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PRiM

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PRiM News

Welcome!

For most of the European fund industry, the publication of the UCITS III Directive was a significant milestone that opened many opportunities. A wider range of activities for fund management companies, simplified prospectuses, new types of fund structures and a wider choice of asset types are some of the improvements that UCITS III introduced. The fund industry welcomed these changes with open arms.

Four years after the approval of UCITS III, however, the European fund industry is realising that change also engenders risk. This issue of the *PRiM Risk Newsletter* is thus dedicated to the new risks that have arisen with the implementation of UCITS III. Key among these risks is an increased use of derivatives in UCITS funds.

This issue of the *Newsletter* differs from previous issues in two significant ways: instead of having our usual one interview,

we have interviewed three people from different areas of the fund industry; it is also more international, since two of the people interviewed are based outside Luxembourg, bringing an international perspective.

The three people interviewed are: **Denis Kissane**, Global Head of Derivative Pricing and Risk at HSBC Alternative Funds Services, Dublin; **Yves de Naurois**, Managing Director of Independent Risk Monitoring Limited (IRML), London; **Philippe Cuelenaere**, Conducting Officer ('Dirigeant') of the self-managed SICAV, PAM (L), promoted by Petercam, Luxembourg.

In addition to the three interviews, we also have an article on compliance risk by **Gabrielle Jaminon**, Senior Manager, KPMG Regulatory & Compliance Services, Luxembourg.

Your ideas for future issues and your comments are always welcome. Please send them to info@prim.lu.

Bonne lecture!

Paul Kleinbart, Editor

The individual opinions expressed in this newsletter do not necessarily reflect the opinion of PRiM nor of any other contributors to this edition

UCITS III Eligible Assets and Related Compliance Risks

Gabrielle Jaminon, Senior Manager, KPMG Regulatory & Compliance Services



On September 5, 2006, the European Commission issued a draft directive implementing the European Council Directive 85/611/EEC regarding the European definitions of eligible assets under the Directive. This draft directive constitutes the first step towards a legally binding document that transposes the final advice of the Committee of European Securities Regulators (CESR) on eligible assets, which was issued in January 2006. The draft directive aims at reducing the scope of divergences in interpretation and implementation of the definitions of the UCITS Directive. It also aims at ensuring that the definitions are understood in conformity with the spirit of the UCITS Directive.

To ensure that the legislation is applicable to the current known investment types and will also be applicable to any future financial innovation, the clarifications described in the draft directive are mainly in the form of a “toolkit” rather than a list of eligible assets. It provides general principles and criteria to be considered when assessing the eligibility of investments. In some instances, however, the compliance criteria are numerous and may require lengthy analysis and/or information gathering. This is the case, for example, with money market instruments. Structured financial instruments embedding derivatives will also require a detailed analysis.

The practical day-to-day implementation of the “toolkit” will require careful consideration as illustrated below.

Ensuring the correct level of understanding of the CESR document and a correct analysis of the instruments

In view of the current search for performance, investment managers are entering more and more into structured financial products and derivatives that will help reduce costs and enhance return. The characteristics of those structured financial instruments may vary significantly and so will their treatment in the computation of investment limits.

As an example, some structured financial instruments will embed derivatives. The

directive defines those instruments as securities that contain a component:

- by virtue of which some or all of the cash flows otherwise required by the transferable security are modified according to a specified interest rate, foreign exchange rate, index of prices or rates and other variables;
- whose economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract;
- which has a significant impact on the risk profile and pricing of the transferable security.

In practice, it may be quite complex to determine if a particular structured financial instrument conforms to the above definition. The question as to whether the instrument embeds a derivative or not is significant, however, as an embedded derivative will have to be considered in the computation of the global exposure to derivatives.

Directors, investment managers and depository banks need a clear understanding of the definitions used when ensuring compliance of the fund with the provisions of the Directive. They must also have the means and the knowledge to tackle the complexity of the analysis and the larger variety of structured products and derivatives.

