

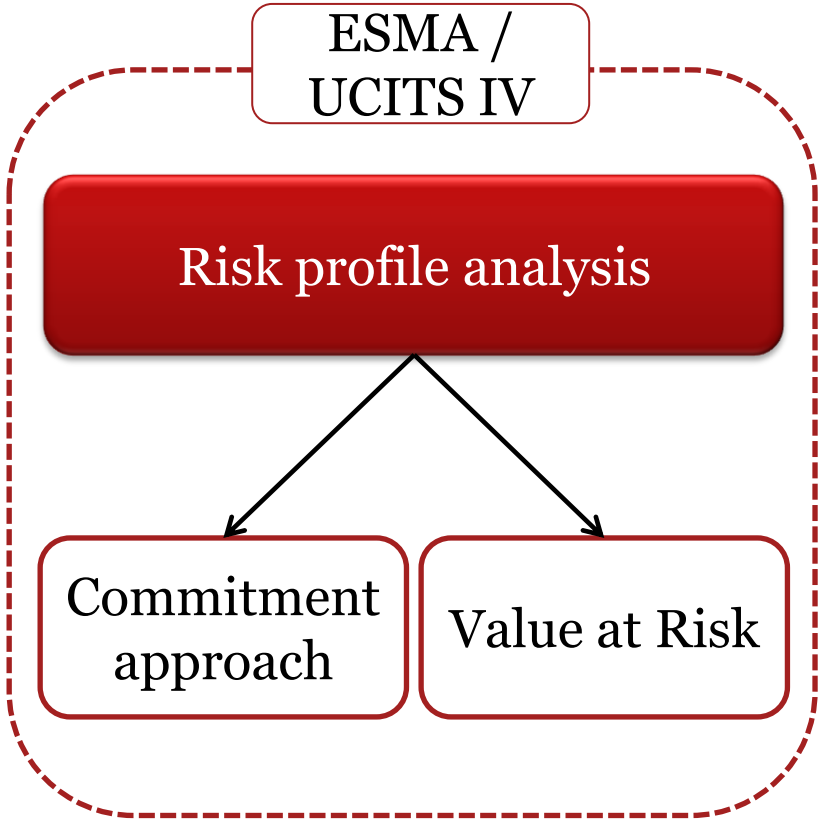
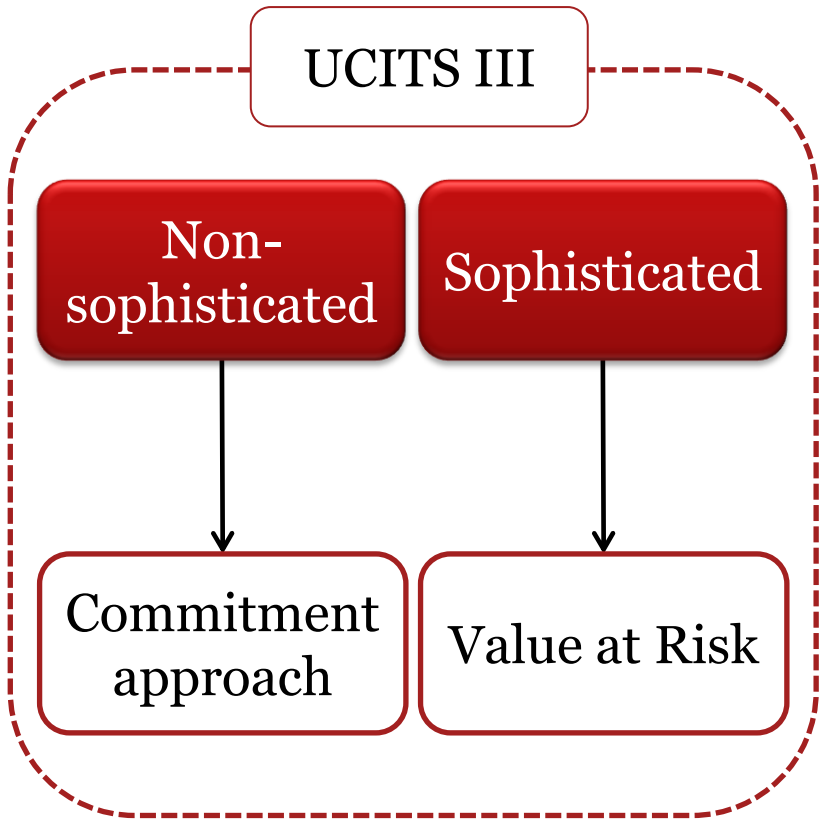
Risk Management Challenges in the context of UCITS IV

