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FEEDBACK STATEMENT

**CESR's Guidelines on Risk
Measurement and the
Calculation of Global Exposure
and Counterparty Risk for
UCITS**



Executive Summary

In this document CESR gives feedback on the responses received to the consultation on CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-108).

In general, respondents were broadly supportive of the approach proposed by CESR. Respondents to the consultation welcomed the conversion methodologies for the different types of financial derivative instruments for UCITS using the commitment approach for the calculation of the global exposure.

In the consultation paper, CESR sought stakeholders' views on the most appropriate approach for an optional 'sensitivity'-based regime in relation to interest rate strategies for the calculation of the global exposure. In particular, CESR consulted on two possible methods. The final version of the Guidelines retains the option which was favoured by the respondents (Option 2). However, the Committee felt it appropriate to include this option into the standard regime of netting and hedging rules (Box 7 of the Guidelines) under a new section labelled "duration-netting rules".

CESR's proposal concerning the VaR approach was broadly welcomed by stakeholders who nevertheless expressed some degree of disagreement with the requirement to monitor the leverage for UCITS using the VaR for the calculation of the global exposure.

CESR also consulted on its initial views on specific guidelines to be applied to a certain category of structured funds. The feedback from the public consultation resulted in a general request to develop such a methodology. Therefore, CESR will carry out further work to assess whether it would be appropriate for certain types of structured UCITS to use other methodologies to calculate the global exposure.



Background

In March 2007, the European Commission announced a series of targeted enhancements to the UCITS Directive (85/611/EEC). Following further work and consultation, the Commission adopted a proposal for the revised UCITS Directive in July 2008, an amended version of which was approved by the European Parliament in January 2009 and adopted by the Council in June 2009. The final text of the revised Directive (2009/65/EC) was published in the Official Journal on 17 November 2009.

On 13 February 2009 the European Commission submitted a provisional request to CESR for technical advice on the content of the implementing measures concerning the future UCITS Directive ('the mandate'). The mandate was split into three parts:

- I. Request for technical advice on the level 2 measures related to the management company passport;
- II. Request for technical advice on the level 2 measures related to key investor information;
- III. Request for technical advice on the level 2 measures related to fund mergers, master-feeder structures and the notification procedure.

CESR provided technical advice to the European Commission on Part I of the mandate dealing with level 2 measures related to the UCITS management company passport (Ref: CESR/09-963) in October 2009. This advice included proposed level 2 measures for the calculation of UCITS global exposure. These proposals had been the subject of a public consultation in June 2009 (Ref. CESR/09-489). The advice also recommended that certain implementing measures dealing with the calculation of global exposure be accompanied by level 3 Guidelines. The CESR advice also proposed that the level 2 measures and level 3 guidelines should be adopted as a single package by July 2010.

Therefore, CESR developed draft guidelines, which were published for consultation on 19 April 2010 (Ref. CESR/10-108). CESR received responses from a range of stakeholders including UCITS management companies, investment management associations, clearing houses and specialist service providers.



1. Definition and scope of Global Exposure

Questions:

1. Do you agree with the proposed Level 3 Guidelines for the definition and scope of global exposure?

Several respondents expressed their general agreement with the definition and scope of global exposure. One of them noted the importance of creating a uniform understanding and fostering a level playing field, while one respondent felt it may also be appropriate to consider whether the UCITS should disclose any internal risk management measures and limits as part of the investment process.

The main comment made by respondents on the definition and scope of global exposure was about the requirement to calculate the global exposure on at least a daily basis. Indeed, many stakeholders disagreed with this requirement and deemed the intra-day calculation very costly and should not be required. Two respondents argued that an intra-day assessment (not calculation) should be carried out only if necessary and under specific market circumstances, while one stakeholder supported the concept of ongoing monitoring rather than daily calculation

Many respondents commented on the Guidelines regarding the circumstances in which an advanced risk measurement approach should be used and some of them made the following drafting proposal for paragraph 4 of Box 1: ‘and where it can be assumed that the commitment methodology is not adequately capturing the market risks of its portfolio the UCITS must use an advanced risk measurement methodology.’

Finally, some respondents felt that the references to ‘complex investment strategies’, ‘negligible part’, ‘negligible exposure’ and ‘exotic derivatives’ were unclear and could be subject to different legal interpretation and asked for clarification.

The Committee strongly believes that it would not be reasonable for UCITS not to monitor the global exposure on a daily basis since this element of risk measurement is of a great importance for the management of the UCITS. Therefore, CESR did not amend the Guidelines for this issue.

Concerning paragraph 4 of Box 1, CESR modified the wording to take on board the drafting suggestions made by some respondents and clarify in subparagraph (c) that an advanced methodology such as the Value at Risk (VaR) approach to calculate the global exposure must be used where:

“The commitment approach does not adequately capture the market risk of the portfolio”

Finally, CESR considered the suggestions made by some stakeholders to define more precisely what would be a negligible exposure to exotic derivatives but came to the conclusion that it would not be appropriate to define a strict threshold and preferred to keep a high level principle.

2. Do you have any alternative suggestions?

Only a few alternative suggestions were made by respondents. According to one respondent, the calculation of the portfolio turnover rate (PTR) could be required in certain circumstances in order to assess the necessity to perform intra-day monitoring of the global exposure, as a high PTR could indicate that the risk profile of the UCITS is changing significantly during the day.



