

AFG recommendations
concerning the Synthetic
Risk and Reward Indicator
(SRRI)

JUNE 2012

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Analysis produced by the SRRI working group of the Asset Management Techniques
Commission

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Introduction

The simplified fund prospectus was replaced by the Key Investor Information Document (KIID) on 1 July 2011. The KIID is a standard two-page document with five sections, including one on the risk and reward profile of the fund. This section contains three subsections: the Synthetic Risk and Reward Indicator (SRRI) denoted on a numerical scale from 1 to 7, a narrative section explaining the risk indicator category and another narrative section dealing with material risks that are not captured by the indicator.

In July 2010, ESMA published guidelines¹ setting out a specific methodology for calculating the SRRI. The standard methodology is based on the volatility of the fund. The historical annualised volatility of total returns is determined on the basis of weekly returns over a five-year period. The fund is then allocated to a risk category using the grid of volatility intervals provided by the European Securities and Markets Authority (ESMA).

General comments

How accurate should the SRRI be?

How much latitude should there be concerning methodology?

The regulator's objective was to propose² a specific³ harmonised methodology that can be applied to all types of funds and leaves no room for manipulation. Therefore, it is inconceivable to deviate from the methods recommended by ESMA or to alter the indicator manually. The indicator must be determined by applying the accepted methodology⁴. The SRRI is an indicator of both risks and rewards, meaning that the published indicator should be as accurate as possible so that neither the risk nor the correlated expected reward is overestimated or underestimated.

The KIID containing the SRRI provides key information that investors need to make informed investment choices. It is important that, in the case of UCITS at least, this document be given systematically to all potential retail or institutional investors.

Which day of the week should be used to calculate weekly returns?

The recommendation is to use Friday for calculating weekly returns.

How should holidays be handled?

If the Friday is a holiday, the latest known valuations should be used.

How frequently should risk category updates and changes be monitored?

- Updates of KIID: once a year

- Monitoring: continuous

The regulator provides for a change of risk category:

- in the event of a material change in the risk and reward profile of the fund;
- if revisions are made to the “Risk and Reward Profile” section following changes in investment strategy or policy;
- if volatility falls outside the current category interval on each data reference point over the preceding four months.

In the latter case, if the SRRI is different from the published SRRI over the preceding four months, the KIID must be updated. The new SRRI is then equal to the one most often observed over the preceding 17 weeks. If two different SRRI levels are observed equally often, then the most recent one is published in the updated KIID.

How many weeks should be covered by the 4-month observation period?

The recommendation is to cover 17 weeks.

How should limits be used?

As a general rule, the use of limits (such as internal risk limits) requires a governance structure for those limits.

Comments about specific cases

How should flexible funds be handled?

Categorisation of flexible funds as total return funds seems to be appropriate, in line with ESMA recommendations.

AFG recommends the following methods to calculate the volatility of the pro-forma asset mix, in order of preference:

1. The volatility of the pro-forma asset mix can be calculated in different ways:

a) ex-ante volatility is calculated with the same methods used to calculate value at risk (VaR), but instead of extracting a quantile, these methods extract a standard deviation. Ex-ante volatility can be based on historical data (as is the case for historical VaR) or implied data (as is the case for a Monte Carlo simulation of VaR).

b) volatility that is consistent with the volatility calculation used to constrain the fund's management with regard to internal risk limits. This is generally ex-ante volatility calculated on the basis of one year's data.

2. The volatility of the pro-forma asset mix can also be calculated by mapping a portfolio of representative indices based, for example, on the asset allocation of the fund. However, unlike the methods outlined in the previous point, this method is somewhat approximate when the correlation between the fund assets and the portfolio of indices is not taken into account.

3. The volatility of the pro-forma asset mix can be calculated by regressing the NAV against indices relating to representative factors.

Exceptionally, flexible funds which have risk limits laid down in their documents (volatility or VaR) that are close to the internal risk limits may be categorised as absolute return funds and the volatility required to calculate the SRRI can be derived from this limit.

How should Constant Proportion Portfolio Insurance (CPPI) funds be categorised?

The recommendation is to categorise these funds as total return funds. The methodology proposed by the regulator does not take account of guarantees offered to investors. Therefore, the recommendation is to accompany the indicator with a narrative explanation stating that the risk indicator was calculated using a methodology designed for funds that do not offer investor guarantees⁵.

The ESMA guidelines regarding total return funds recommend the use of the volatility corresponding to the risk limits of the fund, if any and appropriate. In the case of CPPI funds, if we deem that there is no relevant risk limit, the formula is: $SRRI = \max(\text{Vol_Histo}, \text{Vol_ProForma})$. This formula generally yields conclusive results.

Calculating the SRRI for CPPI funds: calculating the volatility of the pro-forma asset mix

It is acceptable to use internal risk limits to derive the SRRI of the fund.

