Investment Management Association

ima

17 October 2008

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Secretary General
The Committee of European Securities Regulators
11-13 Avenue de Friedland
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France

CESR Consultation on Risk Management Principles for UCITS

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

In the last year, adverse market conditions have certainly tested and continue to test financial services firms' risk management arrangements. This is true for all types of EU financial services firms, whether they be subject to the UCITS, CRD, MiFID or Life Directives. Moreover, it appears that in relation to UCITS, there are variations in practice across Europe. We therefore welcome CESR work on risk management principles.

Such principles should be high level rather than prescriptive, otherwise they are not principles. In this regard, we note that the MiFID Directive provisions on risk management are high level in nature and that it is the responsibility of MiFID firms to implement these requirements. We are not aware of any more detailed Level 3 recommendations for MiFID firms along the lines being proposed for UCITS as set out in this paper.

The MIFID approach is very similar to the UK regulator's principles based approach to regulation and also to responsibility that the Financial Services Authority places upon firms' senior management. Senior management is fully responsible for putting in place and overseeing systems and controls to manage their business.

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In the event that CESR does decide to move forward with detailed provisions, rather than high level, principles, we attach comments on the detail of the consultation paper, together with a marked up version of the paper.

While welcoming CESR's work in this area, we are concerned that, once again, the regulations for UCITS (and therefore cost) is being increased. This will further tilt the already unlevel playing field between 'substitute investment products' sold to retail investors. We urge CESR to impress on its fellow committees of regulators, CEBS and CEIOPS, to draw up similar risk management principles for other retail products.

If you would like to discuss our response further, please let me know.

Yours sincerely

Craig Hall
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Detailed comments to the paper

Definitions (page 5) and frequently used words

We ask CESR to ensure that the application of defined terms is clear, consistent and correct throughout the document:

- "Board of Directors" – the document regularly refers to the Board of Directors but there is no definition within the document. Presumably it is the Board of Directors of the 'Company' as defined; it is not the Board of Directors of the investment company (e.g. SICV) where that investment company is not self-managed. This needs to be made clear.

- "Senior Management" - we believe reference should also be made to the self-managed investment company article (Article 13a) given the defined term 'Company' being used.

- "Outsourcer" – the Company (i.e. the UCITS manager) that delegates is the outsourcer. We believe another term should be used to disclose the party to whom a task is outsourced (e.g. outsourcee or service provider). This will avoid confusion.

- "Risk Management Process/Policy" – we recommend that the term "Risk Management Process" is used throughout the document to avoid confusion.

Risks Relevant to UCITS

It is important that the principles apply to relevant and material risks. Also, each aspect of market risk should be identified in separate paragraphs, likewise each aspect of operational risk. This would reduce the risk of overly prescriptive and inconsequential rules or guidance being applied at national level.

Proposed Level 3 Measures

<u>Box 1: Supervision by competent authorities</u>

Box 1: CESR recommend that the authorisation of the UCITS/Company by the competent authority is, in part, dependent upon the 'adequacy and efficiency of the risk management process'. The guidance also states that the RMP is subsequently monitored on an ongoing basis. In this respect, we ask that further clarification is provided for the authorities on what their exact duties will be. For instance, to what level of detail will they be asked to assess the RMP? We believe that the monitoring relates to the process itself, not the results. We also recommend that the wording reflects that it is the Company which is licensed in terms of the risk management process and not the UCITS.

Paragraph 5: In keeping with the language used in Box 1, the RMP should be <u>considered</u> by the competent authority rather than assessed. Also, as stated above, the competent authority licenses the Company, not the UCITS, in terms of the RMP.

Paragraph 6: As noted above, changes should be considered by the competent authority rather than 'assessed'. In addition, we believe that only material changes should require notification to the competent authority.

Box 2: Definitions of roles and responsibilities

Box 2, Paragraph 2: We recommend that the last sentence is deleted as it does not add anything to the document.

Box 2, Paragraph 3: As discussed earlier, we suggest that risk management "policy" is replaced with "process" throughout for consistency.

Paragraph 7 (c): the investment management function is a part of the risk management process.

