FORDHAM
UNIVERSITY

The Jesuit University of New York

Gabelli School of Business

April 7, 2014

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

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

Dear Sir or Madam:

We are currently undergraduate students at the Gabelli School of Business at Fordham University, all of whom are studying Finance. We will all be working in the finance industry post-graduation, thus the impending regulations designating certain financial institutions as Global Systematically Important Financial Institutions (G-SIFI) could have a direct result on our respective career paths. For this reason, we are interested in sharing our opinion on the current and proposed state of the regulatory environment across financial institutions.

We thank you for the opportunity to comment on the Financial Stability Board Consultative Document *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*. We share the concerns laid out by the FSB's mandate and believe proper regulation of financial institutions will promote capitalism and fairness in the financial markets. We believe, however, that some of the points made in the Consultative Document regarding asset managers are misguided, and that over-regulation of asset managers would be disruptive to the financial markets, harmful to investors, and would go against the inherent goals of the asset management industry.

For the purposes of this comment on the regulation of the asset management industry and the determination of whether certain asset management firms should be designated Global Systemically Important Financial Institutions, it is important to examine how the banking and regulatory environment got to where it is today, namely the function and goals of both banks and asset managers, the differences between the types of institutions in the event of failure, and the other potential risks the industry poses to the financial markets.

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I. The fundamental differences between banks and asset managers require entirely different regulation, but the Dodd-Frank Act recommends nearly identical Prudential Standards for both bank and non-bank SIFIs.

The Consultative Document clearly states that non-bank non-insurer (NBNI) financial entities "have very diverse business models and risk profiles that in many respects are quite different from banks and insurers." For this reason, banks, insurers, and NBNI financial entities are all regulated differently. However, if the FSB were to designate any NBNI financial entities as G-SIFIs we presume that the member jurisdictions of the FSB, including the United States Securities and Exchange Commission, would as well. A SIFI designation for a non-bank financial entity in the United States would subject the entity to the Prudential Standards enumerated in Section 115 of the Dodd-Frank Act, and essentially subject NBNI financial entities to standards similar to those of banks. This apparent non-sequitur from the previously quoted statement is alarming.

We believe that the differences between banks and investment funds are best illustrated by contrasting a savings account and a money market account. We do so in order to highlight the difference between the debt contract entered into by bank depositors and the custodial relationship associated with investment funds. The liquidity provided by the money market system is vital to the function of the capital markets, and we believe subjecting them to the high regulatory standards required of banks and insurers would damage those markets.

II. The major differences between banks and asset managers lead to different respective scenarios in the event of a large-scale failure. The asset management industry lacks the interconnectedness, liquidity issues, and counterparty risks that affect banks, and thus are not systemically important.

The counterparty and credit risks associated with lending combined with the vast interconnectedness of the financial markets lead to high potential for widespread contagion in the event of major bank failure. This level of interconnection and lending credit risk simply does not exist for regulated asset managers. Asset managers are surely tied closely to banks and other managers, but with the general lack of leverage held by asset managers, there is no similar downward spiral in the event of a decline in market value. A significant loss in value of a fund's assets does not in itself lead to a failure of other funds or banks. A loss in fund value simply flows to clients as the bearers of the market risk.

III. While herding risk does exist in the financial markets, increased volatility alone does not jeopardize the markets, and subjecting asset managers to the Prudential Standards will not improve market stability.

While there is little to dispute that herding exists and can increase market volatility, it is unclear how deeming asset managers as G-SIFIs—and subjecting them to the same standards as banks and other non-bank financial institutions—will help to mitigate herding's role in future crises. Also, it is important to understand that imposing capital requirements on asset managers would be a disservice to investors and reduce their willingness to pay someone to manage their money. Increased capital requirements, stress testing, and resolution plans cannot have an effect on any herding risk and would reduce investors' returns. While we agree that the financial market must be regulated in order to protect investors and proactively avoid catastrophic events, we do not believe that subjecting asset managers to the Prudential Standards enumerated in Section 115 would serve this purpose.

