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CESR
11-13 avenue de Friedland
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Subject: Response to CESR's technical advice on risk measurement for UCITS

Robeco welcomes CESR's technical advice to the Commission focusing on risk measurement for the purposes of calculation of UCITS' global exposure. Although we feel comfortable with and agree upon most of the proposals, we do have some points where we feel the proposed methodology could be enhanced or where a different approach would be more suitable.

Please find below the detailed response of Robeco to the CESR Consultation Paper. First we will address the main points where we would suggest a different approach, followed by the response to all questions of the Consultation Paper.

Main remarks

A general point (question 1) is that we are not fully comfortable with the use of global exposure limits. We are of the opinion that the goal should be to set restrictions on the overall risk profile of the fund. Whether that risk is taken via cash positions or derivative positions should not matter (from a market risk perspective). As such, we are of the opinion that the usage of the global exposure (limit) does not do full justice to the intended goal. Additionally, it does not make sense to have a limit on global exposure if there are different approaches to go about measuring and monitoring that measure (Commitment and VaR). We are of the opinion that the directive should clearly indicate that two approaches can be used. The Commitment approach, where exposure is limited to 200% of the NAV of the fund, and the VaR approach. The VaR approach should not be linked to the global exposure definition.

We also propose (question 35) to supplement the approaches put forward in the Circular for restricting the global exposure, with a third approach: limit the 99% 1-month relative VaR (where relative VaR is defined as the Value of Risk of the excess returns of the portfolio over the reference index). A limit of 20% (identical to the limit on the absolute VaR) would be in line with the line of thought put forward in the CESR approach.

Detailed response to all questions

1. Do you agree with the proposed approach in relation to the calculation of global exposure?

We are of the opinion that the goal should be to set restrictions on the overall risk profile of the fund. Whether that risk is taken via cash positions or derivative positions should not matter. As such, we are of the opinion that the usage of the global exposure (limit) does not do full justice to the intended goal.

Additionally, it does not make sense to have a limit on global exposure if there are different approaches to go about measuring and monitoring that measure (Commitment and VaR). We are of the opinion that the directive should clearly indicate that two approaches can be used. The Commitment approach, where exposure is limited to 200% of the NAV of the fund, and the VaR approach. The VaR approach should not be linked to the global exposure definition.

We are also of the opinion that one should not try to combine different risk types (i.e., market, credit and liquidity) in one risk measure.

2. Should the counterparty risk involved in an OTC derivative be considered in the calculation of global exposure

No, we refer to the answer to question 1.

3. Do you agree with the proposed approach or can you suggest an alternative approach?

Yes, we agree.

4. Do you agree that the incremental exposure/leverage generated through techniques such as repurchase and securities lending transactions should be included in the calculation of global exposure?

Yes, we agree.

5. Does option 1 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?

In our view this is a very crude and conservative approach.

In addition, as it does not cover all the derivative positions, it would be necessary to combine options 1 and 2, which is far from ideal.

6. Does option 2 correctly assess the market risk linked to investment in the corresponding instruments, and if so please explain?

Yes, but it does not take into account non-linear risks. An add-on, which accounts for the non-linear risks is one way to resolve this shortcoming.

7. Do you have any comments or other suggestions regarding other possible measurement approaches?

Refer to the answer to question 6.

8. Do you agree with the proposed approach, in particular the inclusion of a non-exhaustive list of financial derivatives?

Yes, we agree.

9. Do you have any alternative suggestions for the conversion method?

Refer to the answer to question 6.

10. Are there other types of financial derivative instruments which should be included in the paper?

Various:

- Contract for Difference,

- Cross Currency Swap,
- TBA,
- Inflation Linked Swap,
- Money Market Futures

11. Are you aware of any type of financial derivative instrument where global exposure cannot be calculated using the commitment approach?

Derivatives with an untraded underlying, e.g.:

- Future on VIX
- Variance Swap

12. Do you agree with the approach regarding TRORS and derivatives with cash or an equivalent position?

Yes, we agree.

13. Do you agree with the proposed use of the sensitivity approach?

No, in our point of view this is an affected approach. In addition, you would expect a commitment approach to come up with an identical exposure whether taken via a cash position or a derivative position. This is not true for the proposed approach. Furthermore, the introduction of the sensitivity approach would increasingly move the commitment approach to a hybrid between an exposure approach and a risk-based approach. We do not advocate such an approach, given the intransparency involved.

14. Do you consider that this should be compulsory for these types of derivative or optional for UCITS?

Refer to the answer to question 13.

15. Do you agree with the analysis of the sensitivity approach described?

Refer to the answer to question 13.

