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Equilibrium Risk Shifting and Interest Rate in an Opaque Financial System*

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Abstract

We analyse the risk-taking behaviour of heterogenous intermediaries that are protected by limited liability and choose both their amount of leverage and the risk exposure of their portfolio. Due to the opacity of the financial sector, outside providers of funds cannot distinguish "prudent" intermediaries from those "imprudent" ones that voluntarily hold high-risk portfolios and expose themselves to the risk of bankrupcy. We show how the number of imprudent intermediaries is determined in equilibrium jointly with the interest rate, and how both ultimately depend on the cross-sectional distribution of intermediaries' capital. One implication of our analysis is that an exogenous increase in the supply of funds to the intermediary sector lowers interest rates and raises the number of imprudent intermediaries. Another one is that easy financing may lead an increasing number of intermediaries to gamble for resurection following a bad shock to the sector's capital, again raising economywide systemic risk. *JEL codes*: E44; G01; G20. *Keywords*: Risk shifting; Portfolio correlation; Financial opacity.

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