



BG/SJ- n°2469/Div.

Mr Carlo Comporti  
Secretary General  
Committee of European Securities  
Regulators (CESR)  
11-13, Avenue de Friedland  
75008 Paris

Paris, 20 October 2008

## **AFG RESPONSE TO CESR ON RISK MANAGEMENT PRINCIPLES FOR UCITS**

Dear Mr Comporti,

The Association Française de la Gestion financière (AFG)<sup>1</sup> welcomes the CESR's consultation paper on risk management principles for UCITS.

AFG wishes to express the following comments made by its members:

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<sup>1</sup> The Association Française de la Gestion financière (AFG)<sup>1</sup> represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 405 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing more than 2500 billion euros in the field of investment management, making in particular the French industry *the leader in Europe in terms of financial management location* for collective investments (with nearly 1500 billion euros managed from France, i.e. 22% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, *and second at worldwide level after the US*. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

1. Risk management is key for us, and the current crisis shows, to put it mildly, that our profession does not compare negatively on that point with other parts of the financial industry
2. While making sure that our industry maintains and develops efficient risk management tools and procedures, important pitfalls should be avoided when drawing up additional regulation. We want particularly to stress that:
  - a. an obligation of results seems unduly to emerge from CESR's consultation paper. Currently, the risk management process and policies induce an obligation of means. The consultation seems to change it into an obligation of results, which would be a very dangerous step
  - b. the principle of proportionality should be clearly taken into account. The risk management policy should be proportionate to the nature, scale and complexity of the Management Company's activities, in order to avoid undue and counterproductive burdens on small and mid-sized companies
  - c. workable implementation timeframe and costs are key. The financial crisis will undoubtedly impact our members P&L, and resources should not be distracted from asset allocation and management and from client contact to implement unnecessary new rules. We urge CESR to take these facts into account when adopting its new level 3 guidelines
  - d. The level playing field principle for UCITS as compared to substitute products should be, at all times, kept in mind.

## **A. General comments**

### **1. an obligation of results seems unduly to emerge from this paper**

Recent market turmoil has again highlighted the importance of a sound and well functioning risk management in the "company"<sup>2</sup>. Effective risk management is one of the key aspects of

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<sup>2</sup> As defined in CESR consultation paper: UCITS III management company or the self managed investment company.

all procedures which aim at ensuring investors protection. With the UCITS III directive, some funds offer the opportunity to increase the use of innovative financial instruments and implement quantitative asset management strategies. Some of these UCITS are therefore exposed to some level and complexity of risk, inducing institutions to demonstrate a more disciplined approach to risk measurement and management. As an example, in France, “type B funds”<sup>3</sup> have to use a quantitative measure of their commitment (VaR, CVaR...). It shows that risk management is already a “hot spot” in companies’ policies aiming at ensuring investors protection.

Moreover, the large majority of our members have already put in place organisational principles in terms of risk management. These internal policies impose requirements to risk management teams: tools used, independence from front office and sales business lines, experience, reporting to top decision-making levels... We also can note that “Technique and Instrument for efficient portfolio management” (see CESR advice on eligible assets for UCITS) must be included in the risk management process, so there is already a process.

So, for our members, CESR’s goal is already a reality into their companies. Risk management is effective, well evaluated and clearly identified into their organisation and is an ongoing process. Risk management policy is an obligation of means, which is duly considered by the competent authorities during the process of UCITS authorization. It is not, however, and cannot be, an obligation of results. As CESR deals with “**all** relevant risks” (eg : box 5) identified “among **all possible** risks ...” it seems that this obligation of means would be turned into an obligation of results. Risk managers would have to identify **all** risks, even unexpected risks. This is simply impossible and it would be dangerous to make people believe it can become a reality. As an example, definition of VaR is the maximum amount of capital that a position can expect to lose within a specified holding period and **with a specified confidence level**. VaR provides no information about the expected size of the loss beyond the considered “**normal market conditions**”.

