COMMISSION RECOMMENDATION

of 27 April 2004

on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS)

(notified under document number C(2004) 1541/1)

(Text with EEA relevance)

(2004/383/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 211, second indent, thereof,

Whereas

(1) One of the aims of the amendments to Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)[1], introduced by Directive 2001/108/EC, was to widen the scope of financial instruments in which a UCITS can invest and to enable UCITS to make use of modern investment techniques. This extension of permissible investments does not only include money market instruments, bank deposits, units of UCITS and other collective investments undertakings: UCITS are now also permitted to employ financial derivative instruments as part of their general investment policy, and not only for the purposes of hedging positions.

(2) Another aim of those amendments was to ensure investor protection. Directive 85/611/EEC, as amended, therefore establishes an extensive system of risk-limitation: In order to ensure that the risks related to the new classes of financial instruments, in particularly regarding derivatives, are duly and accurately monitored, measured and managed, management companies or investment companies are required to apply sound risk measurement processes under the supervision of the competent authorities. In particular, these risk measurement processes should enable them to monitor, measure and manage at any time the risks of the positions and their contribution to the overall risk-profile of the portfolio. Management or investment companies have also to employ processes for the accurate and independent assessment of the value of over-the-counter (OTC)-derivative instruments. These requirements of Directive

[1] OJ L 375, 31.12.1985, p. 3; Directive as last amended by Directive 2001/108/EC of the European Parliament and of the Council(OJ L 41, 13.2.2002, p. 35).

85/611/EEC call for the establishment of an adequate framework for the risk-measurement and -management of a UCITS by Member States. In order to facilitate the development of such a framework and to ensure a harmonised approach, it is desirable to recommend some common basic principles for risk-measurement.

(3) Agreement was reached in the UCITS Contact Committee on the benefits of formulating basic principles, which should be taken into account by Member States. Those principles should help Member States to ensure an equivalent and effective protection of investors throughout the Community and level the playing field for UCITS operators and products regulated under different jurisdictions.

(4) With regard to the limit to global exposure relating to derivatives set out in the first subparagraph of Article 21(3) of Directive 85/611/EEC and the maximum limit to borrowing transactions laid down in Article 36(2) of that Directive, it should be made clear which maximum exposure in total may be incurred by a UCITS.

(5) The total exposure of a UCITS needs to be assessed on the basis of both default risk of the UCITS and leverage produced by the use of financial derivative instruments. It should therefore be ensured that the market risk of a UCITS is adequately measured. It is therefore necessary to recommend possible approaches of market risk measurement, by clarifying the conditions for the use of the following types of methodologies: the commitment approach; the Value-at-risk approach (VaR-approach) and stress tests.

(6) For the same reasons it is useful to recommend some elements for the method of assessing the leverage of a UCITS portfolio produced by the use of financial derivative instruments.

(7) Pursuant to the second subparagraph of Article 21(3) of Directive 85/611/EEC, the exposure of a UCITS must be calculated taking into account not only the current value of the underlying assets, but also the counterparty risk, future market movements and the time available to liquidate the positions. As regards counterparty risk related to OTC-derivatives, specific requirements are laid down in the second subparagraph of Article 22(1) of that Directive. In view of these requirements it is desirable to clarify the method of calculating the counterparty risk associated with financial derivative instruments and the way in which it relates to the methods and criteria provided for in Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions[2].

(8) Pursuant to the third subparagraph of Article 21(3) of Directive 85/611/EEC, the exposure to the underlying of the financial derivative instrument has to be included into the calculation of the issuer concentration limits laid down in Article 22 of that Directive. According to that same provision, Member States may allow that, when a UCITS invests in index-based derivatives, these investments do not have to be combined to the issuer concentration limits laid down in Article 22. It is therefore appropriate to recommend standards for the application of issuer concentration limits with regard to financial derivative instruments.

[2] OJ L 126, 26.5.2000, p.1

(9) Uncovered sales are all transactions in which the UCITS is exposed to the risk of having to buy securities at a higher price than the price at which the securities are delivered and thus making a loss and the risk of not being able to deliver the underlying financial instrument for settlement at the time of the maturity of the transaction. These risks are always relevant for those operations in which the UCITS is forced to buy securities in the market to meet its obligations. In those cases the UCITS is exposed to the risk that it cannot meet all or a part of its commitments under the terms of a financial derivatives operation. Article 42 of Directive 85/611/EEC therefore generally prohibits the execution of uncovered sales in order to avoid heavy losses for UCITS. However, in the context of an operation with financial derivative instruments having the financial profile of an uncovered sale, the risks typically associated with uncovered sales may not always have the same relevance. It is therefore appropriate to clarify the concept of uncovered sales with regard to financial derivative instruments and to recommend criteria applicable to the cover of a derivatives transaction in order to facilitate compliance with Article 42.

