



Independent Risk Monitoring Limited - Newsletter Q4 2007

New signings

- Since our last Newsletter client signings include WestLB Mellon Asset Management (London), Coupland Cardiff Asset Management LLP (London) and RSI (Geneva).
- IRML now works with 25 clients.
- Funds contracted now approaching 600.
- Assets under daily, weekly or monthly monitoring exceed €110 billion.

Staff

IRML now employs 15 full time employees based in London and Luxembourg.

Most recently we have hired **Tasos Constantinou** as Sales Director. Prior to joining IRML Tasos spent 12 years at Thomson Financial. Tasos has an in-depth knowledge of the global financial industry.

We have also been joined by **Jim France** as Head of Process and Research; Jim has been active in the structured credit markets for over 20 years with ING Barings, and CSFB. He has an MBA from Wharton and a BSc in Computer Science from Pennsylvania State University.

CSSF Circular 07/308

It is 3 months since Luxembourg's regulator CSSF published Circular 07/308 during which period world markets have been in tail-spin. From the interim highs in mid-July the FTSE Eurofirst 300 and Eurofirst 300 Financial indices have slumped 11% and 24% respectively as at November 21. The sub-prime crisis, a plunging dollar, oil prices brushing \$100 a barrel and mounting fears of a global recession are just a few of the reasons why 308 is so important.

Little of the Circular was new; the original UCITS III Directive passed into law in 2002 becoming effective for new funds in February 2004 and "grandfathered" for (then) existing funds until February 2007 – but recent market events have more than justified the inclusion of the risk provisions embodied within the Directive:-

- Qualitative requirements of RMP
- Self-determination of risk profile and clear VaR guidance
- Independence of the risk measures and the risk team
- Pre-testing at least as important as back-testing
- Stress test scenario specific to each portfolio
- Clear escalation procedures

Circular 308 has clarified some of the more contentious issues on risk management:-

Article 42 (1) of the original UCITS III Directive required that UCITS implement a risk management process which would enable them to monitor and measure at any time, the risk of their positions and their contribution to the overall risk profile (of the portfolio).

Circular 308 aligned Luxembourg with the Irish, German and French regulators in determining that "non-sophisticated UCITS" (see below) should measure and control risk on at least a bi-monthly basis - and that for "sophisticated UCITS", such frequency should be daily.

It also confirmed that the CSSF would allow a UCITS Board of Directors to delegate a portion, or all, of the risk management and control process to a third-party acknowledged to be specialised in "this type of activity"

However, the CSSF made clear that a UCITS cannot delegate its risk management responsibilities to the risk unit in charge of portfolio management decisions – i.e. to the "front office/desk". It also stated that in the pursuit of independence, a third-party can be as signed the responsibility of taking over all missions incumbent on Risk Management provided that special attention is paid, along with stringent monitoring, to transactions with derivative instruments – given the specific risks associated with this category of instrument – in particular potential leverage effect, high volatility and complexity.

At the very least, the CSSF expects that the work listed below be part of Risk Management's scope of activities:-

- determination and monitoring of global exposure
- determination and monitoring of counterparty risk associated with OTC derivatives
- determination and monitoring of concentration limits
- determination of valuations of OTC derivatives
- Establishment of risk monitoring reports

In differentiating between "sophisticated" and "non-sophisticated" UCITS, Circular 308 defines the former as UCITS which use – "for important part" – derivative financial instruments or which make use of complex strategies; and the latter as UCITS with less, or less complex positions in, derivatives or using derivatives solely for hedging purposes. This is slightly ambiguous – although the sense of the Commission's intention will be clear.

Circular 308 covers all other relevant elements of risk control which must be assumed by the UCITS Board of Directors, including determination of leverage, limitation on market risk, criteria governing the use of VaR, limitation of counterparty risk, concentration risk and monitoring and control of coverage rules.

The complete Circular is accessible at www.cssf.lu/uploads/media/cssf07_308eng_01.pdf— we will be happy to expand on this document if required.

The full impact of Circular 308 will take time to digest but it is clear that the CSSF, along-side the German, Irish and French regulators, is intent on promoting the strictest interpretation of UCITS III in-so-far as risk controls are concerned.

As a regulated entity in Luxembourg, IRML's associated company, Mercuria Independent Risk Solutions SA (MIRS) can provide all elements of the CSSF's requirements – call Chris Butterwick in London (+44 (0)20 7324 1403) or Bruno Vanderschelden in Luxembourg (+352 48 000 2341) for further explanation.

IRML in Luxembourg

IRML has joined forces with Mercuria Services S.A. to form Mercuria Independent Risk Solutions S.A. (MIRS) with services ranging from portfolio risk compliance and advice on the risk management process (RMP) to independent pricing of derivatives, risk analysis, interpretation and investigation.

In particular the solutions offered by MIRS enable the Board of Directors of a UCITS to fulfil their legal obligations in regard to the new CSSF Circular 07/308. MIRS is supervised by the CSSF and is a "Professionnel du Secteur Financier" ("PSF").

Contact Bruno Vanderschelden at +352 42 26 11 or b.vanderschelden@mirs.lu

Risk Compliance

Broadly speaking, during the last 2 to 3 years the regulatory environment across Europe has been gradually moving from a principles based approach to an increasingly prescriptive based approach. It is no surprise to us therefore that our clients are asking IRML for more assistance with compliance rules as well as portfolio risk monitoring. As a result, we have been steadily adding compliance rules to RiskRadar™ according to our clients needs. The result is increasingly meeting the requirements of "Risk Compliance" whereby both "hard" rules (compliance) and "soft" rules (market risk and risk profile) are catered for from one source.

Lunch & Learn

IRML is hosting a series of “Lunch & Learn” sessions focussing on the challenges faced by Asset Managers, Risk Managers, & Compliance Officers in the post-UCITS III environment and in the light of emerging best practice in risk management. The sessions are held over lunch in our Charterhouse Square office – if you would like to attend, please contact Tasos Constantinou +44 (0)20 7324 1404 tasos.constantinou@irml.net

RiskRadar™ Developments

IRML continues to develop and improve the functionality of RiskRadar™ - our internal risk engine integration and workflow management software. We have recently released Version 1.9.61 – new features include:

- Reports showing illiquid and unrecognized positions;
- The ability to handle cross-currency Discount Certificates (DZs)
- An enhanced “Early Warning” system within our Exception Reports to provide daily alerts of risk escalation and changes of trend in addition to deviations from pre-determined risk guidelines.

For more information on these and other RiskRadar™ upgrades, please call Jim France +44 (0)20 7324 1411 jim.france@irml.net

Market Volatility Report

IRML publishes a monthly report discussing trends in market volatility across a broad range of instruments. The report is aimed primarily at risk managers to give an overview of market risk, but will also be of interest to portfolio managers, board members and others interested in volatility and market risk. The report contains an executive summary, one section per asset class, and usually a theme article. Recently we have looked at; “The Dangers of Repackaged Debt”, “An overview of global economic growth and the impact of China” and “Trading Volatility: a closer look at the VIX Index”.

Please contact us if you would like to be added to the distribution list. Archived reports are also available at www.irml.net/news.aspx

Contact us with your views:

IRML aims to be highly responsive in developing RiskRadar™ in conjunction with client requirements. If you have any questions regarding the latest release, planned projects or would like to learn more about IRML, please contact us:

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