VIA EMAIL

5 December 2014

Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
PARKES ACT 2600

Email: fsi@treasury.gov.au

Re: Financial System Inquiry – Draft Terms of Reference

Ladies and Gentlemen,

MSCI Australia Pty Ltd appreciates the opportunity to comment on Financial System Inquiry – Draft Terms of Reference[1], and will be happy to respond to any further questions that the Inquiry may have. We have been an active participant in the dialogue between industry and regulatory bodies worldwide, dating back to the 1996 Market Risk amendment to the Basel Accord.

About MSCI

MSCI Inc. is a leading provider of investment decision support tools to investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indices, portfolio risk and performance analytics, and governance tools. The company's flagship product offerings are: the MSCI indices with close to USD 7 trillion estimated to be benchmarked to them on a worldwide basis; Barra multi-asset class factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; IPD real estate information, indices and analytics; MSCI ESG (environmental, social and governance) Research screening, analysis and ratings; ISS governance research and outsourced proxy voting and reporting services; and FEA valuation models and risk management software for the energy and commodities markets. MSCI is headquartered in New York, with research and commercial offices around the world.

Proposed Areas of Discussion

A famous quote from Benjamin Graham, the father of value investing, is that "The essence of investment management is the management of risk, not the management of return." Better risk management practices across the financial industry, besides benefitting the specific organisations that employ them, also enhance the overall stability of the financial system. Therefore, in light of this inquiry, we would like to convey the value of greater transparency for risk across the financial system, its segments and components, as well as the importance of using the latest risk models and technology. More specifically, from our experience of working with institutional investors globally, we would like to place particular emphasis on the following areas:

- <u>The need for common standards of risk disclosures</u>

  It has been common practice for over a decade for banks (and some other financial institutions) to make public risk disclosures. However the detail provided in these disclosures differs. As we note in our letter to the Basel Committee that we submitted earlier this year (enclosed), it is important for risk disclosures to be comparable across firms and through time. We believe that a common set of risk standards—representative risk models applied to

[1] The Treasury, "Financial System Inquiry – Draft Terms of Reference" November 2013, http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/financial-system-inquiry-tor

representative fixed portfolios—can shed light on some questions left unanswered by existing disclosures.

From a disclosure perspective, the trouble with internal risk models is that they are internal. With very little disclosure of the actual modelling practices, risk disclosures at best permit an analysis of whether an organisation's risk has increased or decreased between filings. However, it is not clear whether any change in risk is active (meaning a shift in positions) or passive (meaning a change in market conditions). Meaningful comparisons across organisations are also not possible.

- The need for multiple perspectives on risk

  Market events in recent years have illustrated the multi-dimensional nature of financial risk. This environment highlighted not only the need to use multiple measures for assessing the risks of investment portfolios (looking at the core as well as the tails of the return distribution), but also the need for robust methods of calculating these risk measures. Borrowing an example from an article by Andrew Lo (2001)[2], a portfolio that is short an equity index option will generate a positive and steady return as long as that option remains out of the money. Using historical returns of that portfolio to measure its risk is very misleading. Moreover, best practices in risk management require not just the measurement, but the forecasting of portfolio risk. Therefore, for effective investment risk management investors need to distinguish between the sources of risk, which may include market risk, sector risk, credit risk and interest rate risk to name a few. Factor models provide a parsimonious view of the sources of portfolio risk, by decomposing risk among various characteristics, or exposures. Moreover, factor models can be applied for forecasting and decomposing both measures of the core of the return distribution (such as volatility) as well as measures of the tails (such as expected shortfall or VaR).

- Increasing the capacity of market participants to perform stress tests

  Recent years have been characterised by a number of volatility shocks in Australian and global markets. In light of this, stress testing and analysis of portfolio reactions to potential local and international market events becomes a crucial part of the risk management toolkit. While many market participants routinely perform historical stress tests on their portfolio, we believe a good risk management process should also consider hypothetical scenarios as well as reverse stress tests. Relevant hypothetical scenarios should be routed in current macroeconomic events and policy environment. A good risk modelling framework should be able to handle the construction of these scenarios and their transmission to portfolio P&L.

