Regulating Shadow Banks: Financial Regulation versus Systemic Risk

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ABSTRACT

I develop a model to show that FSOC-style regulation benefits good financial innovation and reduces systemic risk. Under asymmetric information, the unregulated shadow banking sector induces regulatory arbitrage. Non-innovative banks gain an unfair advantage in competition, eventually crowding out innovative banks and increasing systemic risk. I show that the data-collection power and designation authority has a deterrence effect on excessive risky-taking and can reverse the outcome, highlighting the potential desirability of the Financial Stability Oversight Council (FSOC) as a macro-prudential regulator.

JEL classification: G21, G22, G28.

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