16. What quantitative level would you consider appropriate for the default sensitivity?

Refer to the answer to question 13.

17. Do you have any additional comments or suggestions on this approach?

Refer to the answer to question 13.

18. Do you agree with the proposals regarding netting?

Yes, we agree.

19. Do you have any additional comments and/or proposals?

The proposal focuses on netting of portfolio positions. It does not do justice to a derivative transaction which is used to bring a portfolio in line with a reference index/benchmark. For a benchmarked portfolio, the benchmark should be regarded as the "neutral" position, i.e. any derivative transaction bringing the portfolio more in line to the benchmark should be seen as a decrease of the exposure (and as a very minimum not as an increase). In addition, we would expect further clarification on the treatment of non-linear derivatives (e.g., options) in the netting proposal.

20. Do you consider that hedging as described above should be permitted?

Yes, we agree.

21. Do you consider that the strong correlation requirement should be further clarified by means of a quantitative threshold e.g. 0.9?

Yes, although the beta of the “hedge” should be accounted for.
Correlation does not take into account volatility differences. Two securities can be perfectly correlated, but the beta (and thus the volatility) might be very different.

22. Can you suggest a possible threshold e.g. for the minimum correlation between stock baskets? Please justify your answer based on relevant market data.

We believe an approach with a limit on the risk (e.g. volatility) of the return of the netted position is restricted. The objective of a hedge should be to minimize the residual risk. As such, one could also require that the residual risk (in terms of volatility or VaR) of a hedged position is restricted.

23. Do you agree with this proposal?

Yes, we agree.

24. Do you agree with this definition? Do you have any alternative suggestions?

Yes, we agree.

Alternative: Conditional VaR (focusing on risk under extreme cases)

25. Do you agree with the above approach?

Yes, we agree with the approach, but (referring to question to answer 1), would not want to refer to global exposure. The goal should be to limit risk in the portfolio, not to ensure that “total exposure is within 200% of NAV”.

26. What additional safeguards (if any) are necessary for UCITS which use VaR to calculate global exposure to ensure consistency with the total exposure limit of 200% of NAV?

Refer to the answer to question 25.

Additional measures that may be deemed appropriate: gross market exposure and net market exposure.

27. Do you agree with the approach outlined in paragraphs 2.3, 2.4 and 2.5?

Yes, we agree.

28. Do you have any comments or suggestions?

No, we do not.

29. Do you consider that VaR should be calculated at least daily?

The frequency may be made dependent on the frequency of portfolio adjustments and/or the chosen risk horizon. However, we do believe that a frequency of daily for all portfolios is straightforward.

30. What type of criteria should competent authorities take into account in an assessment of the VaR Models?

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31. Do you consider that VaR models should be approved by competent authorities?

We would prefer a set of requirements (which could then also be used by authorities as the basis for an approval process).

32. Is the proposed 3-step relative-VaR approach adequate to limit the global exposure of a UCITS?

From our point of view, the VaR approach does serve to limit the overall risk of the portfolio. As indicated in answer to question 1, we are hesitant to combine global exposure and VaR. Both the commitment approach as well as the VaR approach serve to limit risk.

Note that we would be in favour of renaming Relative VaR to Ratio VaR, given that Relative VaR is typically used in the market to refer to the VaR of the difference (and not the ratio) between a portfolio and a benchmark.

33. Do you consider that the proposed limitations on the reference portfolio constitute reasonable and adequate safeguards to ensure that the relative VaR method does not result in the UCITS taking excessive risk or leverage?
Yes, we agree

34. What additional safeguards (if any) do you consider necessary?
Refer to the answer to question 26.

35. Can the absolute VaR be considered as an appropriate way of measuring global exposure?
Refer to the answer to question 32. We agree that absolute VaR can be readily used to limit the overall market risk of a portfolio. However, it is a bit peculiar to state that "200% global exposure limit" can be implemented via a "20% absolute VaR limit".

We propose to supplement the approaches put forward in the Circular for restricting the global exposure, with a third approach: limit the 99% 1-month relative VaR (where relative VaR is defined as the Value of Risk of the excess returns of the portfolio over the reference index). For a further argumentation please also refer to the answer to question 19. A limit of 20% (identical to the limit on the absolute VaR) would be in line with the line of thought put forward in the CESR approach.

In our opinion the approaches proposed by CESR (3-step relative VaR and absolute VaR) does not do justice to the investment approach of many asset managers. The approach gives ample room to take active risks in an equity portfolio, whereas the room to do so in fixed income portfolios is limited. Taking a conservative view, the relative approach limit imposed by CESR implies that the tracking error¹ of the fund cannot exceed the volatility of the reference index².

