Identifying Systemic Risk:

An Examination of the Dodd-Frank Act's Systemic Importance Threshold through Legislative History and Recent Academic Research

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Regional Bank Coalition

Introduction
Banking companies with over $50 billion in assets are automatically considered "Systemically Important Financial Institutions" (SIFIs) in the Dodd-Frank Act. This paper explores the origin of the $50 billion threshold and academic research related to the identification of systemic importance.

The legislative history of the Dodd-Frank Act shows the $50 billion threshold was initially intended to exclude smaller banks from regulation by the Federal Reserve Board (FRB). When the Senate later acquiesced to demands from smaller banks to maintain their supervision by the FRB, $50 billion became a *de facto* threshold for enhanced regulation. The record does not evidence a detailed discussion in Congress whether $50 billion is a right or wrong line to draw for defining risk.

Since Dodd-Frank was enacted, a broad consensus has developed that more accurate, transparent and publicly available data exists to segregate banks that pose systemic risks from those that do not, including size, inter-connectedness, complexity, global activity, and dominance in certain customer services. Analysis by the U.S. Department of Treasury Office of Financial Research indicates that only eight U.S. banks qualify as posing systemic risk under the expanded criteria; the remaining 25 U.S. banks with assets above $50 billion demonstrate low risk to the stability of the U.S. and global economies.

These issues are important because the Dodd-Frank Act's enhanced prudential standards impose substantial compliance costs. If the category of oversight is inappropriate – if the enhanced prudential standards are applied to banks that pose little or no systemic risk to the economy – the additional costs incurred by banks misdirect capital that could otherwise be invested in communities to expand local economies and increase employment.

Executive Summary
When the Dodd-Frank Act was enacted, it imposed significant systemic risk regulations on regional banks based on an arbitrary total asset threshold of $50 billion, rather than taking into account a bank's risk profile or business model to determine how much risk that bank's failure presents to the financial system. Dodd-Frank defines systemic risk as a situation in which "material financial distress at the [financial institution], or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [financial institution], could pose a threat to the financial stability of the United States."[1]

[1] Dodd-Frank Act, Section 113.

This paper details the legislative history of the Act, revealing that the law's authors did not intend for the $50 billion asset threshold to serve as a designation of systemic risk. In fact, the Senate Banking Committee report accompanying the measure makes clear that the $50 billion demarcation was intended to enhance regulator accountability, reduce regulatory gaps and limit the regulatory burden on industry, not to designate whether financial institutions with assets greater than $50 billion presented increased risks to financial stability.[2]

Between passage in the Senate Banking Committee and the president's signature, the bill's regulatory framework changed significantly by adoption of a floor amendment authored by Senators Hutchison and Klobuchar that unified the bill's original two-tiered regulatory structure under the Federal Reserve Board. That amendment aimed to maintain a direct relationship between independent community banks and the Federal Reserve in order to preserve the Board's "insight into what is happening in the entire banking system" and to "gauge the impact of banking regulations across diverse institutions."[3] Conforming changes were not made to the bill's Section 165, however, which set the $50 billion boundary. Yet, Congress needed to set a line to protect community banks from the bill's enhanced prudential standards. The $50 billion demarcation already in Section 165 became the dividing line, even though it was never originally intended as such.

As Dodd-Frank has been implemented, academic studies described in this paper have examined a variety of means – in addition to asset size – to better identify financial institutions that pose systemic risk. Regulators at the Financial Stability Board and the Basel Committee for Bank Supervision have developed precise tests, also described herein, to measure systemic risk by examining five factors: size, interconnectedness, complexity, global activity, and dominance in certain customer services, also known as substitutability.

Section 165 of the Dodd-Frank Act directs the Federal Reserve Board to establish prudential standards for Bank Holding Companies (BHCs) with total consolidated assets of $50 billion or more. The prudential standards must include enhanced risk-based capital, leverage capital, liquidity, risk-management, and stress test requirements and single counterparty credit limits.[4] The Board must also impose a 15-to-1 debt-to-equity limit on companies that the Council has determined pose a grave threat to the financial stability of the United States.[5]

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[2] Senate Report Number 111-176.
[3] Letter from Independent Community Bankers of America President Camden Fine letter to senators, May 6, 2010.
[4] 12 U.S.C. Section 5365(b)(1).
[5] 12 U.S.C. Section 5365(j).

By requiring the implementation of the $50 billion threshold, current law misallocates scarce regulatory resources, requiring bank regulators to expend precious regulatory capital on banks that pose little, if any, risk to the financial stability of the U.S. These resources would be better utilized to more appropriately regulate the marketplace to reduce systemic risk and to more properly allocate capital to help local communities strengthen their economies, providing American workers with good jobs with good wages.

