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The Committee of European Securities Regulators
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RiskMetrics Group's Reply to CESR Consultation Paper on Risk Management Principles for UCITS

As each member state implements its interpretation of the UCITS III framework, it has become apparent that the prescriptions for investment and risk management vary across the European Community, arguably leading to "regulatory arbitrage", where certain jurisdictions are favoured above others for certain investment strategies.

In addition, the risk measurement process used by each UCITS/Company to meet the regulatory requirement is typically 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.

It is against this backdrop that RiskMetrics welcomes the publication of CESR's consultation paper on "Risk Management Principles for UCITS", and appreciates the opportunity to comment upon it.

By way of background, 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. 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.

RiskMetrics broadly supports CESR's Level 3 proposals within the consultation paper, especially the proposals with respect to the governance and organization of the risk management process, as well as the identification, measurement, and management of risks relevant to the UCITS.

RiskMetrics endorses 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. The use of limits, model-based risk analyses, stress testing, and backtesting across each UCITS, based on specific risk identification processes, are strongly advocated by RiskMetrics. CESR's proposals on continuous assessment of the risk management process are well conceived.

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. A recent Senior Supervisors Group review[1] on risk management practices during the market turbulence in 2007 states:

[1] Observations on Risk Management Practices during the Recent Market Turbulence – March 6, 2008 - http://www.sec.gov/news/press/2008/report030608.pdf

“At firms that avoided significant losses, risk management had independence and authority but also considerable direct interaction with senior business managers and was not viewed as remote from the businesses. While the independence of risk management functions was not cited as an issue at the firms visited for this review, the degree to which risk management functions interacted with business line management was lower at firms that experienced greater difficulties during the turmoil.”

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.

CESR’s proposals with respect to the risk management function, and elsewhere in the consultation paper, seem to have an emphasis on the separation of duties between the Board of Directors, the risk management function, and the portfolio managers. RiskMetrics strongly believes that risk management should not be seen as an isolated function, but as a core part of the investment process. We believe that there is value in the interaction between the groups highlighted above, and would therefore ask CESR to enhance their proposals to take this into account.

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.

PART 1 - SUPERVISION

Box 1: Supervision by competent authorities

RiskMetrics supports CESR’s proposals with respect to competent authorities assessing the adequacy and efficiency of the risk management process as part of the licensing process for any UCITS/Company.

The general principles concerning risk management from the perspective of UCITS investors include “the identification and measurement of risks relevant to the UCITS”. To uphold this principal, RiskMetrics believes that any “adequate” risk disclosure process should commit to providing high levels of transparency, and providing suitable information/explanation wherever opacity lies within the UCITS/Company.

PART 2 - GOVERNANCE AND ORGANIZATION OF THE RISK MANAGEMENT PROCESS

Box 2: Definition of roles and responsibilities

RiskMetrics supports CESR’s proposals with respect to the definition of roles and responsibilities within the risk management process.

The intrinsic link between the risk management process and the investment process is noted in CESR’s proposals on the risk management function (see next section). It is worth noting that investments operating under UCITS are highly likely to be managed and/or monitored for other internal and regulatory requirements, e.g. based on the fund prospectus, MIFID, and IFRS7, each with their own risk disclosure requirements, and each potentially having an influence on investment decisions for the UCITS/Company.

In addition to the proposals with respect to the definition of roles and responsibilities, and to improve fund transparency, RiskMetrics believes that CESR should review whether the “risk management policy” documentation should contain summary information on any related regulatory risk disclosure requirements that affect investment decisions for the UCITS/Company.

Box 3: The risk management function

In our view, independence is imperative for every institution's risk management process, and so CESR's proposals with respect to the risk management function are strongly supported by RiskMetrics.

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. In such a process, the portfolio managers 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.

Proposals with respect to the risk management function, and elsewhere in the consultation paper, seem to have an emphasis on the separation of duties between risk managers and portfolio managers, but RiskMetrics believes that there is value in interaction between these groups. In this set of proposals, RiskMetrics would ask CESR to review Point 15 of the consultation paper, in particular whether to amend the text to indicate that portfolio managers "should not be solely responsible for the review of specific limits."

Box 4: Outsourcing

RiskMetrics fully support CESR's proposal with respect to the outsourcing of the complete risk management function.

As a provider of risk measurement functions for UCITS across all the appropriate jurisdictions, both directly and indirectly to the Company that manages the UCITS, RiskMetrics will look to adhere to the high standards set in these proposals, especially around the technical ability and professional capacity to provide the outsourced activities reliably and effectively, as well as the continual transparency around the systems, models, and information regarding RiskMetrics as a company.

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

Box 5: Identification of risks relevant to the UCITS

CESR's proposals for the identification of risks relevant to the UCITS are supported by RiskMetrics.

For the risk management function to be able to identify the risks relevant to the UCITS, the function must have a high level of ongoing communication with the portfolio managers, as Points 22 & 23 imply, and RiskMetrics advocates as "best practice". In addition, the identification process links in neatly with the limit review objectives set out earlier in CESR's proposals for the risk management function.

Whilst it is important not to be too prescriptive in setting risk management principles, RiskMetrics asks CESR to consider adding a (non-exhaustive) list of relevant risks, for guidance purposes only, that the risk management function should look to identify.

