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Response to CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

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Questions:

1. Cheyne Capital Management (UK) LLP partially agrees with the definition and scope of global exposure.
2. Cheyne Capital Management (UK) LLP would like to highlight the following points with respect to the alternative suggestions for the definition and scope of global exposure:
    a. The commitment approach does not adequately capture the risks associated with a number of complex strategies and underestimates or overestimates the risk associated with these strategies. For example, there is a discrepancy in how the risk associated with buying or selling credit protection (through the use of credit default swaps) is captured in the current commitment approach.
    b. There is no advice regarding liquidity risk measurement and how this should be addressed in more complex strategies.
3. Cheyne Capital Management (UK) LLP partially agrees with the proposed conversion methodologies with the following exceptions:
    a. Convertible bonds: the proposed delta-adjusted approach (number of referenced shares * market value of underlying reference shares * delta) could potentially underestimate the investment value and invested risk associated with the convertible bond. A more conservative approach would be to take into account the mark-to-market value of the convertible bond rather than its delta-adjusted exposure.
    b. Single name credit default swaps: the proposed commitment methodology (market value of underlying reference asset) would be the most relevant approximation of the maximum risk associated with the credit default swap in the case whereby the UCITS sells credit protection on a particular reference entity. However, in the case whereby the UCITS buys credit protection on a particular reference entity, the conversion methodology should only take into account the net of the mark-to-market value of the credit default swap plus the risk-less present value of the coupons to be paid during the entire life of the credit default swap contract. The reason why you should only count

these values and not the full notional is that the UCITS can not lose the full notional and the full notional tells you nothing meaningful about the risk of loss in value to the NAV of the UCITS.

4. Please see answer in question 3.
5. The numerical examples are quite useful in providing further clarity.
6. Please see answer in question 3 regarding the treatment of single name credit default swaps.
7. Derivatives that do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation.
8. The examples provided do not result in incremental exposure for the UCITS but the universe of examples needs to be expanded to capture cases whereby incremental exposure is resulted by the current commitment approach for a UCITS (for example, buying credit protection on a particular reference entity).
9. Cheyne Capital Management (UK) LLP partially agrees with the proposed definitions of netting and hedging.
10. Cheyne Capital Management (UK) LLP partially agrees with the proposed criteria for netting and hedging in order to reduce global exposure.
11. Hedging needs to be recognised at the portfolio level and not only at the position level. For example, the use of index put options on a delta-adjusted basis to hedge the equity market risk component of equity or equity-linked portfolio.
12. Agreed
13. Agreed
14. Cheyne Capital Management (UK) LLP partially agrees with the examples provided. More specifically, the strategy to hedge a long stock position with purchased credit bond protection (CDS) on the same issuer should be recognised as a permissible hedging strategy provided there is a high correlation between the stock price and the credit spread of the issuer.
15. No further suggestions
16. No further suggestions
17. No further suggestions
18. No further suggestions
19. No further suggestions
20. No further suggestions

21. Cheyne Capital Management (UK) LLP partially agrees with the general principles outlined for the use of VaR. However, solely employing VaR for the measurement of market risk and leverage can materially underestimate the global exposure of the UCITS. Hence, further risk measurement techniques need to be employed in order to measure the UCITS's global exposure in a more robust way (conditional VaR, stress testing).
22. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the choice of the VaR approach.
23. Cheyne Capital Management (UK) LLP agrees with the proposed approach regarding the use of relative VaR.
24. Cheyne Capital Management (UK) LLP agrees with the proposed criteria for the reference portfolio.
25. No alternative suggestions.
26. Cheyne Capital Management (UK) LLP agrees with the proposed description of absolute VaR.
27. Cheyne Capital Management (UK) LLP agrees with the proposed calculation standards for VaR.
28. Cheyne Capital Management (UK) LLP agrees with the proposals regarding setting different default parameters and rescaling.
29. The numerical examples are quite useful in providing further clarity.
30. No alternative suggestions.
31. Cheyne Capital Management (UK) LLP agrees that the VaR model employed for the calculation of global exposure should capture both general market risk and idiosyncratic risk. The stress testing program of the UCITS should attempt to capture the event risk associated with the UCITS.
32. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the completeness and accuracy of the risk management process.
33. Cheyne Capital Management (UK) LLP partially agrees with the proposals regarding back testing of the VaR model. However, the back testing methodology adopted by the UCITS (clean vs dirty back testing) should be determined by the nature of the investment strategy. For example, the clean back testing methodology is better suited for investment strategies with high intraday trading volume while the dirty back testing methodology is better suited for investment strategies with lower intraday trading volume.

34. The back testing methodology adopted by the UCITS (clean vs dirty back testing) should be determined by the nature of the investment strategy. For example, the clean back testing methodology is better suited for investment strategies with high intraday trading volume while the dirty back testing methodology is better suited for investment strategies with lower intraday trading volume. Moreover, due to the operational issue associated with the clean back testing methodology, the default approach should be the use of dirty back testing unless dictated differently by the investment strategy of the UCITS.
35. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the VaR stress testing programme.
36. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the quantitative and qualitative requirements.
37. A list of appropriate stress testing methodologies per investment strategy / asset class could be made available for review by the UCITS community.
38. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the responsibility of the risk management function.
39. Cheyne Capital Management (UK) LLP agrees with the requirements regarding model testing and validation.
40. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the monitoring of leverage and the use of other risk measurement methods.
41. Cheyne Capital Management (UK) LLP partially agrees with the proposals regarding prospectus disclosure.
42. Cheyne Capital Management (UK) LLP agrees with the proposals regarding the leverage disclosure as it will provide further transparency to existing and potential UCITS investors.
43. Cheyne Capital Management (UK) LLP disagrees with the proposed method of calculating leverage for the purpose of prospectus disclosure as the sum of the derivatives notional could overestimate the amount of leverage employed by the UCITS. The prospectus disclosure regarding leverage should be in-line with the method that the UCITS employs for the calculation of global exposure.
44. Cheyne Capital Management (UK) LLP agrees with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology.

45. Cheyne Capital Management (UK) LLP agrees with the proposed criteria for the acceptability of collateral to reduce counterparty exposure.
46. No alternative suggestions.
47. It would be useful to include some examples of minimum haircuts for different asset classes. These haircuts should be driven by the volatility and liquidity of each particular asset class.
48. The clearing house counterparty exposure should not be included in the total counterparty exposure of the UCITS given the whole idea of a clearing house is that the systemic and idiosyncratic risk of the clearing house is lower than any single counterparty exposure.
49. Cheyne Capital Management (UK) LLP agrees that margin passes to a broker which is not protected by client money rules should be included in the counterparty exposure limit.
50. Cheyne Capital Management (UK) LLP agrees that counterparty exposure generated through stock-lending or repurchase agreements should be included in the counterparty exposure limit.
51. Cheyne Capital Management (UK) LLP agrees that the UCITS position exposure should be calculated using the commitment approach if the UCITS employs the commitment approach to measure its global exposure. However, if the UCITS employs VaR to measure its global exposure, the UCITS could be allowed to employ VaR for the calculation of its position exposure (single issuer concentration, 5/10/40, etc.).
52. Cheyne Capital Management (UK) LLP agrees with the proposed cover rules.
53. No further restrictions should be applied.
54. Agreed
55. Definitions of more complex products and their respective treatment could be included in the guidelines in order to provide more clarity.
56. No further suggestions
57. No further suggestions
58. No further suggestions
59. No further suggestions