Box 3: Risk Management Function

Paragraph 9: We suggest replacing "IT structures" with "risk management systems".

Paragraph 14: Specific safeguards should seek to ensure that risk management is carried out with an adequate level of independence.

Paragraph 15: We believe that the last sentence is not relevant in order to provide clarity and meaning to the document.

Box 4: Outsourcing

Box 4, Paragraph 1: The Company has primary responsibility for all matters in the operation of a UCITS. We therefore believe that this guidance should be consistent with existing rules and guidance.

Box 4, Paragraph 2: We suggest that the wording of the last sentence should be changed from "...operation and conditions" to "....operation and risk management process."

Box 5: Identification of risks relevant to UCITS

Box 5, Paragraph 1: This paragraph states that the RMP should assess and address all risks. Whilst this is the case, this paragraph does not belong in the identification of risks relevant to UCITS. We therefore recommend it is deleted.

Box 6: Risk Measurement Techniques

Box 6, paragraph 1: It is the Company, not the risk management policy which specifies the techniques and the tools deemed suitable for use by the UCITS.

Paragraph 28: We believe that the bracketed sentence concerning high risk profile UCITS should be deleted on the basis that complex measures can apply to low risk funds as much as high risk funds.

Paragraph 31: We disagree that all operational risks are non-quantifiable. The reference should therefore be removed.

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

We assume that this box applies to sophisticated UCITS only. It would be helpful if this was made clear.

Box 7, paragraph 2: Ongoing, rather than continuous, assessment is a more practical term to use in terms of the risk management framework.

Paragraph 33: As we believe this section is intended to apply to sophisticated UCITS only, we recommend that the first sentence refers to 'relevant' techniques rather than 'every' technique.

Box 8: The link between risk management and asset valuation

Box 8, paragraph 2: the consultation paper states that the risk management function should provide adequate support to the valuation process concerning exposures to illiquid assets. Whilst we believe that the risk management function should support the valuation process, portfolio managers and traders should do this too. Furthermore, paragraph 40 says that assumptions and models underlying pricing of illiquid assets, structured securities and complex derivatives should be consistent with the risk measurement framework. As CESR's paper is on Risk Management Principles and not on pricing and the role that the Risk Management function should have in pricing, we believe that the entire section should be deleted.

Box 9: Risk management procedures

Box 9, paragraph 1: We suggest some amendments are made to this paragraph to align with current practice, i.e. that approval of investment objectives and risk management processes are made prior to the launch of the UCITS. Furthermore, the Board of Directors approves the risk profile of the fund, it does not define it.

Box 10: Risk limits system

Box 10, paragraph 1: As some risks are not quantifiable, no limits can be set. Therefore risk limit systems should be used to monitor relevant, quantifiable risks.

Paragraph 45: Ensuring that every transaction is immediately taken into account in the calculation of the corresponding limits is impractical and sometimes impossible. We therefore suggest this word is removed.

Box 11: Effectiveness of the risk management process

Box 11: In our response we have recommended that the theme of materiality and proportionality are used throughout the guidance. We therefore believe that a breach should be subject to appropriate corrective action.

Paragraph 47: Following comment immediately above, we have suggested that breaches should be corrected over an appropriate period of time so as to not disadvantage investors e.g., a fire sale of assets. We recommend the removal of the word prompt with 'appropriate' in both box 11 and paragraph 47.

Paragraphs 48 & 49: Where a risk management process uses back testing and models, normal market conditions tend to be the main assumption. We therefore recommend that the majority of paragraph 48 and all of 49 is deleted as it would be impractical.

Box 12: Reporting to the Board of Directors

Box 12, paragraph 2: A UCITS is not allowed actively to breach limits, so only unintentional. The reference to “expected” breaches should therefore be removed. We also recommend the removal of the word ‘prompt’ for the reasons given above.

Box 12, paragraph 3: To ensure consistency, the Board of Directors of the Company does not define the risk profile, it approves it.

Box 13: Monitoring of the risk management process

Box 13, paragraph 1: as the supervisory function is an integral part of the risk management process, we do not believe reference to it is required in this paragraph.

Box 13, paragraph 3: for clarity we recommend this paragraph refers to the Company’s internal or external auditors.

