

Irish Funds Industry Association's response to CESR's Consultation Paper "Risk management principles for UCITS"

The Irish Funds Industry Association (IFIA) is the industry association for the international investment fund community in Ireland, representing the custodian banks, administrators, managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland. Given that as at the end of August 2008 there were total Assets under Administration of €1.5 trillion, with 3,020 Irish domiciled UCITS funds, including sub-funds, with a Net Asset Value of €639 billion, all developments in the UCITS arena are of particular interest and relevance to the Irish industry. The IFIA welcomes both the publication of and the opportunity to comment on CESR's consultation paper on risk management principles for UCITS.

The IFIA acknowledge the substantial contribution made by CESR with regards to risk management in UCITS and the ongoing work from both a principles and technical perspective with the aim of converging regulatory requirements across jurisdictions.

General Comments:

Detailed below are comments regarding the consultation paper in general and not relating to the specific questions posed in the paper.

The consultation paper is considered to be both broad and prescriptive in terms of the scope and depth of the risk management principles that are being proposed. It is believed that should these principles be introduced in their entirety they could add a significant additional burden to fund promoters, investment managers and directors, without comparable investor benefits, which could result in longer timeframes and increased costs for UCITS fund launches. This could ultimately lead to UCITS funds becoming less competitive against other competing products. As such, it is not obvious from a regulatory cost / benefit perspective that the proposals in the consultation paper would ultimately benefit the investor especially as there is currently a robust risk management regime in existence and significant levels of investor protection in place for UCITS.

It is worth noting that both spread limits and derivative exposure limits are risk management techniques which are not given significant consideration in the consultation paper. The monitoring / oversight of these limits are conducted on an independent basis by which the Fiduciary provides comfort that the risk management process within the UCITS management company is working effectively. Ongoing or regularly recurring breaches would provide a strong indication that the risk management process may not be working effectively with the implicit and

existing responsibility for Directors to investigate further. As the consultation paper does not explicitly reference the type of UCITS, the level of derivatives use or their complexity when discussing risk management principles, the concept of proportionality should be enshrined at the beginning of the paper, whereby the Management Company would have discretion and responsibility to determine the appropriate level and complexity of risk management, proportionate to the diversity in size and complexity of the business and organisation of the management company and the UCITS.

The references to all risks and all possible risks throughout the paper should be replaced with reference to all material risks as it would not be practically possible, or meaningful, to manage all possible risks according to the principles outlined in the paper.

In the definitions section on page 5 it would be important to add a definition for the term “Board of Directors” as this term is used constantly throughout the paper and could be interpreted as either the Board of Directors of the UCITS or Board of Directors of the Management Company. For the purpose of this response the term is taken to mean the Board of Directors of the Management Company, however, if the definition is intended to reference the Board of Directors of the actual UCITS fund then many serious concerns would arise with respect to the use of the term throughout the paper.

Whilst the overarching responsibility of the Board of Directors for the risk management process is not in doubt, it is felt that the manner in which this duty is discharged should not be subject to a degree of prescription, particularly the level of detail included in the consultation paper. There are different business models in terms of structure, scale and complexity that operate within the UCITS regime and in many of these the activity of risk management is the responsibility of risk professionals who have the relevant and necessary expertise, within the Investment Manager. As such the consultation paper needs to take additional consideration of differing Management Company business models to focus the emphasis on ensuring the relevant expertise and discretion of the Management Company or the Investment Manager in managing the risks of their business on an ongoing basis.

With respect to the legislative background to risk management for UCITS the consultation paper references various sections of both the UCITS directive and European Commission Recommendation 2004 as support for the application of a Risk Management Process for UCITS. While Article 5f(1)(a) is referenced, this article deals with the requirement for a UCITS to have necessary operational controls in place rather than an all encompassing risk management policy. Whilst Article 21(1) is more relevant and refers to a requirement whereby “[the management company] must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio”, the applicability of Article 21(1) is narrowed further on in the article where it states “It must communicate to the competent authority regularly and in accordance with the detailed rules they shall define, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS”. This would seem to highlight the application of these provisions relating to guidelines on Risk Management

Principles to the derivatives positions held within a UCITS portfolio and further supports the concept of proportionality.

The 2004 European Commission Recommendation states the following which again reinforces the application of the risk management process to derivatives:

"In order to ensure that the risks related to the new classes of financial instruments, in particular regarding derivatives, are duly and accurately monitored, measured and managed, management companies or investment companies are required to apply sound risk measurement processes under the supervision of the competent authorities. In particular, these risk measurement processes should enable them to monitor, measure and manage at any time the risks of the positions and their contribution to the overall risk-profile of the portfolio."

Under the section **General principles concerning risk management from the perspective of UCITS investors** it is agreed that the four main areas outlined in section 1 are appropriate, but their application should be limited in a proportionate manner to derivatives or other structured products with exposure to underlying counterparty, liquidity and credit risk.