Several respondents felt that a tailored approach may be needed for some structured funds and that industry and competent authorities should have the possibility to agree on internal models for selected funds. In this context, one of these respondents took the view that the Guidelines on the VaR approach combined with the cover rules showed the need for a combination of tools to capture global exposure.

The Committee considered carefully the alternative suggestions made by respondents but does not consider it appropriate to take them into account. Therefore, the Committee did not modify the Guidelines except for the amendments mentioned in question 1 above.

2. Calculation of Global Exposure using the Commitment Approach

2.1 Conversion methodologies

2.1.1 Standard Derivatives – Embedded Derivatives and Non-Standard Derivatives

Questions:

3. Do you agree with the proposed conversion methodologies for the different types of financial derivative instrument?

CESR's proposed conversion methodologies for the different types of financial derivative instruments were overwhelmingly welcomed by respondents with some suggestions.

One of them took the position that notional values are in the local currency of the instrument and should be converted into the base currency equivalent using the spot or forward rate as appropriate.

One respondent stressed that the examples should provide universally agreed methodologies and, where appropriate, different options for calculation and that the list should be reviewed on a periodic basis to ensure it remains up-to-date.

The Committee slightly modified the Guidelines to take into account comments and suggestions from stakeholders.

Therefore, it was clarified that the commitment calculation of each financial derivative position should be converted to the base currency of the UCITS using the spot rates and when any currency derivative has two legs that are not in the base currency of the fund, both legs must be taken into account in the commitment calculation.

4. Do you have any alternative suggestions?

See question 3 above

5. Do you find the numeric examples useful in providing further clarity?



Many respondents found the numeric examples useful.

Beyond this, a number of more specific comments were made. One respondent felt it would be useful to include an example of the market value of the underlying for a fixed/floating rate interest rate swap, while one contributor believed that further examples should be provided covering entire demonstration portfolios e.g. to illustrate the exclusions in Box 4 and the application of the netting and hedging provisions. Similarly, it was suggested that it would be useful to provide examples for all types of financial derivative instruments (FDI) and examples for issuer concentration and global exposure for bought call options, bought put options, sold call options and sold put options.

Following the general positive feedback, the Committee decided to maintain the numerical examples in the Guidelines. CESR felt it useful to include an additional example for the conversion methodology for FX forwards.

6. In particular, do you consider that the use of the market (or notional) value of the underlying reference asset for a credit default swap is appropriate? Do you have any alternative suggestions?

Several respondents were of the view that the use of notional value would be easier to apply, particularly in the case of CDS. However, in matching both the CDS and the reference instrument, or similar instruments of the same issuer, it should be quantified in terms of notional in the base equivalent.

One stakeholder felt that the use of the contract's notional value was an appropriate methodology for a CDS but should be limited to the protection seller while another respondent believed that it was not appropriate to use the value of the underlying reference asset when assessing CDS using the commitment methodology as this would disregard the interest rate risk of the position.

Following the feedback from the consultation, CESR modified the Guidelines concerning the conversion methodology for single name credit default swaps to differentiate between circumstances where the UCITS is selling and buying protection.

When the UCITS is acting as protection seller, the conversion methodology is defined as the higher of the market value of the underlying reference asset or the notional value of the credit default swap and when acting as protection buyer as the market value of the underlying reference asset.

2.1.2 Types of financial derivative instruments which may be excluded from the global exposure calculation

Questions:

7. Do you agree that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation? If you do not agree please explain your answer

There was general agreement regarding those derivatives which are not taken into account in the global exposure calculation. A few respondents asked if more examples could be included to deal



with different asset classes e.g. the creation of synthetic credit exposure through the use of credit default swap to overlay a portfolio of sovereign debt.

Following the general agreement from respondents on the CESR proposals the Guidelines were not modified.

8. Do you consider that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for the UCITS?

The majority of respondents considered that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for UCITS.

No amendments were made to the explanatory text of Boxes 3 and 4 due to the general support from stakeholders.

2.1.3 Netting and Hedging

Questions:

9. Do you agree with the proposed definitions of netting and hedging?

CESR's proposed definitions of netting and hedging were supported by the vast majority of respondents.

Following the strong support from stakeholders for the definitions of netting and hedging arrangements proposed by CESR, the Committee did not modify the Guidelines on this topic.

10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure?

The main comment made by stakeholders on the criteria for netting and hedging in order to reduce global exposure concerning the proposal by CESR that UCITS which use a conservative calculation rather than an exact calculation of the commitment for each financial derivative instrument cannot benefit from hedging and netting arrangements to reduce commitment on the derivative involved.

Following these comments the Committee has clarified in paragraph 4 of Box 5 that when a conservative calculation is used rather than an exact calculation of the commitment for each financial derivative instrument, hedging and netting arrangements cannot be taken into account to reduce commitment on the derivative involved if *it results in an underestimation of the global exposure.*



11. Do you have any alternative suggestions?

See question 10 above

12. Do you agree with the examples provided of strategies where netting is possible?

Most respondents agreed with the examples while one qualified its support by stating that classification of trades is not feasible in practice.

CESR did not modify its proposal in line with the general support from stakeholders.

13. Do you agree with the examples provided where hedging is possible?

Most respondents agreed with the examples where hedging is possible.

The Guidelines were not modified following the general support from stakeholders for CESR's proposal.

