1000	2007
Enhanced Investment Technologies Inc.	Collared Long/Short (120/20)	Russell 1000	2007
Shenandoah Asset Management, L.L.C.	130/30 Alpha Extension	Russell 1000	2007
Shenandoah Asset Management, L.L.C.	130/30 Alpha Extension	Russell 1000	2007
Robeco Investment Management Inc.	Robeco BP 130/30 Large Cap Value	Russell 1000	2007
American Century Investments	Large Cap Core 130/30	S&P 500	2007
State Street Global Advisors (US)	Large Cap Core Edge (130/30)	Russell 1000	2006
Los Angeles Capital Management & Research, Inc.	S&P 500 120/20 Plus	S&P 500	2006
Fuller & Thaler Asset Management Inc.	120-20	Russell 1000	2006
State Street Global Advisors (US)	Mid Cap Core Edge (130/30)	S&P Mid-Cap 400	2006
Twin Capital Management, Inc.	TWIN Extended Alpha (130/30)	S&P 500	2006
Independence Investments LLC	Long/Short 130/30	Russell 1000	2006
State Street Global Advisors (US)	Index Plus Edge Strategy (130/30)	S&P 500	2005
UBS Global Asset Management (Americas), Inc.	US Equity 130/30	Russell 1000	2005
RiverSource Institutional Advisors	RiverSource Contrarian 120/20	Russell 3000	2005
Martingale Asset Management, L.P.	Enhanced Alpha (130/30) LargeCap Value	Russell 1000 Value	2004
Martingale Asset Management, L.P.	Enhanced Alpha (130/30) LargeCap Growth	Russell 1000 Growth	2004
Martingale Asset Management, L.P.	Enhanced Alpha (130/30) LargeCap Core	Russell 1000	2004
Robeco Investment Management Inc.	Robeco WPG 130/30 Lg Cp Core Ins	S&P 500	2003

Source: Nelson's Institutional Fund Database

Traditional Market Indices

Traditional market indices have long been used by long only active managers as benchmarks reflective of their opportunity set. These managers strive to beat such benchmarks by taking active bets through alternative selections or weightings of stocks.

Lo and Patel argue that traditional market indices are inappropriate benchmarks for 130/30 managers since there are leveraged long and short positions. We disagree for the following reasons:

1. The leveraged long and short positions are merely active bets, no different than the active bets taken by long only managers. While the effects of leverage may seem profound, they are no different than effects of big factor bets such as style, industry or size.
2. Leverage and shorting notwithstanding, the goal of 130/30 managers is to deliver a portfolio beta of close to 1. This beta is the market beta, which is represented by the appropriate market benchmark.

3. 130/30 managers seek to outperform market benchmarks in a risk controlled fashion. This is illustrated in Exhibit 2, which shows all institutional 130/30 managers adopting market benchmarks as their performance yardstick.

In terms of the qualities of a good benchmark, traditional market indices are clearly measurable, investable, specified in advance, reflective of current investment opinions and specified in advance. We also think they are appropriate, given the points above.

Conclusions

In Exhibit 3, we compare the three benchmarking options against the principles laid out at the beginning. Long only market benchmark indices, in our opinion, meet all the principles required of a good benchmark. While 130/30 strategies are structurally different from traditional long only managers, they are simply another active management strategy in the same asset class. Therefore, the benchmarks should be no different.

Exhibit 3: Benchmarking Options versus Principles of a Good Benchmark

	130/30 Indices	Manager Universes	Market Indices
Unambiguous	Yes	Yes	Yes
Investable	Yes	**No**	Yes
Measurable	Yes	**No**	Yes
Appropriate	**No**	**No**	Yes
Reflective of current investment opinions	Yes	Yes	Yes
Specified in advance	Yes	Yes	Yes

Source: Standard & Poor's

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