Systemic Risk and Macroprudential Policy After the Global Financial Crisis

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ABSTRACT

The 2007–2009 Global Financial Crisis (GFC) exposed fundamental weaknesses in pre-crisis financial regulation: a microprudential focus on individual institution solvency that ignored systemic externalities, insufficient attention to interconnectedness and contagion risk, regulatory gaps for non-bank financial intermediaries (shadow banking), and inadequate capital buffers against tail risks. The post-crisis regulatory architecture—embodied in Basel III capital and liquidity requirements, the Dodd-Frank Act's Financial Stability Oversight Council, and SIFI (Systemically Important Financial Institution) designation and enhanced supervision—represented the most significant overhaul of financial regulation since the New Deal. This paper reviews the economics of systemic risk, the regulatory reforms implemented after the GFC, the academic debate about whether post-crisis regulation has made the financial system more resilient or more fragile, and the emerging systemic risks from climate change, cryptocurrency, and non-bank financial intermediaries.

Keywords: Systemic Risk; Macroprudential Policy; Basel III; Dodd-Frank; Too-Big-to-Fail; Shadow Banking; Financial Crisis; SIFI

1. INTRODUCTION

The 2007–2009 Global Financial Crisis produced the deepest global recession since the 1930s Great Depression, with cumulative output losses estimated at $22 trillion in the United States alone, approximately 15 million jobs lost, and a housing market collapse that wiped out $7 trillion of household wealth. The crisis exposed that pre-crisis financial regulation—focused on individual institution solvency through capital adequacy requirements—had ignored systemic risk: the risk that the failure of individual institutions or the amplification of common shocks through interconnected financial networks could produce system-wide collapse requiring government bailout. Bernanke (2015), in 'The Courage to Act' (W.W. Norton), describes the regulatory and policy response; the academic literature has subsequently evaluated whether this response addressed the crisis's fundamental causes.

Hanson, Kashyap, and Stein (2011) in the Journal of Economic Perspectives (25(1): 3–28) distinguish between microprudential regulation (ensuring individual institution solvency) and macroprudential regulation (ensuring financial system stability as a whole). The pre-crisis regulatory framework was primarily microprudential: Basel II's risk-weighted capital requirements aimed to ensure each bank could absorb its own losses, without accounting for the negative externalities that distressed institutions impose on the broader system through fire sales, credit contraction, and counterparty losses. The GFC demonstrated that systemically important institutions can impose costs on the broader economy that far exceed their private costs of failure—the externality that justifies macroprudential regulation.

2. SOURCES OF SYSTEMIC RISK

2.1 Interconnectedness and Contagion

Financial institutions are connected through interbank lending, derivatives exposures, payment system dependencies, and common asset holdings that create channels for distress contagion. The collapse of Lehman Brothers in September 2008 triggered a global financial freeze not because Lehman's direct counterparty exposures were unmanageable but because its failure generated uncertainty about other institutions' exposures—an 'information cascade' that caused lenders to withdraw credit from all financial institutions. Allen and Gale (2000) in the Journal of Political Economy formalize this mechanism: incomplete financial networks can be less stable than complete networks because idiosyncratic shocks that would be diversified away in complete networks can trigger contagion through partial connectivity.

2.2 Shadow Banking

The 'shadow banking system'—financial intermediaries that perform bank-like functions (maturity and liquidity transformation, leverage, credit risk transfer) without deposit insurance or Federal Reserve access—grew dramatically in the two decades before the GFC. Money market funds, structured investment vehicles (SIVs), repo markets, and mortgage securitization chains all created credit outside the regulated banking system. Gorton and Metrick (2012) in the Journal of Economic Literature document how the repo market—which provided hundreds of billions in short-term funding for securitized asset holdings—experienced a 'run' analogous to 19th century bank runs when repo haircuts rose sharply in 2008, triggering forced asset sales that amplified the housing market correction.

3. POST-CRISIS REGULATORY ARCHITECTURE

Table 1. Post-GFC financial regulatory reforms and assessments.

Reform	Mechanism	Assessment
Basel III capital requirements	Higher quality capital (CET1), leverage ratio, countercyclical buffer; GSIB surcharge	Large bank capital ratios increased substantially; debate about optimal calibration
Liquidity requirements (LCR, NSFR)	Liquidity Coverage Ratio and Net Stable Funding Ratio reduce short-funding vulnerability	Reduces run risk; some evidence of reduced market making capacity
Dodd-Frank / FSOC	SIFI designation; living wills; Volcker Rule; OFR systemic risk data	Improved oversight; SIFI designation contested; Volcker Rule compliance complex
Stress testing (DFAST, CCAR)	Annual macroeconomic stress tests determine capital adequacy and dividend capacity	Significantly improved capital planning; increased resilience as shown in COVID-19

4. EMERGING SYSTEMIC RISKS

Post-crisis regulatory reforms have significantly strengthened large bank resilience—demonstrated by the banking system's performance during the COVID-19 pandemic shock in 2020, which did not produce a financial crisis despite severe economic disruption. However, new systemic risks have emerged or been identified: (1) Climate-related financial risk: physical and transition climate risks could simultaneously impair large numbers of financial institution balance sheets, creating systemic vulnerability; (2) Non-bank financial intermediary risk: the migration of financial intermediation from regulated banks to less-regulated investment funds, insurance companies, and crypto entities has recreated shadow banking risk outside the post-GFC perimeter; (3) Cyber risk: interconnected financial infrastructure creates systemic vulnerability to cyber attack that existing frameworks do not adequately address.

5. CONCLUSION

The post-GFC regulatory architecture has substantially improved large bank resilience through higher capital and liquidity requirements, stress testing, and enhanced supervision of systemically important institutions. The 2023 U.S. regional bank failures (Silicon Valley Bank, Signature Bank, First Republic)—involving bank runs on institutions below the SIFI threshold—suggest that post-crisis regulation's scope was too narrow, and that systemic risk from mid-sized banks and uninsured deposit concentration requires additional macroprudential attention. Emerging risks from climate change, non-bank financial intermediation, and digital assets require extending the macroprudential framework beyond its current banking-sector focus. Future research should develop improved systemic risk measurement methodologies that capture interconnectedness, common exposures, and contagion risk in real time, enabling countercyclical macroprudential policy activation.

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