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Designating Systemic Institutions: Is the Federal Reserve Board's Proposal for Designating GSIBs a Model for FSOC Designations?*

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The Federal Reserve Board (Board) has released, for public comment, a proposed rule to implement a capital surcharge for global systemically important bank holding companies. The Board's proposal includes a quantitative methodology for determining if a bank holding company is systemically important, and, therefore, subject to the capital surcharge.

The quantitative methodology contained in the Board's proposal stands in sharp contrast to the methodology applied by the Financial Stability Oversight Council (FSOC) in designating nonbank financial companies for supervision by the Board. While the first stage of FSOC's nonbank designation process is a quantitative screen, the designations made to date appear to be based upon a more subjective analysis of the impact of material financial distress at nonbank financial companies on the financial stability of the United States. As a result, FSOC's process for designating nonbank financial companies for supervision by the Board has been criticized as vague and opaque.

This article describes the quantitative methodology the Board has proposed for determining whether a bank holding company is systemically important, and suggests that FSOC consider a similar, quantitative approach to its systemic determinations.

The Board's Proposal

The Board's proposed rule would require every bank holding company with more than $50 billion in assets to determine by December 31st of each year whether or not it is a global systemically important bank, or GSIB. This determination would be based upon the application of a risk formula developed by the Board. A bank holding company that is determined to be a GSIB would be subject to the capital surcharge.

The risk formula proposed in the rule would require a bank holding company to assess its exposure to 12 systemic indicators that are grouped into five categories: size; interconnectedness; substitutability; complexity; and cross-jurisdictional activity. For example, the risk indicators in the interconnectedness category are the company's intra-financial system assets, its intra-financial system liabilities, and its securities outstanding.

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From these exposures, a company would derive a "systemic indicator score" that is expressed in basis points. If the company's score equals or exceeds 130 basis points, the company would be deemed to be a GSIB and would be subject to the surcharge.

The systemic indicator score would be determined by a three step calculation. First, a company would be required to calculate the ratio of its exposure to each of the 12 systemic risk indicators compared to the aggregate exposure of the world's 75 largest banking organizations to those same indicators. Data for the company's exposures would be taken from the company's FR Y-15 filings with the Board. Data for the exposures of the world's largest banking organizations would be provided by the Basel Committee. The second step in the calculation would be to multiply the ratio by 10,000 in order to put in terms of basis points. Finally, this amount would be multiplied by an "indicator weight" that apparently is tied to the systemic risk of each indicator. For example, a company's total exposures, which is the key indicator in the size category, would be subject to a 20 percent weight.

The Board has conducted this analysis for all bank holding companies over $50 billion using March 2014 FR Y- 15 filings and found that only eight U.S. bank holding companies exceed the 130 basis points threshold. All of the other U.S. bank holding companies had scores of less than 50 basis points.

FSOC's Process

FSOC has established a three-stage process for determining if a nonbank financial company should be subject to supervision by the Federal Reserve Board. The first stage is a quantitative screen that is based upon several factors, including size. Stages two and three involve an analysis of additional data available from public sources, other regulatory bodies, and the nonbank financial company that is under review. FSOC evaluates this information within the context of eleven factors enumerated in the Dodd-Frank Act, but has not adopted a quantitative formula for designation similar to the Board's proposal. As a result, FSOC's process has been criticized as vague and opaque.

An obvious key to the Board's proposal is the availability of detailed data on individual U.S. bank holding companies as well as the world's largest banking organizations. Therefore, if FSOC were to adopt a more quantitative approach to designating nonbank financial companies for supervision by the Board, it would need to have detailed data on nonbanking companies and the industries in which they operate. Presumably, the Office of Financial Research, which was established to provide data to FSOC, could fill this need. If so, FSOC should give consideration to establishing a more quantitative approach to designations, and thereby addressing some of the criticism associated with the current nonbank designation process.

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