

Giant banks are “systemically-important” for different reasons

By Editorial Staff Thu, Feb 19, 2015

Over-the-counter derivatives positions, which contribute to the complexity of the financial system and helped trigger the financial crisis of 2007-2008, were particularly high at Morgan Stanley and Goldman Sachs.

Five of the eight U.S. banks that are considered globally systemically-important (G-SIB)—Citigroup, JPMorgan, Morgan Stanley, Bank of America, and Goldman Sachs—have high “contagion index” values, according to a new report from the Treasury Department’s Office of Financial Research.

A bank’s contagion index indicates the likelihood that its financial problems might infect other banks. The contagion index combines what the paper called a “connectivity index” with a bank’s size and leverage levels. According to the report:

- The higher the bank’s leverage, the more prone it is to default under stress
- The larger it is, the greater the potential spillover if it defaults
- The greater its connectivity index, the greater is the share of the default that cascades onto the banking system

Of the eight U.S. G-SIBs (those named above plus Bank of America, Bank of New York Mellon and State Street), seven had high financial connectivity index values, the paper said. Bank of New York Mellon and State Street were high on both dimensions despite their relatively smaller sizes.

A bank that has large foreign assets and large intrafinancial system liabilities is a potential source of spillover risk, according to the paper. Five banks had large foreign assets (exceeding \$300 billion) and Citigroup and JPMorgan had large figures for both foreign assets and intra-financial system liabilities. Four of the six largest banks were net borrowers from the financial system. Bank of New York Mellon and State Street, which run large securities lending businesses, had large negative net positions.

Over-the-counter derivatives positions, which contribute to the complexity of the financial system and helped trigger the financial crisis of 2007-2008, were particularly high at Morgan Stanley and Goldman Sachs. Morgan Stanley’s positive OTC derivatives values accounted for almost 30% of its total exposures, the paper said. For Goldman Sachs, the figure was about 15%.

Banks can also become systemically important if they dominate a specific business sector.

Bank of New York Mellon Corp., State Street Corp., and Northern Trust Corp. (NTRS) have large operations as custodian banks. Goldman Sachs and Morgan Stanley have large underwriting businesses. Deutsche Bank Trust (DB), a U.S. subsidiary of the largest German bank, has a high level of payment activity.

Although the world’s largest banks satisfy international standards for risk-based capital, including a new capital buffer, they have relatively low leverage ratios (calculated as Tier 1 capital divided by total exposures) compared to smaller banks, according to the OFR paper.

Last December 9, the Federal Reserve proposed a draft rule implementing the G-SIB buffer for U.S. bank holding companies that could result in some banks holding larger capital buffers than those proposed by the Basel Committee.

The higher the Tier 1 leverage ratio, the more stable the bank. The Tier 1 leverage ratio is calculated by dividing Tier 1 capital ratio by the firm’s average total consolidated assets. The Tier 1 leverage ratio is an evaluative tool used to help determine the capital adequacy and to place constraints on the degree to which a banking firm can leverage its capital base.

[To be *adequately* capitalized under federal bank regulatory agency definitions, a bank holding company must have a Tier 1 capital ratio of at least 4%, a combined Tier 1 and Tier 2 capital ratio of at least 8%, and a leverage ratio of at least 4%. To be *well-capitalized*, a bank must have a Tier 1 capital ratio of at least 6%, a combined Tier 1 and Tier 2 capital ratio of at least 10%, and a leverage ratio of at least 5%.

Capital acts as a buffer or cushion against losses, and the authors of the report say that

higher risk-based capital requirements for the largest global systemically important banks (G-SIBs) “could enhance the resilience of the financial system” by acting as a buffer or cushion against losses.

The report, entitled, “Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data,” was written by Meraj Allahrakha of George Washington University, Paul Glasserman of Columbia University, and H. Peyton Young of Johns Hopkins University.