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Response to Consultation Paper on

CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure Ref.: CESR/09-489

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INTRODUCTION

StatPro Group plc is a public company specializing in data and portfolio analytics for the investment management industry. Our solutions range from performance measurement and attribution, risk management and governance, to independent valuation for financial instruments and their derivatives.

StatPro has been involved in UCITS risk management requirements since 2004, when we successfully performed one of the first UCITS III "VaR system implementations" in Germany. Since that time we have partnered a number of clients in the buy-side industry on UCITS risk projects throughout Europe following both the Commitment and the VaR approach.

During these years we have dealt with the implementation of the UCITS directive 85/611/EEC into national investment law within the Member States and helped industry participants implement their risk management processes in line with regulatory requirements.

We thank CESR for inviting stakeholders to provide comments on the Consultation Paper 09-489 dated 15 June 2009. In the following we provide feedback based on our experience.

It is our opinion that investor protection can only be achieved by ensuring risk transparency of a UCITS and by giving regulatory guidance in the way these risks are computed and presented. The alchemies of financial engineering today allow complex risks to be embedded in instruments that appear simple and not leveraged. A well designed risk management process will lead to improved investment processes at asset management companies and eventually result in improved investor protection.



In general StatPro views the VaR approach as the most suitable measure to capture market and credit risk in a homogeneous way for all financial instruments and to enable a proper representation of the risk-reward profile of a UCITS. It is StatPro's opinion that the use of the VaR approach is leading to a more reliable risk management environment for UCITS capturing all the complexity that financial innovation has introduced even in so-called simple and every-day products for the investor. We also agree with some of the more recent criticism of VaR measures and believe that these measures and methodologies can be improved. In our responses we propose to:

- improve the quality of VaR models and increase their back-testing effectiveness even in times of extreme stress;

- introduce into VaR figures a component of counter-cyclicality to mitigate and in some cases reverse the "pro-cyclicality" of these measures;

- fill the gap in market liquidity risk.



COMMENTS ON VAR APPROACH

2.2 Compliance of the VaR methods with the provisions of Directive 85/611/EC

Question no. 25 – Do you agree with the above approach? Question no. 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?

StatPro agrees that the VaR approach fully and explicitly respects the criteria set forth in Article 51 (3) of the new UCITS directive. It is our understanding that VaR is an appropriate risk measure.

It is true that the use of a VaR-only approach can generate total exposures higher than 200%. It is possible to add to the VaR approach the extra-safeguard of an exposure check. The difficulty lies in defining a universal and robust methodology for the exposure computation.

We believe that any regulatory effort should focus on ensuring the robustness of VaR measurement processes in the UCITS and on filling the gaps demonstrated by VaR approaches in the recent crisis.

In light of evidence that emerged during the recent credit crisis we propose to reinforce the VaR approach with a specific measurement of market liquidity risk.

The definition of a holding period for VaR ensures that the measure accounts for a maximum period for liquidating the assets of a UCITS. E.g. if the holding period is one month, the implicit assumption is that all the assets of the UCITS may be liquidated during that period. While this assumption may be correct, the existence of bid/ask spreads can still generate a higher loss distribution than the one assumed by the VaR measure.

UCITS should therefore accompany "traditional VaR" with a measure of liquidity risk that takes into account the existence of bid/ask spread and the risk that these spreads widen through time.

The addition of liquidity risk measurement will avoid excessive leverage positions being built on instruments with lower liquidity or subject to a risk of liquidity impairment under conditions of market stress.

This prescription should remedy one of the main weaknesses shown by VaR approaches during the crisis: the absence of a dedicated measure of liquidity risk.



2.3 Common VaR calculation models

2.4 Inputs used in the calculation of VaR

2.5 Organisation and means of a UCITS/asset management company using VaR

Question no. 28 - Do you have any comments or suggestions?

In par. 2.4, there is a reference to the potential importance of overweighting recent events in VaR methods. We do not share this view. While there may be intuitive arguments for such an approach, recent research can also lead to the opposite conclusion. StatPro research has recently shown how VaR pro-cyclicality can have positive feed-back effects on markets, exacerbating market volatility. VaR methods weighting most recent history (e.g. GARCH, Exponential Weighting) have generated the biggest positive feed-back effect, forcing de-leveraging and risk reduction when markets are lower and risk engagement when markets peak.

StatPro supports the requirement for UCITS to validate the model and to check that all parameters are well calibrated. In terms of back-testing results, and for robustness, measures need to combine traditional VaR with stress tests in a single measure. They need to introduce a counter-cyclical mechanism in order to prevent the measure declining excessively during bullish markets thus discouraging excessive position building at such times.

We therefore suggest the use of such "Hybrid VaR" measures.

Question no.29 – Do you consider that VaR should be calculated at least daily?

StatPro supports the requirement of a daily VaR calculation because otherwise it would be difficult to generate enough observations to perform a back-test of the VaR model.