(10) This Recommendation is a first step towards a uniform understanding of risk measurement methodologies in the UCITS area. However, risk-measurement methodologies are submitted to a permanent progress. Further steps may therefore be necessary taking into account further developments such as the Basle Capital Accord (Basel II) and the future corresponding Community Directive on capital requirements for banks and investment firms.

(11) This Recommendation provides some basic elements which should be taken into consideration by Member States for their implementation of Directive 85/611/EEC as amended by Directive 2001/108/EC. It should be noted that this Recommendation is not intended to provide exhaustive guidelines on the use of financial derivative instruments for UCITS but to outline some principles which can be considered as an essential basis of a common risk-measurement approach for UCITS,

HEREBY RECOMMENDS:

In the framework of implementing Directive 85/611/EEC Member States should apply the following:

1. Risk-measurement systems adapted to the relevant risk-profile of the UCITS

In applying Article 21(1) of Directive 85/611/EEC, Member States are recommended to ensure that management or investment companies employ risk measurement systems which are adapted to the relevant risk-profile of a UCITS in order to make sure that they accurately measure all material risks related to the UCITS under the supervision of the competent authorities.

2. A harmonised interpretation of limitations to the UCITS' risk- exposure

2.1 Limitation to a UCITS' global exposure on derivatives and overall risk exposure

Member States are recommended to ensure that the global exposure relating to financial derivative instruments may not exceed 100% of the UCITS' net asset value (NAV), and hence that the UCITS' overall risk exposure may not exceed 200% of the NAV on a permanent basis.

2.2 Limitation to possible temporary borrowing

Member States are recommended to ensure that the UCITS' overall risk exposure may not be increased by more than 10% by means of temporary borrowing, so that the UCITS' overall risk exposure may not exceed 210% of the NAV under any circumstances.

2.3 Joint application of points 3 and 4

For the application of the 100% global exposure limit relating to derivatives, Member States are recommended to ensure that both points 3 and 4 are respected.

3. Appropriately calibrated standards to measure market risk

3.1 Adaptation of risk-measurement methodologies to the risk-profile of a UCITS

In conformity with the overarching principle mentioned under point 1 and established in Article 21(1) of Directive 85/611/EEC, Member States are recommended to allow a differentiated methodological approach for the respective categories of "non-sophisticated UCITS", which have overall less and simpler derivative positions by using e.g. a few plain vanilla options, and "sophisticated UCITS". The distinction between, and exact definition of, these categories requires further work in accordance with point 3.4. Pending completion of such work, Member States should move towards a more calibrated approach for measuring market risk in accordance with points 3.2 and 3.3.

3.2 Non-sophisticated UCITS

3.2.1 Use of the commitment approach

Member States are recommended to request their competent authorities to ensure that, in the case of non-sophisticated UCITS, they are satisfied that market risk is adequately assessed by using the commitment approach, whereby the derivative positions of a UCITS are converted into the equivalent position in the underlying assets embedded in those derivatives. For the application of the commitment approach, Member States' competent authorities should also take into account criteria such as the UCITS' overall exposure deriving from the employment of financial derivative instruments, the nature, aim, number and frequency of the contracts entered into by the UCITS and the management techniques adopted.

3.2.2 Technical precisions

In the case of options, Member States are recommended to allow the application of the delta approach, which is derived from the sensitivity of the change in the option's price to marginal changes in the price of the underlying financial instruments. The conversion of forwards, futures and swaps positions should depend on the precise nature of the underlying contracts. In the case of simple contracts, the marked-to-market value of the contracts will usually be relevant.

3.2.3 Invitation to consider further additional safeguards

Member States are required to consider whether additional safeguards are requested in the context of the use of the commitment approach, such as an appropriate cap to the global exposure relating to financial derivative instruments below 100% of NAV for non-sophisticated UCITS.

3.3 Sophisticated UCITS

3.3.1 Standard use of Value-at-Risk (VaR) approach with stress tests

In the case of "sophisticated UCITS", Member States are recommended to require management or investment companies to apply regularly VaR approaches. In the VaR-approaches, the maximum potential loss that a UCITS portfolio could suffer within a certain time horizon and a certain degree of confidence is estimated. Member States are recommended to require management or investment companies also to apply stress tests in order to help manage risks related to possible abnormal market movements. Stress tests measure how extreme financial or economic events affect the value of the portfolio at a specific point of time.

3.3.2 Invitation to develop common reference standards as a further step

For the application of VaR-approaches, Member States are recommended to require the use of appropriate standards in conformity with point 3.1. For this purpose, Member States should consider, as a possible reference the following parameters: a 99% confidence interval, a holding period of one month and "recent" volatilities, i.e. no more than one year from the calculation date without prejudice to further testing by the competent authorities. Once common standards have been developed by further work undertaken by Member States in accordance with point 3.4, Member States should allow management or investment companies to deviate from these standards only on a case-by-case basis, subject to the appropriate examination of the competent authorities in accordance with what is provided for in point 3.3.3.

