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M A R K E T R I S K A N D E F F I C I E N C Y

Regulating Systemic Risk

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Systemic risk is the risk that the failure and distress of a significant part of the financial sector reduces the availability of credit which in turn may adversely affect the real economy. Not all economic downturns involve systemic risk, but the occurrence of systemic risk has almost invariably transformed economic downturns into deep recessions or even depressions.

We argue that the "laissez-faire" amount of systemic risk in an economy will likely be inefficiently high because systemic risk involves externalities. That is, each institution manages its own risks but does not consider its impact on the risk of the system as a whole. We draw the analogy of a firm that pollutes: It is often regulated to limit the pollution or taxed based on the externality it causes. Regulation is needed.

Unfortunately, current financial sector regulations do not address the problem because they seek to limit each institution's risk seen in isolation; they are not sufficiently focused on systemic risk. As a result, while the risks of an individual firm are properly dealt with in normal times, the system itself remains, or is induced to be, fragile and vulnerable to large macroeconomic shocks.

Our proposed solution would focus regulatory attention on systemic risk, provide incentives for regulated firms to limit systemic risk taking, reduce moral hazard, reduce the pro-cyclicality of risk taking, and use tools tested and well understood by the private sector.

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