Ensuring that an appropriate process is in place to identify and validate instruments

Besides a sound understanding of the Directive, a process needs to be in place through which persons with relevant knowledge of the legislation critically analyse the projected investments. It is to be noted that structured financial instruments are often difficult to identify in a portfolio. Although indications in the name of the investment may provide a warning sign, structured instruments often look like “plain vanilla” bonds or other standard transferable securities. This reinforces the need

to put in place an appropriate process to analyse the investments being made.

Another question to be raised is: Where does the review best fit in the depository bank’s operational structure? With investment compliance? With the department responsible for the inclusion of the securities in the global database or with another department?

Understanding the discrepancies between European countries

Although the draft directive aims at reducing the scope of divergences in interpretation of the definitions, further co-ordination between Member States may be required to define common approaches on day-to-day implementation and/or to complement the clarifications contained in the draft directive. In the meantime, there may be discrepancies in the interpretation of products that are eligible in the various Member States. One example is an investment in open-end hedge funds. A strict reading of the legislation would indicate that open-end hedge funds are not eligible assets. A few European countries nonetheless allow the investment in regulated open-end hedge funds, which they consider as “other transferable securities”.

This adds an element of risk in the supervision of the investments made by the asset manager in the sense that he may be located in a country where such assets are eligible, whereas the fund is domiciled in a country where they are not allowed. It also has an impact on the compliance of the fund in the country of registration.

The foregoing discussion illustrates the complexity and risks relating to the appropriate treatment of eligible assets and the need for close monitoring by qualified people, so as to avoid non-compliance issues that could lead to de-registration in countries of distribution or to breaches that must be indemnified.

New Risks Associated with UCITS III



UCITS III has had a significant impact on the European fund industry, offering numerous possibilities that were not foreseen in the original UCITS legislation. With these new possibilities, however, come risks that may be new to for traditional UCITS funds.

To evaluate the impact of UCITS III from a risk perspective, PRiM interviewed players from three different areas in the fund industry – fund management, fund administration and third-party service provision. The people interviewed are:

- On the fund management side, Philippe Cuelenaere, Conducting Officer ('Dirigeant') of the self-managed SICAV, PAM (L), promoted by Petercam, Luxembourg.
- As a fund administrator, Denis Kissane, the Global Head of Derivative Pricing and Risk at HSBC Alternative Funds Services, Dublin.
- For third-party service providers, Yves de Naurois, Managing Director of Independent Risk Monitoring Limited (IRML), a London-based company specialised in risk monitoring services.

Although the three interviews were not conducted simultaneously, the same questions were used in each of them. The responses, therefore, are presented side-by-side below. The opinions presented in the interviews are the personal views of the interviewees and do not necessarily represent the positions of their companies.

PRiM: UCITS III has overcome many of the investment restrictions of UCITS I by allowing new types of funds and a wider choice of asset types. What risks do you associate with these changes?

Philippe Cuelenaere:

In my opinion, the most significant risk arising from UCITS III is the risk linked to the implementation and operation of a management process that is appropriate for the use of derivatives in UCITS funds. To manage this risk, we will need to adapt our current risk management systems to the specific requirements of derivatives. We should not forget, however, that derivatives do not necessarily increase risk. In fact, they are often used effectively to reduce and manage risk.

It is clear as well that the existing risks in UCITS I funds are also impacted by the addition of derivatives in UCITS III. Counterparty risk and pricing risks, for example, have always existed, but now, particularly through the use of OTC derivatives, they have increased considerably.

Another risk arising from UCITS III is the divergence in interpretation and implementation of the directive among the different Member States. It is essential, therefore, that UCITS III be implemented consistently across the entire EU.

Denis Kissane:

Whilst I do not see any major challenges with listed derivatives, I believe over-the-counter ("OTC") derivatives will pose challenges to the industry as funds grow more sophisticated and OTC usage increases. The biggest challenge for the industry will be coping with the requirement of daily valuation and the regular risk monitoring and reporting process required under UCITS III. Integrating OTC derivatives into existing valuation and risk reporting structures requires an increased skill set. OTC derivatives by their nature are bespoke, hence product variations will emerge to add growing complexity as funds become more sophisticated. Sourcing models and the observable market data to price the OTC contracts accurately will pose challenges to those whose experience is limited to administering traditional funds, in which the use of derivatives was limited.

