MSCI

September 29, 2016

Submitted electronically

Autorité des Marchés Financiers

Re: **Public consultation - Guide to the use of stress tests as part of risk management within asset management companies**

MSCI appreciates the opportunity to offer these comments to the Autorité des Marchés Financiers (the "AMF") in response to the proposals set forth in the AMF's recent release entitled *"Guide to the use of stress tests as part of risk management within asset management companies"* (AMC). We support the AMF's goals to promote effective risk management practices and increase investors' protection through enhanced risk processes.

Background

MSCI is a leading provider of risk management and equity analytics (under the RiskMetrics and Barra brands) and equity indexes (under the MSCI brand) to the financial services industry, including the world's largest banks, insurance companies, hedge funds and asset managers. We have been actively engaged in research on the subject of risk management and stress testing for almost 20 years and license our risk analytics to market participants to help to support both their risk management and regulatory compliance activities (e.g., UCITS, AIFMD, Form PF). MSCI's views on the subject of stress testing in general have also been informed by the feedback we receive from our asset manager clients that utilise our suite of risk management tools.

MSCI considers the AMF's proposal to promote stress testing as a core risk management practice a welcome development.

In our view, the proposed guidelines address several important objectives, particularly on the subject of liquidity risk, counterparty risk and operational risk.
For these risk types, clear goals that motivate the adoption of stress test techniques can be identified:

- Counterparty and operational risks are not part of an asset manager's mandate to take on, and as such they need to be mitigated as much as possible with available risk management instruments and standard market practices.
- Liquidity risk is part of an asset manager's ways to generate returns. However, a fund should manage liquidity in order to prevent "investor dilution", namely the undue transfer of value from one shareholder to another caused by possible discrepancies between the redemption commitments of a fund and the real liquidity of the invested assets.

However, we have some concerns with regard to the parallel treatment of market risk (with which we include credit default risk as carried by securities) alongside liquidity, counterparty and operational risk. The bearing of market risk is an integral part of a fund mandate, in order to simply

Ninth Floor • Ten Bishops Square • London, E1 6EG • United Kingdom
T +44 20 7618 2000 • F +44 20 7618 2233

generate returns. There is no natural limit for market risk to ward off, provided risks are transparently communicated to investors prior to subscriptions and risk targets are respected in the investment cycle. While stress test can be a valid instrument for the disclosure of market risk in some cases, it is not clear what type of investment actions (creation of limits, definition of provisions …) a fund should enact on the basis of the result of adverse market risk stress testing, if not in some special cases.

Observations on Liquidity Risk guidelines

MSCI supports the spirit of the AMF recommendations on liquidity risk, as those recommendations are aimed at:

- Raising liquidity risk to the level of a key, non-negligible component of investment risk;
- Protecting fund shareholders from "investor dilution", namely the unfair transfer of costs across different shareholders of the same fund; and
- Aligning liquidity policies on the liabilities side with liquidity of the assets of the fund.

The proposed recommendations are generally in line with MSCI's views on liquidity risk. In particular, we believe it is critical that guidelines require assessment of liquidity risk:

- Across a full spectrum of liquidity, and not only as a binary characteristic (i.e., liquid vs. illiquid);
- In its entire complexity, namely along the multiple dimensions of transaction cost, size, and time to liquidation,
- In a way that avoids a one-size-fits-all liquidity risk measure for all asset classes and fund types. In this regard the proposal is in line with the flexibility of tools proposed by the FCA ("Liquidity management for investment firms: good practice") ad IOSCO ("Principles of Liquidity Risk management for collective investment schemes"). Different liquidity indicators are better suited for different asset classes because of the different degree of market transparency and data availability, and
- Without enforcing rigid rules which could directly impact portfolio composition based on the result of liquidity scorings during stressed events. Even the best conceivable liquidity scorings cannot replace the value of human decisions to manage a portfolio in the course of a market distress.

With regards to the last two points in particular, the AMF is taking a different approach from the SEC Rules on liquidity risk management for open end funds proposed in September 2015. On these aspects in particular, the SEC received fairly critical responses during the public consultation ended in January 2016.

