Response to CESR Consultation Paper CESR/09-489 dd. 15 June 2009
Prepared by Fidelity International for Investment Management Association

CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure

[1.1 CONTEXT / SEPARATION OF MARKET RISK AND COUNTERPARTY CREDIT RISK]

1. **Do you agree with the proposed approach in relation to the calculation of Global Exposure?**
   No. The wording for the definition of Global Exposure as well as Total Risk Exposure only works for the Commitment Approach. For both the Sensitivity Approach (cf. section 1.6 in consultation paper) as well as the VaR approach this does – in our view – not work as a comparison with the NAV of the UCITS cannot be made. If RM(x) is the generic Risk Measure used (here either Commitment, Sensitivity or VaR Approach) then the options are
   a) RM (UCITS incl. FDI) – RM (UCITS excl. FDI) < RM (UCITS excl. FDI) or
   b) RM (UCITS incl. FDI) – RM (UCITS excl. FDI) < RM (benchmark portfolio) or
   c) RM (UCITS incl. FDI) – RM (benchmark portfolio) < RM (benchmark portfolio).
   For the Commitment Approach the three options lead to the same result (assuming that the "commitment conversion" for a non-FDI instrument is simply its market value). Options a) and b) would allow explicit reference to "Global Exposure" as the "incremental [market] exposure". Option c) is what is implied by "Relative VaR Method" (cf. section 2.6 in consultation paper).

   All of the risk measures discussed in the consultation paper focus on market risk and as such "exposure" should generally read "market exposure".

   *The last sentence in the 2nd paragraph should read "..., which means that the **Total Risk Exposure** of a UCITS may at most be doubled through the use of financial derivative instruments."*

   All of the above refers to the relative VaR method only; the option of the absolute VaR method should probably also be mentioned in this opening section.

2. **Should the counterparty risk involved in an OTC derivative be considered in the calculation of Global Exposure?**
   No. Global Exposure should be a market risk measure. Counterparty as well as liquidity risk should be measured separately.

[1.2 SCOPE OF COMMITMENT APPROACH]

3. **Do you agree with the proposed approach or can you suggest an alternative approach?**
   - *There should be no reference to "efficient portfolio management" in this definition (cf. question 51-52) – it should just refer to all FDI positions. The classification of the purpose of a FDI position is in our experience often not possible; however the use of derivatives will always be consistent with the fund's stated investment objectives.*
   - *"only include instruments generating incremental exposure": yes, but the definition of when this is the case has to be consistent with the conversion method (cf. question 9) as well as the definition of netting and hedging (cf. questions 18-22).*
   - *"be able to separate embedded FDI from host instrument": yes*
   - *"include reinvested collateral in calculations": yes*

4. **Do you agree that the incremental exposure/leverage generated through techniques such as repurchase and securities lending transactions should be included in the calculation of global exposure?**
   Yes.

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[1.3 COMMITMENT APPROACH CALCULATION: GENERAL PRINCIPLES]
General Comment:
The second paragraph ("The total commitment arising ...") should use a capital "C" for "Commitment" and say "is defined as the sum" instead of "equals the sum". We feel that it is important to highlight that the actual economic commitment resulting from the use of FDI can be very different from the calculations used in the "Commitment Approach".

5. **Does option 1 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?**
   No. We would consider "market risk" and hence "global exposure" to be somehow – more or less – linearly linked to expected volatility of the investments. Option 1 does not achieve this objective. While the absolute loss might be limited the volatility might be excessive (no theoretical limit for expected volatility).

6. **Does option 2 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?**
   Yes, this is a plausible process. The expected variability or volatility of the investments is linked to the global exposure and limited to double that of the reference portfolio.

7. **Do you have any comments or other suggestions regarding other possible measurement approaches?**
   We think that option 2 above is generally suitable for the overall objective of risk measurement and control. Clearly such an approach does not consider sensitivity of financial derivative instruments involved and we would hence refer to our response to questions 13-17.

[1.4 COMMITMENT APPROACH CALCULATION – CONVERSION METHOD]

8. **Do you agree with the proposed approach, in particular the inclusion of a non-exhaustive list of financial derivatives?**
   Yes, non-exhaustive list is good.