Appendix

PROPOSED LEVEL 3 MEASURES – CESR Guidance

General principles concerning risk management from the perspective of UCITS investors

1. On the basis of the previously mentioned legal provisions, it is possible to identify some key principles concerning risk management which should be complied with in order to ensure protection of UCITS investors. These principles mainly relate to:
(i) the governance and organisation of the risk management process;
(ii) the identification and measurement of risks relevant to the UCITS;
(iii) the management of risks relevant to the UCITS;
(iv) reporting and monitoring.
2. All principles corresponding to the four areas mentioned above should be implemented as part of a coherent set of internal rules that govern the process of identification, measurement and management of the risks incurred by UCITS investors, hereafter referred to as the risk management policy of the Company.
3. Finally, principles regarding risk management at the company level are supplemented by supervisory principles which should guide the review of these processes for the purpose of investor protection.

PART 1 – SUPERVISION

Box 1: Supervision by competent authorities 1. The adequacy and efficiency of the risk management process should be considered by the competent authorities as part of the process for licensing the Company, and subsequently monitored on an ongoing basis.

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4. Companies should comply at all times with the conditions on risk management.
5. The risk management process should be considered by the competent authority in the process for licensing the Companies, and subsequently monitored on an ongoing basis.
6. Material changes to the risk management process should also be notified to the Competent Authorities for their consideration.

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PART 2 - GOVERNANCE AND ORGANIZATION OF THE RISK MANAGEMENT PROCESS

Box 2: Definition of roles and responsibilities

1. In order to fulfil the duty to identify, measure and manage the risks relevant to the UCITS,
Companies should structure, operate and maintain an adequate and proportionate risk
management process, whose functioning and organisational rules should be established as part of the organisational rules adopted by each Company.

2. The risk management process should be appropriately documented, formalised and traceable in the procedures and organisational rules of the Company.

Deleted: The corresponding documents will be referred to as "risk management policy".

3. The risk management process is approved, reviewed on a regular basis and, if necessary, adjusted by the Board of Directors of the Company.

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4. The Board of Directors of the Company should be held accountable for the appropriateness of the risk
management systems and procedures.

7. In particular, with respect to the organisation and functioning of the process, it should:

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(a) identify the personnel and unit(s) that are in charge of the different parts of the risk management process;

(b) define the principles and methods for the periodic identification of the risks relevant to the UCITS;

(c) set out the terms of the interaction between the risk and the investment management function in order to keep the UCITS risk profile under control and consistent with the UCITS investment strategy;

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(d) define the terms and frequency of risk management reporting to Senior Management and to the Board of Directors of the Company.

Box 3: The risk management function

1. Companies should specifically identify the relevant unit, department or personnel in charge of carrying out the risk management tasks (the risk management function).

2. The risk management function should be hierarchically and functionally independent from the operating units, where appropriate and proportionate in view of the nature, scale and complexity of the Company's business and of the UCITS it manages.

3. The risk management function should implement the risk management policy and procedures and report directly to the Board of Directors of the Company and Senior Management. It should operate in accordance with adequate standards of competence and efficiency.

8. An efficient risk management function requires adequate means and organisation. In particular, the risk management function should have the necessary personnel, with the skills, knowledge and expertise needed to be accountable for the responsibilities that are placed upon them.

9. The risk management function should employ sound processes, professional expertise and adequate techniques and risk management systems.

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10. The risk management function is responsible for the identification, monitoring and measurement of risks and the implementation of the methods and procedures necessary for this purpose, including the drafting of the related documentation.

11. The risk management function should provide direct reports to the Board of Directors of the Company. These periodic reports should enable the Board of Directors of the Company to exercise oversight on the consistency between the actual level of risk incurred by the UCITS and its risk profile.

12. The risk management function should also provide reports to Senior Management, at the direction of the Board of Directors, which should enable them to assess the adequacy of the measures adopted to manage risks.

13. For the risk management function to operate successfully, a degree of separation from the Company's front-office functions is required.

14. Where it is not appropriate or practical to have a separate risk management function, the company should nevertheless be able to demonstrate that specific safeguards seek to ensure that risk management is carried out with an adequate level of independence.