Box 6: Risk measurement techniques

Many of the "competent authorities" licensing UCITS/Companies make reference to non-sophisticated and sophisticated UCITS. Market risk for non-sophisticated funds is typically measured using a commitment approach, whilst more advanced techniques are used for sophisticated funds, including stress testing and Value-at-Risk analysis. RiskMetrics strongly believes that the measurement of market risk, credit risk (including event risk), and liquidity risk should be prescribed based on the risk identification proposals outlined by CESR, rather than by rules on how derivatives have been used within the UCITS. It should be the risk identification process that determines the risk measurement techniques employed.

Arguably, recent market turbulence has reinforced the views of authorities, such as BaFin and the AMF, that every UCITS should be monitored under the more rigorous risk measurement techniques recommended for sophisticated funds, which typically include some of the exposures measured for non-sophisticated funds, thereby removing the need for such a classification. CESR's proposals with respect to risk measurement techniques seem to indicate a similar view, and RiskMetrics strongly supports them.

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

As with the proposals with respect to risk measurement techniques, CESR's proposals for the management of model risk seem to apply to any relevant UCITS, regardless of the use of derivatives. If that is the case, RiskMetrics strongly supports these proposals.

Even though RiskMetrics developed the Value-at-Risk process that the majority of institutions use for the statistical measurement of market risk, we have always highlighted that this is just one measure of risk (see below), and that it should be continually back-tested on a case-by-case basis. RiskMetrics applauds CESR's proposals to use backtesting in such a way as to lower model risk.

RiskMetrics would like to highlight that, in our experience, only certain uses of stress testing directly address model risk, e.g. stress tests that evaluate how "costly" it is to make assumptions that certain underlying risk factors are perfectly correlated, or that a basis has volatility zero. The majority of generic stress testing isn't necessarily a test of a statistical model, but is correctly used to complement it.

RiskMetrics has always asserted that the risks associated with a UCITS should be measured with complementary techniques to any statistical measures, such as stress testing. The types of stress tests proposed by CESR in Points 35-37 are strongly advocated by RiskMetrics as "best practice".

As part of the risk identification process proposed by CESR, the risk management function should be tasked with the periodic review of stress scenarios that are used for each UCITS. This will involve setting up scenarios to stress investment processes and strategies outlined by portfolio managers, again highlighting the level of communication required between the two parties.

Box 8: The link between risk measurement and asset valuation

Based upon the IAS 39 standards that many UCITS companies may adhere to for asset valuation, "fair value" is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. IAS 39 provides a hierarchy to be used in determining the fair value for a financial instrument: [IAS 39 Appendix A, paragraphs AG69-82]

a. Quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.

b. If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.

c. If there is no active market for an equity instrument and the range of reasonable fair values is significant and these estimates cannot be made reliably, then an entity must measure the equity instrument at cost less impairment.

This hierarchy seems to be similar to the basis of CESR's proposals with respect to the link between risk measurement and asset valuation. If this is the case, RiskMetrics supports CESR's proposals, and would ask CESR to consider making reference to the standard that is being utilised for clarification.

PART 4 – MANAGEMENT OF RISKS RELEVANT TO THE UCITS

Box 9: Risk management procedures

RiskMetrics supports CESR's proposals with respect to risk management procedures, and also believe that it would be prescient for CESR to offer guidance on the how the risk profile could be constructed for each UCITS.

Box 10: Risk limits system

RiskMetrics supports CESR's proposals regarding the implementation of a risk limits system. As trade volumes, and trade volatility, fluctuate dramatically in the current environment, on-demand access to the limit calculations, e.g. to take into account any new positions as stated in Point 45, will become a much more important feature of the risk management process for a UCITS/Company.

Box 11: Effectiveness of the risk management process

Based on the experiences from the RiskMetrics user community, many institutions employ a system of risk thresholds, which instigate a series of conversations between portfolio managers and the risk management team regarding the investment process. This can either lead to a re-assessment of the existing limits for the UCITS, the creation of new limits based on updated risk identification processes, or the implementation of a risk mitigation strategy. It is worth noting that this is a process between two groups, and both share the responsibilities for measurement and action.

Limit breaches tend to be rare, but risk concentration and decomposition is essential to be able to promptly act upon each breach.

Whilst supporting CESR's proposals on the effectiveness of the risk management process in principle, RiskMetrics believes that the proposal should also reflect that "best practice" involves close co-operation between portfolio managers and the risk management team to assess the most appropriate procedures to undertake when leveraging the limit measurement and management process.

PART 5 – REPORTING AND MONITORING

Box 12: Reporting to the Board of Directors and the Senior Management

RiskMetrics strongly advocates the implementation and maintenance of an efficient internal and external risk reporting process by the independent risk management function, and thereby fully support CESR's proposals with respect to reporting to the Board of Directors and the Senior Management.

Box 13: Monitoring of the risk management process

RiskMetrics welcomes CESR's proposals on the monitoring of the risk management process, which will undoubtedly include the independent oversight of Outsourcers for risk management and measurement.

The Board of Directors and any Supervisory Function have a huge amount of experience and insight that should be leveraged by the risk management process for any UCITS/Company. RiskMetrics advocates a much deeper level of engagement between the risk management function and "The Board", and therefore would ask CESR to consider enhancing the relevant proposals to reflect this view.

RiskMetrics hopes that CESR finds our responses above to the proposals in the consultation paper useful. Once again, 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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