9. **Do you have any alternative suggestions for the conversion method?**
   To keep calculations simple we would recommend to also allow the following methods:
   Index future: number of contracts x value of 1 point x market price of index future
   For index futures this is actually the more correct calculation as it takes the forward pricing of the index into account.
   Bond future: number of contracts x value of 1 point x market price of bond future
   For bond futures there is not one single correct solution The impact of the choice of methodology is generally small and the proposed calculation methodology simpler and less ambiguous.

10. **Are there other types of financial derivative instruments which should be included in the paper?**
    We would suggest to add "unfunded CDO" to the list. It is however important to specify that only unfunded CDO have got the characteristics of a derivative instrument.

11. **Are you aware of any type of financial derivative instrument where global exposure cannot be calculated using the commitment approach?**
    This depends on the definitions. We would favour "gross notional principal" calculations over "maximum loss" type calculations and deltas should only be permitted where they are reasonably stable. Other instruments could be allowed for funds using the commitment approach if the contribution to risk and the maximum loss are not material.

[1.5 TYPES OF FINANCIAL DERIVATIVE INSTRUMENT WHICH ARE NOT INCLUDED IN THE GLOBAL EXPOSURE CALCULATION]

12. **Do you agree with the approach regarding TRORS and derivatives with cash or an equivalent position?**
TRORS: Yes, this is an acceptable method. Issues may however arise if the assets in question (those held in the UCITS and those referenced in the TRORS) are only similar, but not identical (e.g. a basket of stocks vs. stock market index). In those circumstances a process has to be in place demonstrating significant and stable correlation of those assets. Cf. our response to questions 18-22.
Cash: Yes.

[1.6 SENSITIVITY APPROACH FOR DERIVATIVES ON INTEREST RATES IN THE COMMITMENT CALCULATION]

13. **Do you agree with the proposed use of the sensitivity approach?**
Yes, this is in acceptable methodology.

14. **Do you consider that this should be compulsory for these types of derivative or optional for UCITS?**
No, it should not be compulsory. The risk to the UCITS is that a manager could purchase long dated instruments for a short dated mandate and thus increase the relative risk position by a multiple of the intended "double" limit. In absolute terms however the market risk would still be limited. If this is however a concern it would be an option to limit the use of interest rate instruments to 15 year maturities unless sensitivity limits are disclosed and the method described in 1.6 is being applied.

15. **Do you agree with the analysis of the sensitivity approach described?**
Yes, this is an acceptable methodology.

16. **What quantitative level would you consider appropriate for the default sensitivity?**
1 year.

17. **Do you have any additional comments or suggestions on this approach?**
No.

[1.7 COMMITMENT APPROACH CALCULATION: NETTING & HEDGING EFFECTS]

18. **Do you agree with the proposals regarding netting?**
No.

19. **Do you have any additional comments and/or proposals?**
Netting in our view should only be permitted for identical contract specifications (strike prices, dates etc.). Otherwise there is the possibility of unlimited basis risk which cannot be controlled in a commitment approach environment.

20. **Do you consider that hedging as described above should be permitted?**
Yes, in principle. The following should be stated clearly though:
    - *[Historic] Correlation is not a sufficient measure*
    - *Hedges can only refer to security position i.e. where a derivative position is used to hedge the market (or credit) risk arising from security positions.*
    - *The relationship between assets should also be robust under various stress tests. This could for example mean that asset class congruence and regional/sector congruence is required*

(e.g. stocks cannot be hedged with bonds or commodities; US stocks cannot be hedged with UK stocks; UK Gilts cannot be hedged with JGBs; technology stocks cannot be hedged with a utilities index; all irrespective of historic correlations).

21. **Do you consider that the strong correlation requirement should be further clarified by means of a quantitative threshold e.g. 0.9?**
No. Correlation can be defined in many different ways (using daily/weekly/monthly data; midday or end-of-day prices; 100/200/500 day history; equal weighted/exponential weighted history; etc.) – it would not be possible or advisable to define the specific methodology. The manager has to document how this should be done.

