

# DISCUSSION PAPER SERIES

DP16204

## **Financial Architecture and Financial Stability**

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**FINANCIAL ECONOMICS**

**CEPR**

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Discussion Paper DP16204

Published 29 May 2021

Submitted 27 May 2021

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[www.cepr.org](http://www.cepr.org)

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# Financial Architecture and Financial Stability

## Abstract

This paper studies the links between financial stability and the architecture of financial systems. We review the existing literature and provide organizing frameworks for analyzing three empirically important aspects of financial architecture: The rise of non-bank financial intermediaries, the regulatory response to these structural changes, and the emergence of complex interbank networks. One of our main new results is a necessary and sufficient condition for whether non-bank intermediaries are immune to runs in an extended version of the Diamond-Dybvig model.

JEL Classification: G01, G21, G23, G28

Keywords: Financial architecture, Financial Stability, Shadow banks, interbank networks, financial regulation

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### Acknowledgements

We are grateful to an anonymous referee at the Annual Review of Financial Economics for helpful comments that have significantly improved the paper.

# Financial Architecture and Financial Stability<sup>1</sup>

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25 May 2021

**Abstract:** This paper studies the links between financial stability and the architecture of financial systems. We review the existing literature and provide organizing frameworks for analyzing three empirically important aspects of financial architecture: The rise of non-bank financial intermediaries, the regulatory response to these structural changes, and the emergence of complex interbank networks. One of our main new results is a necessary and sufficient condition for whether non-bank intermediaries are immune to runs in an extended version of the Diamond-Dybvig model.

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# 1 Introduction

## 1.1 Motivation and overview

The Global Financial Crisis of 2007-09 (GFC) and the Eurozone Crisis of 2010-12 have renewed interest in financial stability in academic and policy circles. One dimension of novel economic thinking is the study of different and evolving financial architectures. Particularly salient in the crisis of 2007 was the role of “shadow” banks and other types of non-bank intermediaries, whose activities in the US had grown rapidly in the years preceding the crash. Interbank networks with complex networks of exposure came into focus after the failure of Lehman Brothers.

In this paper, we survey the literature that relates these themes to financial stability. We also aim to provide new frameworks that are geared towards organizing the main economic insights. In the latter part of this introduction, we begin with a brief review of the significant international differences in financial architectures, as well as some historical perspectives on the link between financial architecture and stability. We organize the remainder of the paper into three parts.

First, we discuss the role of non-bank intermediaries in financial stability. We focus our review on the concern that non-bank intermediaries, such as “shadow” banks and mutual funds, may be subject to self-fulfilling runs by investors, in a similar sense to Diamond and Dybvig’s (1983) model of bank runs. To organize ideas, we develop a simple theoretical framework that contains the core ideas of the Diamond-Dybvig model but also allows for a wide range of non-bank intermediation contracts, such as mutual funds or money market funds. We derive a necessary and sufficient condition for intermediaries to be “run-proof”, in a sense that has a natural definition. The theory highlights a special role for mutual funds with a floating Net Asset Value (NAV): A floating NAV run in its purest form is run-proof, but also sits on a knife edge, whereby small frictions can bring back vulnerability. We survey the growing theoretical and empirical literatures on non-bank runs in the context of this central idea. In particular, there has been extensive empirical research showing that real-world business models deviate from the floating NAV ideal and can therefore become unstable.

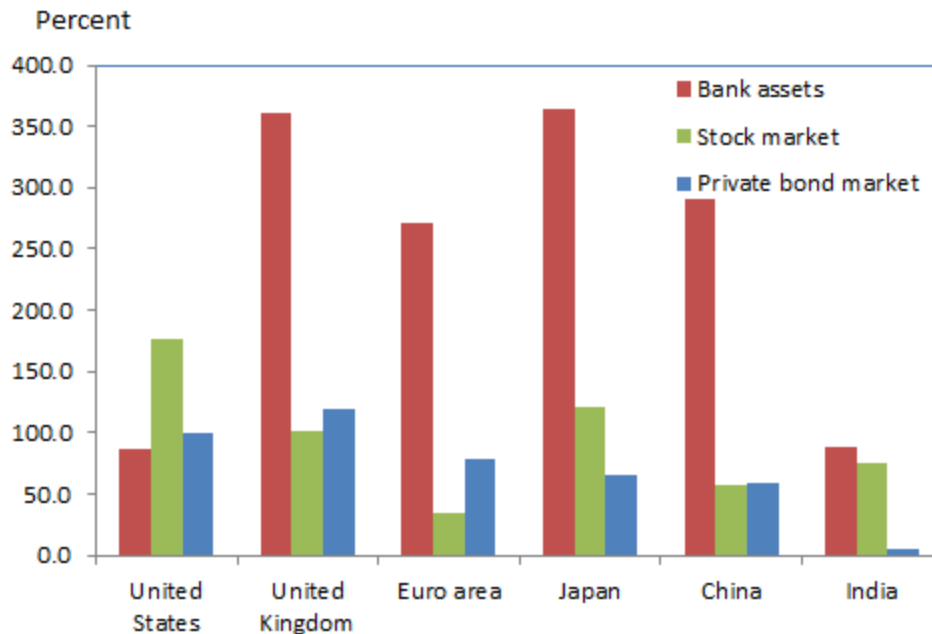
In the second part of the paper, we consider the question of how a diverse financial architecture should be regulated. Shadow banks, mutual funds and other non-bank intermediaries are not subject to the same prudential regulations as banks, but recent research has shown that they can impose similar externalities on the rest of the economy in a crisis. If regulators could easily measure these effects and avoid the emergence of new unregulated intermediaries, then the best policy response would be simple and follows Pigou’s “polluter pays” principle: Any institution or activity imposing externalities should be brought under the regulatory umbrella. We focus instead on second-best regulation, in a world where not all institutions or activities can

be regulated. In that setting, there is a subtle trade-off between imposing strict regulations on the regulated sector, on one hand, and being more lenient in order to prevent excessive leakage to the unregulated sector, on the other hand. We provide an overview of the related theoretical literature, and argue that leakage elasticities across regulated and unregulated institutions are key statistics that determine how regulation should be conducted in a second-best world. We also review recent empirical work that has carefully measured these statistics and can inform policy-makers.

The third and final part of our review focuses on interbank networks. The early theoretical literature following Allen and Gale (2000) focused on contagion between banks – whereby shocks to one financial institution can lead to distress in others – as an equilibrium phenomenon, with endogenous financial contracts. After the crisis of 2009, new methods were used to yield more general characterizations of vulnerabilities and contagion. We discuss one instructive example at length. Some papers in the last few years have also attempted a synthesis, namely, general characterizations with endogenous contracts. We close the paper by reviewing the related empirical literature, and the measures of vulnerability that have been extracted from various datasets on interbank connections.

