FORDHAM UNIVERSITY
THE JESUIT UNIVERSITY OF NEW YORK

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OFFICE OF THE DEAN

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DEAN

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By email to fsb@bis.org

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002 Basel,
Switzerland

Re: Public feedback on FSB Consultative Document Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Ladies and Gentlemen:

The representatives from Fordham University College at Rose Hill, through the guidance of the Center for the Study of Financial Market's Evolution (CSFME) Regulatory Outreach for Student Education program[1], appreciate the opportunity to be writing this commentary letter regarding a study issued in January of 2014 by the Financial Stability Board[2] ("Consultative Document" or "the document"). We support the FSB's general mission to study the asset management industry in order to find threats to financial stability-as well as their willingness to examine whether such threats should be addressed through already present regulation being applied to systemically important financial institutions (SIFI's) or through other regulatory measures.

Unfortunately, after examining the suggested assessment methodologies in the Consultative Document, we believe that many times the FSB fails to capture that which it is trying to seek – an effective way to find and target potential carriers of system risk in the non-bank and non-insurance sector. Therefore, the assessment methodologies in their present form would not serve well as proper identifiers of systemic risk and should be withdrawn.

By correlating our input on the assessment methodologies with the questions put in for public commentary in the Consultative Document, we will state both the shortcomings of an assessment method, as well as in some cases, our suggested remedy.

[1] "CSFME Encourages Fordham Students to Let Their Voices Be Heard." *Center for the Study of Financial Market Evolution.* CSFME, 13 Mar. 2014. Web. 31 Mar. 2014.
[2] *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions. Http://www.financialstabilityboard.org/.* FSB, 8 Jan. 2014. Web. 31 Mar. 2014.

Summary

Ultimately, we will focus our document on the possible effects of SIFI designation on students like us, the FSB's decision to measure the impact that an NBNI financial entities' failure will have on the global economy rather than the risk that a firm could fail, the proposed regulation of OTC-Derivatives, the FSB's concerns regarding the effects of fire-sales and liquidation procedures[3] where there is a clear misunderstanding of the facts produced, and finally the FSB's decision to designate firms as SIFI's based on their leverage ratios. We encourage the FSB to take our comments into consideration as they are more than simple rebuttals of its goal. In fact, we consider our comments to be complementary to its final goal of monitoring and controlling systemic risk. We agree that markets should be better regulated to keep us from an eternal cycle of financial scares, and our comments serve solely as suggestions for a better way to ensure market stability.

Impact of SIFI Designation on American Institutions

I. We would like to open our commentary by discussing the FSB's recommendations regarding the U.S., and take the opportunity to discuss the impact of the global standards being drafted by the FSB on American institutions. What we are concerned with is the potential for non-reduction, or even growth, in systemic risk after SIFI designation. To exemplify this notion, we would like to consider a matter that is very applicable to us during our college careers: student loans. Currently, nearly 70% of student loans are handled by non-bank entities[4] with a major player in the field being SLM Corporation, otherwise known as Sallie Mae. Sallie Mae is an originator, servicer and collector of student loans who as of December 31, 2013 holds well over USD 125 billion in student loans.[5] Recently, in an effort to make itself more efficient in the face of stronger regulation, Sallie Mae has proposed a spin-off of its student loan servicing side, called Navient. Navient will maintain close to USD 103.2 billion in student loans originating under the Federal Family Education Loan Program (FFELP), as well as USD 31 billion in Private Education Loans.[6] Furthermore, Sallie Mae proceeds to securitize these outstanding loans and sell them to willing investors. In January of 2014 alone, USD 994 million worth of class A and class B Student-Loan backed notes have been issued by Sallie Mae with a further sale of USD 676 million of the same securities being issued later in March.[7] This further adds to the nearly USD 25 billion in Student Loan Asset Backed Securities (SLABS) present in the market as of 2012.[8] The underlying assets for SLABS are loans

[3] Assesment Methodologies

[4] Couch, Christina. "More Scrutiny for Student Loan Servicers?" *Www.bankrate.com.* Bankrate, Inc, 3 Dec. 2013. Web. 31 Mar. 2014.

