GROUPAMA AM RESPONSE TO CESR'S CONSULTATION on Guidelines on Risk Measurement and the Calculation of Global

Paris, 31 May 2010

www.groupama-am.fr

Groupama

Asset Management

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

Yes.

2. Do you have any alternative suggestions?

The global exposure is to be monitored on an ongoing basis.

We agree with this provision and would like that level 3 guidelines specify that it is the UCITS' responsibility to monitor the global exposure daily and therefore, since the UCITS is able to verify that the exposure guidelines are complied with on a daily basis, a daily computation obligation as such is not necessarily needed.

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

There is a mistake in the first bullet of Box 2 point 2 ("calculate…is calculated").

We propose for better clarity to intercalate in Box 2 point 2 between the two bullets the level 2 provision stated just above by specifying that *"Identify where the use of financial derivative instruments does not generate any incremental exposure for the UCITS and exclude its underlying exposure from the commitment calculation"*.

We don't agree with some of the methodologies proposed :

- bond futures and options on bond futures (the sensitivity of a bond future is different of the sensitivity of the CTD)

- credit default swaps (the proposed methodology can lead to inconsistencies such as a low exposure if interest rates are very high, or being inadequate when the basis moves)

- variance swaps (the proposed methodology can lead to inconsistencies such as a low exposure for a variance seller if the implied volatility is very low)

- barrier options (using the delta max is incoherent with the vanilla options, particularly for knock out options)

For other complex derivatives, we don't know how the commitment has to be calculated.

4. Do you have any alternative suggestions?

- for bond futures and options on bond futures : take the market value of the future instead of the CTD

- for credit default swaps : notional + mark to market of the CDS

- for variance swaps : to find a methodology which is consistent with the maximum loss (different according to whether the UCIT is buyer or seller of variance and taking the strike into account)

- barrier options : something close to using the max of the delta and the loss incurred if KO is activated for knock out options; using the max of delta when KI is activated and loss incurred if KI is activated for knock in options

For other complex derivatives, using the maximum loss criteria, like in French legislation.

5. Do you find the numeric examples useful in providing further clarity?

For better clarity, numeric examples for swaps should be provided.

6. In particular, do you consider that the use of the market (or notional) value of the underlying reference asset for a credit default swap is appropriate? Do you have any alternative suggestions?

As said in response to point 4, we propose use the sum of the notional value of the CDS and the market value of such CDS with the purpose of reconstituting the underlying reference asset that would actually theoretically correspond to the CDS.

- the use of the market value of the underlying reference asset for a CDS does not always work properly since the underlying reference asset may have a life that is independent from the one of the CDS.

- if a CDS is used for hedging purpose, the features of the reference obligation of a standard corporate CDS may be different in terms of coupons and/or maturity than the ones of the bond from the same issuer that is hedged. That means that taking the price of the underlying reference asset of the CDS to calculate the global exposure in that case would introduce an additional interest rate risk valuation in the global exposure calculation that does not economically exist in the said hedging of the bond.

- there is not always a reference obligation associated to a CDS. For example Itraxx Europe main Index CDS 5Y (125 Investment grade entities from 6 sectors) has no reference obligation.

7. Do you agree that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation? If you do not agree please explain your answer

Yes.

8. Do you consider that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for the UCITS?

The conditions for cash to be considered as risk free should be clarified (rating ? sovereign ? monetary fund ? banking deposit ? asset yielding eonia +- a margin ?)

9. Do you agree with the proposed definitions of netting and hedging?

Yes.

10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure?

Yes.

11. Do you have any alternative suggestions?

To specify whether netting between bond future and deliverable bond is possible.

12. Do you agree with the examples provided of strategies where netting is possible?

Yes.

13. Do you agree with the examples provided where hedging is possible?

How do we determinate that an equity portfolio is diversified enough to apply beta-hedging ? (number of shares + correlation with the index ?)

How do we determinate that the hedging of a bond is possible ? (same duration bucket ?)

14. Do you agree with the examples provided where hedging is no possible?

Yes.

In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

Yes, except for well diversified portfolios (cf. answer to point 13).

15. Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques?

We would like to indicate that there is an issue with the treatment of repo and reverse repo transactions as mentioned in Box 6 item 4 and in paragraph 23.

A further use of some repo (or reverse-repo) collateral as underlying to a new repo transaction *does not create any new risk as such*. There is no reason to add those securities to the global exposure calculation; only the collateral obtained in that 2nd repo transaction might possibly create risk if reinvested in risky assets, as mentioned in items 1 and 2.

Please see hereafter an example:

1. **First reverse repo transaction**: UCITS pays 100, receives stocks for 100 and commits to selling the same stocks for 100 at maturity date.