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15. The portfolio managers should not be responsible for the measurement of the risks which they themselves have taken on, nor for the review of the specific limits or the overall risk limit system. Notwithstanding this principle of separation of functions, the risk management process should operate in parallel with, and should be intrinsically tied to, the investment process.

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process, for which an appraisal only at intervals will not be sufficient.

Box 4: Outsourcing

1. Outsourcing of risk management activities does not exempt Companies from retaining primary
responsibility for the effectiveness and appropriateness of the risk management process.

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2. The Company should properly and effectively supervise the carrying out of the outsourced activities. The Company should establish procedures for the periodic assessment of the Outsourcer's governance, technical and business environment, in order to monitor the quality and the appropriateness of its operations and risk management process.

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3. Outsourcing of the risk management function should not impair the ability of the competent authority to monitor the adequacy and efficiency of the risk management process and the Company's compliance with all its obligations.

16. Companies may delegate, for the sake of efficiency, the performance of risk management activities to a third party (Outsourcer) by written agreement.

17. Outsourcing of risk management activities should not impair the quality of the risk management process, oversight of which remains under the primary responsibility of the Board of Directors of the Company.

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18. The Outsourcer should have the technical ability and professional capacity to provide
the outsourced activities reliably and effectively. Outsourcing of risk management activities should always follow appropriate technical due diligence concerning the systems, methods and information used by the Outsourcer, including an assessment of any potential conflict of interests.

19. The Company should take appropriate action if it appears that the Outsourcer may not

be carrying out the outsourced activities effectively and in compliance with the applicable requirements.

20. Companies should in any event take all reasonable steps to ensure continuity to the risk management process in case of interruptions to the outsourced risk management activities (unexpected breaches of the contract, an urgent need to revoke the mandate, major infringements by the Outsourcer etc...).

21. The Company and its auditors should be able to obtain ready access to data related to the outsourced activities, as well as, if necessary, to the business premises of the Outsourcee.

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PART 3 - IDENTIFICATION AND MEASUREMENT OF RISKS RELEVANT TO THE UCITS

Box 5: Identification of risks relevant to the UCITS

1. The risk management function should identify material risks relevant for the UCITS.

Deleted: 1. The risk management process should assess and address all risks relevant to the UCITS.¶
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Deleted: Relevant risks should be identified among all possible risks incurred by the UCITS, according to the methods and principles defined by the risk management policy of the Company.

22. The risk management process should regard as relevant the material risks that stem from the investment objective and strategy pursued by the UCITS, the trading style adopted by the managers and the valuation process.

23. The identification of risks relevant to the UCITS should be conducted under the responsibility of the risk management function, whose advice should therefore help the Board of Directors provide a meaningful description of the risk profile of the UCITS. However, this identification process should not be a static exercise but, on the contrary, should be periodically revised to allow for possible changes to market conditions or the UCITS investment strategy.

24. The risk management function should carry out an appropriate identification of the material risks relevant to the UCITS without being bound by the use of a specific risk management model (techniques, methods and technical instruments).

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Box 6: Risk measurement techniques

1. The Company should specify the techniques and tools that are deemed suitable to measure the relevant risk factors attached to the investment strategies and management styles adopted for each UCITS.
2. The risk measurement process should allow adequate assessment of the concentration and
interaction of relevant risks at the portfolio level.

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25. Measurement techniques include both quantitative measures, as regards quantifiable
risks, and qualitative methods.

26. Ongoing risk management operations involve the computation of a number of quantitative measures (the risk measurement framework), more or less sophisticated in terms of meaning and methodology, which generally aim to address the effects of market risk, credit risk (including issuer risk and counterparty risk) and liquidity risk.

27. The computation of these (more or less sophisticated) measures is carried out by IT systems and tools, which may need to be integrated with one another or with the front-office and accounting applications.

28. Consequently, while the choice of the risk measurement framework should depend primarily on the characteristics of the investment strategies of the UCITS under management, this may also partly reflect the diversity in size and complexity of the business and organisation of the Companies. However, Companies should employ sufficiently advanced risk measurement techniques, being expected to keep up to date with and consider the use of leading market solutions in the interests of investors.