The objective of active portfolio management is to maximize the active return (i.e., return over benchmark) subject to risk constraints. The limit on active risk is dictated by the risk appetite, as well as the capacity to take active risk given the type of portfolio. We see no evident rationale to make the active risk dependent on the risk of the asset class in question (i.e., to link the amount of active risk that can be taken to the risk of the reference portfolio / benchmark).

Taking the proposed relative VaR (or tracking error) approach, which focuses solely on the active risk component, is in our opinion a more meaningful approach to risk measurement and monitoring for funds that are managed versus a reference index.

36. Do you consider that the proposed thresholds are suitable? Can you suggest other thresholds?
Yes. Thresholds could be made dependent on asset category / instrument universe of the fund.

37. What are your views on the application of stricter criteria to difference types of asset classes e.g. bonds, equities?
Refer to the answer to question 36.

¹ Tracking error is defined as the annualized standard deviation of the differences in return between the portfolio and the reference index.

² For illustration purposes we assume that the Value at Risk ("VaR") of a portfolio is a linear function of the funds absolute volatility. We also assume that active return (i.e., excess return of portfolio over benchmark) manifests a perfect positive correlation with the benchmark return. Under these assumptions the absolute (parametric) VaR of the portfolio is equal to the sum of the absolute VaR of the benchmark and the relative VaR of the portfolio.

38. Do you consider the proposed safeguards, such as the use of appropriate additional risk management methods (stress-testing, CVaR) and the disclosure of the level of leverage, are sufficient safeguards when the absolute VaR method is used in the context of arbitrage strategies or complex financial instruments?

Yes, although we believe that for similar strategies an elaborate description of the investment strategy in the prospectus is all the more important.

Note that stress testing is not just an important additional safeguard for the absolute VaR method, but also for the relative VaR method.

39. Should UCITS using strategies that are potentially highly leveraged under the absolute VaR method be subject to specific marketing provisions, either at the level of the UCITS (minimum initial investment) or during the marketing process?

No, but refer to the answer to question 38.

40. Can you suggest alternative safeguards and/or requirements to avoid UCITS engaging in strategies which generate high levels of leverage?

Additional measures that may be deemed appropriate: gross market exposure and net market exposure.

41. Do you agree with the proposed method for calculating counterparty exposure?

No, we would be in favour of using an add-on approach given that by the very nature of OTC derivatives there is no assurance that they can be liquidated in a time horizon of one day.

We are in favour of discarding of risk-weights. Given that that will increase the overall exposure compared to the current approach, we are of the opinion that the levels of the restrictions should be reviewed (and most likely increased).

42. Can you suggest an alternative method?

Use an add-on approach, or permit the use an internal model approach (comparable to methodology set forward in Basle II).

43. Do you agree with the approach for netting arrangements?

Yes, we agree.

44. Do you consider that additional netting rules should apply?

No, we do not.

45. Do you agree with the proposed approach to agree a set of principles in relation to acceptable collateral to reduce counterparty exposure? Do you have alternative suggestions?

Yes, we agree.

46. Do you consider that rather than following principles based approach specific instruments that can be used as eligible collateral should be identified?

No, we would prefer a set of principles.

47. Should collateral be UCITS compliant in terms of asset eligibility and diversification?

No, as collateral serves as a second line of defence. Collateral does not serve to impact market risk and liquidity risk, but to limit losses in the event of a default of a counterparty.

48. Do you agree that collateral passed to a derivative counterparty should be include in the either the 5%/10% OTC counterparty limit or the 20% issuer concentration limit?

Only for the part of the collateral that exceeds the (negative) value of the outstanding derivatives.

A further elaboration: If the value of the outstanding collateral is lower than the (negative) market value of the derivatives, the fund has no direct credit exposure to the derivative counterparty. In this scenario it would not make sense to include collateral in the counterparty limits.

If however, the level of the collateral exceeds the (negative) market value of the derivatives, the net exposure to the counterparty (i.e., collateral – market value derivatives) should be included in the counterparty and/or concentration limits.

49. Do you have any other suggestions as to how such collateral passed should be treated?

No, we do not.

50. What areas of further work should be carried out with regard to this?

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51. Do you agree with the proposal to abandon the use of the term sophisticated and non-sophisticated UCITS?

Yes, we agree. We are of the opinion that the current distinction between sophisticated and non-sophisticated UCITS is unclear and, furthermore, has no added value.

52. If you object to this proposal could you please provide reasons for this view?

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Yours sincerely,
Robeco

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