=> *no market risk related to those stocks*

2. **Second repo transaction**: UCITS sells stocks for 110, receives cash for 110 and commits to buy same stocks for 110 later-on.

=> *no market risk as long as cash is not reinvested (ordinary treatment of repo according to items 1 and 2 of box 6)*

3. **Unwind of operations**:

Second repo unwinds via UCITS receiving stocks and paying 110 (no PnL related to stocks MtM).

First repo unwinds via UCITS selling the same stocks for 100 (no PnL either).

=> *no PnL even if stock's price has moved.*

16. Do you have any alternative suggestions?

As a consequence (see our comment above to question 15), the end of item 4 of box 6 should be deleted as well as last sentences of second and third bullets of §23 page 18.

The risk free return could be alternatively based on Eonia (or euribor with a short dated tenor) plus/less a margin.

17. What are the advantages and disadvantages of each methodology?

We understand the sensitivity approach as a complementary method to the classic commitment approach that aims at reaching a more adequate commitment calculation for interest rate derivatives. In this perspective, Option 2 is a more appropriate method than Option 1 as Option 2 better suits with commitment calculation principles.

Indeed, Option 2 is based on the calculation of an underlying asset position that simply translates in "cash terms" the derivative's sensitivity to the underlying's changes in price. This conversion naturally allows for netting under specific and calibrated compensation conditions.

Option 1 can be interpreted as a VaR estimation and it is not coherent with the commitment approach of part 2 of the CESR document. It would be much better to use directly the general VaR approach in part 3 of the CESR document. Statement 2 is mixing the commitment and the VaR approach and is therefore confusing.

Step 2 in Option 1 allocates instruments to different sensitivity zones. Compared to the maturity buckets proposed in Option 2 that are designed to encompass the main debt issue maturity points:

- Option 1 zones are less stable;
- Option 1 zones are defined based on volatility and correlation assumptions less up-to-date.

Option 1 includes other arbitrary hypothesis :

- it is equivalent to assume a target sensitivity of 8 for all portfolios.
- the rates stress declines with the sensitivity zone.
- the definition of yield to maturity for a swap is not obvious.

18. Which methodology do you consider more appropriate? Please give explanations and indicate whether additional safeguards should be included.

As stated above, we prefer Option 2 which is a steadier and adequate method for the purpose of global exposure calculation under the commitment approach than Option 1 which is only a VaR approach.

19. In the last step of Option 1, the total amount is multiplied by 12.5. Do you consider that (i) this takes due account of the sensitivity of the UCITS and (ii) that this is in line with the commitment conversion methodology (e.g. conversion of the derivative into the market value of the equivalent position in the underlying assets)?

(i) this does not take due account of the sensitivity of the UCITS, because it is equivalent to assume a sensitivity target of 8 for all UCITS.

(ii) this is a VaR approach and not a commitment approach.

20. Under option 2 the target sensitivity of the UCITS can be longer than the sensitivity of the derivative while the equivalent underlying position is relatively small. This can result in high levels of leverage within the UCITS. Please provide views on the additional safeguards that could be introduced to mitigate this risk.

As in French legislation, the sum of the absolute value of sensitivities of all interest rate derivatives could be capped for UCITS wishing to use the commitment approach.

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.

23. Do you agree with the proposed approach regarding the use of the relative VaR?

Yes.

24. Do you agree with the proposed criteria for the reference portfolio?

To serve as an example and for more clarity, we would suggest adding that *"for instance, bespoke indices such as a series of zero coupons is eligible as reference portfolio"*.

25. Do you have any alternative suggestions?

No.

26. Do you agree with the description of absolute VaR?

Yes.

27. Do you agree with the calculation standards proposed for the VaR approach?

Yes.

28. Do you agree with the proposals regarding setting different default parameters and rescaling?

We are not comfortable with the concept of 99% (or more) confidence interval. Recent history has shown that VaR models are for from being that accurate. We think the cionfidence interval should be limited to 95% and that additional safeguards have to be set to take into account assets with low 95% VaR and fat tails (CVaR, max drawdown…)

29. Do you consider the examples for the rescaling of parameters are useful in providing further clarity?

Yes.

30. Do you have any alternative suggestions?

We are not comfortable with the concept of 99% (or more) confidence interval. Recent history has shown that VaR models are for from being that accurate. We think the cionfidence interval should be limited to 95% and that additional safeguards have to be set to take into account assets with low 95% VaR and fat tails (CVaR, max drawdown…)

31. Do you agree with the requirement regarding the risks which should be taken into account in the VaR model?

Yes.