14. Do you agree with the examples provided where hedging is not possible?

In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

A majority of respondents agreed with the examples provided where hedging is not possible.

However some respondents disagreed with the requirement that beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure because they felt it overly restrictive and one of them proposed the following examples:

- A portfolio management practice which aims to offset the risk of a given share by taking a short position through a future on an index where that share is a relevant component, so the correlation is very high.
- A beta-hedging strategy between two indices should be allowed because the specific risk on an index is not relevant.

Following the large support from stakeholders, CESR did not modify its Guidelines for the examples where hedging is not possible and for beta-hedging strategies.

2.1.4 Efficient Portfolio Management Techniques

Questions:

15. Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques?



Many respondents agreed with the proposed approach.

Several respondents asked for clarification as they felt there might be an issue with the treatment of repo and reverse repo transactions. According to these respondents, a further use of some repo (or reverse-repo) collateral as underlying to a new repo transaction does not create any new risk as such. Therefore, there would be no reason to add those securities to the global exposure calculation.

One stakeholder took the view that stock borrowing does not lead to additional global exposure on the basis that UCITS receive collateral to mitigate risk and collateral is not reinvested insofar as it is safekept on a hedged account. Similarly, the same respondent felt that borrowing and lending in general does not create global exposure.

Due to the support from a majority of respondents to its proposal, the Committee did not modify its proposal for the treatment of leverage generated through efficient portfolio management techniques.

16. Do you have any alternative suggestions?

Some stakeholders took the view that further clarification should be provided on the 'risk-free return' on the grounds that not all short-dated domestic sovereign debt can be considered risk-free in the current economic climate.

Following the remark from some stakeholders asking for further clarification on the 'risk-free return', CESR deemed necessary to amend the Guidelines with a reference to '*high quality government bonds*'.

2.1.5 Sensitivity Approach

Questions:

17. What are the advantages and disadvantages of each methodology?

The main comment made by several members was that both methodologies were considered technically complex.

18. Which methodology do you consider more appropriate? Please give explanations and indicate whether additional safeguards should be included.

Option 1 was favoured by two respondents. For one of them this option was consistent with Basel II while the other respondent favoured Option 1 for the following reasons:

- Option 1 is entirely based on the standard methodology currently developed in the Basel Accord, unlike Option 2, which introduces a calculation of the equivalent cash position which is out of the scope of the Basel Accord and the accuracy of which seems not to have been properly tested.
- Option 1 seems easier to implement because the reference is to the notional and not the equivalent cash position.
- Option 1 is neutral or independent from the UCITS' investment policy.



Many respondents favoured Option 2. These members considered Option 2 more accurate on the grounds that it considers the actual sensitivity of interest rate derivative instruments when computing the global exposure.

Three respondents explained that they understood the sensitivity approach as a complementary method to the classic commitment approach that aims at reaching a more adequate commitment calculation for interest rate derivatives. On this basis, they considered Option 2 more appropriate on the basis that it is more consistent with the commitment calculation principles. They noted that Option 2 is based on the calculation of an underlying asset position that simply translates into 'cash terms' the derivative's sensitivity to the underlying's changes in price. This conversion naturally allows for netting under specific and calibrated compensation conditions.

One stakeholder felt that additional safeguards could include a scenario analysis (stress test) which simulates the twist of the interest rate curve.

19. In the last step of Option 1, the total amount is multiplied by 12.5. Do you consider that (i) this takes due account of the sensitivity of the UCITS and (ii) that this is in line with the commitment conversion methodology (e.g. conversion of the derivative into the market value of the equivalent position in the underlying assets)?

One respondent considered that the application of this constant or multiplier converts a measure of risk into an exposure or into an equivalent position in the underlying assets, in line with the conversion methodology. The same respondent felt that it was consistent to apply the constant of 12.5 which derives from the general 8% capital requirement (given an exposure of 100, the corresponding capital requirement would be 8).

A couple of stakeholders felt this approach did not take due account of the sensitivity and that a more appropriate figure would be obtained by calculating the total amount in terms of years of duration contribution, then converting it (a) into commitment limit usage by applying the calculation total amount in years of duration contribution/benchmark duration in years %, or (b) into a base currency value by applying the calculation total amount in years of duration contribution/benchmark duration in years * NAV in base currency.

20. Under option 2 the target sensitivity of the UCITS can be longer than the sensitivity of the derivative while the equivalent underlying position is relatively small. This can result in high levels of leverage within the UCITS. Please provide views on the additional safeguards that could be introduced to mitigate this risk.

One respondent took the view that Option 2 was not neutral because the results would be different depending on the UCITS' risk profile (or the target sensitivity). It felt this could lead to a non-standard approach because the results could be very different between UCITS which invest in the same derivatives but with different target sensitivities. The same respondent felt that the calculation of the sensitivity approach should only take into account the risk of the derivatives and the results should also be the same for all UCITS (an approach neutral to the risk profile of the UCITS).

One respondent proposed that Option 2 should scale using a 10-year equivalent sensitivity.

The feedback from the consultation revealed that option 2 was more favoured by stakeholders than option 1. Therefore, option 2 was retained in the final Guidelines.

However, the Committee felt it appropriate to include this option into the standard regime of



netting and hedging rules (Box 7 of the Guidelines) under a new section labelled “duration-netting rules”.

