FORDHAM UNIVERSITY
THE JESUIT UNIVERSITY OF NEW YORK

GRADUATE SCHOOL OF
BUSINESS ADMINISTRATION

7 April 2014

Via e-mail to fsb@bis.org

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

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

Ladies and Gentlemen:

The Fordham Graduate School of Business Administration ("GBA") appreciates the opportunity to comment on the Financial Stability Board ("FSB") Consultative Document on *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* ("Proposal"), published January 8, 2014.

The Proposal recommends a methodology for assessing whether certain Non-Bank Non-Insurers ("NBNI") are Globally Systemically Important Financial Institutions ("G-SIFI"). FSB proposes using asset size as a materiality threshold to filter the assessment pool and then a set of five impact factors and indicators to determine their market impact. GBA respectfully suggests the custody of segregated assets belonging to banks and other financial institutions ("end clients") as well as transparency of cash flow payments to end clients may be more important in measuring market impact and systemic risk. This is due to the risk of asset liquidation that may occur if end clients need to meet liquidity requirements without the assets or cash flows that they were expecting.

Response to Section 1: Systemic Risk and Transmission Mechanism

The first section of the proposal is intended to identify the scope of the FSB framework regarding systemic risk, with a focus in determining which transmission mechanisms carry systemic risk. FSB proposes that there are three channels that would transmit further systemic risk: Exposure and Counterparty Channel, Asset Liquidation and Market Channel, and Critical Function or Service and Substitutability.

Comments from Section 1: We suggest that the FSB expand upon section 1.1 to include the importance of transparency in the counterparty channel.

We agree that the three channels suggested in the proposal can potentially transmit financial distress, however, we suggest including a lack of transparency as an issue within the Exposures/Counterparty Channel. Without proper transparency, cash flows that are generated by securitization deals or other trades may not reach the final recipient in a timely manner if a finance company experiences financial distress or failure. The failure to receive a scheduled cash flow may lead to the financial institution, which would be the final recipient, being forced to liquidate other assets in order to meet their liquidity needs, resulting in realized losses for that financial institution. These losses in market value may contribute to the "cascading effect" mentioned in this section.

Additionally, if firms are not transparent with how their assets are segregated, then there could be an increase in systemic risk from delays in winding down a failed NBNI. Multiple claims over the same assets, due to rehypothecation, could create liquidity events and asset liquidations similar to the freeze in cash stated previously.

Therefore companies should maintain a high level of transparency, such that counterparties and regulators understand how cash flows are to be delivered and how assets are to be segregated. This would allow regulators and counterparties better information if an NBNI fails, and would allow more expedient claims on assets and revisions in cash payment schedules. As a result, these assets and scheduled cash payments can be recovered in a timely manner.

Response to Section 2: High-level framework for identifying NBNI G-SIFIs

Section two of the proposal lays out the broad framework for identifying NBNI G-SIFIs. The set of five factors that the FSB is considering includes Size, Interconnectedness, Substitutability, Complexity and Global Activities. Each of these factors has distinct indicators that would help identify the impact factors within each NBNI.

Comments from Section 2: These impact factors and their indicators would adequately capture how the failure of NBNI financial entities could cause significant disruption. Of these impact factors, Interconnectedness, Complexity, and Substitutability have a more significant effect than Size or Global Activities. However, we suggest that disclosure and segregation of assets held for collateral in addition to transparency of cash flow schedules would be able to cover all factors except for Substitutability.

As we mentioned in our comments pertaining to the first section, segregation of assets and transparency of cash flow payments are important to avoid unnecessary asset liquidations and any subsequent cascading effects. Any targeted NBNI can impact these end clients through their interconnectedness if the NBNI experiences financial distress, regardless of size, complexity or global exposure. Therefore, we suggest considering the custody of assets on behalf of the end client and intermediary of cash flows as the impact factors for the NBNIs. Each NBNI impact will then vary based on size, complexity and geographic exposure.

With regard to Substitutability, most NBNIs are in very competitive fields and replacing one firm with another would not be complicated. However, there are some industries that would not have such competition. One example may be the exchanges, where in recent years there has been a wave of consolidation, which has created a small pool of competitors. If one of the exchanges failed, there could be an extended delay in replacing the failed exchange, which would create a freeze in the markets. Because of that risk, Substitutability should be considered as a separate impact factor.

From a sector specific point of view, we agree that finance companies should be included based on the cash flow schedule required during any securitization. We also agree that Broker-dealers should be included due to the assets they hold on behalf of end-clients as collateral. Hedge Funds should also be assessed due to their unique risk as a highly levered entity that is not covered by the 1940's Investment Company Act and Dodd-Frank Act of 2010, but Mutual Funds and other investment funds do not need to be included because they are already covered by these acts and investors are protected by SIPC. Because of the unique relationship between Hedge Funds, their lenders, and their investors, there should be regulations drafted specifically for that industry.

Response to Section 3: Operational framework NBNI G-SIFI methodologies

This section elaborates upon the assessment methodology proposal to measure market impact of an NBNI and determine if it is systemically important. The scope of this assessment is the market impact created in the aftermath of a failure of an NBNI versus the general risk that a failure may occur. The section also discusses using asset sizes of each firm as a materiality threshold to determine the assessment pool for further due diligence.