[5] SLM Corp. 2013 Annual Report. Sallie Mae Corporation, 2013. Web. 31 March 2014.

[6] SLM Corp (pg.25)

[7] "SLM Student Loan Trust 2014-A." *Www.salliemae.com.* N.p., 6 Mar. 2014. Web. 31 Mar. 2014.

[8] Matlin, Chadwick. "Student Loan Bubble Babble." *Http://blogs.reuters.com.* N.p., 7 Mar. 2013. Web. 31 Mar. 2014.

originated both through FFELP, as well as, Private Education Loans. According to Sallie Mae, FFELP loans are issued by state or not-for-profit agencies and are protected by contractual rights to recovery by the U.S. government, while Private Education Loans are neither insured nor guaranteed. Therefore, by selling off these loans through securitization, Sallie Mae passes on the risk of default to the tune of USD 12.1 billion off their balance sheet[9] to investors. While clearing itself of liabilities, Sallie Mae also earned USD $388 million off this securitization in 2013.

An unsettling caveat to the above structure is that FFELP originated securitized loans are not necessarily as stable as Sallie Mae describes them. While the federal government guarantees them, there are ways to obtain a partial discharge for student loans under 11 U.S.C. 523 (a) (8).[10] This would mean that large portions of the underlying securities in SLABS are nowhere near as default free as they are originally said to be.

Now let us consider what would happen if Sallie Mae were to be given SIFI designation due to its perceived addition to systemic risk. If designated as a SIFI, Sallie Mae would be forced to maintain higher levels of capital as a buffer in the case of market downturn.[11] Higher levels of necessary capital would bring down the firms returns on equity and encourage Sallie Mae to issue more loans that would then be securitized. Considering that earnings solely from the interest on FFELP originated loans will continue to fall due to the termination of the FFELP program in 2010, earnings from the selling of the securitizations will have to make up the difference (as they did in 2013).[12] This trend will only add credit risk to the market as Sallie Mae, in an effort to keep returns positive or even stable, will have to issue more securities that are susceptible to default. This addition of credit risk is in direct correlation with one of the three channels through which financial distress of an NBNI entity could be transmitted to other financial firms in the market. If markets were to take a significant downward shift, many students would be forced to default on their loans due to unemployment or other adverse market conditions. This risk would then be amplified by Sallie Mae if it were to be designated as a SIFI rather than mitigated since the large number of outstanding SLABS

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[9] Sallie Mae 10-K (pg.84)

[10] BAYUK, FRANK T. "THE SUPERIORITY OF PARTIAL DISCHARGE FOR STUDENT LOANS UNDER 11 U.S.C. § 523(A)(8): ENSURING A MEANINGFUL EXISTENCE FOR THE UNDUE HARDSHIP EXCEPTION." *FLORIDA STATE UNIVERSITY LAW REVIEW* 31.1091 (2004): n. pag. *Http://www.law.fsu.edu/*. Florida State University. Web.

[11] Consultative Document pg.2 article (ii) The general framework for the methodologies should be broadly consistent with methodologies for identifying G-SIBS and G-SIIs. While no clear direction has been provided by the FSB we see it fair to say that the same concept of living wills will be applied to those NBNI firms designated as SIFIs.

[12] Sallie Mae 10-K (pg.84) Servicing revenue for our FFELP Loans segment primarily consists of customer late fees. The increase in gains on sales of loans and investments in 2013 compared to the prior years was the result of $312 million in gains from the sale of Residual Interests in FFELP Loan securitization trusts in 2013. We will continue to servicethe student loans in the trusts that were sold under existing agreements.

would lose their value. Such a loss in value could force the failure of Sallie Mae and end student access to a large provider of educational loans. The global standard being drafted by the FSB could then be the foreseeable originator of credit risk in an American institution with potential spill over into the world markets, thus adding to overall systemic risk.