Specific comments:

Detailed below is our response to the various specific questions; the format adopted tracks the questions raised in the paper and can be cross referenced to the respective box numbers in the consultation paper.

Box 1

The statement in box 1 refers to the "efficiency" of the risk management process whereas it would probably be more appropriate to refer to the "effectiveness" of the process. Paragraph 5 states the risk management process should be "assessed" by competent authorities, it may be more appropriate if this was changed to "considered". Also, the statement refers to monitoring on an ongoing basis, again it may be more appropriate to state that material amendments must be notified and considered with the appropriate Regulator and paragraph 6 could then read "Material changes to the risk management process should also be considered."

Box 2

As previously stated the term Board of Directors is taken as referring to the Management Company. With regard to point 3 it may be appropriate to remove the words "if necessary, adjusted" such that the sentence may retain its original intention by stating "The risk management Process is approved and reviewed on a regular basis by the Board of Directors".

Box 3

The concept of proportionality should be more clearly emphasised such that the requirements be predicated by reference to the complexity of the management company and the UCITS fund, as such it is suggested that point 2 reads, "Where appropriate and proportionate in view of the value, scale and complexity of the Company's business and of the UCITS it manages, the risk management function should be hierarchically and functionally independent from the operation of the UCITS."

With regard to the first sentence of point 3, it is considered unreflective of particular market practice to deem it necessary for the risk management function to be present while representation is being made to the Board of Directors. As an alternative that is more reflective of potential market practice it is suggested that the first sentence of point 3 reads “The risk management function should implement the risk management policy and procedures and prepare reports which they present either directly or indirectly to the Board of Directors and Senior Management.”

Box 4

The use of the word “full” in point 1 is not deemed to be practical and it is suggested that it would be more relevant if replaced by the word “primary”. It is felt that the points in box 4 are overly detailed and that it would suffice to say “Whilst risk management activities may be outsourced the Management Company remains primarily responsible for the risk management process.”

Box 5

As previously stated under the general comments it would be more appropriate for the term “all risks” in point 1 and “all possible risks” in point 2 to be replaced in both instances with “all material risks”.

The meaning of Paragraph 24 is unclear and would benefit from further explanation.

Box 6

The concept of proportionality should be clearly stated at the beginning of box 6, in addition it would be appropriate to allow discretion in using techniques and tools not specified in the risk management policy if deemed appropriate and with approval of the Board of Directors of the Management Company.

The last sentence in Paragraph 28 does not appear appropriate or proportionate, it may be sufficient to simply state “Companies should employ appropriately advanced risk measurement techniques and review these techniques to ensure they remain appropriate.”

Paragraph 29 may not always be possible in reality and, therefore, it is suggested that it reads “If UCITS invest in structured products, their multiple risk components should be appropriately identified and managed where it is feasible to do so.”

Box 7

Whilst it is generally accepted that models should be subjected to back testing and stress testing it is felt the level of detail or prescription in the supplementary commentary is overly excessive. Specifically with respect to point 2 it is suggested the word “continuous” be replaced with “ongoing” or “regular” and with respect to paragraph 33 it is suggested the word “every” be replaced with the word “relevant”.

Box 8

It is suggested that in paragraph 39 the words “where applicable” are added to the end of the paragraph.

Whilst it may be appropriate for the risk monitoring/measurement function to provide support to the valuation process it may be more appropriate if this was done through participation in a valuation committee, as opposed to direct involvement in pricing assumptions and models.

Box 9

It is suggested that the word “define” be replaced with the word “approve” in point 1 and “defined” replaced with “approved” in point 2. Again as throughout, the term Board of Directors is taken to refer to the Management Company.

Box 10

It would be more meaningful to insert the word “quantifiable” as the penultimate word in point 1 such that point 1 would then read “The risk management policy of the Company should provide, for each UCITS, a system of limits concerning the measures used to monitor and control the relevant quantifiable risks.”

With regard to point 2, it is not immediately obvious what is achieved by adding this statement as it has been established that the Board of Directors should approve the risk management process which would encompass approval of the limits described.

Regarding paragraph 45 it may be more appropriate to remove the word “immediately” from the last sentence.

Box 11

The term “prompt correction” may lead to action that would not be in the best interest of the UCITS and therefore it is suggested that these words are replaced with “corrective action that should be taken promptly over a period of time as determined to be in the best interests of the UCITS.”

Box 12 & 13

It is felt that the points made in both box 12 and box 13 are overly detailed and could be simplified whilst at the same time retaining the essence of their intention by requiring that the risk management policy delivers relevant regular reporting and is monitored by the Board of Directors of the Management Company and any other appropriate persons on an ongoing basis.

The IFIA hope our comments to the consultation paper will be of assistance to CESR and remain at your disposal for any clarification or assistance that we may be able to provide.

Irish Funds Industry Association
17th October 2008