Clarifications were also provided in the final Guidelines that the use of duration-netting rules cannot generate any unjustified level of leverage through investment in short-term position or cannot be used for hedging purposes.

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

3.1 General principles

Questions:

21. Do you agree with the general principles outlined for the use of VaR?

The general principles outlined for the use of the VaR were welcomed by all the respondents who answered the question except one that was of the view that further risk measurement techniques should be employed in order to measure the UCITS' global exposure in a more robust way.

One of the stakeholders suggested the inclusion of the paragraph 36 of the explanatory text directly into the Box 9 as a new paragraph.

One other respondent proposed to amend the Guidelines along these lines “*As part of the overall risk management process, a UCITS must establish, implement and maintain a documented system of internal limits concerning the measures used to manage and control the relevant risks for each UCITS to include at a minimum an overall portfolio VaR limit equal to or less than that imposed by the Regulations. The VaR limits should always be set according to the defined risk profile*”

Following the general support from stakeholders, the Committee did not modify its proposal.

3.2 VaR Approaches – Relative VaR and Absolute VaR – The Choice

Questions:

22. Do you agree with the proposals regarding the choice of the VaR approach?

CESR's proposal was overwhelmingly welcomed by respondents. Only a few comments were made including one from a respondent who believed that the relative VaR will not be understood by customers at all.

Finally, one respondent could agree with the CESR proposal on the assumption that the relative VaR approach is calculated as the difference between the returns and not the ratio of absolute VaRs of the UCITS and the reference portfolio.

CESR felt it necessary to include in the Guidelines a general rule that there must be consistency in the choice of the type of VaR used for the calculation of the global exposure (e.g. a UCITS that has chosen to use absolute VaR cannot switch to relative VaR simply because it has breached the



limits set out in the Guidelines on the use of absolute VaR).

3.3 Relative VaR approach

Questions:

23. Do you agree with the proposed approach regarding the use of the relative VaR?

CESR's proposed approach regarding the use of the relative VaR was supported by most of the respondents who answered the question and only one respondent explicitly disagreed.

Following the strong support from respondents, the Committee did not modify its approach regarding the use of the relative VaR.

24. Do you agree with the proposed criteria for the reference portfolio?

CESR's proposal on the reference portfolio was highly criticized since many respondents disagreed with the prohibition for long-short strategies to use long only benchmark portfolio.

Indeed, several respondents explained that 130/30 strategies are primarily a long 100 fund with an additional 30/30 overlay. Therefore, in their opinion, the use of long only benchmark would be a reasonable approach and if anything somewhat conservative.

According to a couple of members, a reference portfolio with derivatives or embedded derivatives should be allowed when they are provided by general accepted index providers, published and generally available. Some more discretion was asked in the choice of the composition of the reference portfolio as long as the approach is more restrictive than the approach suggested by CESR. In their views, UCITS should have the possibility to use as reference portfolio the actual UCITS portfolio but without the derivative instruments.

CESR did not deem appropriate to take on board the suggestion made by some stakeholders for UCITS with a long/short strategy to have a long only benchmark.

However, the Committee agreed that a UCITS which intends to have a currency hedged portfolio may select a currency hedged index as a reference portfolio.

25. Do you have any alternative suggestions?

Some respondents expressed the following suggestions for the computation of the relative VaR:

- For one stakeholder it would be better to calculate the relative VaR as the difference in returns between the benchmark and the portfolio and limit the VaR on that difference to the same 20% (20 day, 99%) limit applied to Absolute VaR. That would limit the VaR on a portfolio to 20% above the benchmark. This would be consistent with the proposals in relation to Absolute VaR and would be more conservative



- One respondent was of the view that UCITS using relative VaR should also be required to disclose the Absolute VaR to improve transparency and assist comparison between UCITS.
- For a several contributors, it may be more intuitive if the numerator is expressed as the VaR of the UCITS portfolio less the reference portfolio, as opposed to comparing the VaRs of the two portfolios. The CESR proposed formula might incentivize a manager to "game" the measure by selecting a reference portfolio that is unrelated to the UCITS portfolio, purely on the grounds that it generates a more favourable ratio.

So an alternative the formula could be expressed as:

$$\text{VaR (UCITS – Reference Portfolio) / VaR Reference Portfolio} \times 100\%$$

Rather than:

$$(\text{VaR UCITS – VaR Reference Portfolio}) / \text{VaR Reference Portfolio} \times 100\%$$

This approach was also supported by SIFA and Assogestioni.

CESR did not feel the suggestions made by a few respondents were appropriate and therefore did not take them into account in the final Guidelines.

3.4 Absolute VaR approach

Questions:

26. Do you agree with this description of absolute VaR?

All the respondents that answered the question agreed with the proposed description of the absolute VaR.

Due to the strong support from stakeholders, CESR did not modify the proposal.

3.5 Minimum requirements for VaR approach

3.6 VaR approach: Quantitative requirements

3.6.1 Calculation Standards

Questions:

27. Do you agree with the calculation standards proposed for the VaR approach?

CESR's proposal on the calculation standards for the VaR approach was supported by a large majority of respondents. One of them suggested that to avoid "gaming", it should be stated that



regardless the VaR methodologies chosen, the absolute VaR of the UCITS should not be greater than 20%.

For one respondent, the limit should be raised to 50% while one contributor asked for a holding period of 10 days together with a limit of 30%.