## 1.2 International comparisons and historical review

Financial architecture in terms of the role of financial markets and banks differ significantly across countries. Figure 1a provides evidence of this in terms of total value of financial claims for banks and stock and private bond markets. It can be seen that the US is very different from the other countries shown. In the US the stock market is significantly larger and the banking sector significantly smaller than elsewhere (except for India, which has a smaller financial sector). The private sector bond market is also important, being slightly larger in terms of asset values than the banks. It has a “market based” financial system. The UK is also different with a very large banking sector and an important stock market and private bond market. One of the reasons for this large banking sector is that London is a large international financial center. In the Euro area banks are significantly more important than the stock market and private bond market. In fact, the stock market is the smallest relative to GDP compared to any of the other places. It has a “bank based” financial system. Japan is also bank based but has a stock market that is more important than the Euro area. China is also very much bank based although over time the stock market and private bond market are steadily becoming more significant. India has a much smaller financial system than the other places, but interestingly the value of the stock markets is only slightly smaller than bank assets.

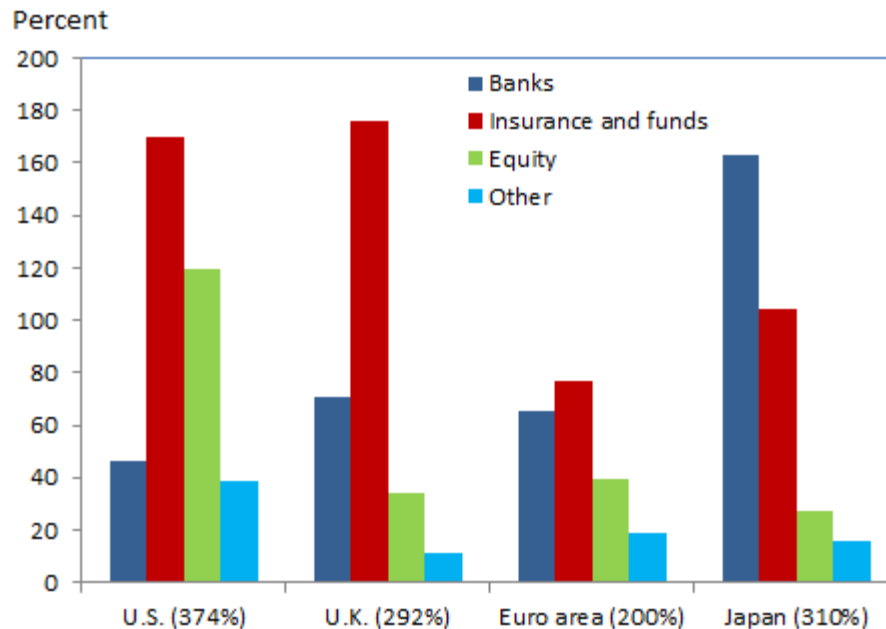


**Figure 1A.**

Value of financial claims in 2019, percentage of GDP

Source: Data from World Bank and national authorities. We are grateful to Michael Chui for this figure.

Figure 1b documents the differences in an alternative way focusing on household portfolio allocations. The US is again significantly different. Much more equity is held directly by households and much less in banks than elsewhere. Insurance company policies and mutual and pension funds are also very important. The UK is similar to the US but with much less in terms of direct ownership of equity. Also, the total amount invested is significantly less with 292% of GDP in the UK versus 374% in the US. The Euro area is also an outlier. It is much smaller in terms of the total resources of 200% of GDP households have in terms of financial investments. The composition has much less in funds and equity than the US and UK. Japan lies between the US and UK at 310% of GDP in terms of the total of financial assets held by households. Investors there also have significantly more in banks than the US, UK or Euro area. These figures, and our literature review below, primarily focus on characteristics of private financial institutions. However, government-owned institutions are important in some countries (e.g., the Japanese government owns a majority stake in the Japan Postal Bank, which is included in the data).



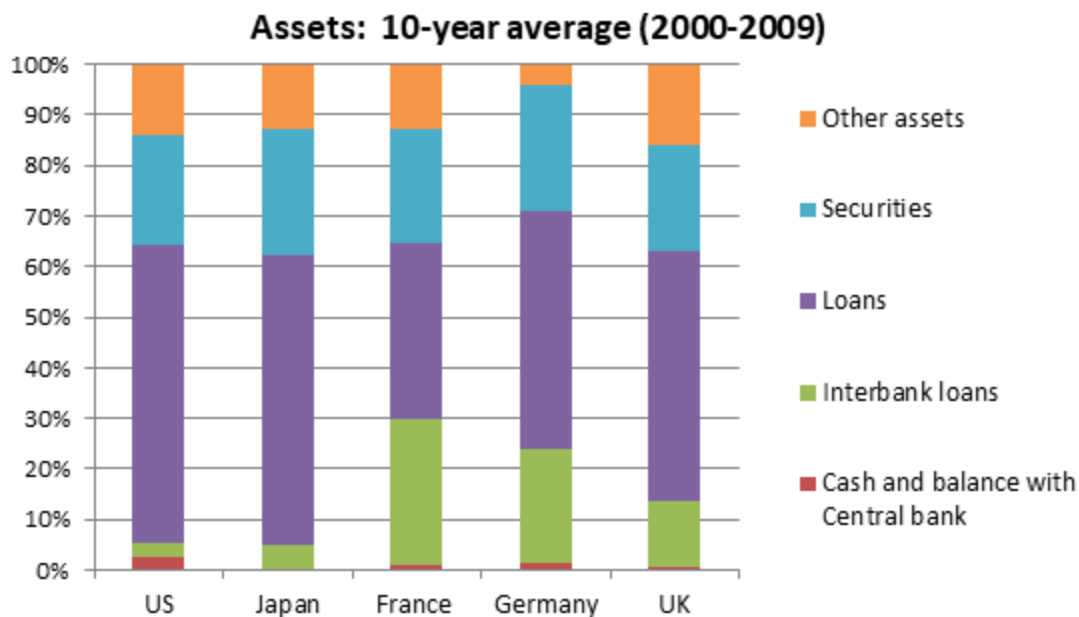
**Figure 1B.**

Household portfolio allocations 2000-2019 and total investments in parentheses, percentage of GDP

