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The Committee of European Securities Regulators
11-13 Avenue de Friedland
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CESR's Consultation Paper on Risk Management Principles for UCITS
Ref: CESR/08~616
Submission by Gutmark, Radtke & Company AG

Dear Sirs,

This submission is made to The Committee of European Securities Regulators ("CESR") by Gutmark, Radtke & Company AG ("GRCO"), in response to the Consultation Paper on Risk Management Principles for UCITS.

GRCO is a privately owned management consulting firm focused on the financial services sector, and we are based in both London and Frankfurt. We advise leading European banks, insurance companies, asset managers and corporate treasuries in all areas related to the measurement and management of economic and regulatory risk. Our expertise covers credit, market, liquidity and operational risk as well as asset/liability management.

More specifically, our firm has been closely involved in the implementation of UCITS III in our core markets, Germany, the United Kingdom and Luxembourg. As part of this process, we have assisted our clients in building and strengthening their framework and infrastructure for managing financial, reputational and operational risk. It is in this context, that we would like to take the opportunity to submit our comments pertaining to the Consultative Paper published by CESR.

GRCO strongly supports CESR's efforts to provide further guidance and to further strengthen the regulatory framework for risk management in the asset management industry, and we are largely in agreement with the proposed guidance. GRCO also believes that this initiative is most timely and appropriate.

As part of this submission, we would like to raise a number of individual points that, speaking from our experience of risk management functions at regulated firms, may be considered in the consultation process. In particular, we make the following comments, which are related to the boxes of the consultation document:

Box 1 – Supervision by competent authorities

GRCO agrees with the approach described in this section. Our only concern would be that paragraph (5) requires the risk management process of each UCITS to be assessed and monitored individually by the competent authority.

For larger companies managing numerous UCITS, this would be likely to lead to a significant amount of duplication. We would therefore suggest that risk management processes be reviewed for groups of UCITS within any one company, reflecting similarities in risk profiles.

Box 2 – Definition of roles and responsibilities

Again, GRCO agrees with the approach set out in this section of the Consultative Paper. However, we would like to add that a key element of a regulated company's risk management framework should be an approval process for new products as well as for entry into new markets.

For instance, a company would be expected to maintain a reference list of suitable and approved financial products. Any trades in instruments not explicitly pre-approved would then require consultation of all organisational units involved in trade capture and position keeping, settlement, accounting, risk and performance measurement, compliance and reporting.

In this respect, the role of the risk management function is twofold. Firstly, it is to enable risk systems to integrate such instruments. More importantly, however, risk managers are responsible for ensuring transparency of new products and for providing detailed analyses of key risk factors related to credit, market, liquidity and operational risk. In particular, it should be the responsibility of the risk management function to highlight those risk factors that cannot directly be observed or modelled in existing systems.

Furthermore, trading in new instruments would typically involve a brief test period, during which a limited number of transactions in such products would be booked in a controlled environment.

Box 3 – The risk management function

GRCO agrees with the approach suggested in Box 3.

Box 4 – Outsourcing

GRCO agrees with the approach suggested in Box 4.

Box 5 – Identification of risks relevant to UCITS

GRCO agrees with the approach recommended in this section. Paragraph (24), however, should also refer to model risk as a material source of risk. The risk management function should therefore be required to assess the level of model risk, particularly where day-to-day risk management activities are expected to be bound by specific and potentially more pragmatic models than those used in front-office valuation processes.

Box 6 – Risk management techniques

While we support the recommendations made in this section of the Consultative Paper, we would suggest that model risk, as briefly discussed in the previous section of our submission, is considered in paragraph (26) as a source of uncertainty to be explored using quantitative approaches.

While we appreciate that model risk is an emerging discipline, companies should be encouraged to develop means to estimate, for instance, the degree to which inaccuracies introduced by the use of more pragmatic models can influence overall risk measures.

Moreover, we believe that the level of integration between relevant IT systems and tools – as discussed in paragraph (27) – should be more clearly emphasised. Completeness, timeliness and accuracy of risk management data is crucial and can only be achieved through consistent integration of risk, transaction and accounting systems.

IT systems relevant to the risk management process should also be required to be reconciled against each other. Reconciliation breaks should continuously be analysed as part of the risk management process.

