Efficiency and Stability of a Financial Architecture with Too-Interconnected-to-Fail Institutions

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Abstract

How to regulate large interconnected financial institutions has become a key policy question. To make the financial architecture more stable regulators have proposed to limit the size and connections of these institutions. I calibrate a network-based model of an over-the-counter market and infer the hidden financial architecture based on bilateral trades in the Federal funds market. A comparison of the calibrated architecture to nine counterfactual architectures reveals that efficiency of liquidity allocation decreases and the risk of endogenous contagion increases non-monotonically as banks face limits on the number of trading partners. I also find that in a less concentrated architecture more banks trigger a large cascade of failures, and it is more difficult to identify these banks ex-ante. Overall, my results suggest it is not optimal to restrict the number of connections of too-interconnected-to-fail banks because it can result in a financial architecture that is less efficient, more fragile, and harder to monitor.

Keywords: financial architecture, trading networks, trading efficiency, contagion risk

∗Date: March 25, 2014. University of Wisconsin - Madison. Email: mgofman@bus.wisc.edu. I thank seminar participants at UW-Madison, Tel Aviv University, the University of Minnesota, conference participants at the Chicago Fed Summer Workshop, the Cleveland Fed and OFR Conference on Financial Stability, the 2013 North American Summer Meeting of the Econometric Society, the Becker-Friedman Institute conference on Networks in Macroeconomics and Finance, the INET conference on Financial and Economic Networks at the Wisconsin School of Business, the CREDIT 2013 conference in Venice, the Bundesbank workshop on Financial Network, and the Info-metrics Institute 2013 networks conference for their comments and discussions. This paper especially benefited from comments and suggestions by Alina Arefeva, Thomas Chaney, Briana Chang, Hui Chen, Dean Corbae, Douglas Diamond, Steven Durlauf, Matt Elliott, Emmanuel Farhi, Lars Hansen, Matthew Jackson, Jim Johannes, Marcella Lucchetta (discussant), Charlie Kahn (discussant), Anand Kartik (discussant), Christian Opp, Mark Ready, Andrew Winton, and Randy Wright. I would like to acknowledge generous financial support from INET/CIGI grant INO1200018, the Patrick Thiele Fellowship in Finance from the Wisconsin School of Business, and travel support from the Wisconsin Alumni Research Foundation. I would like to thank Miron Livny, Bill Taylor, and Lauren Michael from the center for high throughput computing (HTC) at the University of Wisconsin for technical support and computational resources. I am grateful to Alexander Dentler and Scott Swisher for excellent research assistance. All errors are my own.