The advantages of this solution are:

- 1/ it means that the calculation is based on a risk indicator that is actually used to manage the fund,
- 2/ it simplifies implementation.

Exposure x the volatility of the risky asset is an acceptable method for calculating the volatility of the pro-forma asset mix. However, this method cannot be used unless the volatility of the risk-free asset is negligible. This information should be carefully documented.

Monetisation of a CPPI fund

The recommendation is to treat a full monetisation of a CPPI fund as a change (break) in management method, so that the KIID can be revised accordingly. The monetised CPPI fund thus becomes a market fund or a life cycle fund.

In other cases (revolving or annual guarantees), the method for total return funds is still used. When a temporary or partial monetisation occurs, the volatility of the pro-forma asset mix declines and leads to a lower SRRI category after a few weeks.

How should funds with relative VaR limits be categorised?

These funds must be classified as market funds. They cannot be categorised as absolute return funds since a relative VaR limit cannot be treated as a VaR limit.

Structured funds – updating method

It should be borne in mind that the French regulator requires a weekly recalculation of the SRRI of a structured fund and updating of the KIID as necessary, as is the case for other categories of funds.

Different methods can be used to update the SRRI, but each fund must choose a single method:

- historical VaR (method prescribed in the ESMA recommendations)
- probabilistic VaR based on scenarios related to the variation of underlying assets.

Structured funds – choice of the risk-free rate

Here are two examples of acceptable choices:

- the yield of the relevant maturity swap curve,
or
- the yield of the equivalent OAT maturity curve (e.g. assuming linear interpolation).

Structured funds - drift

ESMA does not define the concept of drift with regard to the methodology for structured funds. Nor does it stipulate a method for determining whether drift exists or how to correct for it. In the absence of other elements at the European level relating to the application of the ESMA method for calculating the SRRI, we think this methodology is more specifically suited to calculating the SRRI of a new fund.

However, the management company may determine that it would be better to expand the historical simulation on a case-by-case basis to take account of more diverse situations in rising and falling markets. In this case, we think that expanding the historical simulation is a reasonable means of correcting the drift.

The comments published in the KIID can be used to “modulate” the SRRI, by including the extreme capital loss risk in the narrative explanation of the SRRI published, for example.

Calculating the risk indicator for funds of hedge funds

The recommendation is to use the method prescribed for total return funds and to use the following to calculate volatility:

- a risk limit, if the fund has one;
- a pro-forma asset mix:
 - (preferred option) a transparent calculation of the volatility that relies on the transparency of underlying funds, if the management company has an external tool providing this function, along with an appropriate hedge fund index for the funds that the tool does not cover.
 - (alternative option), using a hedge fund index or a mix of relevant sub-indices for each strategy (such as HFRX, Edhec or Greenwich) for the fund as a whole. This method will be more accurate if it takes account of the correlation between the fund and the index.

- 1) *ESMA Recommendations: CESR's guidelines on the methodology for the calculation of the Synthetic Risk and Reward Indicator in the Key Investor Information Document (CESR/10-673).*
- 2) *ESMA Recommendations: CESR's guidelines on the methodology for the calculation of the Synthetic Risk and Reward Indicator in the Key Investor Information Document (CESR/10-673).*
- 3) *The methodology recommended by ESMA is based on the volatility of the fund (the weekly returns over a five-year period are used to determine historical annualised volatility and a table of volatility intervals is used to categorise the fund on a scale of 1 to 7).*

The ESMA methodology establishes a de facto classification of funds with:

A general category of market funds, where the investment strategy is aimed at reflecting the risk and reward profile of a given segment of the market;

Specific categories, with predetermined risk profiles and target return profiles:

- Absolute return funds, where management strategy is based on variable allocation of the portfolio to different asset classes and a risk limit is present;*
- Total return funds, where the fund has a target return and flexible investments in diverse asset classes;*
- Life cycle funds, where portfolio allocations are changed under predefined rules as a target date approaches;*
- Structured funds, where the method is based on calculating a 99% VaR at maturity.*

4) *However, there may be isolated and very specific cases that require revision of the assumptions used in the accepted methodology to correct for obvious bias, but such revisions must be specifically documented and explained.*

5) *The methodology proposed by the regulator should be revised, at least as far as permanently guaranteed funds are concerned, so that the SRRI can be capped in consideration of the amount that is guaranteed.*

AFG would like to thank all of the members of the working group who took part in compiling this guide, with special thanks to Arnaud Dechatre, Deputy Chief Risk Officer at Lyxor AM, who led this working group of the AFG Asset Management Techniques Commission, which is chaired by Arnaud Faller, Chief Investment Officer at CPR AM. **Adina Gurau Audibert served as the AFG rapporteur for the working group.**

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