- Improving risk modelling standards for alternative asset classes

  Australian Superannuation funds now have an average exposure of 16 percent to "other assets", a category that includes infrastructure, private equity and hedge funds. Private real estate is allocated another 8 percent. These are substantial allocations. Investors have been attracted to private assets by the promise of attractive returns and low and diversifiable risks.

  The measurement of risks of private asset classes is an area where best practices are rapidly evolving. To make informed decisions about allocations to private asset classes and to monitor their risk on an ongoing basis, asset owners need to understand the behaviour of these assets in a portfolio context—not just how they behave in isolation, but also how they relate to other asset classes. For example, investors might want to know how a wind farm will behave alongside equities, bonds, real estate and commodities. Does the wind farm diversify risk or do they add systemic risk through the inherent exposure to energy and the macroeconomy? To answer this question, it is necessary to understand the common drivers of risk and return

[2] Lo, A. (2001) Risk Management for Hedge Funds: Introduction and Overview, Financial Analysts Journal

across all asset classes. Factor models provide a way to capture and analyse these common drivers.

- Capital allocation

  Many insurance companies look to achieve higher long-term risk-adjusted returns from their investment portfolios. While equities are the natural vehicles for obtaining higher potential yield, they tend to incur downside risk and volatility that is often beyond the insurer's risk tolerance.

  Minimum volatility equity indexes have helped to cushion and diversify extreme equity risk and they have offered the potential to capture the "low volatility effect." We have shown that a minimum volatility strategy can have a constructive role to play in the insurer's portfolio. In exploring various scenarios to see how relatively small additions of a minimum volatility equity strategy—as represented by the MSCI Minimum Volatility Indexes—could be incorporated in a 100% fixed income portfolio, we showed that the strategy offers a sensible approach to enhancing the risk/return profile of the fixed income portfolio.

  For a further discussion of the merits of minimum volatility investing refer to the attached paper "Minimum Volatility Equity Indexes, Potential Tools for the Insurance Company".

- Going beyond market risk

  Following the global financial crisis, sophisticated institutional investors have increasingly looked beyond robust measurement of market risk to other pillars of risk, such as liquidity and credit counterparty risk. Better methodologies for looking at these risks are becoming available. For example, measurement of liquidity risk should combine market and funding liquidity analysis. While liquidity analytics are well established in the equity space, consistent measurement of liquidity across different asset classes has not been available until recently. A full-fledged market liquidity analytics system must be capable of estimating transaction costs for multi-asset class portfolios, taking into account market impact of trading under different market and redemption scenarios and different trading horizons. It should be capable of imposing and monitoring liquidity limits, computing optimal liquidation strategies and providing a framework for scenario analysis.

  Calculation of counterparty exposure requires a powerful Monte-Carlo simulation and pricing framework, coupled with the ability to account for complex netting, margining and closeout rules. The system should be able to compute a variety of exposure measures, including current exposure, potential future exposure, expected exposure, effective exposure and others.

  Greater awareness of the need to measure and manage these risks and the best practices for doing so will, in our view, benefit financial system stability.

- Increasing the emphasis on the *management* rather than the *measurement* of risk

  While it is important to have the right tools for measuring risk, risk management should go beyond a reporting function and be an integrated part of the institutional investment process. Risk has a vital role to play in investment decision making and portfolio construction. Tools such as risk decomposition and stress testing are most valuable when they are used to guide investment actions. This requires the right organisational governance and culture that promote an independent and empowered risk function.

We appreciate the opportunity to comment on the Draft Terms of Reference, and hope that our comments prove useful in further deliberations. We would be pleased to provide further clarification or commentary should the Inquiry desire.

Yours Sincerely

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