32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

It seems a little too light : for example the possibility of using only one risk factor for shares of the same geographical zone (so the VaR of a long/short strategy inside that zone is 0 ?).

33. Do you agree with the proposals regarding back testing of the VaR model?

The frequency of the back testing program for monitoring the VaR model is part of a risk management program already in place for those UCITS using the VaR option. We would like to draw attention to the fact that arbitrary fixing the exact frequency is not a relevant measure, as back testing is to be adequately used depending on the market context by the risk management function. Risk management has therefore to be given discretion in monitoring the VaR as it is the UCITS responsibility to ensure appropriate safeguards in relation to the VaR model's use. Otherwise, it may even be dangerous giving the impression that imposed "safeguards" would mechanically lift some of the UCITS responsibility! We therefore suggest leaving the UCITS to decide on the frequency, provided that it shall be at least quarterly.

In the same context, the monitoring of "overshooting" shall remain at the UCITS level and appreciation in terms of adequately measuring the performance of the model in use, without specific figures written as hard limits for a specific back testing period.

34. Do you have any alternative suggestions?

No.

35. Do you agree with the proposals regarding the VaR stress testing programme?

We find the requirements of the stress testing programme a little vague (except for identify the scenarios in which the UCITS NAV could be negative).

36. In particular do you agree with the proposed quantitative and qualitative requirements?

We don't believe in the possibility of "identifying the probability of such (extreme) scenarios being realized"

37. Do you have any alternative suggestions?

Identify situations where the VaR is not reliable (some are mentioned in Box 19 : correlation changes, illiquidity…)

38. Do you agree with the proposed tasks under the responsibility of the risk management function?

Yes.

39. Do you agree with the requirements regarding model testing and validation?

It should be specified whether this applies only to internal models or also to external models and if the independent party performing the validation could be an other service of the asset manager (for instance the quantitative research team).

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?

Yes.

41. Do you agree with the proposals regarding prospectus disclosure?

Yes.

42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?

Yes.

43. Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?

Yes.

44. Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?

Yes.

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?

We don't think that setting hard criteria as proposed would best serve the stated goal of effectively reducing counterparty risk. For instance:

- Liquidity: the liquidity of the collateral could be lower when there is corresponding sufficient haircut linked to the credit quality of the issuer;

- Valuation: valuation of the collateral shall be done with the same frequency as the fund NAV calculation;

- We do not agree with the inclusion of correlation criteria: the monitoring of correlation criteria shall be at the discretion of the management company (ie defining its own tolerance margin in terms of correlation and managing the substitution of collateral at its discretion);

- We do not agree with the diversification criteria, again, the diversification of the collateral shall remain at the discretion of the UCITS;

- Cash collateral could be reinvested in order to pay interest.

46. Do you have any alternative suggestions?

See answer to question 45 above.

47. Do you consider that it would be useful to include some examples of minimum haircuts for different asset classes? Do you have a preference on what these haircuts might be?

Yes : high yield assets, mortgage and other illiquid assets, assets in a different currency…

48. Do you agree that exposure to a clearing house should be considered as part of the counterparty exposure limit? Do you have any alternative suggestions?

Not sure of having understood.

49. Do you agree that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit? Do you have any alternative suggestions?

Not sure of having understood.

50. Do you agree that exposures to a counterparty generated through stock-lending or repurchase agreements should be included in the OTC counterparty exposure limit? Do you have any alternative suggestions?

Yes.

51. Do you agree that a UCITS position exposure should be calculated using the commitment approach?

Not sure of having understood.

52. Do you agree with the proposed cover rules for financial derivative instruments?

Yes.

53. Do you think there should be further restrictions on the assets held by the UCITS as cover?

No.

54. Do you agree with the proposed definitions?

Yes.

55. Do you consider that CESR should provide other definitions in these guidelines? Do you have any suggestions for other definitions?

No.

56. Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?

The Structured Funds industry needs a specific treatment for reasons that we will detail later. This industry represents a significant part of the Asset Management industry. In France for example, as of 30 April 2010, there are 756 funds of this kind, narrowly defined, and they manage 66.7 billion Euros of assets, and nearly all of them are UCITS or UCITS-equivalent funds[1].

Yes we agree with this approach. However, we believe that there is a real risk of abuse of such guidelines. Therefore, it seems to us very important that Structured Funds be defined in a very narrow way, and that the wording uses words and concepts that cannot be interpreted and extended to cover loosely any type of fund. Only a very specific sort of Structured Funds, sometimes named "Formula Funds", cannot fit completely with the standard methodology, but they can fit with some of it. So the standard methodology should be adapted also as narrowly as possible, only to the extent that this is absolutely necessary and justified.