Several stakeholders expressed strong disagreement with CESR's proposal because they were of the view that there should not be a single limit. According to them, the limit should be left to the discretion of each national competent authority and encouraged CESR to implement high level principles which allow a case by case approval in case a maximum limit is exceeded.

The use of long term and very short term measurement of VaR was supported by one respondent.

CESR felt it would not be appropriate to leave to the discretion of each national competent authority to set limits for the calculation standards for the VaR. The aim of the Guidelines is to provide stakeholders with harmonized definitions to ensure and much as much possible a level-playing field among member states.

28. Do you agree with the proposals regarding setting different default parameters and rescaling?

A large majority of respondents supported CESR's proposal regarding setting different default parameters and rescaling.

According to one stakeholder, evidence of 'fat tails' show that losses greater than 2.326 standard deviations happen more than 1% of time. Therefore, publishing this parametric statistic as a 99% confidence interval would be misleading.

A couple of respondents took the view that rescaling should not be allowed because non-linear strategies will not be adequately represented.

In line with the broad support from respondents, the Committee did not modify its proposal regarding setting different default parameters and rescaling. However, CESR clarified the rescaling can *only* be done under the assumption of a normal distribution with an identical and independent distribution of the risk factor returns by referring to the quantiles of the normal distribution and the square root of time rule.

29. Do you consider the examples for the rescaling of parameters are useful in providing further clarity?

All the respondents except two who answered the question considered the examples for the rescaling of parameters as useful in providing further clarity.

The Committee has left the examples for the rescaling of parameters in the Guidelines unchanged.



30. Do you have any alternative suggestions?

One respondent disagreed with the upper limit of 20% for the absolute VaR which should be much higher (50%) to be consistent with the relative limit than can be up to 40%.

One stakeholder proposed that UCITS should, each day, calculate a long term VaR based on long term volatility (3 to 5 years) plus a short term VaR with a 1 day time horizon (even if both are reported on the same 20 day scale).

Finally, one respondent asked for a grandfathering rule for existing UCITS that would breach the 20% limit if adopted.

The Committee considers that the suggestions made were not appropriate and so did not take them into account in the final Guidelines.

3.6.2 Risk Coverage

Questions:

31. Do you agree with the requirement regarding the risks which should be taken into account in the VaR model?

A clear majority of respondents who answered the question agreed with the requirements regarding the risks which should be taken into account in the VaR model.

A couple of respondents who broadly agreed with the CESR's proposal, asked the Committee to clarify under what circumstances additional risks, such as rating migration or default risk should be systematically analyzed and how "stricter measures" should be understood.

In line with the broad support from stakeholders, CESR did modify its final proposal in the Guidelines.

3.6.3 Completeness and accuracy of the risk assessment

Questions:

32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

CESR's proposals regarding the completeness and accuracy of the risk management process were overwhelmingly supported by stakeholders. One of them was of the view that competent authorities should review the validating process for UCITS VaR measurement, in particular the underlying data that drives the forecasting process.

For one respondent, the Committee's proposals would be over-engineered.



Given the support received from Stakeholders' CESR and the Committee did not amend the final Guidelines.

3.6.4 Back Testing

Questions:

33. Do you agree with the proposals regarding back testing of the VaR model?

CESR proposals regarding the back testing of the VaR model was supported by the majority of respondents but with the following comments.

Some respondents felt that the frequency and the limit of 4 'overshootings' above which the UCITS senior management should be informed was too low and asked for a limit of 6 'overshootings' and for a yearly report instead of a quarterly report.

According to one stakeholder, the VaR models should also be reviewed if there are no 'overshoots' at all in a given period because the model can be just as flawed with no exceptions as too many.

One respondent suggested the following alternative based on the orange (over 4 "overshootings") and red (over 9) zones as defined in the Basle Committee paper referred to above: "*UCITS should undertake the back testing program at least on a quarterly basis*" and "*The UCITS senior management should be informed at least on a quarterly basis, if the number of overshootings for each UCITS for the most recent 250 business days (or since launch if shorter than 250 business days) exceeds 4 in the case of a 99% confidence interval*", and the regulator if the number of overshootings exceeds 9.

While, the Committee did not raise the limit of 4 'overshootings' above which the UCITS senior management should be reported on at least a quarterly basis to 6 or to 9 'overshootings' as suggested by some respondents, CESR agreed to decrease the frequency of reporting to the competent authorities from a quarterly basis to a semi-annual basis.

34. Do you have any alternative suggestions?

See the question 33 above.

3.6.5 Stress testing

Questions:

35. Do you agree with the proposals regarding the VaR stress testing programme?

CESR's proposals regarding the VaR stress testing programme were welcomed by stakeholders but with the following comments:



- According to one respondent stress testing should be done when appropriate at the discretion of the UCITS;
- Three contributors wanted to stress that the challenge for asset managers in performing stress tests is to adequately analyze and implement measures for the UCITS, i.e. plausibility test of model as well as direct implications on the investment strategy (e.g. risk reduction);
- One stakeholder was of the view that in paragraph 67 of the explanatory text it should be clarified that the reference is the Senior Management of the UCITS;
- BVI pointed out that stress test, as proposed in Box 18, are difficult to implement in practice and generate very few useful results for the risk management process;

The Committee did not consider it necessary to modify the proposed Guidelines regarding the VaR stress testing programme due to the small number of comments received from stakeholders.