Deleted: (higher-risk profile UCITS may need more complex measures than plain low-risk profile ones)

29. If UCITS invest in structured products, their multiple risk components should be appropriately identified and managed.

30. When quantitative measurement of the effects of some risk factors is not possible, or produces unreliable results, Companies may consider integrating and adjusting their figures with elements drawn from a variety of sources, in order to obtain a comprehensive evaluation and appraisal of the risks incurred by the UCITS.

31. This approach is also likely to apply to the assessment of non-quantifiable risks. For the purpose of this paper, these risks should be taken into account only in so far as they have a direct impact on the interest of UCITS investors (e.g. risks attached to the technical features of the trading, settlement and valuation procedures which directly impact UCITS performance).

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Box 7: Management of model risk concerning the risk measurement framework

1. Companies should deal appropriately with the possible vulnerability of their risk measurement techniques and models (model risk).
2. The risk measurement framework should be subject to ongoing assessment and revision, and its techniques, tools and mechanisms should be adequately documented.

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32. The quality of risk model-based forecasts should be demonstrably assessed. Essentially, the risk management function should run documented tests to verify that model-based forecasts and estimates correspond, with the appropriate confidence level, to the actual values of the relevant risk measures (back-testing).

33. Back-testing should be carried out separately for every relevant techniques used in the risk measurement framework; tests should be run prior to inception (model calibration and internal validation) and, subsequently, on an ongoing basis to check how the model's viability and robustness hold up over time.

34. Companies should also assess in advance the validity range, market conditions and any
inherent or assumed limits of their risk measurements, which generally result from the assumptions underlying the models or the estimation of their parameters. This assessment should be carried out, if needed, through additional diligences which include stress tests. Companies should review their risk management methods whenever needed.

35. Stress tests are usually meant to capture the possibility of rare and severe losses which could occur during market shocks, and which are unlikely to be measured by the models as they tend to follow structural breaks in the functional relationships between market variables (sudden shifts of crucial model parameters).

36. Stress tests should cover all quantifiable risks which affect, to a material degree, the value of the UCITS, with particular attention given to those risks which are not represented with sufficient accuracy by the risk models used. Such risks might

include, for example, unexpected changes to price correlations or to asset (or even market) liquidity.

37. Stress tests may reflect subjective scenario hypotheses based on evidence concerning trading and market conditions (that may relate to either specific securities or an entire portfolio) during past periods of turmoil. However, such scenarios should not merely mirror historical conditions, but should elaborate on the assumption that similar dynamics could affect the risk factors arising from the UCITS' outstanding exposures.

38. When the investment strategy of the UCITS is based on specific trading or portfolio models and algorithms, the risk management function should be adequate to assess and control their use.

PART 4 – MANAGEMENT OF RISKS RELEVANT TO THE UCITS

Box 9: Risk management procedures

1. The Board of Directors should, prior to the launch of the UCITS, approve the product and risk profile of each UCITS managed by the Company. In the initial definition of the risk profile of the UCITS, or in the event of its subsequent revision, the Board of Directors should be advised by the risk management function.
2. The risk management procedures should ensure that the actual level of the risks incurred by the UCITS remain consistent with its risk profile as approved by the Board of Directors.

41. The risk profile of the UCITS should reflect the level of the identified relevant risks that arise from its investment strategy, as well as their interaction and concentration at portfolio level.

42. Risk management procedures can be understood as the set of actions aimed at: (i) identifying and measuring the relevant risks; (ii) assessing their consistency with the UCITS risk profile; (iii) fostering through the appropriate reporting channels the adoption of remedial measures in case of deficiencies; and (iv) monitoring the efficacy of the action taken.

Box 10: Risk limits system

1. 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.
2. These limits should be approved by the Board of Directors, and be consistent with the risk profile of the UCITS.

43. Without prejudice to the limits imposed by the UCITS Directive, a Company should
define for each UCITS the limits (the risk limit system) that should be complied with by
the UCITS to maintain consistency with the chosen risk profile. The risk limit system should be consistent with the UCITS' investment strategy.

44. The self-defined risk limit system provides for an appropriate way to manage and control risk and should be respected as part of the ongoing risk management process.