1. Definition of Structured Funds

The term "Structured Fund" is already too broad, since it often includes many structures, like CPPIs, where there is no compelling reason to adopt a different approach than the standard one. CPPI are funds that have an exposure that is divided between some "risky" assets, for example equities, and "non-risky" assets, for example cash deposits. The only specific characteristics that they have is that they change their allocation between the two types of assets. They can live without any problem with the proposed standard guidelines, that give them the right to be exposed to the risky assets up to a leverage of two, or up to a leverage that respects the VaR requirements.

Structured Funds should be defined for the purpose of these guidelines as purely passively managed funds, in the sense that their return at maturity is purely the result of a mathematical formula that links the return to the value of some underlying securities or indices at certain dates. An investor who would have access to all necessary information on the prices of the relevant securities should be able to determine himself, at maturity of the fund, the redemption price of the fund. The formula has been determined at inception of the fund and cannot be modified by the manager. The manager has therefore no discretion on the final "pay-off" over the life of the fund. This does not preclude the manager of the fund to try to optimize the management of the fund, for example in order to minimize the counterparty risk of the fund, but at any time the manager should be certain, for example through derivatives arrangements, that he can produce the expected pay-off at maturity.

2. Need of an External guarantee

In addition, in order to limit the risks of abuse of the proposed guidelines, we believe that it is essential to make sure that the formula is effectively guaranteed at maturity. For the sake of these guidelines, we should consider as Structured Funds only funds where reaching their promised pay-off at maturity is not only a fiduciary duty of the manager but also a legally binding requirement. We therefore believe that it is important to require that the final predefined payoff be guaranteed by an external entity with enough capital to make a strong, legally binding and enforceable commitment.

[1] See : http://www.amf-france.org/BIO/BIO_PDFS/EEN_ETAT_ENCOURS/30.04.2010.pdf

3. Proposed definition

We propose to limit the use of these specific guidelines to the funds that respect the following conditions:

- The management objective of the fund is to reach, after a determined period, an amount which is determined by the mechanical application of a pre-determined calculation formula that refers to financial markets indicators or securities; and also possibly to distribute dividends, determined in the same way;

- the achievement of the management objective of the fund is guaranteed by a credit institution, an insurance company, or a MIFID company with enough capital, whose registered office are located in a Member State of the Organization for Economic Co-operation and Development.

57. If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.

1. Why cannot Structured Funds completely comply with the standard methodology?

1.1 Structured Funds can respect the standard guidelines at inception

The required standard guidelines, as regards Global Exposure and as regards also Issuer Concentration, are a problem for Structured Funds at inception, but not more than for any UCITS. They can put in place pay-offs (or "Formulas") that comply with the required standard, and indeed most of the classical pay-offs comply with such standards.

Global Exposure is in general not an issue since they tend to have a low leverage, below 1 in general.

Issuer Concentration is also in general manageable, because their pay-off are either based on indices or on a diversified portfolio of securities.

1.2 The problem is that the profile of the fund may, over time, diverge from the standard guidelines.

The problem is that a Structured Fund must be managed in order to provide to investors a pre-determined pay-off at maturity of the fund. They can achieve that, for example, by entering into derivatives transactions that guarantee that the pre-determined pay-off will be reached. The manager of the fund thus does not have much flexibility to follow the guidelines. He is completely constrained to achieve the pre-determined formula that has been promised to investors. He may infringe on the guidelines in a purely passive way.

For example, the pay-off may depend on some conditions related to some specific securities. To cover his pay-off, the manager will enter into barrier options and we know that, if the value of the security is close to the strike of such option and if the maturity is close, the delta of such option can be very important and volatile, and lead to an infringement of the Global Exposure limit (even with a VaR methodology).

A Structured Fund with a pay-off that is based on a diversified portfolio of securities can also have a problem, over time, of concentration limit. For example, if one security of the Formula goes up very much while the others stagnate, he may be over-exposed to this security.

It is important to note that the other limits, like counterparty risk limits, can perfectly be respected at any time by the manager by appropriate means (collateral, reset of derivatives etc.).

2. ***At the same time, we believe that the UCITS framework should allow these Structured Funds***

As mentioned above, Structured Funds are an important part of the European Asset Management industry, with more than 100 billion Euros under management. We do not see any compelling reason not to allow them.

If no Structured Fund could exist under the UCITS Directive, that would mean that these structures would re-appear under other legal forms, especially Structured Notes or other type of banking products, without all the guaranteed that are provided to investors by the UCITS Directive: liquidity at NAV, limitation of counterparty risks, auditing, independent custodian and all the conduct of business rules (conflict of interest, best execution) that will be implemented at level 2 with UCITS 4.

