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Efficiency and stability of a financial architecture with too-interconnected-to-fail institutions*

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Abstract

The regulation of large interconnected financial institutions has become a key policy issue. To improve financial stability, regulators have proposed limiting banks' size and interconnectedness. I estimate a network-based model of the over-the-counter interbank lending market in the US and quantify the efficiency-stability implications of this policy. Trading efficiency decreases with limits on interconnectedness because the intermediation chains become longer. While restricting the interconnectedness of banks improves stability, the effect is non-monotonic. Stability also improves with higher liquidity requirements, when banks have access to liquidity during the crisis, and when failed banks' depositors maintain confidence in the banking system.

JEL classification: G18, G21, G28, D40, L14
Keywords: Financial regulation, Networks, Trading efficiency, Contagion risk, Federal funds market

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