Legislative History of Dodd-Frank Section 165

Senate Banking Committee Chairman Chris Dodd circulated a Discussion Draft[6] of legislation in November 2009. The draft would have created two agencies: the first, the Financial Institutions Regulatory Administration (FIRA) would be responsible for all prudential regulation. The second, the Agency for Financial Stability (AFS), would be responsible for designating any financial company whose "material financial distress" would "pose a threat to the financial stability of the United States or the United States economy during times of economic stress" and subjecting companies so designated to enhanced prudential standards.[7]

The Dodd Discussion Draft did not utilize an asset threshold to differentiate between financial institutions subject to FIRA and AFS jurisdiction. Instead, it directed the AFS to take into account specific factors in devising enhanced prudential standards, including: "the amount and types of the liabilities of the company;" "the amount and nature of the financial assets of the company;" "the extent and type of the off-balance-sheet exposures of the company;" the company's relationships with other major financial companies; and its ownership of any clearing, settlement, or payment businesses.[8]

The follow-on to the Dodd Discussion Draft was the Restoring American Financial Stability Act (RAFSA).[9] RAFSA featured the first appearance of the $50 billion threshold, included in Section 165 that provided for the Federal Reserve to establish enhanced prudential standards for financial companies in order "to prevent or mitigate risks to the financial stability of the United States that could arise from the material distress or failure of large, interconnected financial institutions."[10] Unlike the original Dodd Discussion Draft, RAFSA provided that

[6] Dodd Discussion draft available at: http://www.banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[7] Dodd Discussion Draft Section 105.

[8] Dodd Discussion Draft Section 107(b)(3).

[9] http://www.llsdc.org/assets/DoddFrankdocs/bill-111th-s3217-cmte-prt.pdf.

[10] RAFSA Section 165(a)(1)

Section 165 applied to all "large, interconnected" bank holding companies with consolidated assets of $50 billion or more.[11]

The report of the Senate Banking Committee accompanying RAFSA[12] suggests that the $50 billion threshold was chosen because in "banking organizations with less than $50 billion in assets, the vast majority of assets are in the depository institution."[13] The purpose was for the Federal Reserve to regulate bank holding companies that had securities, insurance, and other nonbank activities. The Office of the Comptroller of Currency or the Federal Deposit Insurance Corporation would regulate bank holding companies that had few or no nonbank assets.[14]

The report indicates that the $50 billion threshold was not intended to separate companies based on whether they presented risks to financial stability, but rather to enhance regulator accountability, reduce regulatory gaps and limit the regulatory burden on industry.[15] Section 165 required the Federal Reserve to employ a "graduated approach" in implementing enhanced prudential standards and specifically directed the Federal Reserve "to avoid identification of any bank holding company as systemically significant."[16]

The proposal required that an "increase in stringency" be applied according to companies' leverage; amount and types of the liabilities; amount and nature of financial assets; the extent of off-balance sheet exposures; interrelations with other significant financial companies; the extent to which assets are managed rather than owned by the company; and any other factors the Federal Reserve deemed appropriate.[17]

When the bill reached the Senate floor, an amendment authored by Senators Kay Hutchison and Amy Klobuchar was adopted restoring the Federal Reserve's jurisdiction over all bank holding companies,[18] thus eliminating the differentiated jurisdiction. The amendment made no change to Section 165, however, leaving the provision deeming any bank with assets above $50 billion to be systemically significant in place, even though the underlying framework on which it was based had been removed from the bill.

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[11] RAFSA Section 312(a).
[12] http://thomas.loc.gov/cgi-bin/cpquery/R?cp111:FLD010:@1(sr176).
[13] Senate Report Number 111-176, at 25.
[14] Senate Report Number 111-176, at 23 and 25.
[15] Ibid.
[16] Senate Report Number 111-176, at 2.
[17] RAFSA § 113; Section 165(a)(1)(B), (b)(3).
[18] Senate Amendment No. 3759, 111th Congress.

The compromise legislation reported by a House-Senate conference committee adopted the amendment offered by Senators Hutchison and Klobuchar, thus requiring the implementation of enhanced prudential standards on banks with assets of $50 billion or more.

Review of Academic Literature on Systemic Risk

In January 2012, researchers Dimitrios Bisias, Mark Flood, Andrew W. Lo and Stavros Valavanis authored a working paper of the Office of Financial Research "Survey of Systemic Risk Analytics" that noted "31 quantitative measures of systemic risk in the economics and finance literature, chosen to span key themes and issues in systemic risk measurement and management." The paper concluded, "Because systemic risk is a multifaceted problem in an ever-changing financial environment, any single definition is likely to fall short, and may create a false sense of security as financial markets evolve in ways that escape the scrutiny of any one-dimensional perspective."[19]

In their February 2015 brief, "Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data," U.S. Department of Treasury Office of Financial Research authors Meraj Allahrakha, Paul Glasserman, and H. Peyton Young used a new dataset collected by the Federal Reserve System to evaluate the systemic importance of the largest U.S. bank holding companies by comparing their scores on size, interconnectedness, complexity, global activity, and dominance in certain customer services (known as "substitutability").

Of the 33 U.S. banks review in the brief, the eight designated as global systemically important banks (G-SIBs) in 2012 had the highest systemic importance scores in 2013. JPMorgan Chase & Co. had the highest score at 5.05 percent, followed by Citigroup Inc. (4.27 percent), Bank of America Corp. (3.06 percent), Morgan Stanley (2.60 percent), Goldman Sachs Group, Inc. (2.48 percent), and Wells Fargo & Co. (1.72 percent).