22. **Can you suggest a possible threshold e.g. for the minimum correlation between stock baskets? Please justify your answer based on relevant market data.**
We would not recommend stipulating a specific threshold for correlations. We would prefer a blend of measures such as correlations and stress tests and those to be defined in the risk management processes of the manager. These can then be subject to regulatory review.

[1.8 COMPUTATION OF CONCENTRATION RISK ARISING FROM THE USE OF FINANCIAL DERIVATIVE INSTRUMENTS]

23. **Do you agree with this proposal?**
Yes. It should be stated clearly that "issuer concentration limits" here apply to the underlying of the financial derivative instrument and not the issuer.

[2.1 DEFINITION OF VAR]

24. **Do you agree with this definition? Do you have any alternative suggestions?**
We agree with this definition.

[2.2 COMPLIANCE OF THE VAR METHODS WITH THE PROVISIONS OF DIRECTIVE 85/611/EC]

25. **Do you agree with the above approach?**
Yes.

26. **What additional safeguards (if any) are necessary for UCITS which use VaR to calculate global exposure to ensure consistency with the total exposure limit of 200% of NAV?**
We would suggest to always require the calculation of the commitment approach exposures, the definition of a limit for this exposure (which could be well above 100% of NAV) and the inclusion of this limit in the Risk Management Process documentation which should be shared with the regulator on a mandatory basis. Investors should be able to request additional information regarding the risk management process. This fact should be disclosed in the prospectus. The additional risk management process information should include such a limit.

[2.3 / 2.4 / 2.5 COMMON VAR CALCULATION MODELS / INPUT USED IN THE CALCULATION OF VAR / ORGANISATION AND MEANS OF A UCITS/ASSET MANAGEMENT COMPANY USING VAR]

27. **Do you agree with the approach outlined in paragraphs 2.3, 2.4 and 2.5?**
2.3 not entirely: we do not believe that pure parametric VaR models are adequate for the risk measurement and control of UCITS with extensive derivatives positions.
2.4 yes
2.5 not entirely:

- *The unit calculating the VaR (= operating the VaR model) should be organisationally separate from the portfolio management and the marketing/distribution units.*
- *If the VaR model is maintained by such an independent unit no further independent validation of the model should not be required as the unit is already independent from potentially conflicted units. The model will also be subject to normal audit procedures.*
- *If the VaR model is maintained by a potentially conflicted unit (such as portfolio management) then an independent validation is required.*
- *The VaR model should be seen as a risk control tool and as such does not necessarily have to be part of the portfolio management process. The VaR model should however be tested against models used in the portfolio management process on a regular basis.*
- *The portfolio management process should at all times be aware of the results of the VaR model.*

28. **Do you have any comments or suggestions?**
As outlined above regarding question 27.

29. **Do you consider that VaR should be calculated at least daily?**
Yes.

30. **What type of criteria should competent authorities take into account in an assessment of the VaR Models?**
As outlined above regarding question 27 combined with back-testing.

31. **Do you consider that VaR models should be approved by competent authorities?**
Yes, but not in detail. The basic principles, which should be specified in the RMP documentation, yes, but not the specific implementation details.

[2.6 / 2.7 DEFINITION OF THE RELATIVE VAR / LIMITS OF THE RELATIVE VAR APPROACH AND PROPOSED SAFEGUARDS]

32. **Is the proposed 3-step relative-VaR approach adequate to limit the global exposure of a UCITS?**
No – it is a good start but not sufficient. Cf. response to question 26.

33. **Do you consider that the proposed limitations on the reference portfolio constitute reasonable and adequate safeguards to ensure that the relative VaR method does not result in the UCITS taking excessive risk or leverage?**
No – for two reasons: a) the reference portfolio should also be consistent with some stated element of the investment objective and b) the methodology does not limit "leverage" from a stress testing or commitment approach perspective.

34. **What additional safeguards (if any) do you consider necessary?**
Requirements as specified in responses to questions 26 and 33.