Overview of Authoritative Power of FSB

When the Dodd Frank Wall Street Reform and Consumer Protection Act was enacted, it created a dangerous precedent by granting the FSOC the power to designate firms as SIFIs if the Council believes that the firms are able to create systemic risk. The FSOC, chaired by the U.S. Treasury, is the regulatory agent within the U.S. who closely follows the FSB's lead in designating firms as SIFIs. As Peter Wallison points out, "no standards under the Dodd-Frank Act in any way cabin the FSOC's discretion. Under section 113 of the act, the FSOC is granted authority to designate any non-bank financial firm as a SIFI "if the Council determines that material financial distress at the U.S. non-bank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. non-bank financial company, could pose a threat to the financial stability of the United States."[13] And since none of these criteria are clearly defined, the FSOC is able to interpret its role in any way it pleases. This is troubling, especially when one considers the asset management industry, since "the industry has never caused the failure of a large bank, let alone a systemic financial crisis, and so it is unclear why it should be the target of increased Council scrutiny."[14] In addition, when the Treasury published a report pushing for the FSOC to expand its regulation into the asset management field, it "rehashed dated arguments and recycled existing research about risks that arise in bank-depositor relationships, not potential risks in the asset management field."[15] Paul Kupiec also makes a good point when he addresses the fact that when Lehman Brothers (the most cited example when discussing the need for more regulation) collapsed in 2008, its asset management division was able to survive and continues to exist today as Neuberger Berman Group LLC. Thus, when one considers the rhetoric and tactics that are being used by the FSOC to expand its influence into the stable asset management industry, it seems right to be concerned that the Council has grown too powerful. Therefore, it is necessary for its powers to be narrowly defined in order to protect industries (such as the asset management industry), which are not systemically risky. Meanwhile, addressing errors in the methodologies used to designate firms as SIFIs will have to serve as the first check on the FSOC's influence.

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[13] Peter Wallison, "Unrisky Business: Asset Management Cannot Create Systemic Risk." *American Enterprise Institute,* 13 Jan. 2014.

[14] Paul Kupiec, "Our Worst Fears About Dodd-Frank's FSOC Are Being Confirmed." *Forbes,* 26 Nov. 2013.

[15] Ibid.

Use of Size as an Impact Factor

II. In discussing the operational framework for NBNI G-SIFI methodologies, the consultative document states that NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the overall economy rather than the risk that a failure of such a firm could occur. In order to measure the impact of such a failure, the FSB proposes to implement five impact factors including: Size, Interconnectedness, Substitutability, Complexity, and Global Activities (Cross-Jurisdictional activities). In regards to the first identifier, size, the threshold after which firms will be subject to Stage 1 examination for SIFI designation is USD 100 billion for finance companies, USD 100 billion (AUM) or 400-600 billion (GNE) for investment funds, and USD 100 billion for other NBNI financial entities. **Q2-1**[16] What is wrong with the use of these indicators as assessment methods is that size, i.e., firm's capital, does not accurately capture the level of systemic risk present within the firm. Like banks, firms may break themselves up to fall under the USD 100 billion threshold level, yet maintain their exposure to a risky asset. The current regulation, therefore, aims to capture systemic risk but only manages to find firms where systemic risk has a greater chance of being present. This exposes a flaw in the assessment methodology as many smaller firms (such as money market funds) would potentially be left out while some of those that don't garner nomination for SIFI status may be captured. A better indicator of systemic risk may be obtained by employing continuously variable market-measures, as proposed by the New York University Stern School of Business volatility lab.[17] There, two tests are proposed, the Marginal Expected Shortfall Test (MES), as well as the Systemic Risk Contribution Test (SRISK%). MES provides a prediction of the expected loss of equity holders if the market were to decline by a set percentage. It obtains this result by incorporating the volatility of a firm, the firm's correlation with the market, and the firm's performance in extreme conditions. The SRISK% Test first measures the percentage of contribution of each firm to the aggregate capital shortfall in the event of a crisis. When a firm experiences a capital shortfall it may not be able to honor its obligations to third parties, thus possibly extending the crisis. The firm's capital shortfall is then compared to the capital shortfall of the whole financial sector, and the firm is given a systemic risk contribution percentage. This is a better way to gauge systemic risk if the FSB decides to focus solely on the impact of a firm's failure, rather than the risk that a firm could fail. However, we would also encourage the FSB to look into ways to gauge the risk, or the probability

[16] Consultative Document: Does the high level frame work for identifying NBNI G-SIFIs adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed?

