



# VaR Limit Clarification

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## VaR LIMIT CLARIFICATION

### Introduction

On 29<sup>th</sup> October, 2008, the Financial Regulator published a short paper<sup>1</sup> and revised Guidance Note 3/03 providing for a clarification of the limits to be applied by a UCITS when calculating global exposure using the absolute Value at Risk methodology (absolute VAR).

### VaR Limit Clarification

The Paper describes the change as a technical clarification which allows flexibility in the quantitative parameters used to measure risk while ensuring that existing limits are not compromised.

### Revision to Guidance Notes 3/03

#### *Guidance Note 3/03 - Purpose*

A Commission Recommendation on the use of derivatives by UCITS (the “Commission Recommendation”)<sup>2</sup> was issued in 2004 requiring competent authorities in Member States to implement risk management guidelines in line with standards indicated in the Commission Recommendation in order to ensure investor protection. In light of this, Guidance Note 3/03 was issued by the Financial Regulator outlining the parameters for the use of derivatives by UCITS and providing guidance on the measurement and control of derivative associated risk by UCITS.

Guidance Note 3/03 contains detailed requirements regarding:

- the format and content of the Risk Management Process;
- the options for measuring and controlling risk exposure;

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<sup>1</sup> Collective investment schemes – VaR limit clarification, October, 2008.

<sup>2</sup> Commission Recommendation 2004/383/EC of 27 April, 2004.

- requirements and limits on position exposure; counterparty exposure; and counterparty restrictions.

#### *Measurement of Global Exposure and Leverage – Sophisticated UCITS*

A sophisticated UCITS fund is required to use an advanced risk measurement methodology to measure global exposure. The Financial Regulator recommends the use of the Value-at-Risk (VaR) method and requires that the VaR model employed by the UCITS meets certain quantitative and qualitative criteria.

#### *VaR*

VaR may be calculated using an acceptable proprietary or commercially available model. Absolute VaR or Relative VaR may be applied. Absolute VaR is the VaR of the fund capped as a percentage of net asset value. The changes to the Guidance Note relate to the parameters for the use of absolute VaR and are considered in detail below. Relative VaR is the VaR of the fund divided by the VaR of a benchmark or a comparable, derivatives-free portfolio. Under Relative VaR, VaR is limited to twice the VaR on the benchmark or comparable, derivatives-free portfolio.

#### *Changes to Parameters for Absolute VaR*

Guidance Note 3/03 now applies a general limit (that may be raised only in exceptional cases) for absolute VaR of 20% of net asset value. This limit was previously set at 5% of net asset value. The quantitative standards applied by the VaR model must include a 99% confidence level and a holding period of 20 days.

The VaR model used must also adhere to the following requirements:

- minimum historical observation period of one year (less if justified, for example on the grounds of recent significant changes in price volatility);
- stress tests carried out at least quarterly (to assess the likely impact of potential movements in interest rates, currencies and credit quality);
- back testing of the VaR model (a formal statistical process to compare actual portfolio returns to the VaR predicted).

Where the VaR model applies a confidence level or holding period other than as set out above, a scaling process must be applied and detailed workings of such process must be provided in the risk management process. The Guidance Note provides details of scaling

calculations to be applied for an alternative confidence level or holding period. Where such alternative quantitative standards are applied, the VaR limit of 20% must be adjusted downwards accordingly.

*Existing UCITS*

A manager of an existing UCITS that measures global exposure using absolute VaR and wishes to avail of these revised measures will need to make appropriate changes to its risk management process and, depending on the level of disclosure, the offering documents of the UCITS. Such changes will need to be made in accordance with the requirements of the Financial Regulator.

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