Systemic Risk Score: A Suggestion

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Abstract: We identify a potential bias in the methodology disclosed in July 2013 by the Basel Committee on Banking Supervision (BCBS) for identifying systemically important financial banks. Contrary to the original objective, the relative importance of the five categories of risk importance (size, cross-jurisdictional activity, interconnectedness, substitutability/financial institution infrastructure, and complexity) may not be equal and the resulting systemic risk scores are mechanically dominated by the most volatile categories. In practice, this bias proved to be serious enough that the substitutability category had to be capped by the BCBS. We show that the bias can be removed by simply standardizing each input prior to computing the systemic risk scores.

1. Introduction

The supervision of globally systemically important financial institutions (G-SIFIs) is a major pillar, along with leverage and liquidity ratios and countercyclical buffers, of the post-crisis banking regulation. As of 2016, the financial institutions that contribute the most to the risk of the financial system will be subject to more intense supervision and have to maintain higher regulatory capital. According to the latest draft released by the Basel Committee on Banking Supervision (BCBS, 2013), the additional capital