We believe that investor's protection is overwhelmingly in favor of continuing to allow such Structured Funds.

58. Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach.

Our comments on the list of criteria provided by CESR:

1. ***The fund is passively managed and structured to achieve a pre-defined payoff***

As mentioned above, we agree on this criteria, provided that the term "passive" means that the manager, at all times, (i) will have to respect the promised payoff, without any right to change it, and (ii) must make sure that he will be able to achieve the required payoff, in practice through derivatives. This should of course not prohibit the manager from his other duties, which are active by nature, like actively managing his relations with derivatives counterparties, actively entering and unwinding derivatives, changing counterparties, managing counterparty risks, managing inflow and outflows etc.

2. ***The pre-defined payoff is based on a calculation formula relating to the performance of financial instruments or other financial parameters***

As mentioned above, we agree on this criteria. We believe that this is the only possible meaning of a "pre-defined payoff".

3. ***The fund has a final maturity date not exceeding 9 years***

We believe that such safeguard is acceptable, since in practice most of these funds have a maturity that is lower than 10 years Structured Funds are purchased by investors on the basis that they will hold them until maturity so it makes sense not to extend too much this duration. It seems to us; however, that 9 year is a little bit too short. We would rather propose 15 years.

4. The fund is not open to new subscriptions

We believe that this is not completely necessary. We proposed hereunder an alternative which is to close the fund if and when it is not able to respect the standard risk guidelines.

5. The prospectus contains full disclosure regarding the investment policy, underlying exposures and pay-off formulas. It should also contain information on leverage levels and the specific risks associated with investing in such a fund.

We agree on this. We believe that, since the payoff is predetermined, it should be explained to investors, in a summary way in the KID, and in a more detailed way in the full prospectus.

6. The final predefined payoff is guaranteed by a credit institution located in the OECD or by entity subject to prudential supervision

We agree. We believe that it is essential to make sure that the formula is effectively guaranteed at maturity. For the sake of these guidelines, we should consider as Structured Funds only funds where reaching their promised pay-off at maturity is not only a fiduciary duty of the manager but also a legally binding requirement. We therefore believe that it is important to require that the final predefined payoff be guaranteed by an external entity with enough capital to make a strong, legally binding and enforceable commitment.

7. Investors capital on maturity is guaranteed by a credit institution located in the OECD or by an entity subject to prudential supervision; or capital protection on maturity is obtained through investments in deposits, debt securities of high quality such as debt securities issued by an entity subject to prudential supervision and registered in a Member State of the EEA or debt securities issued or guaranteed by a Member State of the EEA

Structured Funds are sometimes, but not always, capital guaranteed. In fact, they are less and less so, due to the low interest rates level. Their underlyings can be indices or any allocation of securities, in general shares. Their returns may be linked, for example, to the prices reached, at some pre-determined dates, by shares that belong to a pre-determined basket.

It would be very restrictive to limit such funds to capital guaranteed funds. Investors would have a protected downside but at the price of a very limited possible upside, especially if the maturity is limited to 9 years. Very few formulas would therefore make sense and investors would be extremely restricted in their choice. Structured Notes would become the only standard of the market, at the detriment of UCITS, at the very time

where the EU commission realizes, in the course of the PRIPs debate, that UCITS are much more regulated and protective of investors than alternative products.

59. Can you suggest any additional criteria?

Yes, we believe that additional safeguards are possible. These safeguards are there in order to make sure that the Structured Products guidelines are used only to the extent that they are necessary. Standard guidelines should be implemented as much as possible.

1. An obligation to respect at any time counterparty risks requirement

Structured Funds can respect these constraints. If any doubt, it should be made clear that they will not have any specific guideline in this respect.

2. An obligation to comply with all the standard guidelines at inception

Structured Funds should be created only the extent that they comply with all the standard guidelines at inception. If they are not able to comply at inception, they should not be created.

3. An obligation to comply with all the standard guidelines as long as the fund is marketed

If at some point the manager sees that the standard guidelines, as regards the commitment approach and as regards the issuer concentration limits, cannot be respected, the fund should close to new subscriptions and stop being marketed.

4. An anti-avoidance rule

It would be prohibited to create a Structured Fund where the formula itself shows that the fund will never be able to respect the standard guidelines during its life.

Example of a fund that should not be allowed: a fund with an indexation on an appropriate number of securities in order to respect proper diversification at inception but that, over time, has an exposition that is reduced automatically to a number of securities that is too limited to allow proper diversification, even if the market conditions were at that time the same as at inception.