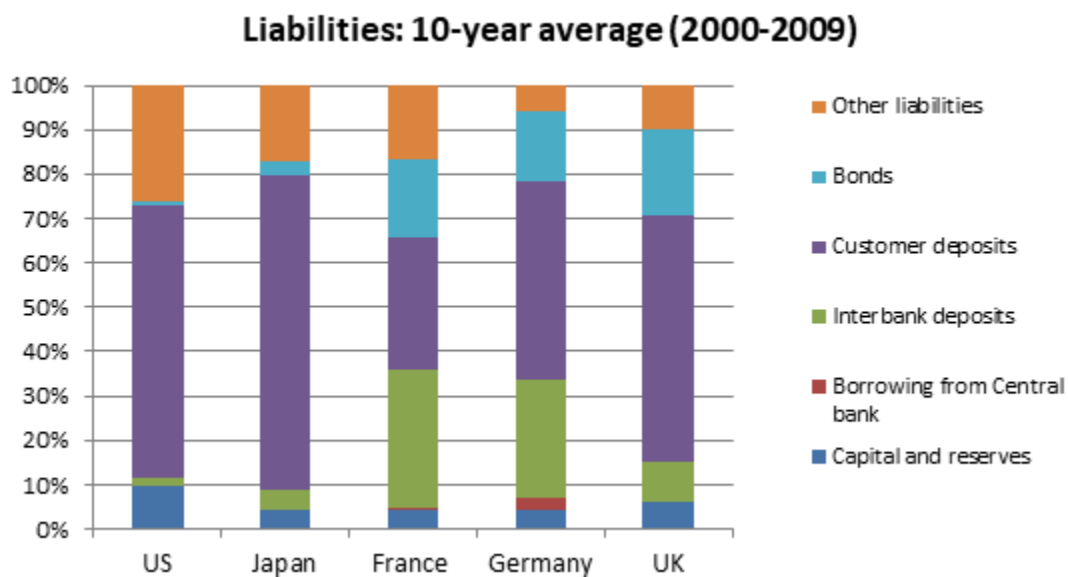
Sources: Data from Bank of Japan, EUROSTAT, Federal Reserve Board, and the IMF. We are also grateful to Michael Chui for this figure.

In addition to the differences in terms of the financial institutions and markets that are used in different countries, there are also significant differences in the way that interbank markets operate. Allen, Covi, Gu, Kowalewski and Montagna (2020) point out that in the US and Japan, interbank markets are small, while in France and Germany they are large with the UK being in between. These differences are illustrated in Figures 2a and 2b. Figure 2a shows bank assets in the different countries, while Figure 2b shows bank liabilities. It can be seen that the assets and liabilities roughly match in most countries and particularly in France and Germany.





**Figure 2A.** Breakdown of 10-year-average bank assets: 2000-2009



**Figure 2B.** Breakdown of 10-year-average bank liabilities: 2000-2009

Source: OECD Statistics; Japanese Banker Association

The Global Financial Crisis of 2007-09 (GFC) and the Eurozone Crisis of 2010-12 have underlined the importance of financial stability. However, as Reinhart and Rogoff (2009) have emphasized

financial instability has been an important factor in the operation of financial systems for many centuries.

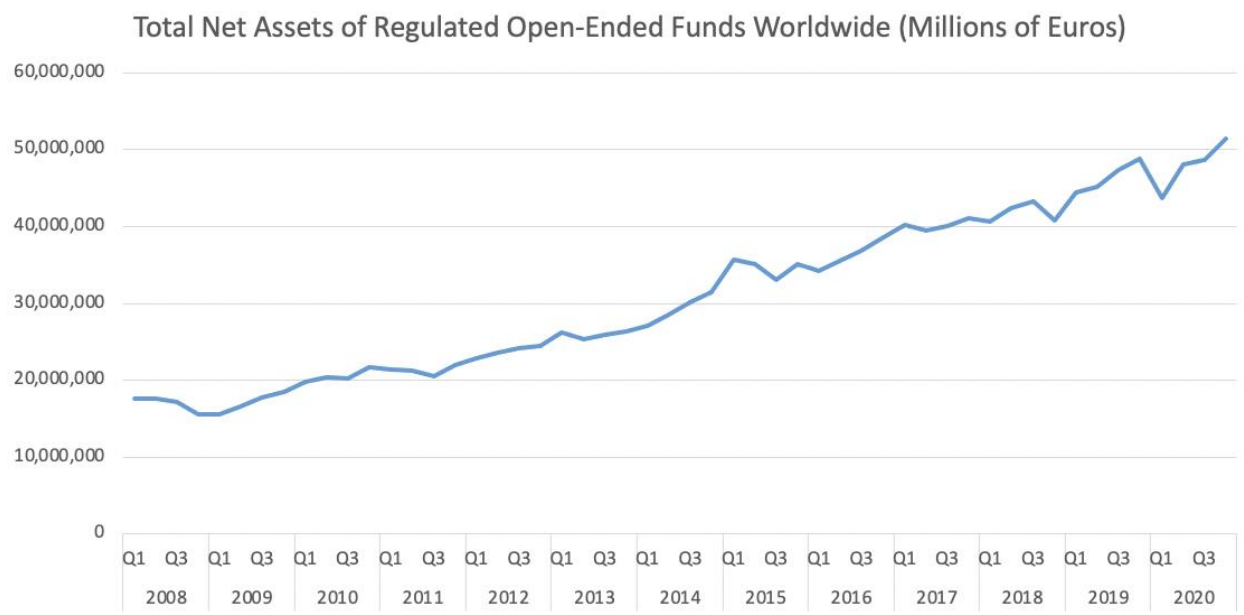
Prior to the twentieth century banking panics occurred frequently. Kindleberger (1993, p. 264) points out that in Western Europe financial crises occurred at roughly 10 year intervals over the last 400 years. Over time, one of the most important roles of central banks came to be ensuring financial stability in the banking system. The Bank of England played a particularly important role in the development of effective stabilization policies in the eighteenth and nineteenth centuries. There were no major banking panics in the UK between the Overend and Gurney crisis of 1866 and the collapse of Northern Rock in 2007 in the early stage of the GFC.

As Reinhart and Rogoff (2009) point out it is not just banks that have been important for financial instability. Historically, another important aspect of financial architecture has been the exchange rate system and the potential this gives rise to for currency crises and sovereign debt default. Also, stock market crashes have also contributed to financial instability as with the Great Crash of 1929 in the US. In this essay, we will focus on the literature on banks versus non-bank intermediaries and the nature of banking networks as this been the area where the theoretical and empirical literatures have developed the most recently.

The next section focuses on runs on non-bank Intermediaries, while Section 3 considers financial regulation, architecture and stability. Section 4 is concerned with banking networks and contagion, while Section 5 contains concluding remarks.

