US Rates Strategy

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Revising the GSIB risk score

Large banks' systemic risks scores rose somewhat atypically in Q2' 25 with across the board increases in the sub-components. The Federal Reserve's plans to reform the risk metric have been tabled since 2023. We expect these will eventually be approved but implementation may still be a couple of years away.

- Large banks are required to hold an extra cushion of capital to account for the systemic risk their size and activities pose to the economy and markets. Required capital is determined by a score across five dimensions of risk.

- **Scores exhibit a high degree of seasonality because of when the Fed calculates the capital surcharge**. They fall sharply in Q4 as banks "risk diet" and rebound in the following quarter. Scores are normally steady in Q2 and Q3.

- **Last quarter's (Q2) increase reflected across the board gains in the subcomponents of the risk measure**. The score was boosted by gains in the GSIBs' share prices.

- **In 2023, the Fed proposed moving the score to an annual average and narrowing the capital buffer buckets to minimize the effects of risk dieting**. Neither change has been adopted.

- The risk framework has not been updated since 2015. **We think this has allowed some "risk creep" to enter the scores**. As a result, the scores may overstate US banks' relative systemic riskiness.

- Current Vice Chair Bowman has argued for regulators to revisit bank capital rules and has spoken in favor about indexing the GSIB risk scores for nominal growth.

Risk score

Basel bank capital rules require large banks to hold an extra capital cushion to account for the systemic risk their size, complexity and activities pose to the economy and markets. **The GSIB risk surcharge is based on a score calculated across five dimensions of bank risk**. These five subcomponents include the bank's size, its interconnectedness, its cross jurisdictional activity as well as its complexity. Size reflects the banks' on and off-balance sheet exposures including derivatives. Interconnectedness includes cross holdings of bank debt and financial derivatives. It also includes the value of their outstanding debt as well as the market price of their own equity. Cross jurisdictional exposures are similar although across borders. This measure does not include banks' offshore derivative holdings although the Fed was considering adding these to the score in 2023. The complexity measure reflects banks' cleared and uncleared derivatives activity as well as their trading and available for sale securities (AFS). While some of these ingredients are captured in multiple sub-components, they often are calculated differently to account for balance sheet offsets and risk formulas.

The fifth component measures the extent to which the bank's services can be replaced by another provider (substitutability). While this is part of the Method 1 score used by US banks, the largest institutions are required to use the higher Method 2 score which replaces substitutability with the banks' use of short-term (<1y) wholesale secured and unsecured funding. The Fed uses the bank's Q4 score to calculate its capital cushion using a prescribed schedule. Currently, each 100bp increase in the score is worth an additional 50bp of capital.

The timing of the capital calculation introduces some seasonality in scores. **Banks have an incentive to reduce their scores in Q4 – either to move into a lower capital buffer or to keep from shifting into a higher one**. This has long attracted regulatory scrutiny – in the US and abroad.[1]

In Figure 1, we plot the average seasonal effect in the banks' overall risk scores between 2018 and 2024. The seasonality in the averages is pronounced in Q4 (scores fall an average of 11bp) and rebound in the following quarter (by an average of 22bp). These averages are larger for the top three GSIB banks (Figure 2). Scores hardly budge in either Q2 or Q3. **However, this year, the average GSIB's Q2 score increased 30bp (and 46bp at the top three)**. Some of this atypical increase reflects higher bank share prices, but the other components of the risk score also rose last quarter. That said, it is unclear if banks are managing their systemic risk differently in anticipation of changes to the scoring framework.

Risk dieting

Q4 risk dieting typically takes several forms. Banks move to lower their scores by trimming their derivatives activity – both cleared and uncleared. They also step back from some cross border transactions and reduce their holdings of trading and AFS. Risk dieting has occasionally caused temporary spikes in repo rates and short-maturity cross currency bases during the quarter. Once the score is calculated, banks can quickly ramp up these activities in Q1.

That said, while banks can influence some of the components of their risk score, there are others over which they have little control. A bank's interconnectedness measure includes changes in its own share price; an increase adds to the bank's overall risk score. This component alone has risen nearly 50% since mid-2021. In figure 2 we plot the average quarterly percent change in banks size and OTC derivatives holdings to illustrate seasonal (OTC) and non-seasonal influences (size) on the risk score (Figure 2). We have scaled these effects based on their coefficient weights in the overall score. The size component (green) has generally risen from quarter-to-quarter with a few exceptions in 2022. By contrast, banks OTC derivatives holdings (yellow) have declined in every fourth quarter except for a small increase in 2021.

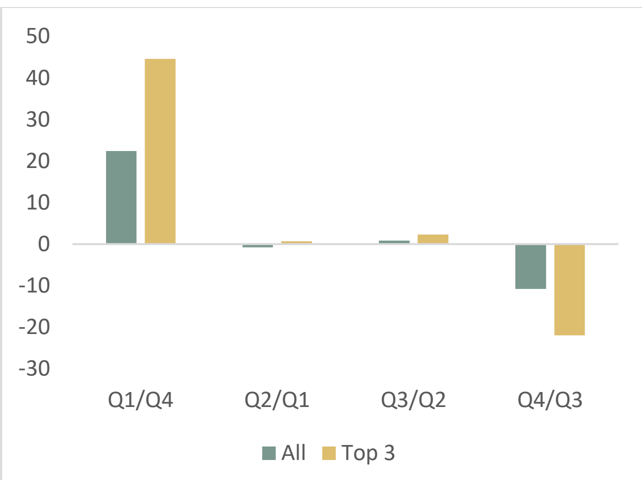
We think risk dieting raises two important questions. First, we do not think the regulatory issue is necessarily with dieting. After all, for banks to internalize their riskiness, in addition to holding more capital they must also be able to prune their activities in ways to de-risk. Instead, our sense is that

[1] See, for example, "Effect of the GSIB Surcharge on the Systemic Risk Posed by the Activities of GSIBs", M. Migueis and S. Peirce, Federal Reserve Board of Governors, March 2025.

regulators' concerns are with the yo-yo'ing effect on risk.[2] Banks' dieting seems more focused on temporary, short-term transactions rather than a full-scale risk revamping.

