Contribution

Re: Consultation Paper CESR/10-108

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

By EM Applications

About EM Applications

EM Applications (www.emapplications.com) is a leading supplier of investment risk solutions to asset managers and securities firms. Asset managers rely on EM Applications' systems to monitor and operate long-only, long-short, hedge and fund of funds strategies. Securities firms use EM Applications' systems in proprietary trading and derivatives and to support the services they deliver to their clients. By delivering portfolio risk analytics to the fund manager's desk in the form of a dynamic Excel workbook, EMA's risk system is uniquely well suited to helping asset managers fully integrate risk analysis into their investment process.

Feedback

Question No.	Question	Response
General	We support CESRs decision to continue to allow the use of VaR as a measure of the riskiness of an investment portfolio. We believe that the ability of VaR to estimate the risk of any investment portfolio comprised of reasonably liquid assets or derivatives where the underlying is reasonably liquid means that, over time, it will become the standard for risk control. On the other hand, the imprecision and inflexibility of the Commitment Approach means it will require frequent regulatory updates to remain appropriate as markets develop and new instruments are used. Because of this, we expect the Commitment Approach, over time, to fall into disuse. Consequently, our comments focus on the proposals in relation to VaR.	
21	Do you agree with the general principles outlined for the use of VaR?	Yes
22	Do you agree with the proposals regarding the choice of the VaR approach?	Yes, but only on the assumption that the Relative VaR approach is calculated from the difference of returns, not the ratio of absolute VaRs.
23	Do you agree with the proposed approach regarding the use of the relative VaR?	No. Relative VaR as designed allows UCITS portfolios with extraordinarily high levels of risk. For example, at time of writing, (10th May 2010), the VIX stands at 41, meaning that a UCITS with the broad based S&P500 as its reference portfolio would be permitted to have a volatility of an extraordinary 82%.Where the reference portfolio is a more generally volatile index, such as the NASDAQ or one of the Shenzhen Indices, the level of risk permitted by the Relative VaR measure would create a very speculative fund that could make catastrophic losses

		in a short period of time.
24	Do you agree with the proposed criteria for the reference portfolio?	Yes
25	Do you have any alternative suggestions?	Yes. It would be better to calculate the "Relative" as the difference in returns between the benchmark and the portfolio and limit the VaR on that difference to the same 20% (20 day, 99%) limit applied to Absolute VaR. That would limit the VaR on a portfolio to 20% above the benchmark. This would be consistent with the proposals in relation to Absolute VaR and would be more conservative.
26	Do you agree with this description of absolute VaR?	Yes
27	Do you agree with the calculation standards proposed for the VaR approach?	No. As the Turner Review observed and as evidenced by banking practice, there is a need for both long term and very short term measurement of VaR. Long term requires a multi-year (typically 3 to 5 years) observation period as these models are useful because they include both low and high volatility periods in their datasets and 250 days is not enough to guarantee that. Short term models will need to have a horizon of 1 day, not 20 days, to satisfy the backtest requirements and it will not be possible in practice for managers to implement them when "a shorter observation period is justified by a significant increase in price volatility (for instance extreme market conditions)" as market volatility can spike in a couple of days whereas the implementation of a suitably calibrated model would take months.
28	Do you agree with the proposals regarding setting different default parameters and reseating?	No, it would be better to set a standardised set of parameters so that when the VaR of a UCITS is communicated there is no ambiguity as to the measure being used. As explained above, we recommend the calculation of two VaRs every day - a long term VaR (3 to 5 years history) and a daily forecast VaR.
29	Do you consider the examples for the rescaling of parameters are useful in providing further clarity?	No. We believe investor understanding would be better if there was standardisation on the parameters for VaR calculation and disclosure for all UCITS, with the only variation being the dataset - long term or short term.
30	Do you have any alternative suggestions?	Yes. UCITS should, each day, calculate a long term VaR based on long term (3 to 5 year) volatility plus a short term VaR with a 1 day time horizon (even if

		both are reported on the same 20 day scale). The Absolute and Relative VaR limits should apply to both measures. This will protect investors from the short term cyclically of VaR and prevent the pro-cyclical risk taking behaviour that the Turner Review considered to be a major contributor to the Credit Crunch Banking Crisis. Where short term VaR's are historically low the long-term (3 to 5 year average) VaR will limit the riskiness of a portfolio, where short term VaR is above the long term average it will become the limiting factor. This approach is necessary to prevent the problem of relying on a single VaR number and to protect investors and the UCITS brand.
31	Do you agree with the requirement regarding the risks which should be taken into account in the VaR model?	No. This is over-engineered. The backtest requirement will ensure that a VaR method is taking account of all relevant risks. This clause will create a complex box-ticking exercise of no value.
32	Do you agree with the proposals regarding the completeness and accuracy of the risk management process?	No. This is over-engineered. The backtest requirement will ensure that a VaR method is taking account of all relevant risks and is complete and accurate. This clause will create a complex box-ticking exercise of no value.
33	Do you agree with the proposals regarding back testing of the VaR model?	They make sense but we believe that will be onerous for managers as administration systems are not set up to do "clean" portfolio re-valuations and carrying out the analysis with "dirty" valuations will all too often fail the 4 exceptions test. We would recommend that the proposal explicitly recognise the fact that dirty valuations will lead to significantly more than 4 exceptions but that, where the additional exceptions could reasonably be considered due to the dirty method, then they will not count as exceptions. The use of clean valuations should be stated as something that should be developed over time - up to 5 years.
34	Do you have any alternative suggestions?	As above, just that it should be recognised that the use of clean valuations is unworkable in the near term and dirty valuations will lead to many more than 4 exceptions.
35	Do you agree with the proposals regarding the VaR stress testing programme?	No, the proposals are overly specific and confused. For example, there is a contradiction between saying the stress tests should be done monthly and that they should inform investment decisions. To do the latter, they need to be done daily or pre-trade.

36	In particular do you agree with the proposed quantitative and qualitative requirements?	No, the proposals are unnecessarily detailed, which will lead to box-ticking that serves no practical purpose.
37	Do you have any alternative suggestions?	Yes, the UCITS manager should simply be obliged to carry out appropriate stress tests at appropriate intervals, leaving the manager to determine what makes sense given the UCITS in question. Given the daily measurement of VaR and the absence of limits on the stress test output, the stress test is simply informational. It would be better for the industry to develop best practice than to impose an imperfect and cumbersome approach.
38	Do you agree with the proposed tasks under the responsibility of the risk management function?	Yes, except in relation to the leverage reporting given that this is not applicable for a UCITS using Absolute VaR.
39	Do you agree with the requirements regarding model testing and validation?	Yes
40	Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?	No. It is generally impractical to define, let alone measure, leverage. The definition of leverage given in Box 23 will cause some UCITS to report "leverage" significantly higher than 2 which will question the integrity of these very proposals in relation to limiting leverage.
41	Do you agree with the proposals regarding prospectus disclosure?	No, expected VaR ranges will be useful but leverage ranges will be confusing and not meaningful.
42	In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?	Absolutely not. This is a very bad idea as leverage will often be significantly above 2, especially for UCITS using Absolute VaR, and such reports would both confuse (as they do not relate to risk) and bring the regulations into disrepute.
43	Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?	No, it will cause some strategies to report extraordinarily high leverage, without communicating anything useful about risk.
44	Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?	Yes