The other 25 banks evaluated by the OFR average 0.14 percent of systemic importance, with the highest score among the group registering less than 10 percent the systemic importance of JPMorgan Chase & Co. The report concluded, "The largest banks tend to dominate all indicators of systemic importance."[20]

Two economists with the Bank of Canada, Éric Chouinard and Erik Ens, in their

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[19] U.S. Department of Treasury Office of Financial Research Working Paper #0001, "A Survey of Systemic Risk Analytics," Dimitrios Bisias, Mark Flood, Andrew W. Lo and Stavros Valavanis, January 5, 2012.

[20] U.S. Department of Treasury Office of Financial Research Brief, "Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data," Meraj Allahrakha, Paul Glasserman, and H. Peyton Young, February 12, 2015.

December 2013 report "Assessing the Systemic Importance of Financial Institutions," explored the approaches used by authorities to identify systemically important financial institutions (SIFIs) in both the global and domestic financial systems.

Their report reviewed how the indicator-based methodology used by the Basel Committee on Banking Supervision (BCBS) to identify global systemically important banks (G-SIBs) could be adapted to domestic systems, observing that the BCBS "principles articulate that authorities should take into account factors such as size, interconnectedness, complexity and substitutability."

They concluded, "The identification of systemically important financial institutions is a key step in efforts by regulators to end 'too big to fail' and prevent future financial crises. While regulators take different approaches in assessing systemic importance, all of them look beyond size to evaluate the importance of each institution for the financial system. These efforts can help regulators to develop more effective policy frameworks, which will be aided by future refinements in the techniques for assessing the methodologies." (Emphasis added.)[21]

A May 2014 paper "Bank Size and Systemic Risk" by Luc Laeven, Lev Ratnovski, and Hui Tongpaper of the International Monetary Fund's Research Department, investigated the relation between measures of bank size, market-based activities, and organizational complexity and measures of bank risk. They found that "among large banks only (over $50 billion in assets), size *per se* ceases to be an independent risk factor" and that "large banks create more systemic risk …when they engage more in market-based activities or are more organizationally complex."[22]

In a September 2014 Congressional Research Service report prepared for Members and Committees of Congress, "Systemically Important or Too Big to Fail Financial Institutions," Marc Labonte (Library of Congress Specialist in Macroeconomic Policy) explored policy options for shielding government, the public and the economy from "too big to fail" (TBTF) financial institutions.

Labonte observed, "If TBTF is primarily a function of size, policy makers could require TBTF firms to sell businesses, divest assets, or break up to the point that they are no longer TBTF." Questioning the concept of size alone as an indicator of what makes a firm a source of systemic risk, Labonte asked, "(S)hould the line

[21] Bank of Canada Financial System Review, "Assessing the Systemic Importance of Financial Institutions," Éric Chouinard and Erik Ens, December 2013.
[22] International Monetary Fund Staff Discussion Note "Bank Size and Systemic Risk," Luc Laeven, Lev Ratnovski, and Hui Tong, May 2014.

be drawn at, say, $1 trillion, $100 billion, or $50 billion of assets? … A firm could be TBTF because of its overall size or because of its size or importance in a particular segment of the financial market, suggesting that overall size alone may not be a sufficient determinant of systemic importance. It is also possible that if all institutions were smaller because of a size cap, the largest institutions would still be systemically important, even though their size would not be large by today's standards. A parallel might be the decision to rescue Continental Illinois in 1984—it was the seventh-largest bank, but had assets of only $45 billion at its peak, as geographic restrictions meant that the average size of all banks was smaller."[23]

Conclusion
As demonstrated by the legislative history of Section 165 of the Dodd-Frank Act, the $50 billion asset threshold for the enforcement of the Act's enhanced prudential standards was never the original intent of the legislation, but was a byproduct of the adoption of a floor amendment that sought to maintain a direct relationship between the Federal Reserve Board and independent community banks. In order to prevent the application of the Act's enhanced prudential standards to community banks, Section 165's $50 billion threshold came to divide banks by asset size, with banks larger than $50 billion subject to the enhanced standards.

Since the Dodd-Frank Act became law, a broad consensus of industry, regulatory and academic experts, including the U.S. Department of Treasury Office of Financial Research, have demonstrated that better methods are readily available, utilizing transparent, publicly available data, to better sort banks that present systemic risks from those that do not. The Office of Financial Research analysis indicates that only the eight U.S. banks designated as global systemically important banks in 2012 had the highest systemic importance scores in 2013. The difference between the systemic risks scores of the eight and the remaining 25 U.S. banks with assets above the $50 billion asset threshold demonstrates the low risk these institutions pose to the stability of the U.S. and global economies.

The application of enhanced prudential standards on banks that pose little or no systemic risk to the economy misdirects regulatory resources that would be better utilized to regulate banks that pose systemic risk and to free capital to help communities build local economies with good jobs.

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[23] Congressional Research Service, "Systemically Important or "Too Big to Fail" Financial Institutions," Marc Labonte, September 19, 2014.