History

While we are approximately eight years past the peak of the housing market and more than five years past the bottom of the stock market, there are still many economic wounds that have not fully healed since the financial crisis of 2007-2009. Since this crisis, there have been dozens of different theories and studies published on how the world economic system was pushed to the brink of collapse, yet survived. There is little debate surrounding the explanation that the collapse of the sub-prime mortgage market in the United States and across Europe was the straw that broke the camel's back. However, in order to give the economy its best chance at avoiding a crisis of the same proportion in the future, it is important to analyze all of the factors that contributed to the worst economic downturn since the Great Depression.

Depending on who is answering the question, there are various explanations of what led to the Great Recession. Some will go back to the movement away from the gold standard when the money supply and consumer credit were allowed to expand freely; others will blame the dot com bubble for pushing people to invest in alternative asset classes (namely real estate); some will point towards the rating agencies which rubber-stamped subprime CDOs as AAA based on their supposed geographic diversification; some will blame the government for promoting home ownership; and others will blame the banks for facilitating the processes which led to the creation of a bubble in home prices.

While the true roots of the economic crisis may take years to fully understand, there is more certainty to explain why the past crisis was so deep and has persisted longer than other downturns. The best explanation points to the fact that the economy was doubly levered, both from the consumer side as well as the banking side, to a point that it had never been before. Consumers were using their homes' equity and other forms of credit in order to make purchases that they ultimately could not afford once the economy swung to the other side of normalcy. Meanwhile, the banks had been issuing loans with unprecedented levels of leverage. Some banks were levered as highly as 35 to 1, showing that a decline of less than 3% in the bank's equity would result in a bankruptcy. One of the reasons these failures happened was because nobody had foreseen that home prices across the country would decline dramatically at the same time, thus eliminating the effect of geographic diversification. After all, this is something that had never happened in the history of the United States.

It is indeed necessary to correct the mistakes that caused the financial crisis. However, it is more important to take a proactive, forward-thinking approach in dealing with the markets. It is to be expected that there will be another crisis sometime in the future, but it is nearly impossible to pinpoint what will be the cause. This is the reason why the task of identifying gaps in the current structure proposes such a burden for those to whom it has been entrusted.

Regardless of opinion on the financial system, there is no doubt that it plays an integral part in the economy and that it is essential to its success. The financial system is highly complex, with many aspects misunderstood by those on the outside (and even some on the inside). These two facts are the reasons why it is necessary to make sure that the banking and financial system is functioning properly at all times, whether in times of recession or growth. In other words, the system has the ability to create times of prolonged prosperity; however, it is essential to focus on controlled growth so that the world economy does not swing so abruptly in each direction.

The most effective way to manage the economy is to regulate financial institutions in a manner in which they are able to accomplish their goals and properly service their customer base while adhering to clear risk prevention guidelines. For purposes of these comments, the overall banking system and regulated asset managers (mutual funds, ETFs, money market funds, and other registered funds) will be the focus.

I. The fundamental differences between banks and asset managers require entirely different regulation, but the Dodd-Frank Act recommends nearly identical Prudential Standards for both bank and non-bank SIFIs.

In order to emphasize the differences between banking institutions and asset managers, it is vitally important to explain the characteristics differentiating savings accounts and money market accounts.

While the two accounts both aid in circulating money through the economy, there are fundamental differences between a traditional savings account and a money market account that we find significant. The first is the different ways in which they accomplish the goal of circulating money. The primary difference between the two accounts is that savings deposits are used by the bank to make loans, and money market deposits are invested across a wide range of low-risk assets. The investments made by money market funds are crucial in providing liquidity in the markets. It is important to note that even though money market funds can lose investor money, this is a very rare occurrence. Federal regulation and professional money managers have proven to be so successful at managing risk that only two money market funds have failed to return the full principal invested since their creation in the 1970's. The most recent was in 2008, when the Reserve Quantities Fund, which held a relatively large position in Lehman Brothers debt, was still able to return 99 cents on the dollar.

Overall, it would be difficult to overstate the importance that money market funds play in the financial system. Ordinary individuals, businesses, and state and local governments use money market funds every day to minimize their portfolio risk while gaining a better return than they would in a basic savings account, and they are a vital part of their operations.