36. In particular do you agree with the proposed quantitative and qualitative requirements?

Committee's proposals regarding quantitative and qualitative requirements for stress testing were broadly supported by stakeholders.

Considering the broad support from stakeholders, the Committee did not modify its proposals.

37. Do you have any alternative suggestions?

One respondent considered that the UCITS manager should simply be obliged to carry out stress tests at appropriate intervals. Given the daily measurement of VaR and the absence of limits on the stress test output, the stress test is simply informational.

It was suggested by one stakeholder that the Committee should publish a list of appropriate stress testing methodologies per investment strategy/asset class which could be made available for review by the UCITS community.

The Committee analyzed the suggestions made by respondents but did not feel it necessary to take them on board.

3.7 VaR approach: Qualitative requirements

Questions:

38. Do you agree with the proposed tasks under the responsibility of the risk



management function?

The proposals for the responsibility of the risk management function were broadly supported by the respondents

Several respondents disagreed with the requirement for the risk management function to monitor the leverage of the UCITS for the reason that this information is not relevant for UCITS using the VaR approach.

Due to the strong support from respondents CESR did not modify its proposal concerning the tasks under the responsibility of the risk management function.

39. Do you agree with the requirements regarding model testing and validation?

Some respondents agreed with CESR's proposals while others felt CESR's proposal disproportionate and costly. Indeed for one respondent the backtesting of the model and the review of the model by the risk management function coupled with the backtesting report to the competent authority (who has validated the model general lines when accepting the risk management process presented on the UCITS initial application) should be sufficient

One stakeholder asked competent authorities to review the validation process for UCITS VaR measurement while another respondent took the view that could be performed by the fund auditor;

The Committee found it useful to clarify that the validation of the VaR can be done by a third party independent from the management company. Therefore, a new paragraph was added under Box 21 stating that the validation of the VaR model following its initial development can be conducted for example by a relevant competent authority, by an internal or external auditor or by an external service provider independent of the building process.

3.8 VaR: Additional safeguards and disclosure

3.8.1 Additional safeguards

Questions:

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?

CESR's proposal to monitor the leverage for UCITS using VaR was criticised by respondents who answered the question who believed that this information was not relevant and could be confusing for the investors. For these respondents, the VaR should be the only measure used because the leverage is not a relevant concept for these UCITS. Only two respondents supported CESR's approach.

For one contributor, UCITS should be allowed discretion on this because for some strategies, especially those trading across multiple assets classes and including fixed income, leverage is not the most useful measure of risk.



One respondent stressed that it was not always the case that the risk within a UCITS was due to leverage and 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.

The Committee considered the general disagreement from stakeholders for the monitoring of leverage for UCITS using the VaR approach for the purpose of the calculation of the global exposure.

However, CESR strongly believes that UCITS using the VaR approach should not ignore the level of leverage of their strategy and therefore kept the Guidelines unchanged.

3.8.2 Disclosure

a) Prospectus

Questions:

41. Do you agree with the proposals regarding prospectus disclosure?

Only a few respondents fully supported CESR's proposals regarding prospectus disclosures.

Many stakeholders disagreed with requirements for UCITS to disclose in its prospectus the expected level of leverage and the possibility of higher leverage but agreed with the requirement to disclose the methodology used for the calculation of the global exposure.

42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?

Almost all the respondents were of the view that UCITS using VaR to calculate global exposure should not disclose the expected level of leverage in the prospectus.

One respondent who supported the CESR's proposal believed that further work may be required on prospectus disclosures proposals as investors have frequently been confused by the volume and differing content of such documents.

For one contributor, only the targeted VaR should be disclosed because separate leverage disclosures would be confusing.

Despite the disagreement from stakeholders to disclose the expected level of leverage and the possibility of higher leverage for UCITS using the VaR approach for the calculation of the global exposure, CESR was of the view that investors should be provided with this information.

In order to have more symmetry between the disclosure regime applicable to the prospectus and the annual report, CESR felt necessary to require that the prospectus should contain information on the reference portfolio when the UCITS uses the relative VaR for the calculation of the global exposure.



43. Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?

The methodology proposed by CESR for the calculation of the leverage was criticized and most of the respondents disagreed with it. Indeed, most of the stakeholders felt that the method was inconsistent with the commitment approach and would not provide with an accurate estimation of the leverage.

One of the stakeholders took the view that this methodology would result in an overestimation of the leverage used while one of the respondents believed that the right methodology would be to calculate the incremental exposure generating by financial derivatives rather than the sum of the notionals.

Respondents' disagreement on the proposed method for the calculation of the leverage for the purpose of prospectus disclosure was analyzed by CESR.

The Committee acknowledged that the proposed methodology had some drawbacks but had the merit to be simple and easy to compute. Therefore, the methodology was not modified in the final Guidelines.

b) Annual reports

Questions:

44. Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?

Mixed views were expressed concerning the disclosure of the VaR methodology in the annual report.

Like the adjustment made to the disclosure regime for the prospectus, the Committee decided to require that the annual report should provide investors with the level of leverage employed during the relevant period of time when the UCITS uses the VaR approach for the calculation of the global exposure.

4 OTC Counterparty Risk Exposure

4.1 Collateral

Questions:

45. Do you agree with the proposals in Box 25? In particular, do you consider that the proposed criteria for the acceptability of collateral to reduce counterparty exposure are appropriate?

