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GLOBAL ASSET MANAGEMENT

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

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These specialist investment managers include Legg Mason Capital Management, Western Asset, Royce & Associates, Brandywine Global Investment Management and Batterymarch Financial Management — each a wholly owned subsidiary of Legg Mason.

CESR Consultation

On 15 June CESR issued a consultation paper in relation to technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure. We are delighted to respond with the following answers to the specific questions raised in the consultation.

The Investment Management Association (IMA) in the UK has provided a detailed response to the consultation and our answers below are broadly in agreement with this. Furthermore we support the additional detailed analysis provided by the IMA with the regards to the majority of the questions, particularly in their request for additional clarification with regards to certain issues.

Answers to consultation questions

1. Yes
2. No, this should be reduced to its market risk dimension.
3. Agree. There does need to be clear guidance on embedded derivatives. This guidance needs to perhaps go further than the EAD and the associated CESR guidance on embedded derivatives. For example many regulators still require specific risk disclosure and the inclusion of "Warrants" in the measurement of market risk even when assurance and wording is supplied in the investment policy that such warrants will not embed derivatives.
4. Yes, but again guidance needs to be very clear on the treatment in terms of inclusion in the calculation. Another area of concern is that of liquidity risk where collateral from stock lending is/was invested in securities such as at the time A+ rated ABS/MBS and because of liquidity and downgrade issues higher redemption fees and or ADL were introduced to the detriment of investors. The instruments available for the reinvestment of collateral need to be more clearly defined as the market risk calculation will not necessary prevent or highlight this particular issue.
5. The consensus was that this approach would asses the market risk linked to the investment but may be very conservative
6. We were unsure of what was being proposed under this option and would appreciate further clarification of this method.
7. No.
8. Yes, but the list needs to be as long as possible and certainly longer than the current list. There should be a mechanism whereby this list can be updated regularly or as required.

9. No.
10. See answer to number 9 above.
11. No.
12. We agree with the approach regarding TRORS but need further clarity of the example and situation regarding derivatives with cash or an equivalent position.
13. Yes.
14. Compulsory and disclosed in the Prospectus.
15. Yes.
16. If it is to be compulsory and disclosed in the Prospectus we don't see the point in setting default sensitivity.
17. No.
18. Yes.
19. No.
20. Yes, but the paper states "UCITS that want to benefit from such hedging effects must be able to demonstrate that the prices of both the positions to be hedged and the financial derivative instrument always move in opposite directions and demonstrate a strong and negative correlation in all market conditions" which causes a concern, particularly given events over the last 12 months where virtually all asset classes seemed to correlate and move down. Instead we would favour wording that such as "current conditions prevailing at the time of entering into the hedging transaction" or "average market conditions".
21. Yes. We would suggest a similar limit to FAS 133 in the US. This is as follows

> "FAS 133 refers to the possible use of regression or correlation analysis to document hedge effectiveness, but does not provide specific guidelines for applying these methods or identify the minimal standards that must be met to qualify for hedge accounting treatment. In the absence of specific guidelines, the accounting industry has come to embrace the "80–125 dollar offset ratio standard" as a widely used reference for effectiveness testing. The dollar offset ratio is defined as the change in the value of the hedging instrument divided by the change in the value of the hedged item over the assessment period.
>
> Under this standard, a hedge is considered effective if there is a high degree of confidence that the dollar offset ratio will remain within a range of 0.80 to 1.25 over the hedge horizon (that is, the change in value of the hedging instrument will be between 80% and 125% of the change in value of the hedged item).
>
> The potential effectiveness of a hedging relationship refers to the strength of the historical relationship between a hedging instrument and the asset or liability to be hedged.5 It will also reflect the amount of risk reduction possible by applying the optimal (that is, minimum risk) hedge ratio to a given hedging instrument. By hedge ratio, we mean the position ultimately taken in the hedging instrument relative to the hedged item. The strength of the hedging relationship depends on the correlation between price changes in the hedged item and the hedging instrument under consideration. The amount of risk reduction possible is measured by the square of this correlation. Correlation or regression analysis should reveal the strength of the hedging relationship for alternative hedging instruments, and should thereby aid in choosing among them. This analysis also reveals the extent of risk reduction possible, given the choice of the preferred hedging instrument and the optimal hedge ratio. "

22. No.
23. Yes.
24. Yes and no additional suggestions.
25. Yes.
26. Additional safeguards could include – required prior agreement with the home regulator, stress tests, back testing, and disclosure of the maximum leverage levels or a range as measured

by the commitment approach in the Prospectus and marketing material, longer time periods for VaR criteria.

27. Yes

28. Greater clarification on the internal validation of the model. Who does CESR consider as suitable to carry out this validation? Could this be outsourced to a third party say the Depository or independent auditor? How often would revalidation need to take place?

29. Yes.

30. Statistical Distribution methodology; Volatility Inputs and methodology; Correlation Inputs and methodology; Pull back/mean reversion methodology; Back testing; Mathematical accuracy/ soundness; Models application to different asset classes; Transparency.

31. Yes.

32. Yes.

33. Yes.

34. Back testing of results and implementing necessary changes if too many anomalies result.

35. Yes.

36. Yes, provided there is full disclosure on possible leverage levels under the commitment approach.

37. It is possible that bond funds should have lower Absolute VaR limits than equity funds.

38. Yes.

39. Yes. Both Prospectus disclosure and marketing disclosure should be considered.

40. No with the exceptions of generally the more risk measurement tools available the better to safeguard, especially when the resulting UCITS has high or potentially high levels of leverage.

41. Yes.

42. No.

43. Yes, so long as the necessary legal agreements are in place and there is clear rules governing what is allowed and what should therefore be included in these agreements.

44. No.

45. Yes. No alternative solutions.

46. Yes, a list of specific instruments or instrument types would be preferred but there would need to be a mechanism for adding to the list.

47. Yes, but this may be difficult to monitor.

48. Yes.

49. No, with the exception that collateral received and passed should be subject to netting.

50. Yes.

51. Yes. Exposure will need to be subject to full disclosure and the additional safeguards in relation to funds employing a VaR methodology. There should additionally be greater influence on investor education at all levels, investment companies, local industry bodies, national regulators and at the EU level. The KII document will need to sufficiently and clearly explain the risk methodology and exposure levels.

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Legg Mason Investments (Europe) Limited