## 2 Runs on Non-bank Financial Intermediaries

A striking trend since the financial crisis of 2008 has been the growth of non-bank financial intermediaries, in particular, of asset management firms. The data in Figure 3, compiled by the Investment Company Institute, shows that the global assets of open-ended funds have more than doubled since 2009, and now account for about €50trillion. This trend reflects the growing complexity of the global financial system, where asset managers and levered “shadow banking” institutions conduct a large share of intermediation.



**Figure 3.** Global growth of non-bank financial intermediation

Source: [www.ici.org](http://www.ici.org)

In this section, we consider two broad sets of questions. First, we consider whether non-bank financial intermediaries are likely to suffer from runs. To organize the existing work on this topic, we present a generalized version of the Diamond and Dybvig (1983) model. In this model, we derive necessary and sufficient conditions for vulnerability to runs when intermediaries (e.g., asset managers or money market mutual funds) face sudden withdrawals of short-term funding. This result informs our review of the growing empirical literature on non-bank runs. In practice, there is also a trade-off between guaranteeing financial stability, on one hand, and avoiding excessive regulation or financial repression that could hamper economic growth, on the other hand. Loayza et al. (2018) provide an excellent review of the related empirical evidence, and conclude that there is strong evidence in favor of a growth-stability trade-off, whose implications may be different in advanced and middle-income economies. Given limited space in this paper, our formal analysis mostly emphasizes the conditions that ensure stability in a system with non-bank intermediaries.

Second, in the next section, we discuss an active theoretical and empirical literature on the problem of “leakage” in the financial system, whereby more stringent prudential policies in the regulated segment of the system lead to increased activity by unregulated (or less strictly regulated) intermediaries.

## 2.1 A Model of Non-Bank Runs

We analyze a canonical model which suggests a simple test for stability of non-bank intermediaries with arbitrary architectures. This is complementary to a growing theoretical

literature which studies the stability of particular business models of non-bank intermediaries, such as mutual funds, in more detail (see, for example, Zeng (2017), Morris, Shin and Shim (2017), Chen, Goldstein and Jiang (2010), Grochulsky and Zhang (2019), and references therein). We discuss the relationship of our model to the wider literature at the end of this subsection.

### 2.1.1 Model Environment

The environment in this section is akin to the classic model in Diamond and Dybvig (1983). In their analysis, the key economics arise from strategic complementarities among investors: If all other depositors are withdrawing from a bank, any individual has a strong incentive to also withdraw before the bank runs out of cash. As such, their model demonstrates that illiquid investment paired with demandable deposits can trigger instability and bank runs. We consider a similar setting, with illiquid assets, but allow demandable contracts to take a more flexible shape, so that we can analyze the stability of banks and non-bank intermediaries in a unified framework.

The model has three dates indexed by  $t = 0, 1, 2$  and a single consumption good. A unit measure of households is born at date 0 with an endowment of one unit of consumption. At date 1, each household learns whether it is an early or late consumer. With probability  $\lambda$ , each household is an early consumer and enjoys utility  $U(c_1)$  from consumption at date 1 only. With probability  $1 - \lambda$ , it is a late consumer with utility  $U(c_2)$  from consumption at date 2.

At date 0, households can invest in a long-term asset. Each unit invested yields  $R$  units of consumption at date 2. Long-term assets can be liquidated at date 1 only by selling them to outsider investors. We do not explicitly model the behavior of outsiders, but represent them by their demand curve for long assets. When households sell  $S$  units of the long assets in total at date 1, the liquidation value of long assets at that date is  $P = p(S)$ , where  $p(\cdot)$  is a decreasing function of sales and satisfies  $p(S) \leq R$  for all  $S$ . This formulation allows us to capture different kinds of illiquidity in long-term investments. For example, if  $p(S) \equiv r$ , then the long asset has a fixed liquidation value, as is commonly assumed in the literature on banking.

If  $p(S) = R - \beta \cdot S$ , then the parameter  $\beta$  measures the “depth” of the market into which tradeable assets can be sold, and is analogous to Kyle’s “lambda” (Kyle, 1985). The latter case allows a better description of non-bank intermediaries like mutual funds, who hold assets that can be traded in markets of varying liquidity. Our formalism can therefore capture the creation of price pressure when there are economy-wide early sales. Idiosyncratic sales by individual consumers, by contrast, do not have any price effect because consumers are infinitesimal relative to the aggregate sale  $S$ .

Our focus is on a key ingredient of financial architecture, namely, the design of financial intermediaries that issue *demandable claims*, which allow customers to withdraw funds early. Different kinds of intermediary handle this problem very differently in the real world – for example, banks tend to offer fixed deposit claims, money market funds offer demandable claims with fixed Net Asset Values (NAV), and mutual funds allow their NAV to float. We argue that the devil is in the detail: The design of demandable claims is an important determinant of financial stability. We also review additional theoretical literature that highlights other important

distinctions between different kinds of intermediary, such as the fact that banks tend to be more leveraged than funds.

### 2.1.2 Efficient Allocation

We first consider “constrained efficient” allocations. This refers to allocations chosen by a benevolent social planner who can dictate consumption and investment decisions to households, but who cannot force outsiders to buy assets at a price that is not on their demand curve. The constrained planning problem is:

$$\max_{c_1, c_2, S, P} \lambda U(c_1) + (1 - \lambda)U(c_2)$$

subject to the budget constraints

$$\begin{aligned} \lambda c_1 &= PS \\ (1 - \lambda)c_2 &= R(1 - S) \end{aligned}$$

and the pricing constraint

$$P = p(S).$$

Substituting the budget constraints into the objective and taking the first-order condition for  $S$  gives us

$$U'(c_1)P + \mu \frac{\partial p}{\partial S} = U'(c_2)R,$$

where  $\mu$  denotes the Lagrange multiplier on the pricing constraint. The first-order condition for  $P$  is

$$U'(c_1)S = \mu.$$

Combining, we obtain a condition which (along with resource constraints) pins down the efficient allocation  $(c_1^*, c_2^*)$ :

$$U'(c_1^*)(1 - \eta_p) = \frac{R}{P} U'(c_2^*)$$

where

$$\eta_p = \left| \frac{\partial \log p(S)}{\partial \log S} \right|$$

is the elasticity of outsider’s demand. This expression captures the classic trade-off between asset liquidity and consumption insurance. Indeed, when the early liquidation payoff  $P$  is a constant, then outsiders’ demand is inelastic and the first-order condition above reduces to the standard risk-sharing equation  $U'(c_1) = \frac{R}{P} U'(c_2)$ : The marginal rate of substitution between periods 1 and 2 is set equal to the rate of return  $\frac{R}{P}$  on the long asset between dates 1 and 2. When the demand is more elastic, then the planner distorts  $c_1$  downwards because he internalizes the adverse price impact of early liquidation.

