An Economic Framework For Determining Systemically Important Financial Institutions

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This proposal focuses on the process of the designation of Systemically Important Financial Institutions (SIFI) rather than on a specific definition. As such, it does not strictly meet the mandate of the contest to provide metrics with which to identify and designate institutions. However, any methodology proposed through this challenge and during the process of designation should conform to sound economic principles. Thus, the discussion included herein addresses the following issues highlighted in the call for proposals:

The designation comes with significant regulatory costs and administrative burdens for affected institutions. Those costs must be weighed against the potential benefits of increased financial stability.

Given the substantial costs to SIFI designation for both the company and the Federal Reserve, it is important that the Council consider the basic economic principles for justifiable regulation as proposed in Circular A-4. (Neither the Council nor the Federal Reserve are bound by Circular A-4.) Circular A-4 states that the key elements of regulatory analysis are: (1) a statement of the need for the proposed action, (2) an examination of alternative approaches, and (3) an evaluation of the benefits and costs, both quantitative and qualitative, of the proposed action and the main alternatives identified by the analysis.

I propose that any process for determining designation, including the criteria used to define a SIFI, consider the following three questions. What is the fundamental economic problem that the criteria for designation addresses? Are there alternative regulatory solutions to the problem in addition to designation of specific institutions? What are the costs and benefits of the proposed solution and each of the feasible alternatives?

Circular A-4 directs executive agencies to specifically address the need for government intervention stemming from a market failure or social good. In order to assess whether regulation is needed, it is imperative that the fundamental problem to be addressed be clearly identified. The FSOC considers whether the material financial distress (italics added) of a company could pose a threat to financial stability and considers three transmission mechanisms for the threat to financial stability: (1) the exposures of counterparties, creditors, investors, and other market participants to the company, (2) the liquidation of assets by the company, which could trigger a fall in asset prices and thereby could significantly disrupt trading or funding in key markets, and (3) the inability or unwillingness of the company to provide a critical
function or service relied upon by market participants and for which there are no ready substitutes. These considerations are ambiguous with respect to the precise underlying economic problem that designation is designed to address. More specifically, the current framework presupposes that the company is already in material financial distress without considering the economic conditions and/or firm behavior that led to this outcome. Designation of the institution becomes highly likely because it is reasonable to conclude that the financial distress of a large firm has the potential to disrupt the economy through one or more of the three transmission channels. Thus, one possible economic problem that could be addressed by the criteria used to define a SIFI, and by the designation process itself, is to reduce the risk that a firm enters into financial distress. In order for the regulatory process to be effective, any proposed criteria for designation should address the conditions under which financial distress may occur, the likelihood of such conditions being present, the ability of the firm to mitigate the risk and how regulation may reduce the probability of the event occurring.

As the current process now stands, the designation of a firm as a SIFI is intended to mitigate the effects of the transmission mechanism on other firms and markets. However, the criteria for regulatory intervention should consider whether alternative mechanisms are available to solve or mitigate the underlying economic problem. In particular, the analysis should determine whether designation of a specific institution is the appropriate solution or whether additional regulatory oversight of certain risky activities common to a number of institutions is needed. Although the Federal Reserve is tasked with overseeing SIFIs, the Council is composed of all financial regulators who may have alternative mechanisms that may, in isolation or in tandem, reduce the risk of financial stability in addition to the designation of individual firms as SIFIs. A discussion of the available tools, their efficacy and costs should be part of the designation process.

Finally, any proposed criteria for SIFI status should take into consideration the costs and benefits of designation to the financial institution and to society as a whole. While many of the benefits are difficult to quantify, the proposal should be clear as to the criteria used to determine the financial firms contribution to systemic risk and the ways in which the regulatory intervention may reduce the potential for failure of an individual institution and its effect on overall systemic risk. In particular, the analysis should be clear as to the type of regulatory actions the Federal Reserve will conduct and how these actions will reduce the entity’s contribution to systemic risk. After the criteria is set, rigorous economic analysis for each individual designation allows for flexibility in the application of criteria and in the potential regulatory solution. Providing an economic analysis that weighs the costs and benefits, both at the initial definition stage and at designation, improves transparency regarding the Council’s decision-making that can be used by potential designees to “make it easier for firms to take preemptive actions to reduce their contributions to systemic risk and thus avoid SIFI designation.”

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Hanley, K. and S. Nikolova, 2015, Rethinking the use of credit ratings in capital regulation, Lehigh University working paper.