[17] Acharya, Viral V. *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*. Hoboken, NJ: John Wiley, 2011. Print. (132)

of a fund's failure, after applying the two tests above. Trying to gauge the risk of a fund's failure would force the FSB to again look past capital levels and more so at the asset classes of the firm. While obtaining information regarding individual firm's asset allocation may be challenging, it would help to serve as a better indicator of a firm's systemic risk as some asset classes are innately more risky.

Regulation of OTC Derivatives

III. When looking at asset class, derivatives activity should be considered a main source of potential systemic risk due to the possible leverage activity associated with the process. Hedge Funds have a significant presence in the derivatives market since regulatory capital requirements have not been adjusted to reflect all aspects of OTC exposures, which make risk taking with OTC Derivatives more attractive.[18] The consultative document acknowledges this and states that the greater the number of non-centrally cleared OTC derivative contracts a finance company enters into, the more complex a finance company's activities become.[19] The document suggests that an indicator be instituted to measure complexity in a finance firm by capturing the notional values of all types of derivatives (i.e. sum of foreign exchange, interest rate, equity, commodities, and credit derivatives.) **Q4-3**[20] While we understand why the FSB may be interested in such information, we would like to note that this data must be used logically and regulation should be done transparently and not through imposing arbitrary capital requirements in an effort to ward off risk. According to data from the International Swaps and Derivatives Association (ISDA)[21], collateral agreements grew from $2.1 trillion to $4 trillion in 2009 alone and have continued to grow. Most derivative collateral agreements are done with large banks, which are already subject to heavy regulation following the Dodd Frank Wall Street Reform and Consumer Protection Act.[22] Furthermore, it would be illogical to simply take the sum of the notional value of all types of derivatives for financial companies and compare it to the total collateral. Historically, credit and fixed income are the most collateralized while FX, equity, and commodities are less so. This is due to the fact that FX derivatives are far less risky than fixed income derivatives because they are used primarily as a hedging tool with end users as one counterparty.[23] In fact, it is useless to consider FX derivatives as a complexity indicator since the Dodd Frank Act has ruled them to be exempt from derivatives reform because FX derivatives primarily work to help

[18] Regulating Wall Street (443)
[19] Assessment Methodologies (pg.18)
[20] Are the proposed indicators appropriate for assessing the relevant impact factors?...should it [methodology] consider other indicators that are more tailored to a finance company's business model and risk profile?
[21] "ISDA Margin Survey 2009." *Www.isda.org.* ISDA, Inc, n.d. Web. 31 Mar. 2014.
[22] ISDA Margin Survey (pg.8)
[23] Regulating Wall Street (chp.13)

manage business risk.[24] Even if one were to ignore the fact that the same could be said for a large portion of positions in interest rates and commodity derivatives, it is still unclear as to why the Consultative Document would try to gauge complexity risk using data which has been deemed invalid for measurement of systemic risk by Dodd Frank. We contend that the notion of transparency in OTC derivatives is essential to cutting down on systemic risk, however, only through a clear look into derivatives contracts can regulators then gauge appropriate levels of collateral; hedge positions should have less collateral while non-hedging positions be better collateralized.

