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The Committee of European Securities Regulators
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RiskMetrics Group's Reply to CESR's Consultation Paper regarding Proposed Level 3 Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

RiskMetrics Group was originally founded upon a measurement of market risk in a portfolio. The Value at Risk (VaR) measurement techniques that we documented in 1994 have since acted as the baseline for many internal and regulatory risk disclosure practices.

Subsequently, RiskMetrics has also developed frameworks for the measurement of credit risk, used within both trading and traditional banking books. Over time, these have also been incorporated into risk management processes.

RiskMetrics is an Outsourcer of risk measurement functions for UCITS across all the appropriate jurisdictions, both directly and indirectly to the Company that manages the UCITS. This includes the majority of Europe's leading asset managers, hedge funds, and custodians, as well as non-EU based asset managers who wish to launch UCITS vehicles. RiskMetrics appreciates the opportunity to submit its views on CESR's proposals, based upon best practices that we have observed, for the measurement of UCITS' global exposure.

As with previous responses that RiskMetrics has submitted, comments regarding the commitment approach are limited, and the emphasis of this response is around the use of VaR for the calculation of global exposure.

First, CESR is to be complimented for continuing to affirm its commitment to measure and control derivatives activity using, at least as one alternative, a model-based approach. Despite the recent criticism of risk models, they remain an objective, scalable way to measure risks, extend naturally to new asset classes and provide straightforward treatment of issues such as netting, hedging and offsets. A continued commitment to a model-based approach, coupled with necessary scrutiny, will only lead to better models and controls in the future.

The guidelines on using the commitment approach seem to be onerous for any UCITS with a significant concentration of financial derivatives, irrespective of whether they are used for hedging purposes. It is also unlikely that this will be the sole approach used by UCITS for their internal risk management process.

It would seem prudent for UCITS to take the conversion methods in Section 2, apply them to the calculation of issuer concentration, irrespective of the method used to derive global exposure. Assuming that this will be the case, as proposed in Box 26, RiskMetrics suggests that CESR complement the conversion methodologies with guidelines on the assignment of the commitment to an issuer, especially in the case of instruments which have multiple exposures, e.g. basket options, credit default swap indices, convertible bonds etc.

RiskMetrics would advocate a thorough appendix for the calculation of the commitments associated with Financial Derivative Instruments (FDIs), both for global exposure and issuer concentration.

Regarding the use of VaR to measure global exposure, CESR has produced a very balanced set of proposals, including the disclosure of risk measures used in the management process, although there should be a review as to whether there is too much emphasis placed on leverage measurement and

disclosure. RiskMetrics would advocate daily data collection and risk monitoring across all measures used by the UCITS in question.

To help counter the effects of varying market volatility through economic cycles, RiskMetrics also proposes that CESR recommend guidelines that will allow for the Maximum Absolute VaR level for UCITS across the EU to be adjusted by a centralized authority as part of a regular review process.

The methodology laid out for the calculation of counterparty risk in this proposal makes a significant assumption about the availability of daily liquidity. As we have seen over the past 24 months, daily liquidity should not be taken for granted. Whilst RiskMetrics acknowledges the simplification argument presented, we would ask CESR to complement the current proposals with recommendations to stress UCITS, to assess the impact on OTC counterparty risk of not having daily liquidity.

A more comprehensive set of responses can be found below. RiskMetrics greatly appreciates CESR's time and attention, and would be delighted to discuss our thoughts with the Committee in further detail.

Section 1 – Definition and Scope of Global Exposure

1. RiskMetrics agrees with the proposed Level 3 guidelines for the definition and scope of global exposure.

   The guidelines are proposing daily monitoring of global exposure at a minimum. There will be areas within the consultation paper where RiskMetrics believes that CESR's proposals do not concur with the best practices for daily monitoring of UCITS.

   For rigour and complete transparency, CESR may also wish to consider whether the UCITS should disclose any internal risk management measures and limits as part of the investment process.

Section 2 – Calculation of Global Exposure using the Commitment Approach

CESR is to be complimented on clarifying the commitment conversion methodology. Many UCITS, across all jurisdictions, have requested clarification on this issue.

It would seem prudent for UCITS to take these conversion methods and apply them to the calculation of issuer concentration, irrespective of the method used to derive global exposure. Assuming that this will be the case, as proposed in Box 26, RiskMetrics proposes that CESR compliment the conversation methodologies with guidelines on the assignment of the commitment to an issuer, especially in the case of instruments which have multiple exposures, e.g. basket options, credit default swap indices, convertible bonds etc.

