DERIVATIVES

Finding a less restrictive derivatives framework

In replacing the regulatory framework for the use of derivatives in investments, Germany has opened the industry to more innovative use of the asset class and allowed funds to provide tailored fund solutions for investors, say Stefanie Ginsbach and Marc Boettinger, fund managers of DWS structured products

For some considerable time, the regulatory framework in Europe has been very restrictive in terms of how derivatives may be used in funds. As such, the Capital Investment Companies Act (KAGG), now superseded by the Investment Code (InvG), provided for an approved list of derivatives and their uses. In practice this meant that derivatives could not be used if they were not on the list.

The InvG and the Derivatives Regulation take a different approach and offer the capital investment management company many other avenues. The Derivatives Regulation provides clear guidelines within which the use of derivatives is permissible. Indeed a specific list of permitted derivatives has been deliberately avoided.

FORMER FRAMEWORK

Under KAGG the guidelines which applied to derivatives were rigid. Investment management companies were permitted to use derivatives purely for the purposes of management and hedging. The maximum permitted nominal was based on the fund's total assets, rather than directly on the inherent risk of the derivatives. As such, derivatives were entirely limited to orderly fund administration and hedging. Leverage was possible only to a certain degree. KAGG, derivative financial instruments were permissible only under the following circumstances (special asset funds):

- securities, (hedging and income enhancement);
- equity indices, (hedging and income enhancement);
- interest rates, (hedging and income enhancement);
- foreign exchange, (only for hedging purposes);
- swaps, (only for hedging purposes).

One of the most important restrictions under KAGG was that funds-of-funds and derivatives could not be used simultaneously. In practice this meant, for example, that the equity fund component of funds-of-funds could not be hedged in the short term using futures, nor could duration management be carried out using futures and swaps. OTC instruments under KAGG were permitted depending on the individual circumstances. This white list of permitted derivatives was exceptionally restrictive.

CURRENT FRAMEWORK

The modernised stipulations of EU guidelines as well as the needs of financial institutions, investors and supervisory authorities all came together in an independent corpus of laws based on a new system, the InvG, comprising 146 sections, and the Investment Tax Act (InvStG), comprising 19 sections. These are the two components of the Investment Improvement Act which came into force on 1 January 2004.

This document puts the concept, issue and distribution of investment funds in Germany on a broader footing: the InvG covers not only the issue of domestic funds, but also the public distribution of foreign funds (passporting) as well as scope for setting up foreign branch offices. In addition to the stated goal of improving investor protection, the joint EU standard on harmonisation of the legal requirements has been attained. One of the key points of the law remains the registration and regulation of hedge funds and hedge funds-of-funds, which can now also be issued by investment management companies in Germany.

These crucial changes relate to the wider range of uses, especially for derivatives. For the purposes of investment, all types of derivatives are permissible assets, provided that the underlying title may be acquired in accordance with InvG and contractual conditions:

- securities;
- money market instruments;
- exchange rates and currencies;
- investment units;
- recognised financial indices.

These may be combined without restriction as equivalent assets while observing extended investment limits (issuer limits) within the funds compliant with guidelines (richtlinienkonformes Sondervermögen).

German investment law has seen considerable product-related changes: the InvG has predominantly removed the legal forms of special asset funds as defined by the KAGG and has redefined these under funds compliant with guidelines. As a very clear classification criterion, German investment law differentiates between funds compliant with guidelines and funds not compliant with guidelines and, from now on, divides the fund world into two categories. In simple terms, traditional fund types such as equity, bond and money market funds fall into the compliant category. By contrast, all innovative fund constructions, which are now permitted under the new legal framework, are treated as funds not compliant with guidelines. These include pension provision, real estate, special funds as well as composite funds (Gemischtes Sondervermögen).

This expansion urgently requires adequate risk monitoring and comprehensive risk management. In determining the market price risk, the Derivatives Regulation differentiates between and the simple and qualified approaches.

While the simple approach is restricted to the basic forms of permissible derivatives and roughly equates to the old investment limits under KAGG (200 per cent), the qualified approach can be applied to all types of derivatives, provided that the underlying title conforms to the guidelines and, as such, all significant risks can be both presented and quantified. The comprehensive risk management objective of this approach under Ucits III requires dynamic risk assessment for all risks, both in quantitative and qualitative respects.

In this case, it is crucial that the market risk approach is limited by a so-called derivative-free comparable fictitious benchmark: the qualified approach is based on the principle of risk assessment by comparing the fund risk with a derivative-free comparable fictitious benchmark (risk benchmark).

The comparative asset, representing a synthetic construction, is, in principle, freely selectable. For this comparative asset to be economically meaningful, it must, however, fulfil the same requirements as the fund (in terms of investment policy and planned investment strategy). As far as possible, DWS Investments selects the fund's return benchmark as a comparative asset. In this case, the market risk of the fund may not at any time exceed 200 per cent of the market risk of the comparative asset (see chart). This relative limit is explained in the following example: the DWS EuroStoxx Fonds invests in the EuroStoxx and as such, its comparative asset is also orientated to the EuroStoxx. Observing the qualified approach, the fund can now invest 100 per cent in EuroStoxx equities while also maintaining a nominal in futures or other derivatives with the same risk exposure according to value-at-risk. For futures on the EuroStoxx, clearly long 100 per cent nominal has the same risk exposure. For options on the EuroStoxx the maximum permissible nominal depends on the risk of the option, i.e. especially on the option's Delta and Vega.