"Herding" and Fire-sale risk in Financial Firms

IV. In regards to interconnectedness, we would like to address the methodology used to describe asset management entities as being systemic risk transmission mechanisms. The consultative document mentions how distress or failure of an investment fund could impact other market participants. An argument presented states that forced liquidation of positions could cause temporary distortions in market liquidity that causes indirect distress to other market participants. Focusing on hedge funds, the document mentions that identical strategies or strategies which may be highly correlated could lead to a "crowded-trade" phenomenon and how such a contraction of segments could have wider ramifications. Referenced is the 2007 Quant Crisis as described in *Inside the Black Box-The Simple Truth about Quantitative Trading.*[25] **Q6-2**[26] The book comments on how the Quant Crisis was caused by four main drivers, (1) large sums of money invested in value-based quant strategies with at least some similarity to each other—in other words, the "crowded trade" effect; (2) poor year-to-date performance in quant long/short trading in the United States; (3) cross-ownership of illiquid credit-based strategies that were experiencing large losses alongside more liquid quant strategies, causing the latter to be used as an ATM in a time of crisis; and (4) the decline of volatility, which led to increased leverage both because of volatility targeting-based leverage adjustments and the desire to produce higher nominal returns.[27] The author explicitly states that these strategies were algorithmically based quantitative strategies, including statistical arbitrageurs and quant long/short traders with a high dependency on market volatility and liquidity levels. While they were heavily correlated and dependent on each other, it cannot be assumed that every hedge fund trades on the quantitative strategies mentioned above, and thus stands to lose in the same fashion. Furthermore, the author also explicitly states that there was no general market panic during this period. While funds suffered losses ranging form -5 to -45 percent, U.S. stocks were

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[24] H.R. 11-203, 111 Cong., 1375 (2010) (enacted). Print.
[25] Assessment Methodologies pg.31 footnote #40
[26] Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?
[27] Narang, Rishi K. *Inside the Black Box: The Simple Truth about Quantitative Trading.* Hoboken, NJ: Wiley, 2009. Print. (chapter 10)

approximately flat during the same time period. Historical data provided by the Investment Company Institute (ICI)[28] also shows the correlation between funds and the overall market. Instead of market to hedge fund activity, the ICI presents data that displays hedge fund to market activity. In the same way that the market did not sell on news of staggering losses at quant funds, funds don't sell on news of market loss. According to research conducted by the ICI regarding mutual fund investor's reactions during market corrections, during the 2007-2009 financial crisis while the S&P 500 fell by 53%, mutual fund outflows equaled only 4.1% of the assets of equity funds at the start of this period.

Leverage Requirements

V. **Q6-10**[29] In regards to the consultative document's recommendation to designate firms as SIFI's based on their leverage ratios, we would like to discuss and contest indicators of systemic risk which relate to leverage ratios and other related topics in both hedge funds and mutual funds. It is mentioned in the document that "leverage can pose greater potential risk to the financial system...because [it] acts as a multiplier in times of market stress."[30] Here, the consultative document fails to mention the specific context in which leverage is used and the specific features of the investment strategy. In the simplest terms, "higher leverage does not always indicate higher risk" and, therefore, does not necessarily pose any systemic risk.[31] With regards to hedge funds, regulators have shown concern that hedge funds generate systemic risk through "their extensive use of leverage and short positions."[32] And while it is true that certain hedge fund strategies are highly levered and may generate the counterparty risk, which can be systemic if highly interconnected to other firms, there is no evidence that hedge funds caused or contributed to the recent financial crisis.[33] Additionally, hedge funds "typically have a much lower rate of leverage on average (two to three times leveraged) than other segments of the financial sector (investment banks are often leveraged between 14 and 40 times)."[34] In fact, even if a manager at a hedge fund did use leverage to amplify returns on an asset, one should feel comfortable, assuming the asset is compelling.[35] Conversely, one should show considerable concern if a manager

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[28] Public Feedback on OFR Study on Asset Management Issues. Www.ici.org. ICI, 1 Nov. 2013. Web. 31 Mar. 2014. (Appendix A, Figure 3:Net flows to Equity Mutual funds as a Percent of Stock Market Capitalization.

[29] Are there additional indicators that should be considered for assessing the relevant impact factors? Should leverage or structure of a fund also be considered for assessing complexity?

[30] Assessment Methodologies

[31] Barbarino, F. (2009). Leverage, Hedge Funds and Risk. NEPC

[32] Acharya, 423

[33] Acharya, 423

[34] Dixon, Lloyd S. Hedge funds, systemic risk, and Dodd-Frank : the road ahead / Lloyd Dixon, Noreen Clancy, Krishna B. Kumar. pages cm ISBN 978-0-8330-8083-7

[35] Barbarino

uses leverage in an attempt to magnify the returns of a weak position.[36] Clearly the context in which leverage is used and the underlying asset is essential in determining the level of risk that such leverage poses.