### 2.1.3 Financial Architecture with Intermediaries

One way for households to implement the efficient allocation is by setting up an intermediary, which operates as follows. The intermediary collects everybody's endowment at date 0, and invests it in the long asset. It then promises consumption  $c_1$  to any household who asks to withdraw his claim early (at date 1) and consumption  $c_2$  to any household who withdraws late (at date 2). At date 1, the intermediary liquidates an appropriate measure  $S$  of the underlying long asset for  $p(S)$  per unit, in order to honor its promise to early withdrawers. An intermediary is feasible if  $(c_1, c_2, S)$  satisfy the budget constraints in the previous section. The efficient allocation is feasible by definition. Note also that the efficient allocation always satisfies

$$c_1^* \leq c_2^*$$

Hence, the intermediary solution is incentive compatible: Early households will withdraw  $c_1$  at date 1, while late households find it optimal to refrain from mimicking early ones, and therefore wait to withdraw  $c_2$  at date 2.

The only assertion we have made so far is that there is an intermediary that implements the efficient allocation  $(c_1^*, c_2^*)$  along the path of *some subgame perfect equilibrium*. In that equilibrium, all households withdraw in line with their consumption needs, so that the measure of early withdrawals is always exactly  $\lambda$ . However, a practical implementation of this intermediary must also specify what happens off the equilibrium path, that is, the consumption  $(c_1(n), c_2(n))$  that is allocated to early and late withdrawers when a general measure  $n \neq \lambda$  of households choose to withdraw early. The rigorous version of our assertion is therefore that exists a feasible intermediation contract  $(c_1(n), c_2(n))$  such that, on one hand,  $c_1(\lambda) = c_1^*$  and  $c_2(\lambda) = c_2^*$  and, on the other hand,  $n = \lambda$  households withdraw early in a subgame perfect equilibrium.

Different models of financial intermediation in the real world share the demandability of claims, but diverge when specifying what happens for different  $n$ . Bank deposits, for example, offer fixed demandable claims  $c_t(n) = D_t$ . Shares in an investment fund, by contrast, can typically be liquidated by placing a sell order at date  $t$ , which results in a liquidation value per share that is proportional to the fund's *Net Asset Value* (NAV) at the end of date  $t$ . The contract between the fund and investors specifies how NAV is calculated. The standard model in mutual funds is to calculate a *floating NAV*, which is the value of the fund's total assets at date  $t$  after any necessary liquidations have been made. An alternative, common among Money Market Funds before the crisis of 2008, is to have a fixed NAV normalized to \$1 per share. The fixed-NAV model makes the contractual arrangements very similar to a banking contract, unless excessive liquidations or bankruptcies force the fund to "break the buck", i.e. to adjust its NAV below \$1.

Floating-NAV funds are of institutional interest, but as we will see below, they also provide a useful benchmark for financial stability. Therefore, it is worthwhile to spell out what floating NAV means algebraically in our model. If  $n$  households withdraw early, the floating NAV of a fund at date 1 is

$$F(n) = p(S(n))S(n) + (1 - S(n))R,$$

where

$$S(n) = \min\{S | p(S)S = nc_1(n)\}$$

is the minimum liquidation required to service withdrawals. So far, we have two equations and four unknowns  $(F(n), S(n), c_1(n), c_2(n))$ . A floating-NAV fund closes the system by requiring that the payout per share at date 1 is exactly the floating NAV,

$$c_1(n) = F(n),$$

and that the payout per share at date 2 satisfies the resource constraint

$$(1 - n)c_2(n) = (1 - S(n))R$$

It is easy to see that this set of equations implies a unique floating-NAV contract  $(c_1(n), c_2(n))$ , which moreover has the special property that  $c_1(n) = c_2(n)$ . This property will be important in the next section, which discusses financial stability.

#### 2.1.4 Financial Stability with Intermediaries

The fundamental problem of financial stability that we focus on is as follows: While it is possible for intermediaries such as banks to implement the efficient allocation in a subgame perfect equilibrium with  $n = \lambda$ , it is also possible that another subgame perfect equilibrium with  $n \neq \lambda$  exists. For instance, in the Diamond-Dybvig model, the intermediary offers bank deposit claims  $D_t$ , where  $p(S)S < D_1$  for all  $S \in [0,1]$ . If all households decide to withdraw early, then the bank cannot raise enough money to repay them by liquidating assets, and will therefore be bankrupt at date 1. Early withdrawers then liquidate the bank and share its remaining value, which is

$$V_1 = \max_S p(S)S,$$

while late withdrawers obtain nothing. Hence, if everybody withdraws early, it is optimal to follow, and a bank run with  $n = 1$  is another equilibrium. The same issue applies to a fixed-NAV fund.

How, in general, is stability determined? We adopt a robust definition of stability which generalizes our earlier incentive compatibility condition. We say that an intermediary contract  $(c_1(n), c_2(n))$  is **run-proof** if it satisfies

$$c_1(n) \leq c_2(n)$$

for all  $n \in [0,1]$ . This condition rules out classic bank runs where everybody withdraws ( $n = 1$ ) but also less extreme cases with partial inefficient liquidation ( $0 < n < 1$ ).

It turns out that there is a simple necessary and sufficient condition for run-proofness:

**Proposition.** *An intermediary contract  $(c_1(n), c_2(n))$  is run-proof if and only if the demandable claim  $c_1(n)$  satisfies*

$$c_1(n) \leq F(n),$$

where  $F(n)$  is the demandable claim of a floating-NAV mutual fund.

The good news is that in the ideal case defined above, a floating NAV fund is run-proof. This ideal case also provides a natural bound for all other intermediaries. Banks without deposit insurance, and money market mutual funds that offer a fixed NAV, for example, are vulnerable to runs because they do not always satisfy our condition for run-proofness.

The bad news is that floating NAV is a knife-edge case. There are a few ways in which small deviations can cause runs on mutual funds. We will consider two concrete examples. First, we have assumed that investors are certain that the floating NAV model is used and that they fully understand it. Suppose instead that investors believe that the NAV at date 1 is fixed at  $D_1$  with probability  $\epsilon > 0$ , and floating with probability  $1 - \epsilon$ . Assume that  $p(S)S < D_1$  for all  $S \in [0,1]$ , so that the fund cannot pay back the fixed NAV if everybody withdraws early. Then if everybody is expected to withdraw early, the net payoff from early withdrawal is

$$c_2(1) - c_1(1) = \begin{cases} 0, & \text{w. pr. } 1 - \epsilon \\ V_1, & \text{w. pr. } \epsilon \end{cases}$$

The expected incentive to withdraw is  $\epsilon V_1 > 0$ , and therefore, there is a “fund run” equilibrium where everyone withdraws, even for infinitesimally small  $\epsilon$ . Chen, Goldstein and Jiang (2010) and Morris, Shin and Shim (2017) both consider deviations from the ideal floating NAV case along these lines, where early withdrawers are promised a fixed claim.