Section 3 – Calculation of Global Exposure using the Value at Risk (VaR) Approach

3.1 General Principles and general requirement

21. RiskMetrics agrees with CESR that it is the defined risk profile that will determine the use of an approach such as VaR for the calculation of global exposure.

3.2 VaR Approaches – Relative and Absolute VaR – The Choice

22. RiskMetrics agrees with the proposals outlined in this section. Another method being used for selecting the reference portfolio entails replacing any leveraged instruments in the UCITS with its equivalent cash exposure. This allows VaR to be used to also determine the impact of leverage.

3.3 Relative VaR Approach

23. CESR's proposals for the use of relative VaR are widely used for UCITS currently, and are generally well accepted.

24. As CESR point out, the choice of the reference portfolio is the key when using the Relative VaR approach. The criteria proposed are well constructed. However, it is worth noting that whilst the risk is limited based on the reference portfolio, this does not mean that UCITS utilising the relative VaR approach are less risky than those UCITS utilising the absolute VaR approach.

25. UCITS assessing global exposure by means of the relative VaR approach must also be required to disclose the absolute VaR of the UCITS. This will provide greater transparency, and allow for better comparison between UCITS for investors and regulators.

3.4 Absolute VaR Approach

26. RiskMetrics agrees with CESR's description of the absolute VaR approach

3.5 Minimum requirements for VaR approach

3.6 VaR approach: Quantitative requirements

3.6.1 Calculation Standards

27. It has been stated earlier that the global exposures must be monitored on a daily basis at a minimum. Assuming that the UCITS has daily updates of prices, it should be eminently possible to be able to utilise daily data set changes, rather than the quarterly specified. As we have observed over the past 18 months, regime changes can happen suddenly. CESR should not encourage the use of stale data, irrespective of the market conditions.

    For clarity, and to avoid the "gaming" of reference portfolios, CESR should explicitly state that regardless of the VaR approach used to calculate global exposure, the absolute VaR of the UCITS cannot be greater than 20%.

    As is well documented, volatility varies through economic cycles, and tends to take on its lowest levels during bubbles or periods of significant expansion. The consequence of the Absolute VaR approach, then, will be to permit significant levels of leverage during expansions (when volatility is low), and constrain leverage during economic contractions, as volatility is higher. A UCITS following this approach and maintaining leverage at the maximum permitted level essentially becomes a momentum investor, buying in rising markets and selling in falling ones.

    To help counter the effects highlighted above, RiskMetrics proposes that CESR recommends guidelines that will allow for the Maximum Absolute VaR level for UCITS across the EU to be adjusted by a centralized authority as part of a regular review process.

28. Considering that the VaR approach will be used when there is a significant level of FDIs, it is unwise to allow the use of rescaling, as non-linear investment strategies will not be adequately represented.

29. Based on the principles set out, the examples provided are useful.

30. Seeing as the driver for using the VaR approach is the use of financial derivative instruments, which will exhibit high levels of leverage and non-linearity, it would be unwise to recommend the use of any approach that does not re-evaluate the UCITS in full under every simulation over the 20-day horizon recommended.

3.6.2 Risk Coverage

31. RiskMetrics broadly agrees with the requirements described in this section. RiskMetrics would like CESR to clarify under what circumstances additional risks, such as rating migration or default risk, should be systematically analysed.

3.6.3 Completeness and accuracy

32. The minimum requirements detailed by CESR in this section are welcomed by RiskMetrics. There are two key components to any VaR measurement process for a UCITS: the first is to model the link between the relevant risk drivers and the Net asset value (NAV) of the (assets held within the) UCITS; the second is to forecast movements in the underlying risk drivers, that are used to ascertain a change in the NAV of the UCITS, and hence an estimate of the risk.

    RiskMetrics believes that both of these components need to be transparent, well-documented and validated by the risk management function and the competent authorities. They also need to be independently verifiable (where applicable). RiskMetrics would ask competent authorities to review the validation process for UCITS VaR measurement; in particular the underlying data that drives the forecasting process.

3.6.1 Back Testing

33. RiskMetrics welcomes CESR's proposals that back testing should be used to validate the VaR model used, and the use of hypothetical P&L as the ideal choice for comparison in the monitoring process.