[2.8 DEFINITION OF ABSOLUTE VAR]

35. **Can the absolute VaR be considered as an appropriate way of measuring global exposure?**
Yes.

36. **Do you consider that the proposed thresholds are suitable? Can you suggest other thresholds?**

Threshold is suitable.

37. **What are your views on the application of stricter criteria to difference types of asset classes e.g. bonds, equities?**
Not required from our perspective.

[2.9 ADDITIONAL SAFEGUARDS TO MITIGATE THE RISKS RELATED TO THE USE OF THE ABSOLUTE VAR APPROACH]

38. **Do you consider the proposed safeguards, such as the use of appropriate additional risk management methods (stress-testing, CVaR) and the disclosure of the level of leverage, are sufficient safeguards when the absolute VaR method is used in the context of arbitrage strategies or complex financial instruments?**
CVaR is unlikely to add much value. Disclosure of commitment approach leverage and according limit (cf. response to question 26) would be recommended.

39. **Should UCITS using strategies that are potentially highly leveraged under the absolute VaR method be subject to specific marketing provisions, either at the level of the UCITS (minimum initial investment) or during the marketing process?**
Yes, that is a possibility. We would however be concerned that explicit regulatory prescription might lead to distortions. The general requirement for adequate disclosures should allow investors to exercise informed choice.

40. **Can you suggest alternative safeguards and/or requirements to avoid UCITS engaging in strategies which generate high levels of leverage?**
Cf. response to question 26.

[3.2 OTC COUNTERPARTY RISK CALCULATION METHODOLOGY]

41. **Do you agree with the proposed method for calculating counterparty exposure?**
Yes.

42. **Can you suggest an alternative method?**
Not applicable.

43. **Do you agree with the approach for netting arrangements?**
Yes.

44. **Do you consider that additional netting rules should apply?**
No.

[3.3 TREATMENT OF COLLATERAL RECEIVED]

45. **Do you agree with the proposed approach to agree a set of principles in relation to acceptable collateral to reduce counterparty exposure? Do you have alternative suggestions?**
Mostly - however: The first four bullet point principles do not appear to be fully consistent with the second set of nine bullet point principles. Our points here would be:
    - *The value of the collateral does not have to exceed the amount at risk, but a lesser amount/valuation of collateral will result in a lower reduction of such amount.*
    - *Collateral can itself be subject to more than negligible risk as long as this is appropriately taken into account through haircuts when calculating the risk reducing amount.*

- *Correlations: the collateral should not be correlated with either the underlying of the contracts or with the counterparty.*
- *Diversification: diversification is less important than correlation (as referred to in previous bullet). Diversification is one way of achieving low correlations, but should not be assessed to strictly in isolation as collateral is only a secondary recourse.*

46. Do you consider that rather than following principles based approach specific instruments that can be used as eligible collateral should be identified?
No – a principles based approach is appropriate.

47. Should collateral be UCITS compliant in terms of asset eligibility and diversification?
No – there should be no "look-through" to collateral composition. Collateral is only a secondary recourse to reduce issuer risk. Haircuts should be used to take the composition of such collateral into account. However, the UCITS has to be able to model the risk of any asset provided as collateral in order to support such an assessment.

[3.4 THE TREATMENT OF COLLATERAL PASSED]

48. Do you agree that collateral passed to a derivative counterparty should be included in the either the 5%/10% OTC counterparty limit or the 20% issuer concentration limit?
Yes – but as an off-set to counterparty credit risk only. Over-collateralisation – unless collateral is provided by transfer of cash or available for rehypothecation – should not be treated as an additional exposure due to its contingent nature.

49. Do you have any other suggestions as to how such collateral passed should be treated?
No.

[3.5 COUNTERPARTY LIMITS]

50. What areas of further work should be carried out with regard to this?
Not applicable.

[SOPHISTICATED/NON-SOPHISTICATED UCITS]

51. Do you agree with the proposal to abandon the use of the term sophisticated and non-sophisticated UCITS?
Yes. The terms are ambiguous and create more confusion than clarity.

52. If you object to this proposal could you please provide reasons for this view?
Not applicable.