When discussing how a bank operates versus asset managers and other institutional investors, it is imperative to highlight the difference between debt and equity contracts.

We find these differences to be significant because they have a much different impact on the financial system in times of panic. Being that banks enter into debt contracts with their depositors, even strong firms could struggle in times of great stress. This would cause further implications for the economy because of the ripple effects that would occur from a bank run. The overall health of the financial system is directly related to the health of the broader economy, thus making bank regulation of the highest significance. In short, the collapse of a bank has the ability to bring down a large part of the economy (including perfectly healthy parts). On the other hand, asset managers enter into an equity contract with their investors. We believe this difference to be the most important when comparing banks and asset managers.

As stated in the Consultative Document, NBNI financial entities contrast sharply with banks and insurance companies in the manner in which they raise capital, as well as in the relationships they have with their clients. Although operation specifics may differ from asset manager to asset manager, the general asset management investment model, as well as each fund’s relationship with its clients, is common among all asset management firms with fund managers acting as agents on behalf of their clients. At no point does the firm claim ownership of the contributed funds or the assets that they purchase with those funds. By contrast, banks take on depositors’ funds as a liability, and the amount to which they can loan out these funds is only limited by reserve capital requirements. This practice presents extensive credit and counterparty risks which justifies their G-SIB designation. On the other hand, asset managers are not allowed to use investor capital to make loans. Because of this purely custodial relationship, the pain of losses is only felt by investors. There is no contagion to other funds or banks, dissimilar to the widespread panic we saw in the financial crisis caused by bank failures.

The fact that both gains and losses are enjoyed and suffered, respectively, by mutual fund investors alone explains why the successes and failures of mutual funds does not drastically impact the financial system as a whole. As previously stated, mutual fund managers are not permitted to loan contributed capital from investors to potential creditors in the way that banks do. As a result, there is a much smaller possibility of default. Additionally, all assets purchased by mutual fund managers are easily liquidated and returned to investors upon request. In our opinion, designating large investment managers as G-SIFIs would restrict these funds from accomplishing their goals by subjecting them to regulations meant to protect the financial system from threats that the funds themselves are not capable of posing.

II. The major differences between banks and asset managers lead to different respective scenarios in the event of a large-scale failure. The asset management industry lacks the interconnectedness, liquidity issues, and counterparty risks that affect banks, and thus are not systemically important.

Since bank deposits are loaned to a number of different individuals, institutions, and other banks, the bank could be forced to foreclose on those loans in order to meet the cash demands of their clients in a liquidity crisis. In the case of loans such as equity repurchase agreements, these foreclosures are fairly straightforward and take place in relatively liquid markets. However, in the case of home loans, or other long-term, illiquid instruments, foreclosure and liquidation would be difficult, potentially leading to a shortfall of capital and bank default. This is what occurred in some of the largest banks in the most recent financial crisis.

As mentioned, asset managers are pure agents of their clients' money. The large registered fund managers are currently subjected to stringent restrictions on the amount of leverage they can employ, and they cannot borrow against their clients' assets, unlike a bank. This general lack of leverage alone makes it much more difficult for funds to default. Additionally, in an event of significant perceived risk, clients can simply redeem their stake in the fund and receive their funds or the assets in-kind within a few days' time.

Further, the regulated funds whose size would surpass the $100 billion AUM materiality threshold set by the FSB operate in the most liquid capital markets without leverage. Given these circumstances, it would be nearly impossible for the largest index funds and money market funds to fail. For instance, an index fund will follow its respective index and can potentially see a major loss in market value in a crash. However, this loss will simply flow directly to clients as pure equity stakeholders. If the market value of a bank's assets falls significantly, the bank becomes a riskier counterparty. This in turn decreases the creditworthiness of the bank's thousands of counterparties, leading to a downward spiral exacerbated by a liquidity crisis.

This level of interconnection and counterparty risk simply does not exist for regulated asset managers. Asset managers are surely tied closely to banks and other managers, but with the general lack of leverage held by asset managers, there is no similar downward spiral in the event of a decrease in market value. A significant loss in value of a fund's assets does not in itself lead to a failure of other funds or banks. A loss in fund value simply flows to clients as the bearers of the market risk.