Deleted: Box 8: The link between risk measurement and asset valuation¶
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1. Risk measures should be computed having regard to sound and reliable data.¶
2. The risk management function should provide appropriate support to the valuation process concerning exposures to illiquid assets, structured securities and complex derivatives.¶
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39. If robust market prices are available, the risk measures should be computed relying on a complete and adequate time series of marked-to-market values. However, when measuring risks of illiquid assets, risk managers should thoroughly check the robustness of their estimates, testing the data used for the computation against the valuations of actual comparable trades.¶
40. Assumptions and models underlying pricing of illiquid, structured financial instruments (whether or not they embed derivatives) or complex derivatives should be consistent with the risk measurement framework used by the Companies. These should be maintained and revised over time accordingly (using back-testing etc.).¶

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45. The limit system should refer to the risk profile of the specific UCITS and should set appropriate limits for all potentially relevant risk factors. That is, it should cover all risks to which a limit can be applied and should take into account their interactions with one another. The Company should ensure that every transaction is taken into account in the calculation of the corresponding limits.

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46. The limit system should be clearly documented. Records should also be kept of cases in which the limits are exceeded and the action taken.

> **Box 11: Effectiveness of the risk management process**
>
> The risk management policy should define procedures that, in the event of breaches to the risk limit system of the UCITS, result in an appropriate correction of the portfolio and provide for the timing of this.

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47. The risk management process becomes effective when it allows actual control of the risk profile of the UCITS. In order to achieve this objective, the process should be designed to trigger a reaction, over an appropriate period of time so as to not disadvantage investors, from fund managers if the UCITS' target risk limit is breached. In order to ensure an efficient rebalancing of the portfolio in these circumstances, the risk management process should employ risk management tools and measurement techniques able to provide precise information about the most relevant risk factors to which the UCITS is exposed.

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48. The risk management process should allow warnings to be generated so that appropriate corrective measures may be taken on a timely basis to prevent breaches.

Deleted: While ongoing warnings should primarily relate to the imminent breach of the predetermined risk limits as set by the risk limit system of the UCITS, exceptional warnings may result instead from specific risk assessments addressing possible forecast scenarios that result from a particular concern.¶
49. In this context, stress tests may contribute to the generation of exceptional warnings, which should be adequately taken into account within the investment decision-making process.

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PART 5 –REPORTING AND MONITORING

> **Box 12: Reporting to the Board of Directors and the Senior Management**
>
> 1. Companies should implement and maintain efficient internal reporting by the risk management function. The terms, contents and frequency of this reporting should be defined.
> 2. The risk management function should report regularly to the Senior Management and, if necessary, to the heads of the different operational departments, highlighting the current level of the risks relevant to the UCITS, and outlining any actual breaches to their limits to ensure appropriate action is taken.
> 3. Periodic written reports should be submitted to the Board of Directors, providing an in-depth analysis of the consistency between the actual risks and the risk profile of the UCITS as approved by the Board of Directors.

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50. The Board of Directors should be informed regularly, through a formalised periodic reporting process, of the actual level of risk incurred by the UCITS. If the risk management function reports evidence that the risk profile of the UCITS needs to be updated, the Board of Directors should do so promptly.

51. Prior to the definition, update or change of the risk profile, the Board of Directors should consult the risk management function.

52. The risk management function should periodically report to the Senior Management about the results of the controls regarding the risk profile of the funds, the overall adequacy of the risk management and the measures taken to address any deficiencies.

Box 13: Monitoring of the risk management process

1. The Board of Directors should receive on a periodic basis written reports from the risk management function concerning: (i) the adequacy and effectiveness of the risk management process; (ii) any deficiencies in the process with an indication of proposals for improvement; and (iii) whether the appropriate remedial measures have been taken.
2. The risk management function should review the adequacy and effectiveness of measures taken to address any deficiencies in the risk management process.
3. The risk management process should be subject to review by the Company's internal or external auditors.

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53. The risk management function should periodically assess, and consequently report to the Board of Directors and Supervisory Function, the adequacy and efficiency of the structures, procedures and techniques adopted for risk management.