Derivative Regulation

Simple approach	Qualified approach
■ Restricted to basic forms of permitted de-rivatives	■ All forms of derivatives possible • provided underlying title permitted • provided all significant risks can be pre-sented and quantified
■ Roughly equivalent to investment levels under old KAG (200 per cent)	■ Dynamic risk assessment of all risks: quantitative + qualitative
■ CDS only for hedging purposes	■ Utilisation is correlation-appropriate for structured products (not in every case)
■ Fundamental positive delta	■ Limitation of market risk potential with derivative-free comparable ficti-tious bench-mark
■ Transparent presentation of structured pro-ducts	
■ Regular monitoring of permissibility of simple approach	

Risk adequate stress tests + back testing

Comprehensive risk management process §1 Implementation Code

Source: DWS Investments

MUTUAL FUND SECTOR

The investment sector has reacted extremely positively to the InvG. The minimum levels of harmonisation of investment fund rules which it achieves have considerably increased the scope for investment management companies and have brought the legal issues into line with new investment models.

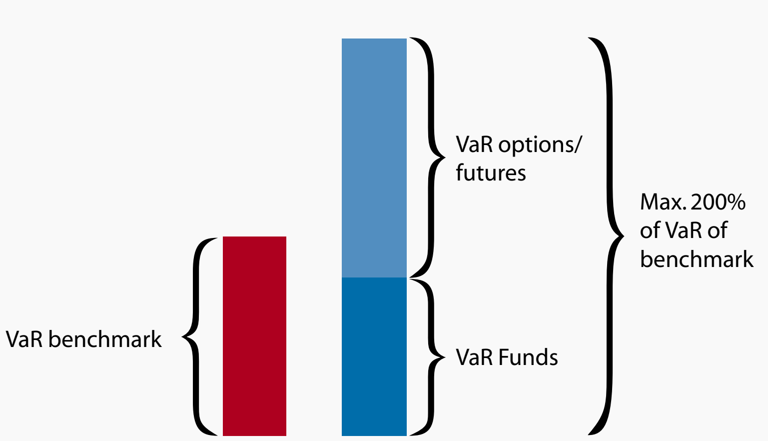
For funds under German legal jurisdiction, this means substantially more flexibility and a clear increase in the room to manoeuvre afforded fund managers. As the registration of new products has also been overhauled, speeding up the process of registering new investment funds, investment management companies will be in a position to react more swiftly to market developments and opportunities.

The new regulations have provided the fund industry with extensive innovation potential, most notably the spectrum of funds has been extended to allow investment in money market instruments, bank deposits, mutual fund units and financial derivatives. A key reform is the significant broadening of the permissible underlying derivative assets – not only for hedging purposes. Derivatives may now form an explicit component of the investment policy.

The much broader asset allocation universe for investment funds under new German investment law also provides the fund industry with new performance potential. These include total return strategies based on derivatives, active foreign currency management or separating the range of return sources from their investment strategies (alpha and beta). Market-inverse transactions, overlay management and leverage remain possible. OTC derivatives are also allowed, provided they fall within the definition of derivatives.

An exciting development is the new option to use exotic derivatives on new underlyings as well as fund derivatives. DWS Investments has already exploited this new investment opportunity in an innovative

Chart one: Qualified approach to Ucits III



Source: DWS Investments

fund concept: the DWS Funds Bric Rainbow. This fund is coupled to the performance of the target funds DWS Brazil, DWS Russia, DWS India and DWS China, using a so-called rainbow strategy whereby it is retrospectively more heavily weighted in the underlying target fund showing the best average performance. At the same time, investor preference for lower risk can be met with a 90 per cent initial unit value guarantee at maturity.

In general, the new regulations now permit investment funds which are subject to few sanctions on the investment opportunities they seek out and enjoy major freedom in terms of the asset classes they invest in. As such, a fund is no longer required to concentrate on a single investment focus, but rather can diversify in combinations of securities, money market funds and even exchange traded funds (ETFs). Consequently, highly flexible funds-of-funds constituents are permitted which, in the form of special funds for example, have much wider scope for investment. It remains to be seen which versions will be developed in practice and if these constructions will become the golden rule.

Another innovation for the fund industry is the opportunity to create quasi hedge funds. These are subject only to a secondary condition that the underlying asset must be eligible under Ucits III. These funds compliant with guidelines may now pursue investment strategies which used to be the exclusive preserve of hedge funds and therefore inaccessible to the private investor. These funds compliant with guidelines, which may have a variety of constructions, can pursue multi-faceted strategies and therefore provide new opportunities.

In this environment, ideas in the fund industry should know no bounds. Indeed, FX funds (over-collateralisation limit removed for FX) or commodity funds are permissible, for example. Some supervisory authorities now recognise the GSCI or the AIG, for example, as financial indices. Indeed, in France, funds which have the value-at-risk as their investment strategy are already established: a maximum value-at-risk serves as an investment criterion.

Furthermore, according to the new investment law, it is now possible to issue pension funds for institutional clients, where the use of derivatives will exactly cover their liabilities (interest and inflation).

PROSPECTS

For the investment sector, this new-found flexibility is a key improvement which has been greeted with widespread approval. Optimising the legal framework in Germany for fund producers is a successful move to inhibit or prevent the migration of German investment funds into other European countries. Indeed, EU passporting opens the door to cross-border distribution of innovative products.

In practice, this new-found flexibility and structuring options do bring new challenges. Extended obligations for investment funds have radically broadened the scope of responsibilities for investment management companies and in addition have substantially raised the bar in terms of quality.

It is therefore crucial that investment management companies reorganise to reflect the new regulations. However, these changes in German investment law should be viewed in equal measure as a challenge and an opportunity to provide tailored fund solutions for investors.