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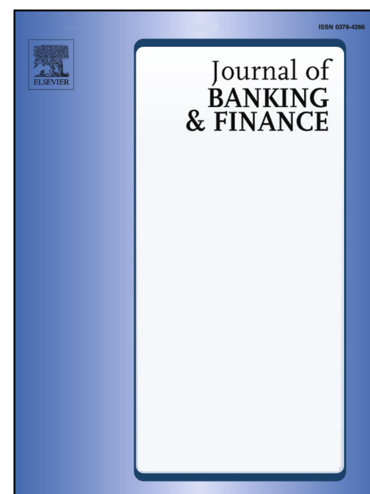

Has The Financial System Become Safer After The Crisis? The Changing Nature of Financial Institution Risk

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Has The Financial System Become Safer After The Crisis?

The Changing Nature of Financial Institution Risk

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ABSTRACT

Six years after the collapse of Lehman Brothers, the question of whether the U.S. financial system has become less risky remains unanswered. On the one side, new regulations including Dodd-Frank and Basel III have made improvements by requiring higher bank capital, and financial institutions themselves have reduced risk-taking activities. On the other side, it has been argued that "the fundamental risks remained and the efforts of regulators and politicians were simply rearranging the deckchairs on the Titanic." (Baily and Elliott 2013) This paper highlights the changing nature of financial institution risk from 2005 to 2011. It finds that while these institutions have become less risky individually after the crisis, the financial market has become more vulnerable to systemic contagion. The causal inference that the crisis and the post-crisis legislation have gradually changed the nature of financial institution risk is drawn from a quasi-experimental design. This finding suggests that the ever more integrated financial system might experience more synchronized contractions in future crises, providing empirical support for the proposals of the inter-bank collective regulation of banks by Acharya (2009) in addition to the intra-bank collective regulations as in Froot and Stein (1998) and BIS (1996, 1999).

Keywords: banking risk, financial institution, systemic risk, catastrophic risk
JEL Code: G01, G20, G32

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