34. Whilst emphasis is placed on 'overshootings', it is also important to recognise that the model may need review if there are not enough VaR breaches, though this tends to be rarer in the industry.

3.6.2 Stress Testing

35. RiskMetrics welcome the text on the process to regularly define, monitor, disclose and manage stress tests.

36. The quantitative and qualitative requirements are well formed. However, the emphasis of the stress testing framework seems to be around changes in NAV, and a minimum requirement of monthly assessment. Best practice risk management process should go much further.

37. The stress testing framework should not only look at changes in NAV, but also changes in VaR utilising periods of significant stress. In addition, UCITS should be required to simulate potential increases in counterparty exposure.

    UCITS should be required to run stress tests that are consistent with the pricing methodologies used for VaR, which would also entail the daily monitoring of these tests.

3.7 VaR approach: Qualitative requirements

38. RiskMetrics strongly believes that risk management should not be seen as an isolated function, but as a core part of the investment process. CESR's proposals with respect to the risk management function seem to emphasise both the independence of this group, and the value in the interaction between the between the Board of Directors, the risk management function, and the portfolio managers.

    The proposals outlined here complement CESR's Risk Management Guidelines, and should be welcomed by the asset management industry as well as investors.

39. There are two keys components to any VaR measurement process for a UCITS: the first is to model the link between the relevant risk drivers and the NAV of the (assets held within the) UCITS; the second is to forecast movements in the underlying risk drivers, that are used to ascertain a change in the NAV of the UCITS, and hence an estimate of the risk.

    RiskMetrics believes that both of these components need to be transparent, well-documented and validated by the risk management function and the competent authorities. They also need to be independently verifiable (where applicable). RiskMetrics would ask competent authorities to review the validation process for UCITS VaR measurement; in particular the underlying data that drives the forecasting process.

3.8 VaR: Additional safeguards and disclosure

40. It is not always the case that the risk within a UCITS is due to leverage. Whilst leverage is important to monitor, the emphasis of the proposals should be based on a thorough, balanced assessment of all the risks that a UCITS carries.

41. CESR's proposals regarding prospectus disclosure are well-conceived.

42. RiskMetrics agrees that it is prudent for a UCITS prospectus to contain information about risk management processes, including the expected level of leverage. However, further work may be required on prospectus disclosure proposals, as investors have frequently been confused by the volume and differing content of such documents.

43. Assuming that each UCITS must calculate the level of underlying exposure for FDIs as part of the commitment approach, it would be practical for CESR to recommend using the same approach for the disclosure of leverage within a prospectus. Item 3 in Box 23 seems to indicate this approach, but may need further clarification.

44. RiskMetrics welcomes the increased transparency that CESR is proposing, both to investors and to the Board of Directors.

Section 4 – OTC Counterparty Risk Exposure

As RiskMetrics has stated in previous consultations, CESR's proposal for assessing the risk of OTC counterparties rely heavily on the assumption of daily liquidity.

RiskMetrics proposes that UCITS are required to stress their OTC exposures to counterparties, using methods such as the Potential Future Exposure approach, which simulates the valuations of both securities and collateral over multiple holding periods.

As stated earlier, given that CESR is recommending the use of the commitment approach for the derivation of issuer exposure, it would seem prudent for UCITS to take the conversion methods proposed in Section 2, irrespective of the method used to derive global exposure. RiskMetrics proposes that CESR complement the conversion methodologies with guidelines on the assignment of the commitment to an issuer, especially in the case of instruments which have multiple exposures, e.g. basket options, credit default swap indices, convertible bonds etc.

Section 5 – Cover Rules for transactions in FDIs

52. RiskMetrics agrees with CESR's proposals on the cover rules for transactions in FDIs.

Section 6 – Glossary

54. RiskMetrics welcomes the use of a glossary within the consultation paper

55. In a similar way, RiskMetrics would advocate a thorough appendix for the calculation of the commitments associated with FDIs, both for global exposure and issuer concentration.

RiskMetrics has also been in discussions with regulatory bodies in Europe, the US, and Asia regarding the risk management requirements around structured products, with special consideration of the requirements of the MiFID regulations. Currently, RiskMetrics is reviewing a very detailed analysis from CONSOB, which CESR may also wish to review as a basis for their thoughts on structured UCITS.

RiskMetrics hopes that CESR finds our responses above to the consultation useful. RiskMetrics greatly appreciates CESR's time and attention, and would be delighted to discuss our thoughts with the committee in further detail.

Yours sincerely

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