CESR's proposal to provide a list of criteria which assets should comply with in order to be used as collateral instead of a list of eligible assets was welcomed. However the following comments were made:



- Liquidity: One respondent felt that there should be a clear definition of the expected level of liquidity. For a couple of stakeholders the liquidity could be lower when there is a corresponding sufficient haircut linked to the credit quality of the issuer.
- Valuation: One respondent was of the view that the valuation of collateral should be done with the same frequency as the fund NAV calculation.
- Correlation: One respondent considered that avoiding correlation could be impossible and asked the Committee together with stakeholders to define more precisely the notion of correlation in that context while one strongly opposed this criterion.
- Diversification: Several respondents believed that there was no need for collateral diversification and that it should remain at the discretion of the UCITS;
- Collateral must be held by a third party custodian: A couple of respondents disagreed with this requirement;
- Collateral must be fully enforced by the UCITS at any time: CESR was asked by two respondents to make it clear that in some circumstances collateral may not be immediately available to the UCITS and can still be used to reduce counterparty exposure.
- Collateral cannot be sold, re-invested or pledged: This requirement was highly criticised by stakeholders. Indeed, they were of the view that an exception should be made for cash, for which reinvestment is necessary in order to generate the yield expected by the counterparty for OTC derivatives. For one respondent, collateral should be allowed to be re-invested in, for example, money market funds.

The Committee took on board the remarks from stakeholders concerning the prohibition for the collateral to be sold or re-invested. Indeed, the Committee acknowledged that it should be possible to re-invest cash collateral in order to generate yield with the restriction that this investment should only be made into risk-free assets.

However, CESR maintain its position concerning non-cash collateral that cannot be sold, re-invested or pledged.

46. Do you have any alternative suggestions?

See the question 45 above

47. Do you consider that it would be useful to include some examples of minimum haircuts for different asset classes? Do you have a preference on what these haircuts might be?

Respondents expressed mixed views on the proposal to have some examples of minimum haircuts for different asset classes.



Following the lack of strong opinion from stakeholders for this proposal, the Committee decided not to include examples of minimum haircuts in the final Guidelines.

4.2 Counterparty/issuer Concentration

Questions:

48. Do you agree that exposure to a clearing house should be considered as part of the counterparty exposure limit? Do you have any alternative suggestions?

A majority of respondents disagreed with this proposal. In their view, given the possibility that for some derivatives only a single clearinghouse might be set up, it would be impossible to meet the exposure limits.

Furthermore, stakeholders that disagreed with this requirement argued that the concentration rule is in place to avoid too big a build-up of credit risk with a single counterparty. CCP clearing is being introduced as a means of reducing counterparty credit risk, – i.e. the risk that the counterparty will default before completion of the contract - which is mitigated by the CCP (designed to be well capitalised and subject to funding arrangements that prevent failure) taking the place of the buyer for every seller and of the seller for every buyer. Accordingly, an OTC derivative counterparty that novates its exposure to the clearing house is *a priori* less risky for the UCITS than with the original counterparty and it follows that, if the European Commission wishes to encourage CCP use, limiting the exposure of a UCITS fund to a clearing house on the grounds of reducing counterparty credit risk does not make sense.

Only a few stakeholders supported this proposal.

CESR took into account the comments received during the consultation and qualified the final Guidelines concerning cleared OTC transactions.

Indeed, CESR decided not to prescribe that exposures to a clearing house should be systematically considered as part of the counterparty risk but rather the UCITS should consider, when entering into cleared OTC transactions, whether the exposure is to the OTC counterparty, the broker or the clearing house.

49. Do you agree that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit? Do you have any alternative suggestions?

A majority of stakeholders expressed their support for the proposal.

The stakeholders' agreed with CESR's views and the Committee did not change its proposal. However, CESR clarified "*that initial margin posted to and variation margin receivable from a broker*" should be included in the counterparty exposure limit.



50. Do you agree that exposures to a counterparty generated through stock-lending or repurchase agreements should be included in the OTC counterparty exposure limit? Do you have any alternative suggestions?

A majority of respondents expressed their support for the proposal.

Despite the general support from stakeholders with CESR's proposal, the Committee felt it more appropriate to include exposures to a counterparty generated through stock-lending or repurchase agreement in the overall issuer concentration limit rather than in the individual counterparty risk limit. Therefore, these exposures must be taken into account when calculating the overall issuer concentration limit of 20%.

51. Do you agree that a UCITS position exposure should be calculated using the commitment approach?

CESR proposal was overwhelmingly welcomed by respondents who answered the question. However, several respondents who supported this proposal mitigated their position by stating that in some very specific circumstances, for derivatives instruments with very volatile delta, the use of VaR should be permitted.

In line with the general agreement CESR maintained its proposal to calculate the issuer concentration risk using the commitment approach.

However, the Committee recognized that when the commitment approach leads to an infinite value (with binary option for example) the position exposure should be equal to the maximum potential loss as a result of default by the issuer.

5 Cover rules for transactions in Financial Derivative Instruments

Questions:

52. Do you agree with the proposed cover rules for financial derivative instruments?

CESR's proposal for cover rules was unanimously supported by respondents.

Considering the unanimous support from respondents the Committee did not modify its proposal for cover rules for financial derivative instruments.