Comments from Section 3: We agree with the scope of the assessment, but suggest using a different determinant for the materiality threshold since the proposal weighs different asset classes equally. We instead suggest the use of custody of segregated assets and intermediaries of cash flow payments as the materiality thresholds.

We support the scope of the assessment largely due to the importance placed on measuring the impact of a market failure. However we must note that it will be difficult to practically measure such an impact. As we mentioned previously, it is more relevant to measure such a market impact by analyzing the segregated assets held as collateral and transparency of cash flow payments.

We do not believe that the proposed materiality threshold will be an appropriate filter. This is due to the fact that assets can be funded by either equity or debt, with assets funded by equity having less systemic risk than those funded by debt. The proposed materiality threshold will also create difficulties in differentiating various asset classes, resulting in the threshold measuring cash at the same level as more complex asset backed securities. We suggest that the threshold be based on any assets held on behalf of end clients as collateral and any firm that acts as an intermediary of cash flow payments.

Similar issues occur with regard to the increased notional exposure for hedge funds. Although it is important to add all long and short exposures instead of netting them, we need more information to determine whether those assets are funded by debt or equity. This is necessary as the leverage hedge funds implement creates systemic risk.

Finally, we suggest that the materiality threshold should be based on the assets that firms hold for others as collateral as well as the liabilities they owe from securitized loans, as long as the original borrower has not defaulted. From a practical standpoint, the Proposal's methodology for a materiality threshold is most likely the simplest, due to the fact that the bottom line of the firms' assets is the benchmark used. However, our proposed materiality threshold would also be simple, provided the appropriate level of transparency.

Response to Section 4: Sector-specific methodologies (1): Finance companies

The next three sections discuss the specific methodology used for each sector of NBNIs, with section 4 relating to Finance Companies. The proposal seeks to determine which of these companies would have significant market impact if it experienced financial distress or failure. The two market disruptions the proposal seeks to prevent are a withdrawal of lending that Finance Companies issue, and losses to the funding providers who lend to the Finance Companies, specifically through securitization. The proposal suggests using the assessment methodology in Section 2, in addition to specific indicators about Size, Interconnectedness, Substitutability, Complexity, and Global activities.

Comments from Section 4: As we discussed in our comments for Section 2 and Section 3, we agree with the importance of Interconnectedness as an impact factor for any NBNI and suggest using custody of segregated assets and intermediary relationship of cash payments as the materiality threshold. We suggest focusing on the role of Finance Companies as intermediaries of cash flow payments due to the importance that securitization plays in their business models.

We agree that the systemic risk from a Finance Company comes from the interconnections with other financial institutions, through securitization. End clients rely on these cash flows, and liquidity events may occur if those end clients need to sell other assets to meet their liquidity needs. The proposal should exclude the liquidity factors created when Finance Companies cannot receive additional funding themselves due to market impact. This is due to our belief that lending by the Finance Companies creates the demand for the funding provided to those companies, as opposed to companies seeking funding. Finance Companies can normally obtain the funding they need when they are originating loans backed by performing assets. However, funding will slow when those funding providers believe that the loans are backed by assets that will eventually be non-performing, thus, not generating the cash needed to service the securitization debt.

We agree that Interconnectedness, Substitutability, and Complexity are relevant impact factors. Interconnectedness is the most important of the factors as it relates to the cash flows from lending activities and the flow to the end customers who purchased them through securitization.

Complexity is important, as it relates to securitization, if cash payments go through several intermediaries before being delivered to the final recipient.

Substitutability is most important in sectors where there are a limited number of participants. Although most sectors have many participants, the impact factor of having one major participant for an entire sector is important enough for Substitutability to be included in the assessment.

Size and Global activities are not as important. We suggest that they not be accounted for in the assessment methodology. Failure of a small finance company which uses securitization extensively can have more of a market impact than a large finance company that backs loans with equity. Global activities have the same relevance as a domestic company with extensive securitization exposure has more of a market impact that a global one with less.

Since we agree that interconnectedness is a relevant indicator, due to our belief that the securitization and cash payments are the most important market impact of finance companies, we believe there are no additional key indicators for assessment.

We strongly agree with the importance of transparency, especially for securitizations of all complexities, and for any securities held on behalf of their financial clients. This data exists because contracts are needed for such activities and the details of payment within those contracts. This transparency should then be provided to the end customers who will be the final recipient of the payments, as well as a regulatory body that can make amendments to existing cash flow schedules if one of the intermediaries fails. The information should be confidential to all other parties.

Response to Section 5: Sector-specific methodologies (2): Market intermediaries (Securities broker-dealers)

This section discusses the methodology specific to Market Intermediaries. Similar to section 4, the proposal seeks to determine which of these companies would have significant market impact if it experienced financial distress or failure. The two market impacts Market Intermediaries seek to prevent are drawdowns in market value due to margin calls as well as loss of client money, and other assets that Market Intermediary firms hold as collateral. The proposal suggests using the assessment methodology in Section 2, specifically indicators about Size, Interconnectedness, Substitutability, Complexity, and Global activities.