3.3.3 Internal risk-measurement models

Member States are recommended to accept only those internal risk-measurement models proposed by a management or investment company which are subject to appropriate safeguards, including those set out in this recommendation. The models concerned should be subject to appropriate examination by the competent national authorities. Member States are also recommended to disclose a list of models recognised by the competent national authorities, and make them publicly available by appropriate means.

3.4 Recommendation to carry out further work

Considering that these risk-measurement methodologies need further refinement, Member States are recommended to encourage their competent authorities to undertake further work with a view to elaborating more advanced and elaborated methods of risk-measurement and thus develop a convergent Community-wide approach. This concerns in particular:

— a) the criteria to identify sophisticated and non-sophisticated UCITS;
— b) the conversion of financial derivative instruments into equivalent underlying assets and the netting of positions underlying the financial derivative instruments in case of the application of the commitment approach;
— c) best practices in the area of VaR and stress tests;
— d) the standards which internal models must meet in order to be used by UCITS.

4. Appropriately calibrated standards to assess leverage

4.1 Use of the commitment approach

In the absence of the advanced methodologies mentioned under point 4.2, Member States are recommended to request the use of the commitment approach to assess a UCITS' leverage, in combination with the VaR-approaches and the stress-tests required for the purpose of measuring market risk exposure of sophisticated UCITS under point 3.3.

Member States are also recommended to allow management or investment companies which use the commitment approach according to point 3.2 to also employ the commitment approach for the assessment of leverage.

4.2 Invitation to allow the use of further advanced methodologies

In the case of sophisticated UCITS under point 3.3, provided that the supervisory authorities are fully convinced that a given management or investment company has already developed and tested an appropriate method of assessing leverage by the means of VaR-approaches and stress tests and provided that this method is duly documented by the management or investment company, Member States should consider recognising it for the assessment of leverage. For this purpose, Member States are specifically recommended to consider approaches relying on a standard of comparison such as the VaR/stress test value of an appropriate reference portfolio which complies with the investment policy of a UCITS or the VaR/stress test value of an adequate benchmark.

4.3 Recommendation to carry out further work

Member States are recommended to take into account that the methods for assessing the leverage of a UCITS need further refinement, in particular with respect to the maximum VaR/stress-test value corresponding to a total exposure of 200% of a UCITS' NAV. Therefore they should encourage their competent national authorities to undertake further work to develop more advanced and sophisticated methods of assessing leverage aiming at the development of a convergent Community-wide approach.

5. Applying appropriate standards and recognised risk-mitigation techniques to limit counterparty risk

5.1 Criteria for the limitation of counterparty risk exposure to OTC derivatives

Member States are recommended to ensure that all the derivatives transactions which are deemed to be free of counterparty risk are performed on an exchange where the clearinghouse meets the following conditions: it is backed by an appropriate performance guarantee, and is characterised by a daily mark-to-market valuation of the derivative positions and an at least daily margining.

5.2 Recommendation to use maximum potential loss

Member States are recommended to require the exposure per counterparty on an OTC-derivative transaction to be measured on the maximum potential loss incurred by the UCITS if the counterparty defaults and not on the basis of the notional value of the OTC contract.

5.3 Invitation to use the standards laid down in Directive 2000/12/EC as a first reference

In compliance with the fixed quantitative prudential limits already imposed by Directive 2001/108/EC, Member States are recommended to require the assessment of counterparty risk with regard to OTC-derivatives in accordance with the marking-to-market method laid down in Directive 2000/12/EC of the European Parliament and of the Council[3], notwithstanding the need of appropriate pricing models when the market price is not available. Member States should also require the use of the full credit equivalent approach laid down in Directive 2000/12/EC, including an add-on methodology to reflect the potential future exposure.

5.4 Recognition of collateral for the purpose of assessing a UCITS' counterparty risk exposure

5.4.1 General criteria

Member States are recommended to allow for the recognition of collateral in order to reduce a UCITS' counterparty risk provided that, in accordance with the prudential rules laid down in Directive 2000/12/EC and taking into account further developments, the collateral:

— a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;
— b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
— c) is held by a third part custodian not related to the provider or is legally secured from the consequences of a failure of a related party;
— d) can be fully enforced by the UCITS at any time.

5.4.2 Risk concentration limits

In accordance with the general principle of risk-spreading, Member States are recommended to ensure that the exposure to counterparty risk on a given entity, respectively group, after taking into account any collateral received from that entity, or group, may not be higher than the 20% limit laid down in Directive 85/611/EEC, both at individual level, under the second sub-paragraph of Article 22(2) and at group level, under Article 22(5) of that Directive.