In large well-developed markets such as London, New York, Hong Kong and Tokyo, regulators have a long history of working with OTC derivatives as part of the investment banking regulatory environment. Administrators and regulators in large alternative fund markets such as Luxembourg and Dublin have gained experience in the use of sophisticated derivatives from exposure to the alternative funds industry, so fortunately

Yves de Naurois:

The first impact is the blurring of the notion of asset class as we knew it with UCITS I. Before there were relatively simple bond, equity or money market funds that were created under UCITS and derivative funds were viewed as something completely different. Investors could base their expectations on the broad evolution of the indices representing the asset classes in which the funds were investing. With the introduction of derivatives, the categories of UCITS funds and their risk profiles become rather fluid and no longer so simple. Competition from hedge funds and between fund managers is driving this trend and is gradually leading to increasing complexities.

One of the key drivers in the risk profile of investment portfolios is leverage. This issue existed before to a limited extent, but the use of derivatives could increase it dramatically. Because derivatives can be highly leveraged, it is often difficult to evaluate the level of risk, to which their use exposes a fund. Even simple derivatives or combinations of them can result in significant leverage. It is therefore essential that funds apply effective and appropriate risk management techniques, as required in Article 21 of the UCITS Directive (Article 42 in the Luxembourg Law of 20.12.02). The operating word is appropriate. In this

some experience does exist.

Denis Kissane (contd.):

However so far it has not been focused on the traditional funds arena. The challenge that the industry now faces is leveraging the experience gained in these sectors to meet the growing needs of the UCITS III funds. Two possible sources for acquiring this type of expertise are the service providers for alternative funds and some of the traditional investment banks. Attracting the necessary expertise and infrastructure, however, will be expensive, which could in turn lead to price increases among fund administrators. This is exactly the approach HSBC have followed over the last number of years investing heavily in recruiting a global team of derivative specialists to create automated valuation and risk measurement solutions for its alternative funds clients. This same team is also supporting the growing number of UCITS III funds that need this expertise.

Yves de Naurois (contd.):

regard, funds must follow the spirit, not just the letter of the law. For example, some of the simple crude VaR calculations widely used may not be enough in many cases and a single number, mathematically correct, but not properly derived with regard to the type of instruments in the fund, will not necessarily paint an adequate picture of a portfolio's risk profile. The same argument could be made regarding the commitment approach that is used for portfolios with simple derivatives, but with significant hidden leverage. The danger is to transform the risk monitoring activity into a purely administrative process with no insight into the strategy of the portfolios.

So for me the main risks are a lack of proper understanding and communication of the resulting risk profiles of the investment portfolios and a lack of appropriate insight into these risk profiles by transforming the required monitoring into a simplified compliance exercise. Management companies will continuously have to question the effectiveness of their risk management processes (RMP's).

PRiM: Do you think that the risk management of service providers in the fund industry will require significant improvement because of the risks associated with UCITS III? If yes, in which ways?

Philippe Cuelenaere:

While I believe that in Luxembourg we have sufficient expertise in derivatives on the portfolio management side, it is necessary for portfolio managers to become more like investment bankers in their understanding and use of derivatives.

Denis Kissane:

My personal opinion is that as derivatives use becomes more widespread in UCITS III funds the industry will need to utilise the more sophisticated risk management techniques that are already in existence to manage and control their portfolio risk. At present, most

Yves de Naurois:

Certainly the need for more sophistication in RMPs is a challenge for practically all service providers to the fund industry. The traditional linear risk models that have been broadly used by the investment industry were well suited to traditional asset class portfolios

Philippe Cuelenaere (contd.):

There is also a need to develop derivatives expertise among risk managers, who need continuing training to keep themselves up to date with regulatory changes and new developments in the industry. In this context, Luxembourg should be more open to foreign expertise. One major risk that risk managers face is underestimating what they do not know, particularly with regard to derivatives. They therefore have an obligation to educate themselves in the detailed use and operation of derivatives. We should not forget that the benchmark for risk management should be protecting the investor's interests, which is the uniting factor that links all our activities.

Denis Kissane (contd.):

funds are likely to follow the simple approach rather than the sophisticated approach. In the interim, however, this approach might increase sub-optimal risk management, as funds are forced to take risk management decisions to comply with regulations. These same decisions may not necessarily be ideal in terms of managing the fund from a risk and return profile.