This example shows three major ideas:

- i. Risk management is clearly an obligation of means. Risk managers have to put in place the best practices in terms of risk monitoring, computing and managing risks.
- ii. If CESR aim is to turn this obligation of means into an obligation of results, the last developments in risk management – which were very costly to implement - will

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<sup>3</sup> Funds using complex derivatives such as CFD, CDS, TRS, CLN, Asian options, backward-looking options, or funds implementing arbitrage strategies.

become out of date, because they are all based on statistical calculation. This implies to refer to historical data (but what if historic is short?), market conditions which can fluctuate (but what if, for example, volatility rises at levels never reached?) and human decisions that one can not predict (what if all hedge funds suddenly decide to use gates?). And we are not dealing with risks due to misconduct, fraud or negligence by nature unpredictable...

- iii. The switch from obligation of means to obligation of result would lead to a new situation where investors can claim damages, if an unexpected risk has occurred. It is not acceptable to be liable for any unpredictable event while all measures have been taken to prevent predictable risks.

**We urge CESR to clearly write in the final advice, as an overarching principle, that risk management does not imply any obligation of result but an obligation of means.**

**CESR should therefore refer only to “predictable and material risks” throughout the paper instead of “all risks” or “all material risks”.**

2. **the need to take into account the principle of proportionality and**
3. **the implementation delays and costs**

66% of French asset managers are entrepreneurial companies, i.e. not belonging to a bank or an insurance group. Moreover less than 5% of the 8 424 French UCITS are using VaR calculation because 95% of UCITS are “plain vanilla” UCITS. So, risk management policy must be adapted to the size of the fund or its company, its investment objectives and strategies, the financial instruments used, ... This principle of proportionality was already successfully followed in the context of the MiFID for instance: a “one size fits all” approach as seems to be proposed by CESR would be inconsistent not only with the French landscape of asset management but also with the European legislative approach in the field of financial services. In order to ensure a level playing field approach with other financial services covered by the MiFID, this principle of proportionality must be introduced by CESR. **There is obviously a need to apply the principle of proportionality taking into account the nature, scale and complexity of the company business and of the UCITS it manages.** It

has already been considered by CESR in box 3 (point 2), covering the risk management function, but should be extended to the whole CESR paper approach.

**The point 2 of box 3 should become an overarching principle of the final CESR position on risk management.**

We should not impose on small management companies – or management companies in creation – a specific risk management department with several people (that we can deduce from point 1 Box 3) in addition to other departments currently involved in regulatory compliance monitoring. Barriers to entry would be too high for new players. Of course, this approach only concerns non complex UCITS.

The principle of proportionality must also imply that the board is not the only body involved in the risk management process. We find more rational and efficient, depending on the type market conditions or risks, that the relevant / skilful persons will be involved in the risk management process.

To illustrate, when there is only a little excess in a ratio, only the risk manager will deal with that. When there is a need to replace the risk management tools (software) the IT and internal audit will be involved in addition to the risk manager. Finally in case of sudden market turmoil which necessitates an adjustment of liquidity conditions, of course the top decision-making levels must be involved.

**The principle of proportionality cannot be applied without taking into account an “equation” linking two parameters to give the appropriate answer: on one side market conditions and/or risks and on the other side the relevant persons involved in their management.**

**In any case we ask CESR to take into account the current economic crisis when drafting the final document and later for its implementation at national level.**

#### **4. Proportionality of risk management for UCITS as compared to substitute products – e.g. equities, derivatives or structured products**

As already mentioned above, the vast majority of UCITS are plain vanilla UCITS. In this case, the potential risks are, more often than not, lower than other types of financial products equally offered to retail investors, such as direct investment in equities, derivatives or structured products.

As you know, UCITS have very stringent risk limitation rules through the legally binding requirement of the UCITS Directive: rules of dispersion for investments (by investment and by issuer), limitation in borrowing, limitation in derivative commitment. By contrast, the direct investment by investors in equities, derivatives or structured products could imply higher risks:

- for direct investment in equities, higher average price volatility;
- for derivatives, higher leverage effect and difficulties for following the evolution of the price (because of the crucial link between on the one hand the pricing of derivatives and on the other hand the evolution of the implicit volatility plus temporal value);
- for structured products, and even more complex price valuation.

Therefore, we urge CESR to keep risk management requirements for UCITS proportionate to the risks involved by those products as compared to substitute products, which can often be more risky.