With regards to the requirement to consider the use of leading market solutions – as expressed in paragraph (28) – we would suggest that companies be required to seek dialogue with and analyse developments within their peer-group comprising companies of comparable size and managing UCITS with comparable risk profiles. Also, we would recommend shifting the emphasis of paragraph (28) from solutions, which may be interpreted as a primarily software-related issue, to both solutions and methodologies.

Finally, while paragraph (29) introduces the decomposition of complex products as a key requirement, further guidance should be provided setting out the definition of structured products. In particular, the treatment of optional features embedded in fixed income instruments, such as corporate bonds, should be clarified.

Box 7 – Management of model risk concerning the risk management framework

As discussed in paragraph (33), back-testing must be a key element of a company's model risk policy. However, back-testing cannot be readily applied to all categories of risk. For instance, neither liquidity risk nor credit risk events can be observed with sufficient frequency to allow statistically meaningful back-testing. A back-testing policy must therefore address issues related to the time horizons applicable to individual types of risk.

Stress-testing is an equally established tool covering, in contrast, all relevant types of financial risk. The majority of European companies are capable of stressing portfolio valuations under a broad variety of historical and hypothetical scenarios.

However, companies may then lack clear guidance as to the interpretation of stress-testing results. A company's stress testing framework should therefore also comprise stress limits and procedures for dealing with excesses in such limits. Moreover, stress limits should be monitored consistently across all UCITS managed by a company.

Finally, we would submit that the assessment and control of trading algorithms – as mentioned in paragraph (38) – should also consider on the conditions under which such algorithms would need to be either recalibrated or temporarily deactivated due to unanticipated market developments.

Box 8 – The link between risk measurement and asset valuation

GRCO believes that, particularly with regards to the valuation of complex products, full consistency between valuation models used by front-office functions and those used by risk management – as mentioned in paragraph (40) – may not always be achievable.

This is due to the fact that front-office pricing functions can generally be more computationally expensive, as they tend to be applied to a smaller set of transactions at any one time. They are also likely to be more flexible in terms of accommodating structural features of individual transactions, and they typically use more extensive input data, including information that would not be readily available for all relevant instruments at all times.

While the risk management function may therefore not always be able to apply consistent models, we would nevertheless submit that key differences between valuation and risk measurement models used should be required to be documented, analysed, and, ideally, assessed in terms of potential model risk impact.

Box 9 – Risk management procedures

GRCO agrees with the approach suggested in Box 9.

Box 10 – Risk limits system

GRCO agrees that the implementation of a limit management system is a key requirement for managing risk across different UCITS and within the company. We would also agree with the requirement for immediate accounting for risk positions in such systems, as formulated in paragraph (45).

However, it should be considered that immediate accounting generally implies a trade-off between timeliness, where transaction data is sourced from trade capture systems, and quality, which tends to be higher where data this obtained from the company's books and records.

In our view, companies should be permitted to source position data from their books and records given that it is accounted for without undue delay, and that the limit management system enables risk managers to identify any critical exposure levels which may lead to intra-day limit breaches. This could be achieved through a "heat map" approach, summarising exposure levels within each type of risk.

As pointed out in our comments related to Box 6 above, the development of a robust limit management system generally also requires a high degree of data integration and cross-systems reconciliation.

Box 11 – Effectiveness of the risk management process

GRCO agrees with the approach suggested in Box 11.

Box 12 – Reporting to the Board of Directors and the Senior Management

In the case of the risk management function reporting evidence that the risk profile of a UCITS has changed to a significant degree, as discussed in paragraph (50), GRCO believes that an immediate update of the relevant risk profile by the Board of Directors may be only one potential course of action.

Based on careful deliberation, the Board may also decide that the level of risk in such UCITS be reduced to a level in line with their current risk profile. This may be a more desirable course of action in cases where elements of risk profiles are violated that have been agreed with or communicated to investors.

Box 13 – Monitoring of the risk management process

GRCO agrees with the approach suggested in Box 13.

Overall, GRCO believes that this consultation process launched by CESR is a further step towards European leadership in setting global standards for risk management in the financial industry.

We are grateful for the opportunity to make these submissions and would be happy to provide any further submissions or representations sought by the Committee.

Yours faithfully,

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