Assessing liquidity risk is not an easy task and poses unique challenges compared to other types of risk such as market, credit or counter-party risk. Liquidity risk measures suffer from scarcity of appropriate data sources for many asset classes. Consequently, quantifying asset or portfolio liquidity can require strong assumptions, which may compromise objectivity, testability, audit-ability and comparability of the metrics. In this respect, assets traded over-the-counter, and specifically

bonds, pose a serious challenge. On this subject, we observe that the announced MiFID2 reforms on the matter of enforcing pre- and post- trade transparency for bond markets in particular, are expected to represent a turning point not only in Europe but worldwide for the dissemination of consolidated trade and quote data for bond markets, fundamental for the development of more objective metrics of liquidity than is possible nowadays. In the transient between now and the implementation of such reforms (expected Q1 2018), bond liquidity metrics will still necessarily have to rely heavily on strong assumptions. The hope is that in the near future, objective and testable data will gradually replace these assumptions.

Observation on Market Risk Stress Tests

The AMF guidelines on the use of stress test encompass multiple types of risk: market, liquidity, counterparty and operational. As we have noted previously, while clear objectives can be identified for the mitigation of the last three types of risk, it is not as clear in the case of market risk, **what the ultimate objective of a stress testing framework should be**.

In the case of asset management companies, clients are shareholders and not creditors. A fund, as opposed to a bank, doesn't have a regulatory capital meant to withstand adverse scenarios and guarantee its solvability. Clients of a fund mandate the asset manager to take on market risk for the purpose of generating returns, and are willingly exposed to such risks, as long as those risks are disclosed transparently and are in line with the fund's regulatory disclosures. With this in mind, it's not clear what objective stress test should have in actively managing the risks of a fund, at least in the general case.

We think for instance of the common case of a fund indexed to a (equity or bond) benchmark. Risk is transparently disclosed to investors through the definition of the benchmark, and extreme adverse events are best defined in terms of benchmark performance itself. Stress testing in this case will not provide useful insight neither for portfolio management purposes nor for investor disclosure. Enforcement of limits based on stress tests would lead to benchmark departures prior to the actual occurrence of envisioned crashes, something that appears clearly unacceptable. Risk disclosure based on stress tests defined in benchmark terms would not add any useful information.

We see only two meaningful applications of market risk stress test, but both are limited in scope and suited only for active funds.

1. <u>Stress testing as a tool for investor **risk disclosure**</u>, when expressing risk in stress testing language helps understanding it. This is most useful for active funds, to report risks in a compact dashboard and to unveil potential hidden risks. Some examples are:
    a. The somewhat trivial case of risks expressed as sensitivities (Greeks). Sensitivities are a standardized type of stress test (e.g. 'what if rates drop 1%'), although typically designed to account for standard as opposed to extreme market shocks. In the AMF guidelines, however, stress testing does not seem to encompass sensitivities.
    b. Possible cases in which a stress test is the best way to exemplify and illustrate a potential hidden risk in a fund.
        i. Ex: the case of a CPPI fund, in which the minimum redemption target cannot be achieved if there's a sudden market gap larger than some threshold (e.g.

Ninth Floor • Ten Bishops Square • London, E1 6EG • United Kingdom
T +44 20 7618 2000 • F +44 20 7618 2233

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more than -30% in 2 days). In this case, a stress test provides information otherwise difficult to retrieve from the definition of the CPPI investment strategy.

2. Defining **stress test based investment limits.** We see this as an application suited only for active funds, for the reasons expressed above speaking of benchmarked funds.
   Ex: a fund could maintain a set of hypothetical or historical scenarios and set a maximum tolerable loss as an investment limit.
   Although the example is not unrealistic, we observe that it is more common to define investment limits in terms of leverage, sensitivities, concentration, or risk measures (VaR, volatility, etc.). Stress test may add to these practices thanks to its forward looking nature and its responsiveness to new information, at the cost however of the inherent subjectivity in scenario definition.

Based on the above considerations, we believe that the subject of market risk stress test should be better explained in the proposed guidelines, for a better clarification of the goals of the exercise. The guidelines should clarify for what type of funds different stress test practices are required or useful. Passive funds should also be exempted in that case.

Thank you again for the opportunity to comment on the AMF's proposals. If you have any questions about MSCI's comments or would like additional information, please contact us at carlo.acerbi@msci.com or laurent.louvrier@msci.com.

Sincerely,

/s/ Carlo Acerbi	/s/ Laurent Louvrier
Carlo Acerbi	Laurent Louvrier
Executive Director, Research	Executive Director, Products
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