## **B. Specific comments**

### *PART 1 – SUPERVISION*

#### *Box 1: Supervision by competent authorities*

Although we agree that risk management should be considered by the competent authorities during the process of UCITS authorization, AFG strongly believes that this cannot lead to a re-assessment of the risk management process each time a new UCITS is authorized. “Fast track” processes could be implemented: if a company launches a UCITS with the same risk profile than older ones, there is clearly no need to assess again the previous agreement.

Furthermore, such an assessment is not included in Art. 4 of the UCITS Directive, which regulates the authorization of UCITS, and therefore such an obligation would exceed the requirements of the UCITS Directive.

With regard to Para. 5, AFG also believes that the language should be aligned with Box 1 and the risk management process should not be “assessed” by the competent authority in the process for licensing the UCITS, but rather “considered”.

## *PART 2 - GOVERNANCE AND ORGANIZATION OF THE RISK MANAGEMENT PROCESS*

### *Box 2: Definition of roles and responsibilities*

AFG is of the opinion that a separate “risk management policy” document is not necessary, and that the risk management process can continue to be duly documented within existing organizational rules and procedures. The last sentence in Para. 2 (“The corresponding documents will be referred to as ‘risk management policy’”) should therefore be deleted, and the reference to the “policy” in Para. 3 should be modified into “risk management process”.

With regard to Para. 7, in the first sentence the reference to the risk management policy should be removed and the sentence should read: “In particular, with respect to its organisation and functioning, the process should:”

### *Box 3: The risk management function*

In Para. 1 of Box 3 the reference should be to unit(s), (not unit), as used in Para. 7(a).

In Para. 3 of Box 3 the reference to the risk management policy should be deleted. Instead of “policy and procedures”, we suggest that CESR refers to the “risk management process”.

The reference to “IT structures” in Para. 9 is unclear. We would suggest stating that “the risk management function should employ sound processes, professional expertise and adequate risk management techniques and systems”.

In Paragraph 14 of the explanatory text, the term “guarantee” ought to be replaced by “ensure”.

### *Box 4: Outsourcing*

Para. 1 Box 4: AFG fully agrees that it should be possible to outsource risk management. However, it would be better to state that the Management Company retains “primary responsibility” for the effectiveness and appropriateness of the risk management process, rather than “full responsibility”.

Para. 2 Box 4: The reference to “the appropriateness of its operations and conditions” should be replaced with “the appropriateness of its operations and risk management process”, as ”conditions” is unclear.

Para. 20 of explanatory text: The reference to “Outsourcer” should be changed to “Outsourcee”.

### *PART 3 - IDENTIFICATION AND MEASUREMENT OF RISKS RELEVANT TO THE UCITS*

#### *Box 5: Identification of risks relevant to the UCITS*

Para. 22 of the explanatory text - AFG suggests modifying the sentence as follows: “The risk management process should regard as relevant the material risks that stem from the investment strategy and profile of the UCITS and the valuation process” (the reference to the manager’s trading style should be removed).

Para. 24 of the explanatory text: AFG would appreciate a clarification of the meaning of the last part of the sentence (“...without being bound by the use of a specific risk management model...”).

#### *Box 6*

Para. 1 of Box 6: The reference to the “risk management policy” should be deleted (see our comments to Box 2). The sentence should read: “The Company should specify ...”. We also propose that “each” (for each UCITS) will be replaced by “... for the different categories of UCITS managed by the company.” As we have already said, there is no need to make an exhaustive list of each UCITS but the main categories that have the same risk profile. For example, all Eurostoxx50, long only, without derivatives ... UCITS funds should be considered as a same category, with the same risk profile so there is not need to describe techniques and tools for each of them, but only for the entire category.

AFG disagrees with the last sentence in Para. 28, which could be interpreted in an overly prescriptive way – especially the statement “...consider the use of market-leading market solutions” – for management companies utilizing adequate in-house solutions.

#### *Box 7: Management of model risk concerning the risk measurement framework*

Box 7, Para. 2: the word “continuous should be replaced by “ongoing”.

Para. 33 of the explanatory text: AFG suggests the following modification: “Back-testing should be carried out separately for every relevant technique used in the risk management framework”, as back-testing is not relevant to all techniques.

