

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

Dated 23 August, 2010

In February 2009, the Committee of European Securities Regulators ("CESR") was mandated by the European Commission to provide a technical advice on the content of the implementing measures concerning the UCITS IV Directive. As part of this mandate, CESR released a technical advice in October 2009, which included implementing measures for the calculation of UCITS global exposure. In this advice, CESR recommended that additional guidelines should accompany the implementing measures.

Level 3 guidelines (the "Guidelines") were released by CESR on 28 July, 2010 to accompany these implementing measures further to a consultation launched in April 2010. They will certainly be transposed in a CSSF Circular in the near future.

Investor protection is one of the pillars of the reputation of the UCITS brand. Therefore, in order to warrant and foster investor protection, these Guidelines put an emphasis on three major aspects: a common approach amongst EU Member states to monitor the risks incurred by the use of financial derivative instruments, a focus on the role of Risk Management, whether in terms of risks supervision or in terms of reporting to senior management or to the Board of Directors and disclosure requirements in the prospectus and/or annual accounts of the UCITS.

Major changes compared to current regulatory framework

- **The "sophisticated funds" versus "non-sophisticated funds" classification will be abandoned**

The methodology chosen for the calculation of Global exposure shall be determined based on the risk profile of the UCITS. Typically UCITS engaging in complex investment strategies or using exotic derivatives for more than a negligible part of their investment policy shall use a Value at Risk ("VaR") approach. In addition, if the commitment approach does not adequately capture the market risk of the portfolio, the VaR approach should also be used.

- **New definitions and monitoring requirements will be introduced**

Reference portfolio

Contrary to what was initially provided in Circular CSSF 07/308, the benchmark portfolio, in the case of relative VaR, may include derivative financial instruments. For example, currency hedged UCITS or UCITS engaged in a long/short strategy may respectively select currency hedged indices or a reference benchmark using financial derivative instruments to gain short exposure.

Duration-netting rules

Duration-netting rules can be used as described in the Guidelines but remain optional. Duration-netting rules may not be used for hedging purposes as CESR expects UCITS to use of the exact calculation in hedging arrangements.

Hedging

Investment strategies such as long/short strategies or market neutral strategies may not be considered as hedging arrangements since the aim of those strategies is to generate a return

Margins relating to exchange traded and OTC derivatives

Initial margins posted to and variation margins receivable from a broker should be submitted to the counterparty limit of 5%/10% if they are not by client money rules or other arrangements.

- **Monitoring frequency**

Currently, CSSF Circular 07/308 requires a bi-monthly monitoring for Luxembourg UCITS using the commitment approach. Tomorrow, with this new piece of regulation the Global exposure will be monitored either with the commitment approach or with the VaR on a daily basis.

It is even envisaged that in some cases, an intra-day monitoring could be carried out.

- **Need for an initial validation of the VaR model by an independent third party**

Initial validation of the VaR model must be performed by an independent third party (internal auditor, external auditor...). This model should adequately capture all the material market risks associated with portfolio positions. CESR considers that the VaR model should cover a sufficient number of risk factors which will imply a deeper review of models' specifications.

- **Monthly instead of quarterly backtesting and reporting in case of VaR overshootings**

Reporting to the senior management, should be done at least on a quarterly basis if the number of overshootings over the last year (250 business days) exceeds 4. A similar reporting should be sent to the regulator, on a semi-annual basis, if relevant. The reporting should include the analysis of the overshootings and measures taken to improve the accuracy of the model.

- **Disclosure requirements in the prospectus and annual accounts**

Prospectus

It should disclose the method used to calculate the global exposure, the expected level of leverage, calculated as the sum of the notionals of the derivatives used, and the possibility of higher leverage levels. In the case of relative VaR, the reference portfolio should be disclosed.

Annual accounts

In the annual accounts, the method, reference benchmark and level of leverage should also be disclosed. They should also include the VaR measure, and more precisely the lowest, highest and average VaR utilisation of the year under review.

As far as the Luxembourg market is concerned, although the CSSF Circular 07/308 already sets out many rules of conduct in the Risk Management of UCITS, market players will have to assess the impact of the implementation of the measures proposed by CESR. Following the decision to abandon the "sophisticated" versus "non-sophisticated" classification, the Risk Managers together with the Board of Directors will have to assess and validate the risk profile of the funds they are managing.

In that context, and even if no specific method is currently recommended, they will also need to reconsider their management of the liquidity and operational risks linked to their UCITS, since CESR has classified this monitoring as being part of the main responsibilities of Risk Managers.

Management companies and self-managed SICAV should perform gap analyses to ensure that the existing processes are in line with the Guidelines or are updated before the transition to UCITS IV, i.e. 1 July, 2011. Although this may create some constraints from an operational point of view, these Guidelines maintain flexibility offered by UCITS in terms of investments and strategies.

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