

27 March 2009

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008 PARIS – FRANCE

RiskMetrics Group's Reply to CESR Call for Evidence on Possible Implementing Measures Concerning the Future UCITS Directive

RiskMetrics Group was originally founded upon a measurement of market risk in a portfolio. These risk 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.

For investors around the world, funds which adhere to the UCITS standard are viewed extremely highly in terms of their transparency and risk management processes. However, concerns still exist with respect to whether funds registered in different member states apply the UCITS management guidelines homogeneously.

It is against this backdrop that RiskMetrics welcomes the European Parliament's proposal for a Directive containing amendments to the UCITS Directive (85/611/EEC), and the European Commission's request for assistance from CESR on the content of the implementing measures. RiskMetrics appreciates the opportunity to submit its views on risk management and the Key Investor Information (KII) that should be present within the Key Investor Document (KID) to CESR for consideration in its advice to the Commission.

PART I – 1.2.4. – Risk Management (Article 51)

Subsequent to the call for evidence, CESR also published its final advice on "Risk Management Principles for UCITS" (CESR/09-178). RiskMetrics contributed to the consultation process preceding the release of this document (CESR/08-616).

The aforementioned CESR Document also states that: "The principles will be complemented by a paper on the aforesaid technical and quantitative issues regarding UCITS portfolio parameters to measure global exposure, leverage and counterparty risk concerning financial derivative instruments." RiskMetrics looks forward to reviewing and commenting upon this document.

It is assumed that CESR's "Risk Management Principles for UCITS" will form the basis of any advice that CESR offers to the Commission with respect to Article 51. RiskMetrics would ask CESR to place particular emphasis upon the following:

1. The Risk Management Function should be a core part of the investment process, not just seen as an independent compliance unit.

From experience, “best practice” risk management processes have always involved a high level of interaction between the portfolio managers and the risk management team, where the latter can set up processes to actively monitor the specific investment decisions made by the former. Having significant insight into the investment strategies also enables the risk management function to quickly identify any operational abnormalities, e.g. portfolio managers positioning themselves to take advantage of any shortcomings of the risk management process.

In such a process, the portfolio managers, and the Board of Directors, can provide useful insight into the limits, e.g. the leverage requirement for UCITS under the “absolute” approach, which should be managed and monitored by the independent risk function.

RiskMetrics strongly believes that any adequate risk management should not be seen as an isolated function, but as a core part of the investment process. One of the criteria for this risk management function should be that it is represented at board-level. As the current market crisis has shown, transparency is critical across the financial institution, and any adequate risk management function should be mandated to provide such clarity.

For UCITS that choose to outsource (part of) their risk management function, e.g. to Management Companies, it is imperative that the Outsourcer is adequately resourced to rigorously identify and monitor the risks generated by the investment strategies of the relevant UCITS.

2. The Risk Identification and Measurement process must be consistent across all UCITS, regardless of the underlying investments.

In RiskMetrics’ opinion, CESR’s advice on the identification, measurement, and management of risks relevant to the UCITS published in the paper mentioned cannot be emphasised strongly enough in any advice offered to the Commission.

The risk measurement process used by each UCITS/Company to meet the regulatory requirement is currently determined by the use of derivatives, and does not reflect “best practice” for the management of the risks being generated by portfolio managers during the investment process. RiskMetrics believes that this leads to a lack of transparency for the UCITS investor.

RiskMetrics strongly supports CESR’s views that the risk profile of each UCITS should be determined by a rigorous risk identification process managed by an independent risk management function, and should not be determined by how derivatives are used in a UCITS – typically classified as non-sophisticated and sophisticated funds.

Each UCITS should be placed under the same level of scrutiny for the assessment of market, credit, liquidity and operational risks, on the provision that the techniques advocated for the measurement of such risks can be effectively applied to both the individual assets, and the overall UCITS, at any time.

3. The Risk Measurement techniques, and the data used to determine forecasts of risk, are transparent and independently verifiable

There are two key components to any UCITS risk measurement process: 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.

Movements in the underlying risk drivers can be generated systematically (e.g. event risk on a Money-Market Fund being driven by the average rate of drawdown over the past quarter, the exponentially-weighted moving average volatility of stock prices), or can be defined based on some sort of opinion (e.g. the current recession will turn into a 1930's-style "Depression"). Typically, it is the underlying data for the risk drivers that determine the forecasts made (e.g. the key equity index, nominal and inflation movements over the 1930's).

As has been witnessed with the modeling of sub-prime investments, where many risk managers estimated the risk of AAA-rated structured assets using data derived from AAA-rated corporate debt, there is no value in risk driver forecasts if they do not have any relevance to the assets in question.

RiskMetrics believes that both the modeling assumptions and the underlying data that drives the forecasting process need to be transparent, well-documented, as well as validated by the risk management function. They also need to be independently verifiable (where applicable). RiskMetrics asks CESR to review the validation process for UCITS risk measurement to take these issues into account.

4. The Commission must look to ensure that there are no potential ways in which key risk data could be monopolised, and that the data used to determine forecasts of risk is readily available to the risk management function.

In numerous cases, RiskMetrics has seen that risk management functions have identified the key risk drivers (or asset-modeling data) for assets with a UCITS, but are unable to access the underlying data for such drivers (e.g. credit-default swap spreads, waterfall structures behind structured credit investments) due to contractual limitations imposed by providers of such data. Many risk managers would argue that such data vendors are potentially monopolising key information that can help manage the risk of UCITS.

RiskMetrics would ask CESR to advise the Commission on providing a regulatory landscape whereby the risk management function would be able to readily access the relevant data, to allow for better forecasting and risk measurement, within reasonable contractual boundaries.

PART II – 2.2.1. – Content and Presentation of KII (Article 78(7))

Whilst RiskMetrics understands the "raison d'être" for the Key Investor Information (KII) within the Key Investor Document (KID), we feel that it is necessary to register our concerns that the risk of a UCITS may be greatly misrepresented by what is being proposed for the risk-reward indicators in the KID. RiskMetrics feels that investors will demand some level of transparency into the risk of the UCITS, and therefore the KID should be expected to report some of the same risks as seen by the Board of Directors of the UCITS.

RiskMetrics will nevertheless look forward to responding to CESR's "Consultation paper on technical issues relating to Key Information Document (KID) disclosures for UCITS" (CESR/09-047). RiskMetrics assumes that the results of this specific consultation process will form the foundation of CESR's advice to the Commission on the KII Level 2 Measures.

Looking through previous CESR consultations on the risk management function for UCITS, we have noticed that very few responses have been attributed to the many existing risk management teams that monitor UCITS. If CESR would consider it beneficial at this stage of its process, RiskMetrics would be delighted to set up a series of confidential "one-on-one" meetings between CESR and the risk management teams that we work with on UCITS, whereby CESR can gather evidence "first-hand" from practitioners who will be expected to act upon any recommendations made by CESR and the Commission. RiskMetrics has had provisional dialogue with a couple of interested parties, should CESR wish to pursue this.

RiskMetrics hopes that CESR finds our responses above to the call for evidence 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

A handwritten signature in black ink, appearing to read 'Kaylash Patel', with a stylized flourish at the end.

Kaylash Patel
Head of Institutional Business Strategy, EMEA
RiskMetrics Group
1 Commodity Quay
East Smithfield
London E1W 1AZ
Tel: +44 (0) 20 7063-5663
Fax: +44 (0) 20 7063-5601