Question

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

The explanatory text (in particular Box 1, point 2) states that "CESR expects that the commitment approach should not be applied to UCITS using, to a large extent and in a systematic way, financial derivative instruments for investment purposes and/or making use to a certain extent of more complex strategies or instruments even if such UCITS do not fall within the scope of paragraph 4 of Box 1". This would seem to preclude the use of the commitment approach for UCITS funds which invest wholly in fully funded Total Return Swaps (TRS), even if the reference asset underlying such swaps is non complex or has, at most, a negligible exposure to exotic derivatives. This would seem to force such funds to use an advanced risk measurement technique even when using a basic TRS to gain exposure to a standard index or basket of indices, for example. We believe this to be overly onerous.

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

The proposed conversion methodology for the Barrier Options looks to be overly conservative and inconsistent with the proposed conversion methods for other types of derivatives. In particular, the calculation for the Barrier Option includes the maximum delta of the option in all possible market scenarios, whereas for more vanilla options, the calculation just takes the current delta. The maximum possible delta for a Barrier Option can be very largely positive or negative when the option is close to the strike and maturity, two conditions which would presumably fall under "all possible market scenarios". Thus the Consultation Paper implies that the global exposure of a Barrier Option under the commitment approach would always be extremely high, even when the underlying is far away from the strike and the option has a long time to maturity. Rather than include the maximum possible delta in the commitment calculation for Barriers, we would suggest that the current delta is used with an appropriate haircut to reflect the discontinuity in the payoff for these types of options.

15) Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques? We would welcome some numeric examples here for further clarity.

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

Box 9 states that the global exposure calculation by means of the VaR approach should Α. consider all the positions of the UCITS portfolio. Explanatory note 43 goes on to clarify that all efficient portfolio management (EPM) exposures should be included within the calculation. However, the Paper does not provide any guidance at this point, or elsewhere, on how share class level EPM assets should be incorporated into the VaR calculation.

In particular, we are thinking here of FX hedge positions for non base currency share classes which are, in effect, share class level assets. Including FX hedge positions in the VaR calculation at the UCITS fund level will result in a distorted (upwards) VaR for the fund and a VaR which would not represent the risk that any single investor would actually be exposed to either investing in the base currency or otherwise.

We illustrate this by way of example:

Consider a fund which has share classes in a currency other than the base currency and those share classes are FX hedged. The FX hedge will have a value as the market FX rate moves. For simplicity, assume (i) a perfect FX hedge, (ii) that the market value of the funds core assets (held in the base currency) doesn't change, (iii) FX rates move:

- At the share class level: The change in value of the FX hedge will be equal and opposite to the change in value of the fund core assets (apportioned to the share class) when measured in the share class currency

=>Result: No change in NAV of the share class

- At the fund level: The funds core assets will not change in value (our assumption for simplicity), but the value of the FX hedge will change (due to FX moves) as measured in the base currency.

=> Result: Change in the NAV of the fund

So, by including the FX hedge, the NAV at the share class level is unaffected by the FX rate move, but the NAV of the fund *is* affected by the FX rate move. Thus, the volatility of returns for the share class will be <u>lower</u> than that of the fund. And consequently the VaR when measured at the fund level will be <u>higher</u> than that measured at the share class level. This is due to the translation of the FX hedge into the base currency.

We would propose two possible solutions to this anomaly:

(i) The VaR calculation is run at the fund level, but that the FX hedges and other *share class level* EPM exposures are excluded from the calculation. They are not part of the investment strategy of the fund in any event. The resulting VaR would then reflect the actual risk to an investor investing in the base currency. If perfect FX hedging could be achieved, this would also be the same risk to which an investor in a non-base currency share class would be exposed. (Although in practice of course, perfect hedging is very unlikely to be achieved).

(ii) The VaR calculation is run at the share class level and all FX hedges and other *share class level* EPM exposures are included in the calculation. In the absence of perfect hedging, this would result in differing levels of VaR for different share classes, with the individual VaR levels reflecting the risks of the individual share classes. In this scenario, we would propose that VaR was reported per share class with VaR of the class being limited to 20% of the effective NAV per class.

B. UCITS that use VaR as their risk management methodology must ensure that all efficient portfolio management exposures are also included in their calculations and limits." Page 27. 3.1 Para.43

Given that the reverse repo tools of EPM are fully collateralised what exposure should a UCITS risk manager seek to capture through the VaR approach?

In the Commitment approach we're told to include in the global exposure calculations the **market value** of the instrument concerned if non-cash collateral is held (2.1.4 para 2). However VaR in general attempts to model **changes** in market value. Given that the market value of non-cash collateral does not affect the market value of the UCITS itself, rather it is the interest received through the use of EPM which affects the market value of the UCITS. Should we therefore be looking to include the changes in market value of the interest received on the non-cash collateral used in EPM? For example, build into the VAR approach the volatility of the income stream from a reverse repo rather than the changes in the value of the non-cash collateral itself.

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?

The criteria for the acceptability of collateral to reduce counterparty exposure includes the criterion that the collateral is diversified, stating that there is an obvious risk if collateral is highly concentrated in one issue, sector or country. This would seem to preclude the use of single government securities as collateral here, yet such securities could be amongst the most highly rated and liquid across the whole market. We believe this to be inappropriate.