Second, we have made a stark assumption about asset valuation: At date 1, the fund values its remaining long assets at exactly their date 2 value, which is  $R$  per unit. In reality, this continuation value would itself correspond to a market price. If the price effects of forced sales liquidation linger over time, then investors again have potential incentives to run. For simplicity, consider a reduced-form version where early withdrawals simply reduce the average late return by  $\epsilon$  per unit, so that the actual asset value at date 2 is

$$\tilde{R} = R - \epsilon S.$$

This formulation can capture lingering price impacts. Zeng (2017) provides another foundation for this assumption, which is based on fund managers’ incentive to re-build their cash balances after outflows. In this model, early withdrawals lead to a predictable decline in NAV. In our reduced form version, late withdrawers’ claim satisfies the new budget constraint

$$(1 - n)c_2(n) = (1 - S(n))(R - \epsilon S)$$

Then it is again easy to see that a run equilibrium exists for all  $\epsilon > 0$ .

Our analysis highlights a simple point: Even an *infinitesimal* deviation from the ideal case can generate fragility in funds. Having a traditional bank is not a necessary condition for generating runs in the spirit of Diamond and Dybvig (1983).

Further insights on mutual fund runs can be derived by selecting a unique equilibrium of the coordination game among investors. The most popular selection technique is to introduce small



deviations from common knowledge in a global game. This criterion implies that investors tend to play the “bad equilibrium” (i.e. a run on the intermediary) whenever they observe bad news about the fundamental strength of the intermediary. In this context, Morris, Shin and Shim (2017) analyze the fund’s cash management policy in anticipation of withdrawals is key. If the fund uses cash to smooth out withdrawals, this dampens the strategic complementarity arising from costly liquidations (in our notation, the elasticity  $\eta_p$  is low when the intermediary services redemptions with cash). If, by contrast, the fund hoards cash in anticipation of further outflows, then the strategic complementarity is exacerbated. Also using global games, Chen, Goldstein and Jiang (2010) derive empirical predictions that link the vulnerability to the liquidity of assets and the concentration of fund ownership.

#### 2.1.5 Relationship to the broader theoretical literature

A rich literature develops the theory of classical bank runs. Allen and Gale (2009) provide a more detailed review. On one hand, papers subsequent to Diamond and Dybvig (1983) considered other architecture aspects such as the information and liquidity structures (e.g., Gorton (1985, 1988), Chari and Jaganathan (1988), Jacklin and Bhattacharya (1988), Allen and Gale (1998), Rochet and Vives (2004), Goldstein and Pauzner (2005) and Diamond and Rajan (2005)). This classic banking literature focusses on single banks rather than the banking system (e.g., Bryant (1980), Diamond and Dybvig (1983)) – but even here architecture mattered as Cone (1983) and Jacklin (1987) pointed out that depositors must have restricted access to financial markets. On the other hand, the literature on bank runs advances two additional, complementary perspectives. First, runs and crises can be driven by real events and downturns in the business cycle, in addition to sunspots and self-fulfilling beliefs (e.g., Gorton (1988), Allen and Gale (1998)). Second, bank runs give rise to some interesting dynamics (e.g., He and Xiong (2012), Zhong and Zhou (2020)). Since the risk of runs is no longer confined to the traditional banking system, these views also have the potential to shed light on the nature of fragility in non-bank intermediaries, although we are unable to review them in detail in this paper.

We have focused on runs on non-bank intermediaries in the broad terms set by Diamond and Dybvig. A growing, complementary literature makes the point that non-bank intermediaries can be fragile even without runs. This literature typically uses macroeconomic models with financial frictions (see Brunnermeier, Eisenbach and Sannikov (2012) for a detailed review). A core idea is that non-bank intermediaries can face binding financial constraints, and also increased costs of financing themselves, if they have a limited ability to pledge (safe) assets as collateral in downturns. This effect forces them to sell assets into depressed markets, in order to cover funding shortfalls, which then amplifies the downturn (see, for example, Gennaioli, Shleifer and Vishny (2013), Luck and Schempp (2014), Moreira and Savov (2017), Ordonez (2018), and Martinez-Miera and Repullo (2019)). Also related to the business cycle view of financial instability is a recent line of research that studies the impact of large insurance companies on systemic risk (e.g., Koijen, 2019).

## 2.2 Empirical Evidence on the Stability of Non-Bank Intermediaries

There is a long literature examining bank runs in the data, which we will not survey in detail (see, for example, Calomiris and Mason (1997), Gorton (1988), Iyer and Puri (2012), Iyer, Puri and Ryan (2015), and references therein).

In the crisis of 2008, runs affected not just traditional banks but also “shadow banks” who had financed themselves heavily with securities that resemble demandable debt. Schmidt, Timmermann and Wermers (2016) study runs on money market funds that occurred in September 2008 after a major fund (Reserve Primary Fund) “broke the buck”. Studying different share classes within the same fund, they argue that runs were more pronounced in funds with more sophisticated investors, which is consistent with the global games solution to a bank run game. Kacperczyk and Schnabl (2013) link these runs to increased incentives for money market funds to take risk during the years before the crisis. Another common business model up to 2008 was to finance portfolios of securitized, often housing-related assets and financed themselves with short-term debt such as repurchase agreements (repo) or asset-backed commercial paper. Since short-term debt had to be frequently rolled over, these vehicles were vulnerable to bank runs. Runs on repo and ABCP programs are documented and compared in Gorton and Metrick (2012), Covitz, Liang and Suarez (2013) and Krishnamurthy, Nagel and Orlov (2014) among others. Adrian and Ashcraft (2016) provide a more comprehensive review of the post-crisis literature on shadow banking.

In the rest of this section, we focus on the more contentious question of whether runs and fire sales also affect mutual funds. If a mutual fund is vulnerable to runs, then one might expect that the signals observed by investors, such as the fund’s past performance, determine whether or not there is a run. Thus, many theories of runs would imply that fund performance and outflows are negatively correlated. Of course, this correlation does not constitute evidence of runs. For instance, performance-based flows might be an optimal arrangement because they provide incentives for fund managers, or because investors learn about managers’ skills over time. However, *differences* in the strength of this correlation across different funds can aid our understanding of runs.