Question no. 30 – What type of criteria should competent authorities take into account in an assessment of the VaR model?

It is our opinion that back-testing is the most powerful ex-post test for the quality of VaR models. Exante validation should look at the capacity of VaR models to consistently take into account the entire set of risk factors that can change the UCITS' NAV.

Question no.31 - Do you consider that VaR models should be approved by competent authorities?

It is our opinion that model validation strongly contributes to risk awareness and should form an integral part of the risk management process. An external validation process could level the playing field and ensure adequacy of VaR methodologies through the different UCITS.



Par. 2.6 Definition of the relative VaR

Par. 2.7 Limits of the relative VaR approach and proposed safeguards

Question no.33 – Do you consider that the proposed limitation 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?

StatPro fully agrees with the principle that the relative VaR approach should be used only when there is strong proximity between the investment strategy of the portfolio and of the benchmark.

Par. 2.8 Definition of Absolute VaR

Question no.35 – Can the absolute VaR be considered as an appropriate way of measuring global exposure?

In our opinion the VaR method is a robust way of measuring global exposure if the VaR methodology consistently takes into account all the risk factors to which a portfolio is exposed.

We recommend adding a specific measure of liquidity risk to the VaR measurement to take into account the risk of sudden liquidations of the leverage contained in a UCITS or to reductions of assets under management due to reimbursement of UCITS subscribers.

Question no.36 – Do you consider that the proposed thresholds are suitable? Can you suggest other thresholds?

Question no.37 – What are your views on the application of stricter criteria to different types of asset classes e.g. bonds, equities?

UCITS investing in absolute strategies can have a variety of risk profiles and attitudes to risk. Given financial innovation, this variety cannot be captured with a simplified distinction of asset classes. In addition, while for a UCITS linked to a benchmark it is easier for the investor to understand what type of risk the fund is linked to, absolute strategies are opaque in this regard.

Our suggestion is to define a limited number of possible risk profiles for a UCITS with absolute strategy. E.g. a 3-tier structure could use the profiles "Moderate", "High", "Highly Leveraged".

The UCITS should make full disclosure to the public of the chosen risk profile.



Each profile should have a different VaR limit and the riskiest one should have a limit higher than the 20% of VaR 99% 20 working days mentioned in par.2.8. Given recent market events a 20% limit may actually be too low.

Given the risk of positive feedback and pro-cyclicality, we recommend discouraging the use of volatile and pro-cyclical VaR methodologies to measure compliance to risk limits.

Par. 2.9 Additional safeguards to mitigate the risks related to the use of the absolute VaR approach

Question no.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?

StatPro strongly supports the use of stress testing. Thinking of what can go wrong is an essential part of a sound process of building investment portfolios. We consider analyses highlighting the x worst stress test scenarios of a wide selection of stress scenarios to be very informative of what type of extreme risks the UCITS is facing.

StatPro shares the view that additional measures to monitor the risk profile are needed. Instead of CVaR as a stand-alone measure, the ratio between CVaR and VaR could be a consistent measure of how fat-tailed the underlying UCITS return distribution is. If CVaR- measures are enforced we recommend avoiding the use of Gaussian and similar methodologies as they systematically undervalue the skewness of the expected distribution of returns.

Question no.40 – Can you suggest alternative safeguards and/or requirements to avoid UCITS engaging in strategies which generate high levels of leverage?

StatPro recommends enforcing the measurement of market liquidity risk. Leverage may not necessarily pose a problem if it is pursued with highly liquid instruments. It becomes dangerous if it builds on highly illiquid instruments, as we discovered during the credit crisis.



Sophisticated/Non-Sophisticated UCITS

Question no. 51 – Do you agree with the proposal to abandon the use of the term sophisticated and non-sophisticated UCITS?

Question no. 52 – If you object to this proposal could you please provide reasons for this view?

The introduction of the distinction between Sophisticated and Non-Sophisticated UCITS has created pressure to introduce a VaR approach for Sophisticated UCITS. The introduction of VaR has forced an industry that was looking mostly at Tracking Error as a risk measure to also focus on the tail risks, as measured by VaR.

In pragmatic terms, the existence of the difference between Sophisticated and Non-Sophisticated UCITS has forced many companies to adopt VaR approaches and to move from a static risk control environment to a dynamic risk control environment.

StatPro fears that the abolition of the distinction could be used to de-classify the risk management requirements of the UCITS, moving some UCITS out from the VaR approach and back into the Commitment approach that, by its nature, offers more opportunity to exploit any weakness in the regulatory framework. If the acceptance of the Commitment approach is maintained and the distinction between Sophisticated and Non-Sophisticated UCITS is abolished there is a threat that risk management procedures will be relaxed: which would be a paradox after the recent turmoil and severe market stress of the last two years.

Thank you very much for the opportunity to share our views on the consultation paper.

Kind Regards

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