With regards to mutual funds, there is concern that they "can be susceptible to runs that generate systemic risk," due to daily redemption requirements.[37] This point is moot, however, because mutual funds are "required to maintain liquidity for ordinary redemptions and no more than 15 percent of a fund's portfolio can be held in illiquid securities."[38] Mutual funds are exemplary of nonbank financial institutions with low degrees of leverage.[39] "The maximum leverage ratio allowed for mutual funds is 1.5-to-1—and most operate with less."[40] Additionally, mutual funds already operate under tight restrictions due to the Investment Company Act of 1940, which limits "the extent to which they can borrow, sell securities short, purchase securities on margin, or invest in certain derivatives."[41] Most importantly, mutual funds cannot lose more than their shareholders' investment, thereby significantly reducing systemic risk.[42] We believe that in order to properly assess whether a hedge fund or a mutual fund poses systemic risk and therefore, could be designated as a SIFI, one must not only look at the leverage ratios, but more importantly, one should observe the following: (1) the net asset value of the fund, (2) the leverage of the fund, (3) the illiquidity of the assets, and (4) the extent to which the value of the fund moves with the positions of other financial institutions.[43] By looking at not only leverage, but all of the aforementioned, one can prevent the unnecessary designation of a given hedge fund or mutual fund as a SIFI, thereby promoting financial stability by preventing assets from falling into the hands of financial intermediaries, which present greater systemic risks.

Overview and Conclusion

Given the loose definition of criteria and the FSOC's unrestricted power, the current assessment methodologies for identifying risk and economic effects of NBNI entities need to be improved. The impact of SIFI designation can have a potentially harmful impact on systemic risk instead of alleviating it. If non-bank loan-servicing companies were designated as SIFIs, it could lead to increased defaults on student loans as a result of the firm's required higher levels of capital. With regards to size, a combined method of applying variable market measures and viewing asset allocation is a

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36 Barbarino

37 Acharya, 424

38 Stevens, Paul S. "Why Mutual Funds Do Not Pose Systemic Risks." 16th Annual Investment Company Directors Conference. Amelia Island, FL. 11 Nov. 2009.*Www.ici.org*. Web. 31 Mar. 2014.

39 "Restoring American Financial Stability Act of 2010 (S. 3217)." Jul 2010. Council on Foreign Relations. Mar 2014.

40 Stevens, Paul S. "Why Mutual Funds Do Not Pose Systemic Risks." 16th Annual Investment Company Directors Conference. Amelia Island, FL. 11 Nov. 2009.*Www.ici.org*. Web. 31 Mar. 2014.

41 Stevens

42 Stevens

43 Acharya, 430

better measure of systemic risk than the current USD 100 billion threshold. An asset class that should get paid particularly close attention to is derivatives, as they have a considerable amount of risk associated with them. A transparent look into said derivatives will allow the FSB to better gauge collateral needs for NBNI entities. When looking at interconnectedness, it is important to note that systemic risk within one firm does not necessarily cause a ripple effect. It is necessary to properly identify data and understanding different fund strategies before blanketing them all as being potentially systemically risky. Finally, designating an NBNI as a SIFI based on leverage ratios should be preceded with caution. Higher leverage does not necessarily indicate systemic risk, so it is important to keep in mind other factors such as the net asset value of the firm. The fact of the matter is, these asset management companies in question have continued to survive throughout financial crises in the past. The use of questionable data to justify undefined standards of evaluation, do not capture an effective way to find and target potential carriers of systemic risk in NBNI firms.

Thank you again for the opportunity to provide our views and comments on the Consultative Document. This was a tremendous learning experience for our team and we appreciate the time you will put in to reviewing our requests.

Very Respectfully,

Marrelle Cerven

Nicholas Gliatta

Kevin Harvey

Eric Jensen

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The Fordham College at Rose Hill Team