Derivatives are a zero sum game – when one side wins then the other side loses an equal amount. In this sense, the “buy side” and the “sell side” are mirror images of one another. The “sell side” (primarily investment banks) already employ the more sophisticated portfolio risk management techniques of assessing the net portfolio exposure. This approach is in stark contrast to the approach of measuring the market or notional value of each derivative separately, depending upon its use as either a hedge or a speculative position. Since the use of derivatives is so wide and varied the “one size fits all” approach advocated by the simple approach may not stand the test of time. Any risk management technique for monitoring and controlling must be suitably sophisticated to ensure the net “economic” exposure is what is measured and controlled.

In this context, the increasing use of Value at Risk (VaR) calculations must be welcomed. Although most UCITS funds are still non-sophisticated, many of them are using VaR calculations to evaluate their exposure to derivatives and

Yves de Naurois (contd.):

and broadly understood by a large number of participants. The same models struggle with derivatives and even more with complex and hybrid instruments. This is forcing the asset management industry to turn to new providers and explore approaches that have been developed so far by and for investment banks. These solutions are often not geared to asset management, are difficult to implement and create challenges in particular because of the data feeds they require. With only a few notable exceptions, the traditional risk model providers have not made enough visible progress with the necessary developments.

Some providers have taken their linear risk models and “tweaked” them to deal with a limited set of derivatives. This can be problematic, because it can significantly underestimate a fund's risk profile, in particular with regard to hidden leverage or hidden down side risk in the case of extreme events. Other risk model providers are indeed developing and integrating different approaches such as historical simulation, Monte Carlo, etc. and are able to provide a more appropriate mix of solutions.

The capacity of investment banks to come up with new types of instruments is creating a continuous challenge for independent risk model providers to evolve their models and create new ones; at the same time, for a risk manager it is becoming less feasible to rely on a single model.

All service providers to the fund industry, custodians, fund

Denis Kissane (contd.):

counterparties. VaR is not a panacea, however, since it is based on past data, which some people would suggest, is like “driving a car by looking through the rear view mirror”. VaR in itself is just “one tool in the bag” of risk management controls and techniques that need to be utilised. VaR must be augmented by other forward-looking techniques such as scenario analysis, stress testing, concentration risk and liquidity management. The increased use of VaR in the fund industry is nonetheless a positive trend. VaR is a more precise tool in evaluating net exposure and risk drivers, taking account of the volatility of investment returns and the correlation of investments in the portfolio. But many funds that are still inexperienced in the use of derivatives and their risk mitigation capabilities will need time to assess and evaluate the impact of moving to VaR, in terms of cost and the actual value it adds over the simple approach.

Yves de Naurois (contd.):

administrators and management companies are all potential suppliers and users of risk monitoring services. However the multiplicity of models to be employed and the necessary expertise required to deploy them represent a significant limiting factor.

The need to contain costs will likely result in two trends: increasing after sales services provided by investment banks and the emergence of specialised intermediaries. As investment banks focus increasingly on the asset management industry, they are likely to evolve their services and provide increasing “after sales” support, leveraging their existing capacity, in particular in the domain of independent pricing, stress testing, etc. Independent intermediaries are concentrating and leveraging the required expertise, which is both relatively scarce and expensive, and can implement efficiently multiple models and integrate the required specialised data.

PRiM: Some industry observers would claim that with a wider acceptance of derivatives through UCITS III, the difference between traditional UCITS funds and alternative investment funds is narrowing. Would you agree with that position?

Philippe Cuelenaere:

Not necessarily. It all depends on what we understand under “alternative investment funds”. If we define alternative investment funds as including private equity funds, venture capital funds, real estate funds and funds investing in collateralised debt obligations or commodities, then UCITS funds are still relatively conservative. If the definition of alternative investment funds is limited to hedge funds and

Denis Kissane:

Certainly in the past the limitations on using derivatives in UCITS funds were a key difference between UCITS and alternative funds. This difference between alternative and traditional funds is blurring under UCITS III, but the mere use of derivatives does not make a fund “alternative”. Alternative funds are allowed to use more aggressive, “alternative” investment techniques, such as short

Yves de Naurois:

Yes. As mentioned before, the differences between asset classes are becoming blurred. These differences can be subtle, but significant. Limitations on short selling in UCITS funds, for example, can partly be overcome through the use of derivatives. This approach, of course, brings those funds even closer to alternative investment funds.