*Box 8: The link between risk measurement and asset valuation*

In reference to Para. 2 of Box 8 and in particular to Para. 40 of the explanatory text, AFG agrees that the risk monitoring/measurement function should support the valuation process. This support, however, should take the form of participation in the management company’s valuation function, not of imposing its pricing assumptions and models on the valuation function.

The valuation function should exercise its activities independently of the risk monitoring function, and should be responsible for choosing the most appropriate pricing source or valuation model.

We suggest adding at the end of Para. 39 the wording “where available”, as actual comparable trades might not be available.

#### PART 4 – MANAGEMENT OF RISKS RELEVANT TO THE UCITS

*Box 9: Risk management procedures*

AFG believes that the language of Para. 1 of Box 9 should be modified to better define the role of the Board of Director as follows: “The Board of Directors should approve the risk policy which aims to define the product and risk profile for the different categories of UCITS managed by the company prior to their launch.”

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| Para. 2 should be similarly modified: “The risk management procedures should ensure that the actual level of the risks incurred by the UCITS remain consistent with its product and risk profile as defined for the different categories of UCITS managed by the company.” |
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For consistency reasons, the terminology “product and risk profile” should be used in Paras. 41 and 42 as well.

*Box 10: Risk limits system*

Para. 1 of Box 10: AFG suggests the following modification: “The risk management policy of the Company ... measures used to monitor and control the relevant quantifiable risks”, as

non-quantifiable risks clearly cannot be subject to a limit system. The same addition of “quantifiable” should be made to the first sentence of Para. 45.

In Para. 45, AFG does not believe that it is necessary or even feasible for every transaction to be taken into account immediately into the calculation of the corresponding limits for all risks, and the word should therefore be deleted.

*Box 11: Effectiveness of the risk management process*

AFG believes that that the requirement in Box 11 of a “prompt” correction of the portfolio in case of breaches to the risk limit might not necessarily be in the best interest of UCITS investors. CESR should recognize that corrective action should be discussed and agreed with the investment management function, and the appropriate timing of corrective action has to be evaluated according to the best interests of the UCITS and its investors.

AFG agrees with the fact that the risk management process should allow warnings to be generated so that appropriate corrective measures may be taken on a timely basis to prevent breaches. However, in our opinion the second sentence of Para. 48 and the entire Para. 49 should be deleted, as the use of specific risk assessment measures and in particular of stress testing should be left to the discretion of the management company. Furthermore, such details seem to be too prescriptive for these principles.

## PART 5 –REPORTING AND MONITORING

*Box 12: Reporting to the Board of Directors and the Senior Management*

In Para. 2, we do not believe that it is possible to outline “expected breaches”, a reference to which should therefore be deleted.

As discussed in our comments to Box 11, the word “prompt” in Para. 2 is inappropriate. It would be sufficient for CESR to refer to “appropriate action”.

*Box 13: Monitoring of the risk management process*

The “Supervisory Function” seems unclear for us. If this supervisory function means the regulator, we think it should be deleted as it would represent an additional burden. If the supervisory function means the internal auditor, CESR’s proposal makes sense as long as the proportionality principle is applied and as long as this supervisory function can be performed by the board itself for the small and medium-sized Management Companies.

In Para. 3, we believe that the reference to “internal or external independent oversight” is too unclear. The paragraph should therefore be modified as follows: “The risk management process should be subject to appropriate review by the Company’s internal or external auditors”.

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We thank CESR very much for taking into consideration our comments and remain at your disposal for any further questions. Please feel free to contact myself at 33 1 44 94 94 14 (e-mail: [p.bollon@afg.asso.fr](mailto:p.bollon@afg.asso.fr)), our Head of International Affairs Stéphane Janin at 33 1 44 94 94 04 (e-mail: [s.janin@afg.asso.fr](mailto:s.janin@afg.asso.fr)) or our Management Techniques Senior Adviser Bertrand Gibeau at 33 1 44 94 94 31 (e-mail: [b.gibeau@afg.asso.fr](mailto:b.gibeau@afg.asso.fr)).

Yours sincerely,

(signed)

Pierre Bollon