April 2011

1. Changes in regulation

ESMA guidelines - Sophisticated / non sophisticated

Global exposure = Market risk



1. Changes in regulation

ESMA guidelines - Commitment

Risk Management challenges	UCITS IV – ESMA
Derivatives not taken into account	<ul style="list-style-type: none">• Totally swap the performance of a financial asset in the portfolio / offset the market risk of the swapped asset• Financial derivative fully cash backed
Hedging/netting	<ul style="list-style-type: none">• Very specific guidelines on what is and what is not accepted• Examples: Hedging: Only trades leaving no material risk should be taken into account – No beta hedging to extract the Alpha Netting: netting of call and put on same underlying => need to use actual delta

1. Changes in regulation

ESMA guidelines - Commitment

Risk Management challenges	UCITS IV – ESMA
Conversion methodology	<ul style="list-style-type: none">• Plain vanilla options: Full commitment on long position and not only the premium (=> open-ended funds)• CDS: no difference between long and short position. Exposure = market value of the underlying reference asset or the notional value• Accuracy and validity of commitment approach for CDS on basket to be assessed• Conversion methods have been specified for much more derivatives than it was done in the CSSF circular 07/308

1. Changes in regulation

ESMA guidelines - Commitment

Risk Management challenges	UCITS IV – ESMA
Sensitivity analysis for interest rate derivatives (optional)	<ul style="list-style-type: none">• Calculating the exposure linked to interest rate derivatives through the classic commitment approach leads to considering interest rates with different maturities as different underlying assets and thus excluding any netting or hedging between instruments on these interest rates• ESMA proposes a Duration based approach for interest rate exposure
Computation frequency	<ul style="list-style-type: none">• For non-sophisticated (CSSF circular 07/308) bi-monthly computation was allowed• Following the last publication of the ESMA, the global exposure will need to be monitored on a daily basis

1. Changes in regulation

ESMA guidelines - VaR

Risk Management challenges	UCITS IV – ESMA
Value-at-Risk	<ul style="list-style-type: none">• Value-at-Risk is kept for Market risk computation• Conditional VaR (CVaR) and use of the other Risk indicators are recommended
Model Risk	<ul style="list-style-type: none">• The model should undergo a validation by a party independent of the building process for ensuring that the model is conceptually sound and captures adequately all material risks• Model should cover all risk factors

1. Changes in regulation

ESMA guidelines - VaR

Risk Management challenges	UCITS IV – ESMA
Backtesting	<ul style="list-style-type: none">• ESMA recommends to perform a daily backtesting at least on a monthly basis where the CSSF Circular 07/308 was recommending to perform it on a quarterly basis
Stress testing	<ul style="list-style-type: none">• Stress test calculation results should be monitored and analyzed by the Risk Management function and should be submitted for review to the Senior Management• Stress tests must be performed to illustrate the potential default of the UCITS (i.e. NAV < 0) when using high level of leverage

1. Changes in regulation

ESMA guidelines - Counterparty risk, Leverage

Risk Management challenges	UCITS IV – ESMA
Leverage	<ul style="list-style-type: none">• Monitoring of leverage is now part of the Risk Manager responsibilities (even if computing VaR)• Also, leverage level will be published in the prospectus and in the financial statements (more comments in disclosure part)

1. Changes in regulation

ESMA guidelines - Counterparty risk, Leverage

Risk Management challenges	UCITS IV – ESMA
Counterparty risk	<ul style="list-style-type: none">• Clear valuation of the exposure to counterparties• Add-on factor will be abandoned• Initial margin and additional margin received (and receivable) should be included in counterparty risk (even for exchange traded instruments)

1. Changes in regulation

ESMA guidelines - Operational risk

Risk Management challenges	UCITS IV – ESMA
Operational risk	<ul style="list-style-type: none">• Was part of “other risks” in 07/308 and should need to be part of the analysis should they may cause losses to UCITS• ESMA (level 2+level3): “In particular, the Risk Management policy shall comprise procedures which enable the management company to assess the exposure to market risks, liquidity risks, counterparty risks and to all other risks, including operational risks, which might be material to each UCITS it manages”

1. Changes in regulation

ESMA guidelines - Liquidity risk

Risk Management challenges	UCITS IV – ESMA
Liquidity risk	<ul style="list-style-type: none">• Was not mentioned as a risk per se in the CSSF circular 07/308• ESMA (level 2 + level 3): “In particular, the Risk Management policy shall comprise procedures which enable the management company to assess the exposure to market risks, liquidity risks, counterparty risks and to all other risks, including operational risks, which might be material to each UCITS it manages”

1. Changes in regulation

ESMA guidelines - Disclosure

Risk Management challenges	UCITS IV – ESMA
Disclosure	<ul style="list-style-type: none">• Prospectus: method used to compute global exposure, expected level of leverage, reference portfolio used for relative VaR• Financial statements: method used to compute global exposure, reference portfolio used for relative VaR, lowest/highest/average utilization of VaR limits, Level of leverage• KIID and SRRI

Contact

Thierry López

Risk Management Services Leader

+352 49 48 48 – 4141

thierry.lopez@lu.pwc.com

Benjamin Gauthier

Manager, Risk Management Services

+352 49 48 48 – 4137

b.gauthier@lu.pwc.com

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