A well-known stylized fact, established for example by Chevalier and Ellison (1997), is that flows respond to performance, but that this relationship is non-linear. For the average fund, positive performance generates significant inflows, while the relation between negative performance and outflows is muted. Thus, flows are convex as a function of performance. At first glance, this seems inconsistent with runs. To test more directly for runs, Chen, Goldstein and Jiang (2010) focus on funds that hold illiquid assets. The relationship between flows and performance is closer to linear for these funds, which is consistent with these funds being more vulnerable to runs. Going further, Goldstein, Jiang and Ng (2017) show that the relationship becomes *concave* when one focuses on corporate bond funds, which operate in particularly illiquid asset markets. Frazzini and Lamont (2008) argue that mutual fund flows can be interpreted as driven by investor sentiments rather than fundamental values, consistently with a “sunspots” view of runs. Taken together, this evidence does suggest performance-related outflows for funds in general, but also that there are run-related outflows for funds that operate in illiquid asset markets.

A complementary empirical literature tests a core assumption driving fund runs, namely, that funds cannot liquidate their underlying assets at fair value. This looks like a stronger assumption for mutual funds than for banks, because the underlying assets of funds are traded in open markets. Coval and Stafford (2007) define fire sales as situations where outflow-driven sales by equity funds are concentrated in a small number of securities. These situations are associated with price declines of about 8%, which (in contrast to episodes where funds sell voluntarily) revert when the selling pressure subsides. Edmans, Goldstein and Jiang (2012) find similar effects, while Gompers and Metrick (2001) use the relative prices of small and large company stocks to demonstrate the price impact of large institutional investors. Overall, the evidence suggesting that mutual fund may be illiquid is quite consistent. Thus, if there is a run on a large mutual fund, or a simultaneous run on many small ones, funds would have to liquidate at a substantial discount, which generates fragility.

As discussed above, whether funds follow a “cash smoothing” or a “cash hoarding” strategy in the face of outflows is an important ingredient of run incentives. The evidence so far is that both strategies are at play, and in practice, these strategies are not mutually exclusive. Chernenko and Sunderam (2016) study US equity and bond funds in the early 21<sup>st</sup> century. They find that 23-33 cents of every dollar of outflows is accommodated by funds’ cash cushions. This suggests smoothing, and the effects are stronger in funds that face illiquid conditions in the underlying asset markets. By contrast, Morris, Shin and Shim (2017) find evidence of significant cash hoarding in a sample of global bond funds between 2013 and 2016. They propose an empirical decomposition of fund asset sales into sales driven by investor flows, and additional discretionary sales. The latter are suggestive of hoarding, and amount to 10 cents for every dollar of flow-driven sales. This evidence is reviewed more carefully in Goldstein (2017). Overall, the mixed findings imply that cash management strategies in practice are a mixture of hoarding and smoothing.

Three further insights from recent empirical work are worth emphasizing. First, the fragility of funds is not confined to open-ended mutual funds, but also appear to affect exchange traded funds (e.g., Ben-David, Franzoni and Moussawi, 2018). Second, there is evidence that the details of contract design, which we discussed in our model above, are important for stability in practice. For example, Jin, Kacperczyk, Kahraman and Suntheim (2020) show that a small adjustment to the price at which withdrawals are redeemed, known as “swing pricing” in open-ended mutual funds, served to eliminate first-mover advantages in UK corporate bond funds. Third, the economic importance of fire sales and fund runs is underlined by their real effects, such as on corporate investment. Significant real effects have been demonstrated by Edmans, Goldstein and Jiang (2012) as well as Hau and Lai (2013) and Dessaint, Foucault, Fresard and Matray (2018).

### 3 Financial Regulation, Architecture and Stability

In this section, we review a growing theoretical and empirical literature that studies the link between financial policy, financial architecture, and financial stability. Do traditional financial stability policies that focus on traditional banks remain fit for purpose when the financial architecture changes? In what directions should those policies, in principle, be adjusted to

account for changes in architecture? These are natural and important questions given the recent rise of non-bank financial intermediaries (see, for example, Figure 3 above), and given the potential worries about the fragility of non-banks that we have discussed in the previous section.

A particularly important concern, on which we will focus in this review, is the issue of “leakage” from regulated to unregulated activities. Indeed, many commentators have attributed at least some of the recent rise of shadow banking in the US (e.g., Buchak, Matvos, Piskorski and Seru, 2018), as well as in China (e.g., Hachem (2018)), to the tighter regulatory requirements that the respective regulators imposed on traditional banks.

It has become customary to refer to these effects, whereby tougher regulation of traditional banks increases the market shares of non-bank intermediaries, as an “unintended consequence” of financial regulation. This label is somewhat misleading, however, since several strands of recent research have cast a lot of light on what their consequences are, and how regulation should address them once they are well understood.

### 3.1 Theories of Financial Regulation with Non-Bank Intermediaries

The theory of financial regulation in the presence of “leakages” has been studied from several different but complementary perspectives. Plantin (2015) was one of the first papers to study the consequences of financial regulation, and shows that tougher capital requirements on the regulated segment of the financial system can increase overall risk because it fuels a rise in unregulated intermediation. Bengui and Bianchi (2018), Begenau and Landvoigt (2020) and Dempsey (2020) explore these effects quantitatively in the context of macroeconomic models.

An important result of this analysis is that leakages are significant, including in realistically calibrated models. However, it is not clear whether this problem calls for weaker or stronger interventions in the regulated segment. One common intuition is that regulators should “ease off” regulation on traditional banks in order to avoid pushing activity into the unregulated segment of the system; another intuition is that regulators should “crack down” on regulated institutions when there is unregulated risk-taking, because only tougher regulation can keep the system as a whole safe. There are also some subtle differences between different models in this literature that could be driving the different conclusions. For example, leakage in some papers occurs because banks themselves engage in unregulated “off balance sheet” activities, so that leakages occur *within* intermediaries. Other models focus on activities shifting *across* intermediaries to different, unregulated institutions (see also Chretien and Lyonnet (2020)).

Davila and Walther (2020) show that the design of optimal regulation in each of these cases is driven by the same underlying principles. In this section, we give a brief illustration of their approach, which will also guide our review of the relevant evidence in the next subsection.