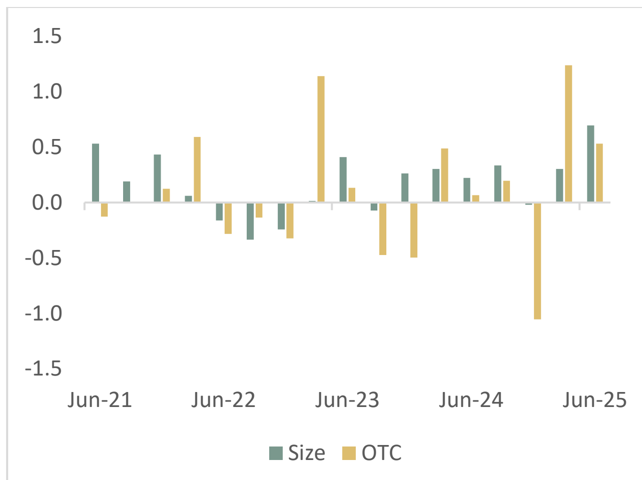
The second issue is related to the need for dieting. The risk score is a relative measure of riskiness scaled to global banking activity. But the score's coefficients have not been updated since the framework was adopted in 2015. As a result, they have gotten stale. We think this has allowed some "risk creep" in the scores – the framework may overstate banks' *relative* systemic riskiness. Indeed, GSIB banks risk scores have increased an average of 26% since mid-2017. At same time, the US economy has expanded 56%. While economic growth has some influence on the size of bank balance sheets it might not account for changes in cross jurisdictional activity or bank efforts to simplify their balance sheets. **As a result, it is hard to determine what portion of the 26% increase in scores is due to inertia and factors outside banks' direct control**.

Figure 1: Change in GSIB scores (bp)



Note: Average change across all eight banks over the 2018-24 period. The top 3 banks are BoA, Citi, and JPM. Source: Federal Reserve, SMBC Nikko

Figure 2: Weighted change in sub-components (% q/q)



Note: See text for full description. Source: Federal Reserve, SMBC Nikko

Revising the scores

In 2023, the Fed proposed several changes to the risk score's framework to reduce its seasonality. First, it recommended using **annual averages** of the quarterly scores to calculate the capital buffer. In turn, the quarterly readings should use daily observations as opposed to end-of-period values. The Fed already uses daily averages for some of the (on balance sheet) exposures in the size as well as in the short-term wholesale funding components.

Second, the Fed planned to **revamp the bandwiths in the score and capital buffers to reduce cliff effects.** Instead of a 100bp differential between capital buffers, the July 2023 plan would have reduced the thresholds to 20bp. Each 20bp increase in the score would add 0.10% to the bank's required capital. The slope – or the sensitivity of capital requirements to the changes in the risk score would not change.

[2] See, for example, "Holistic Capital Review", Federal Reserve Vice Chair for Supervision, M. Barr, July 10, 2023.

However, the narrower score buckets with smaller incremental increases in capital might reduce threshold effects and incentives to risk diet.

Last fall, the former Vice Chair for Supervision Barr proposed adjusting the coefficients underlying the risk score to account for growth in the economy.[3] There would be two adjustments – a one-time rebenchmarking and then an annual update where future coefficients would be indexed to nominal GDP growth. The former is meant to resize the coefficients to reflect changes in the relative share of US banks in the global industry totals for each of the sub-components in the risk score. Global industry totals are published in euros, so the rebenchmarking would also account for currency effects. Based on the proposal, the coefficients would be lowered for all the risk sub-components except complexity. **The new re-weightings under this methodology recognize that despite the increase in their risk scores since 2015, US banks have become *less* systemically risky compared to their non-US competitors**. Likewise, their relative riskiness has grown more slowly than nominal GDP.

Barr's replacement, Bowman, appears on board with updating the score weights. In a recent speech she recommended indexing GSIB "surcharge coefficients and regulatory thresholds" to nominal GDP.[4] Whether she advocates rebenchmarking and indexing the risk scores along the lines that Barr outline last year is unclear. While none of the 2023 proposals or the coefficient updates has been adopted yet, our sense is these are coming. In 2023, the Fed envisioned a 2y implementation period for the new scoring framework. Assuming the proposed changes are adopted relatively soon, they might take effect in 2028.

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[3] See, "The Next Steps on Capital", Federal Reserve Vice Chair for Supervision, M. Barr, September 10, 2024.
[4] See, "Unintended Policy Shifts and Unexpected Consequences", Federal Reserve Vice Chair for Supervision, M. Bowman, June 23, 2025.

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