Our view is that in the

Philippe Cuelenaere (contd.):

managed futures funds, then I would agree with this position.

Even if we only consider hedge funds, then the use of short selling, a high degree of leveraging and other aggressive investment techniques represent significant differences. It is clear, however, that a heavy use of derivatives in UCITS funds does indeed bring them closer to alternative investment funds.

Denis Kissane (contd.):

selling, leveraging and securities borrowing, which so far are not allowed in UCITS funds under the revised legislation.

One very positive aspect of this issue is the “mainstreaming” of alternative funds, meaning that these funds are now recognised as being very effective in managing risk, as opposed to the traditional image of them being high risk. Because of the more aggressive techniques they use, most alternative funds have dedicated risk managers, whereas traditional funds have relied on compliance officers to fill this role. The need for dedicated risk managers is likely to be a hot topic for debate for UCITS funds in the future with the possible likelihood that UCITS funds may need to obtain derivatives expertise from alternative funds. Another factor that may well bring the two fund types even closer together in the future.

Yves de Naurois (contd.):

long term the differences between UCITS funds and alternative investment funds will be minimal. Being more transparent with much broader access to retail investors, UCITS funds can maintain their distinct advantages and can continue to represent the major share of the European investment fund market. This evolution is slow and requires UCITS fund managers, their service providers and the regulators to gain more visibility and experience with the usage of derivatives. However we have seen the number of derivatives in UCITS funds administered by major institutions increase several fold over the last 12 months. The end-of-year long form reports for 2006 will certainly provide auditors with an interesting challenge in this respect.

PRiM: In how far do you think that managing the risks arising from UCITS III should be regulated?

Philippe Cuelenaere:

I think that the role of regulators in the implementation of UCITS III is very important, since they are the basis for establishing industry standards. The requirement to use two independent sources for pricing is a good example. While it is often difficult to find two sources for pricing OTC derivatives, it is essential that a fund be sure of the accuracy of the prices it uses. It seems to me that relying only on a broker for a swap price, which may include a large spread between bid and ask, or using a price from the fund manager, who cannot be considered independent,

Denis Kissane:

Regulators certainly have a very important role to play in supervising the use and associated risks of derivatives in UCITS funds. It is essential, however, that they too acquire a high level of expertise in derivatives, which will enable them to keep up with the most innovative players in the market. Without the necessary expertise, regulators often have no choice but to take a very conservative position, which could inadvertently result in obstacles to market development.

Whilst in some situations it makes sense for the regulator

Yves de Naurois:

This is the traditional dilemma - Should best practice lead regulation or regulation lead best practice? We have had very good examples of the first case, in particular in the domain of KYC (“Know your customer”), in which the initial recommendations to the Basel Committee came from the initiative of a few major private banks and were subsequently passed into regulation.

Article 21 (Article 42 in the Luxembourg Law of 20.12.02) is very clear, albeit short, in revealing the expectations of the regulators for appropriate risk management processes. In

Philippe Cuelenaere (contd.):

represents a significant risk for a fund. This example illustrates how important the requirements imposed by regulators are in reducing risk, despite opposition among some market players and despite the difficulties finding independent pricing sources.

Both regulators and risk managers need to understand the requirements of the market and support fund managers in the development of new products. The support they should provide is making fund managers aware of the risks that new products entail. The Committee of European Securities Regulators (CESR) has already provided the market with some useful insights into derivatives. For risk managers, part of this task is modelling risk to understand how it impacts a fund. If we look at the work of Markowitz, Sharpe or Black/Scholes and the impact it had on financial markets, we can understand how risk managers can make a difference.

On the other hand, regulators must avoid becoming too conservative and discouraging innovation. In this regard, I think risk managers have a major role to play. They should challenge fund managers, while at the same time maintaining a constant dialogue with regulators.