5.5 Recognition of netting

Member States are recommended to allow UCITS to net their OTC-derivative positions vis-à-vis the same counterparty, provided that the netting procedures comply with the conditions laid down in Directive 2000/12/EC and that they are based on legally binding agreements.

6. Using adequate methodologies when applying limitations to issuer risk

6.1 Adaptation of the risk-measurement methodologies to the derivatives typology

Considering that the fourth subparagraph of Article 21(3) of Directive 85/611/EEC provides that, in order to include financial derivative instruments into the issuer concentration limits foreseen by Article 22, they should be converted into equivalent underlying positions, Member States are recommended to require the use of methodologies adequate to the type of instrument considered. For example, Member States may allow the use of the delta approach for options. In cases where this approach is not relevant or technically impossible, due to the complexity of the concerned financial derivative instrument, Member States may then allow

[3] OJ L 126, 26.5.2000, p.1

the use of an approach based on the maximum potential loss linked to that derivative as a maximum threshold assessment of the solvency risk.

6.2 Case of index-based derivatives

Member States are advised, in the use of their discretionary powers for the application of the option foreseen by the third subparagraph of Article 21(3) of Directive 85/611/EEC, to take into account whether the underlying index of a financial derivative instrument meets the requirements of Article 22a of that Directive. For the application of Article 21(2) and the third subparagraph of Article 21(3) of that Directive, Member States are recommended to consider that, a management or investment company should generally be prevented from using financial derivative instruments based on a self-composed index with the intent to circumvent the issuer concentration limits of Article 22. Member States are also recommended to consider that a management or investment company should be prevented from using financial derivative instruments based on indices which do not comply with the concentration limits set by Article 22a of Directive 85/611/EEC.

6.3 Risk-concentration limits

Member States are recommended to require management companies or investment companies to cumulate counterparty risk with issuer risk versus the same entity or group for the application of the 20% NAV-limit pursuant to the second subparagraph of Article 22(2)and Article 22(5) of Directive 85/611/EEC.

7. Applying relevant cover rules to transactions with both listed, and OTC, financial derivative instruments

7.1 Appropriate cover in the absence of cash-settlement

When the financial derivative instrument provides for, either automatically or at the counterpart's choice, physical delivery of the underlying financial instrument on maturity or exercise, and provided that physical delivery is common practice on the considered instrument, Member States are recommended to require UCITS to hold this underlying financial instrument as cover in their investment portfolios.

7.2 Exceptional substitution with an alternative underlying cover in the absence of cash settlement

In cases where the risks of the underlying financial instrument of a derivative can be appropriately represented by another underlying financial instrument and the underlying financial instrument is highly liquid, Member States should consider allowing UCITS to hold exceptionally other liquid assets as cover provided that they can be used at any time to purchase the underlying financial instrument to be delivered and that the additional market risk which is associated with that type of transaction is adequately measured.

7.3 Substitution with an alternative underlying cover in the case of cash-settlement

Where the financial derivative instrument is cash-settled automatically or at the UCITS discretion, Member States should consider allowing the UCITS not to hold the specific underlying instrument as cover. In this case, Member States are recommended to consider the following categories as acceptable cover:

– a) Cash;

– b) Liquid debt instruments (e.g. government bonds of first credit rating) with appropriate safeguards (in particular, haircuts);

– c) Other highly liquid assets which are recognised by the competent authorities considering their correlation with the underlying of the financial derivative instruments, subject to appropriate safeguards (e.g. haircuts where relevant).

In the context of the application of Article 42 of Directive 85/611/EEC, Member States should consider as "liquid" those instruments which can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market. Member States are recommended to ensure that the respective cash amount be at the UCITS' disposal at the maturity/expiry or exercise date of the financial derivative instrument.

7.4 Calculation of the level of cover

Member States are recommended to require the level of cover to be calculated in line with the commitment approach.

7.5 Nature of the underlying financial instrument

Member States are recommended to require that the underlying financial instrument of financial derivative instruments, whether they provide for cash-settlement or physical delivery, as well as the financial instruments held for cover have to be compliant with the Directive and the individual investment policy of the UCITS.

7.6 Recommendation to undertake further common work

As regards cover of transactions with financial derivative instruments, Member States are recommended to encourage their competent authorities to identify a common typology of transactions with financial derivative instruments in which the risk profile of an uncovered sale may be identified.

8. The Member States are requested to inform the Commission, insofar as possible, by 30 September 2004 of any measures they have taken further to this Recommendation and to inform it of the first results of its implementation, in as far as they are able, no later than 28 February 2005.

9. This Recommendation is addressed to the Member States.

Done at Brussels, 27 April 2004.

For the Commission
Frederik BOLKESTEIN
Member of the Commission