III. While herding risk does exist in the financial markets, increased volatility alone does not jeopardize the markets, and subjecting asset managers to the Prudential Standards will not improve market stability.

One potential risk outlined both in the Consultative Document and U.S. Department of the Treasury Office of Financial Research's *Asset Management and Financial Stability* study is that of herding and a cascade of fire sales that could result from such herding in an event of a market shock. It is well-documented that asset managers around the world tend to hold largely similar portfolios and will operate in the markets in much the same way. Managers will "herd" to the same well-performing assets. There are a number of reasons for this, not the least of which is due to the fact that manager compensation is usually based on fund performance in relation to a benchmark. If a manager were to deviate widely from this benchmark and underperform, she would be to blame. For this reason, most managers hold a portfolio very similar to the benchmark.

This practice can be negative for the financial markets, as thousands of money managers are buying the same assets. In the event of a sharp decline in market prices, market operators sell all the same assets, further exacerbating the drop as more and more investors join the fire sale. Thus, the herding tendency causes the market to be more volatile and could increase market risk. This has the potential to cause a crisis in other financial institutions as the market value of their assets rapidly depreciates, which could merit the designation of systematic importance.

While there is little to dispute that herding exists and can increase market volatility, it is unclear how deeming asset managers as G-SIFIs—and subjecting them to the same standards as banks and other non-bank financial institutions—will help to mitigate herding's role in future crises. The primary regulations under the Dodd-Frank Act in regard to G-SIFIs are higher capital requirements, stress testing, and the development of a resolution plan. It seems misguided to claim that any of these Prudential Standards (or any of the others listed in Section 115 of the Act) would limit asset managers' systematic importance. The already highly-regulated registered funds are subject to certain reporting, liquidity, leverage, and valuation requirements. The requirements instituted by the Dodd-Frank Act would have little effect in mitigating risks taken on by asset managers. Also, it is important to understand that imposing capital requirements on asset managers would be a disservice to investors and reduce their willingness to pay someone to manage their money. From an investor's standpoint, it does not make sense to pay management fees to someone who is tracking an index when the manager is required to keep part of the investment as cash on the books. It should also be noted that a large quantity of the money coming into the largest mutual funds is "sticky" money. This is defined as money that is going to come into the markets regardless of the market's momentum because it comes from sources such as defined contribution retirement plans, which often make contributions on a stable, periodic basis. Research shows that mutual funds account for a small percentage of trading in the market in times of fear when compared to the percentage of the equity market that they own.

Increased capital requirements, stress testing, and resolution plans cannot have an effect on any herding risk and would reduce investors' returns. While we agree that the financial market must be regulated in order to protect investors and proactively avoid catastrophic events, we do not believe that subjecting asset managers to the Prudential Standards enumerated in Section 115 would serve this purpose.

Concluding Comments

The complex nature of the asset management industry does not lend it to sweeping, one-size-fits-all regulations. There are many different aspects to the industry that must be addressed before classifying individual participants under a broad group of regulations. On one hand, there are some aspects, such as the large quantity of money that is being managed, that make the asset management industry very similar to banks and other non-bank financial institutions. On the other hand, the different risk-reward characteristics of the larger asset management industry as opposed to those of bank and insurance institutions make it somewhat irresponsible and inefficient to treat each under the same overlying regulations.

While the recommendations of the FSB do not themselves impose regulations on any financial entities, we believe the influence of a body made up of the financial regulators of the world's largest markets would lead to adoption of the same standards by the member jurisdictions. This we believe would be detrimental to the functioning of different financial institutions considering there is only one broad set of regulations that would be imposed in the United States across these institutions. We do not intend to conclude with a suggestion for how to regulate each institution, but merely to suggest that additional regulation be customized for each differing institution. Collectively declaring large asset managers as G-SIFIs, potentially leading to the imposition of even more stringent regulatory requirements on them, would materially limit their ability to adequately provide their services to investors, and thus undermine the basic principles of the capital markets.

Sincerely,

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