Comments from Section 5: As we discussed in our comments for Section 2, Section 3, and Section 4, we agree with the importance of Interconnectedness as an impact factor for any NBNI and suggest using custody of segregated assets and intermediary relationship of cash flow payments as the materiality threshold. For Market Intermediaries specifically, we suggest focusing on the custody of assets held on behalf of an end client, with an emphasis on preventing rehypothecation and promoting segregation of assets held for collateral away from other trading assets.

We agree that there is risk and market impact of assets if the assets are segregated but cannot be returned to their rightful owner. This freeze of assets puts end clients in a situation where they may be forced to sell other assets to meet liquidity needs. This asset liquidation can create unnecessary drops in the value of these assets, creating a cascading effect for other investors. In addition, those losses could be realized losses.

We also agree that there is risk involved when margin calls are made on asset sales but the risk of margin calls is a part of market risk inherent in any trade. Market risk should not be included in any regulation as it would create an asymmetrical risk return profile for any trade. We suggest that this aspect of Market Intermediaries should not be included.

Interconnectedness, Substitutability, and Complexity are appropriate indicators for Market Intermediaries. Interconnectedness is an important indicator due to the assets that are held by broker-dealers on behalf of the end client. Complexity is important in relation to Interconnectedness if assets are rehypothecated for multiple transactions. Substitutability is important as well. As discussed previously, a pertinent example would be to examine the impact that the NYSE (as Broker-Dealer) could have in the event of failure. With over 75% of the market share of the daily volume in the U.S. exchanges, if the NYSE were to fail, it could cause a freeze in assets, harming economic confidence. This could lead to a panic and fire sale of assets when the exchange is reopened or the securities are moved to other exchanges.

For the same reasons as previously mentioned, Size and Global-activities are less important. Due to the relationship between broker-dealers, their end clients, and the assets that are being held, Interconnectedness should be the main focus of the market impact.

We agree with the importance of transparency, especially for the assets being held for collateral. This data is obtainable because of the contracts that are needed for issuing collateral. As previously mentioned in the securitization case, this transparency should be provided to the end client, as the owner of the assets, and the regulatory body who can ensure that those assets are segregated and prevent any rehypothecation.

Response to Section 6: Sector-specific methodologies (3): Investment funds

This section expands upon the methodology specific to Investment Funds. Similar to the previous two sections, the proposal seeks to determine which of these companies would have significant market impact if it experienced financial distress or failure. The two market channels Investment Funds seek to prevent are Asset Liquidation, including any assets sales that arise from rehypothecation issues, and Counterparty Channels. The proposal suggests using the assessment methodology in Section 2, using specific indicators about Size, Interconnectedness, Substitutability, Complexity, and Global activities.

Comments from Section 6: We suggest that Mutual Funds should not be included in this proposal because they are already regulated by the SEC and other international entities, such as the European Commission. We also suggest that Hedge Funds should be included in a separate proposal, due to their unique risk as levered entities and the illiquid asset classes in which hedge funds invest.

One of the major risks with many Hedge Funds is their leverage. This risk was a major issue in 2007-2008, as market losses were exacerbated by the increased leverage. Leverage restrictions are not an appropriate solution for Hedge Funds as their investors and lenders are normally sophisticated investors. Instead we suggest that any regulations regarding Hedge Funds be based on higher transparency in regards to the amount and kind of leverage. This transparency can assist lenders and investors about the risk of additional leverage to the fund.

An additional risk is the rehypothecation of assets. As previously stated, broker-dealers can rehypothecate certain assets for their own collateral. Hedge Funds sometimes accept this arrangement in exchange for reduced fees or collateral that broker-dealers charge. This mutual agreement works well until there is a significant increase in demand for liquidity and those rehypothecated assets need to be returned, at which point they are not available. However, since we suggested previously that all assets used for collateral should be segregated and not allowed to be rehypothecated, no additional regulation is necessary.

One final issue that arises in this section is the impact of Substitutability. Hedge Funds sometimes invest in ubiquitous and illiquid asset classes. As a result, these asset classes might not get the funding they need if Hedge Funds face financial distress and can no longer invest. However, this will not create a market impact due to the fact that other investors have the ability to invest in these asset classes if they choose to, but have decided not to due to their risk. This implies that their risk is already properly priced in the market.

Response to Section 7: Guiding methodology for all other NBNI financial entities

This final section encompasses all other financial firms that engage in "financial intermediation or auxiliary financial activities." The proposal seeks to prevent systemic risk based on short-term funding and uses the same set of five impact factors and indicators to determine which firms are deemed systemic important.

Comments from Section 7: We agree that all other financial firms that are not explicitly banks, insurance companies, finance companies, market intermediaries, or investment funds should also be included if they are in custody of assets or are intermediaries of cash flow payments. We suggest that we exclude any short term lending provisions, as long as the potential lenders have full transparency of the other lending that has been provided and of the assets that cover those liabilities.

Sincerely,

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