53. Do you think there should be further restrictions on the assets held by the UCITS as cover?

In line with the general agreement for cover rules proposed by CESR, respondents did not propose further restrictions on the assets held by UCITS as cover.



No further restrictions on the assets held by the UCITS as cover was added due to the general support to CESR's proposal.

6 Glossary of Terms

Question:

54. Do you agree with the proposed definitions?

CESR's proposed definitions were overwhelmingly welcomed by respondents with the following comments:

- A couple of stakeholders proposed to amend the definition of "general market risk" with the deletion of the reference to interest rates.
- It was suggested by one respondent that the use of the word "option" in the definition of "path dependency" was not entirely accurate and should be deleted.

55. Do you consider that CESR should provide other definitions in these Guidelines? Do you have any suggestions for other definitions?

Some respondents proposed to include into the Guidelines the definitions of "currency leg", "client money rules", "structured UCITS", "leverage", "back testing" and "stress testing".

CESR took on board some of the suggestions made by stakeholders and added definitions of VaR back-testing and VaR stress-testing.

The Committee also took into account the comments made concerning the definitions of "general market risk" and "path dependency".



CESR's initial views on specific Guidelines for structured UCITS

Questions:

56. Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?

CESR's initial views on specific guidelines for structured UCITS were overwhelmingly welcomed by stakeholders.

57. If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.

For a couple of stakeholders, the problem is that a structured UCITS must be managed in order to provide investors with a predetermined pay-off at the maturity of the fund. They can achieve this, for example, by entering into derivatives transactions that guarantee that the pre-determined pay-off will be reached. The manager of the fund thus does not have much flexibility to follow the Guidelines. He is completely constrained to achieve the pre-determined formula that has been promised to investors. He may infringe on the Guidelines in a purely passive way.

For example, the pay-off may depend on some conditions related to some specific securities. To cover his pay-off, the manager will enter into barrier options and we know that, if the value of the security is close to the strike of such option and if the maturity is close, the delta of such option can be very important and volatile, and lead to an infringement of the Global Exposure limit (even with a VaR methodology).

A Structured UCITS with a pay-off that is based on a diversified portfolio of securities can also have a problem over time in complying with the concentration limits. For example, if the value of one security in the Formula goes up while the others stagnate, he may be over-exposed to this security.

For these stakeholders, it was important to note that the other limits, like counterparty risk limits, can be respected at any time by the manager by appropriate means (collateral, reset of derivatives etc.).

58. Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach

Mixed views were expressed concerning the potential criteria identified by CESR for the scope of a specific regime.

Indeed, while some respondents agreed with the necessity to have capital guaranteed or protected other respondents were of the view that the compulsory guarantee should be limited to the payoff and not to the capital.

The requirement to have a UCITS closed to new subscriptions was also broadly criticized since respondents considered it as superfluous.

However, a vast majority of respondent supported the requirement that structured UCITS who would benefit from a specific should have a predefined payoff based on a calculation formula relating to the performance of financial instruments or other financial parameters. While most stakeholders agreed with the requirement that structured UCITS should have a final maturity date they opposed the limit of 9 years. According to them, there should not be any strict limit for the duration of the



formula.

59. Can you suggest any additional criteria?

A couple of respondents proposed that structured UCITS should be required to respect at all times the counterparty risk requirements, to comply with all the standard Guidelines at inception and as long as the fund is marketed. Finally, any formula showing that the funds will never be able to respect the standard Guidelines during its life should be prohibited (anti-avoidance rule).

Following the positive feedback from the public consultation on CESR's initial views on specific Guidelines for structured UCITS, CESR will carry out further work to assess whether it would be appropriate for certain types of structured UCITS to use other methodologies to calculate the global exposure.



Annex 1: List of Respondents

	Name of respondent
1.	Erste Sparinvest
2.	Old Mutual
3.	La Banque Postale Structured Asset Management
4.	Alternative Investment Management Association
5.	CPR AM
6.	EM Applications
7.	ETF Securities
8.	Eurex Clearing
9.	Inverco
10.	The International Securities Lending Association
11.	JP Morgan Asset Management
12.	KBC Asset Management
13.	Maples and Calder
14.	Meeschaert
15.	Morgan Stanley
16.	Risk Metrics
17.	Swiss Life
18.	Vereinigung Österreichischer Investmentgesellschaften
19.	Wadhvani
20.	Association Française de Gestion
21.	Lyxor
22.	Association Française des Investisseurs Institutionnels
23.	Association Luxembourgeoise des Fonds d'Investissements
24.	Allianz GI
25.	Amundi
26.	Arthur Cox
27.	Assogestioni
28.	Belgian Asset Manager Association
29.	Black Rock
30.	Bundesverband Investment und Asset Management e.V.
31.	Cheyne Capital Management
32.	Fund-axis
33.	German Insurance Association
34.	Groupama Asset Management



35.	Irish Fund Industry Association
36.	KBC Poland
37.	KBC Belgium
38.	La Banque Postale
39.	Mandarine Gestion
40.	Matheson Ormsby Prentice
41.	OFI Asset Management
42.	Pictet Funds (Europe)
43.	PIMCO
44.	Rotschild & Cie Gestion
45.	Swedish Industry Fund Association
46.	Investment Management Association
47.	Europe Association of CCP Clearing Houses
48.	European Fund and Asset Management Association