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Statement No. 319

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Statement of the Shadow Financial Regulatory Committee on

The Financial Stability Board's Methods for Defining Globally Systemic International Banks

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The Group of Twenty (G-20) asked the Financial Stability Board (FSB) to devise a process for identifying Globally Systemic International Banks (G-SIB). In July the FSB released a consultative document setting forth the methodology for identifying G-SIBs and in November produced its first list using this methodology (Appendix 1).

The proposed methodology attempts to be transparent with maximum emphasis on the use of observable indicators of systemic risk. It provides a limited provision for the supplementary exercise of supervisory judgment in the use of these and other indicators. Supplementary actions are to be clearly documented and expected to be quite rare. Providing a role for supervisory judgment recognizes that no set of observable measures can fully capture the potential threat to the global financial system. An admirable feature of the system is that it is designed to encourage large, complex, international banks to reduce their systemic potential (given the indicators selected by the FSB). The FSB plans to sort institutions into five risk categories (or "buckets") that will be assigned increasingly higher capital requirements as summarized in Appendix 2.

The methodology focuses on five bank characteristics that are thought relevant to systemic risk: (1) size of bank; (2) the interconnectedness of the bank with the rest of the financial system; (3) the lack of readily available substitutes for services the bank provides; (4) the degree of cross-jurisdiction activity; and (5) the extent of complexity. While one could imagine the addition of other characteristics or argue about how these characteristics should be weighted or the indicators that should be used for each characteristic, the basic structure seems sound in general. Appendix 3 provides a summary of the characteristics and indicators.

The main purpose of this statement is to focus the FSB's attention on the potential dangers of relying on any observable measure that can be influenced by the bank. Although the indicators are meant to influence a bank's behavior in a way that reduces its systemic risk, the FSB should be wary of the law of unintended consequences. Observable bright line measures that delineate the risk buckets, while having the benefit of transparency, may create incentives for a bank to change its operations to move to a more favorable bucket without meaningfully reducing its threat to the financial system. Two types of bank behavior raise concerns. The first is measurement manipulation that is designed to conceal the riskiness of the fundamental activities and that results in misleading financial reports on which the indicators are based. The second is manipulation of the bank's activities, engaging in activities that are at least as risky but appear to be less risky as measured by the defined observable indicator.

All of the indicators are subject to these distortions to some extent. We discuss two specific indicators to illustrate the two previously noted potential problems. The first example is the extent of a bank's Level 3 assets, an indicator of complexity because Level 3 valuations are subject to the greatest degree of uncertainty.[1] Level 3 assets provide an excellent example of the potential distortions associated with measurement manipulation. Ideally, we would like to be able to rely on the classification of securities to understand the uncertainty surrounding the measurement of the bank's financial instruments. But if banks are provided capital incentives to minimize Level 3 assets, the uncertainty in the measurement of the fair value of the bank's financial instruments will be understated. Moreover, the bank's incentives to manipulate the classification depend on whether the financial instruments are in a gain or loss position, which leads to time-varying reliability of the indicator as a measure of complexity. In summary, without knowing the full set of incentives that influence bank's decisions to classify assets as Level 3, it is impossible to assess whether this particular indicator will encourage overstatement or understatement of the bank's complexity.

The second example is the notional value of OTC derivatives, another indicator of complexity, which provides an excellent example of the potential distortions associated with manipulation of the bank's activities. Banks can achieve similar risk taking across different kinds of financial instruments by manipulating other terms of the instrument without increasing notional value. For example, the pay-offs of most OTC derivatives can be replicated with various combinations of exchange-traded futures and options, thus reducing this indicator of complexity without reducing the complexity of the firm's operations.

Similar examples could be devised for each of the indicators. These two illustrate the trade-off between the benefits of the observability of a specific indicator and the potential distortions that may arise from the selection of that indicator. When choosing among indicators, the FSB should attempt to evaluate each of the proposed indicators and reject indicators where the potential for distortion outweighs the benefits of observability. Overlaying supervisory judgment on the observable indicators to determine systemic risk ought to be particularly intense for the indicators that are especially vulnerable to manipulation.

[1] Financial accounting standards define three levels of inputs to be used in determining the fair value of financial instruments. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are observable prices used in a valuation model for a financial instrument; they are not the price of the financial instrument being valued. Level 3 Inputs are unobservable valuation model inputs and represent a reporting entity's assumptions about the assumptions that market participants would use in pricing the asset. The fair value measurement of assets measured using Level 1 inputs are considered the most reliable and those measured using Level 3 inputs are subject to the greatest degree of uncertainty.

Appendix 1
FSB Proposed List of G-SIBs

Bank of America
Bank of China
Bank of New York Mellon
Banque Populaire CdE
Barclays
BNP Paribas
Citigroup
Commerzbank
Credit Suisse
Deutsche Bank
Dexia
Goldman Sachs
Group Crédit Agricole
HSBC
ING Bank
JP Morgan Chase
Lloyds Banking Group
Mitsubishi UFJ FG
Mizuho FG
Morgan Stanley
Nordea
Royal Bank of Scotland
Santander
Société Générale
State Street
Sumitomo Mitsui FG
UBS
Unicredit Group
Wells Fargo

Appendix 2
Proposed additional loss absorbancy rates

Bucket*	Minimum additional loss absorbancy (common equity as a percentage of risk-weighted assets)
5	3.5%
4	2.5%
3	2.0%
2	1.5%
1	1.0%

*None of the G-SIBs on the FSB proposed list in Appendix A currently fall into the Category 5 bucket.

Appendix 3
Overview of risk attributes, individual indicators, and indicator weightings

Category (and weighting)	Individual indicator	Indicator weighting
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability (20%)	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	OTC derivatives notional value	6.67%
	Level 3 assets	6.67%
	Book value of trading and available-for-sale securities	6.67%