Denis Kissane (contd.):

to prescribe that the notional amount of a swap or the market value of the underlying asset in a futures contract is used, it is not suitable or it is possibly counterproductive in some circumstances. Two funds with the same exposure are likely to have very different risk profiles, yet a non-sophisticated approach does not make allowance for this fact. To accomplish a strong regulatory risk management environment, regulators need to have a profound understanding of derivatives and their use in different types of funds. To some degree the resources placed at the disposal of regulators will need to increase so they can attract and retain the skill set needed.

Yves de Naurois (contd.):

response to requests for further clarification, regulators have published numerous circulars and guidelines. Personally I feel that the existing regulatory framework was sufficiently clear on what is required for the use of derivatives in UCITS funds. It is up to the fund industry to establish market standards and define best practice, rather than expecting the answer to come from regulators.

The debate between regulators and representative bodies of the industry is active, but it seems to have been initially dominated by fund administrators and custodians pushing in the direction of simplified and more easy-to-implement controls. The active involvement of IMA and other bodies representing the investment managers is more recent and has been more in a reactive mode. I believe the new powers offered to investment managers and the competitive pressures between them will increasingly change the balance in this dialogue.

PRiM: What do you think will be the long-term impact on the fund industry of the new risks that have arisen out of UCITS III?

Philippe Cuelenaere:

I think that the long-term impact will be significant, but UCITS III represents only a first pillar. It is also a point of no return. In this sense, I agree with the position of ALFI (Luxembourg Association of Investment Funds) that the market now must enter into an implementation phase, in which the changes of UCITS III will be applied and tested. The results of this phase will be both the development of new functions and the transformation of existing functions, like risk management. Finally, I hope this implementation phase will result in a rationalisation of the fund industry.

The increasing maturity of the fund industry will benefit the final investor, who will be better protected through the increased expertise of the fund industry. Through the consistent implementation of UCITS III and the corresponding regulations across the EU, funds will become more standardised, enabling their commercialisation across the EU on the same basis and increasing competition among service providers.

Denis Kissane:

I think that the widespread use of derivatives in UCITS funds will lead to a significant enrichment of the market, in terms of both sophistication and risk management. The challenges represented by derivatives will force the players in the fund industry to improve their expertise as well as their methods for managing risk. Fund administrators need to move away from the common reliance on broker statements and develop their own expertise, particularly in the areas of independent pricing and risk modelling.

Yves de Naurois:

Former constraining regulations and controls on investment and pension funds have resulted in the creation of the alternative fund industry, an exodus of investment talent and a dangerous lack of transparency.

The fund industry is already changing significantly. The hedge fund culture is the ferment of a fundamental change in the industry, which drives product innovation and remuneration. But transparency and control of risk need to evolve at the same pace.

The expertise and the role of portfolio managers has been evolving towards the implementation of more systematic processes. However the role of the product manager, in parallel with that of the independent directors, is emerging as the key in evolving investments funds towards the appropriate blend of innovation and reliability through appropriate controls, thus keeping the funds in the realm of practicality.

The fund industry has been given the opportunity to better meet investor needs, but it will have to change fundamentally the way, in which it approaches the management of risk.

PRiM: Thank you for sharing your views with us.

PRiM News

News

Already the final quarter of 2006 is upon us! Our next edition of the *Newsletter* will appear in January, though technically due at the end of the year. It will announce a year of major milestones as **PRiM** will be celebrating its first ten years of existence, so look out for a major event to mark this anniversary. Before then, we look forward to celebrating with **IACI** (Luxembourg's Internal Audit association) their own 10th anniversary. With **ALCO**, whose 5th anniversary also fell this year, Luxembourg's professional associative life is bubbling with energy. We look forward to building on our joint work and cooperation with them and all of the many Luxembourg-based risk professionals

Between now and then, our association is preparing a follow-up to the highly successful conference in early summer on **MiFID**, while examining an number of other possible options for additional conferences.

The launch of our (re-)assurance working group took place earlier this year and we expect this to open up additional avenues of risk research and knowledge-sharing for members as the fruits of its initial reflections become available.

And don't forget our web-site, now re-launched and on which we hope to build a launch pad for risk initiatives here in Luxembourg in the coming months and years ahead.



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