Consider an economy where there are two segments of financial intermediary indexed by  $i \in \{1,2\}$ , two dates  $t \in \{0,1\}$ , and an uncertain state of the world  $s$ , which is revealed at date 1. Both types of intermediaries select their volume of risky lending  $k^i$ . Davila and Walther (2020) derive micro-foundations for the choices of leverage in accordance some canonical theories in banking and corporate finance. The model can further be extended to include other choice

variables such as the magnitude and allocation of risky investment in different asset classes, or the choice of leverage. However, an important point is that the formulae determining optimal policy do not depend on those details, so that we omit them here for brevity.

Regulatory intervention is motivated by the possibility of an ex-post bailout (or other distortive policy, such as monetary easing) in states of the world when one or several types of intermediary are troubled. The possibility of a bailout introduces a social cost that intermediaries do not internalize. For simplicity, we write the externality in this review in reduced form as  $\Delta(k^1, k^2)$ , and note that it depends on the joint activities of both types of intermediary. In order to address the externality, a regulator can impose a corrective (Pigouvian) tax  $\tau_k^i$  per unit of leverage on the investment choices of intermediary in segment  $i$ . The textbook Pigou principle (i.e., the “polluter pays”) would suggest that corrective taxes on intermediaries of type  $i$  should be set according to

$$\tau_k^i = \frac{\partial \Delta}{\partial k^i} \equiv \delta_k^i$$

This is the well-known policy whereby corrective taxes are set equal to the marginal Pigouvian distortion  $\delta_k^i$ , which measures the difference between marginal private and social costs at equilibrium. In other words, the first-best policy imposes restrictions until private and social marginal incentives are aligned.

A more challenging scenario is where the regulator faces constraints due to the presence of unregulated intermediaries. For instance, consider the case where intermediaries in segment 2 are unregulated or only partially regulated. To model this, assume that the tax  $\tau_k^2$  is fixed at an exogenous level (e.g., at zero, in the case where segment 2 is completely unregulated), but that the regulator is still free to choose any level of taxes  $\tau_k^1$  in the regulated segment. In this second-best policy problem, Davila and Walther’s results yield the following necessary condition for optimal policy:

$$(\tau_k^1 - \delta_k^1) + (\tau_k^2 - \delta_k^2) \frac{dk^2}{dk^1} = 0$$

The first term in this equation measures the “Pigouvian wedge” ( $\tau_k^1 - \delta_k^1$ ) between private and social marginal costs of leverage in the regulated segment. Indeed, if this wedge is zero, then  $\tau_k^1 = \delta_k^1$ , so that the then intermediaries of type 1 are regulated in accordance with the Pigou principle. The second term is the product of the Pigouvian wedge, e.g., ( $\tau_k^2 - \delta_k^2$ ), between private and social marginal costs in the *unregulated* segment. Crucially it is multiplied by the “Leakage elasticity”  $\frac{dk^2}{dk^1}$ , which quantifies the total impact of a tax reform that increases  $k^1$  on  $k^2$  in general equilibrium (i.e., taking into account all changes in prices and interest rates that the reform brings about).

To understand the formula for second-best policy, consider some concrete examples. On one hand, if there is no connection at all between regulated and unregulated intermediaries, then the leakage elasticity is zero, and the Pigou principle should apply in the regulated sector. On the other hand, the most common case discussed in the literature (e.g., Plantin (2015), Bengui and

Bianchi (2018), Begeau and Landvoigt (2020)) is when (i) the leakage elasticity is positive with  $\frac{dk^2}{dk^1} > 0$ , meaning that the activities of regulated and unregulated intermediaries are gross substitutes, and (ii) the Pigouvian wedge in the unregulated segment satisfies  $\tau_k^2 - \delta_k^2 < 0$ , meaning that social marginal costs of unregulated intermediaries' activities exceed the private costs. In this case, it is easy to see that the optimal policy for regulated intermediaries implies a negative Pigouvian wedge:  $\tau_k^1 - \delta_k^1 < 0$ . This result implies that the optimal policy is *sub-Pigouvian*, i.e., that the regulator should stop short of the Pigou principle, imposing less stringent policies than would be needed to align private and social marginal costs. In this sense, under-regulation in one segment of the financial system spills over into *optimal* under-regulation in other segments.

However, it is important to note that even when negative wedges are optimal, it is possible that the absolute level of the intervention  $\tau_b^1$  grows larger when there is imperfect regulation. This is because heightened activity in the unregulated sector can raise the expected marginal social costs  $\delta_b^1$  of regulated activities at equilibrium. This scenario applies, for example, when risky lending by shadow banks increases the level of bailout required to restore stability in bad states of the world, and thereby also raises the marginal (fiscal) cost of helping traditional, regulated banks. Therefore, the second-best analysis helps to clarify that “easing off” (in the sense of Pigouvian wedges) and “cracking down” (in the sense of the stringency of intervention) are both valid intuitions that should guide policy.

A central implication of these arguments is that that Pigouvian wedges and leakage elasticities are jointly *sufficient statistics* for the optimal second-best policy in the presence of non-bank, unregulated intermediaries. Indeed, Davila and Walther (2020) point out this is not only the case in the simple model we have considered here, but also in a wider range of settings where there are unregulated activities within bank (e.g., off balance sheet vehicles) or one-size-fits-all policies (e.g., “activity-based” regulation in short-term borrowing markets, as recently adopted by the Financial Stability Oversight Council in the US, and discussed in more detail in Kress (2017)). This sheds new light on the active empirical literature that studies shadow banks and leakages, which we review in the next subsection.

## 3.2 Empirical Evidence on Regulation and Non-Bank Intermediaries

There is a growing empirical literature that casts light on the impact of regulation on financial architecture. In particular, we review a number of papers that estimate leakage elasticities between regulated and unregulated activities. As we saw above, these are crucial statistics for well-calibrated second-best regulation in the presence of unregulated intermediation activities.

Buchak, Matvos, Piskorski and Seru (2018a) study the rise of shadow banking and “Fintech” lenders in the US mortgage market, arguing that both increased regulatory burdens and technological improvements have contributed to the decline of traditional banks' market share. In particular, they exploit geographical variation across US lenders to estimate leakage elasticities between commercial banks and unregulated intermediaries in mortgage originations. They find robust evidence of substitutability between unregulated and regulated lenders. For example,

their estimates suggest that a one percentage point increase in commercial banks' capital requirement increases shadow bank lending volumes by 3.4%, and increases shadow banks' market share by a similar 3.3%. Interestingly, the symmetry between the estimated responses of lending volumes and market shares suggests that the total volume of lending remains roughly constant in response to capital requirements – implying near-perfect substitution between traditional and shadow banks. In a related paper, Buchak, Matvos, Piskorski and Seru (2018b) confirm similar numbers in an estimated structural model of regulated and unregulated lending.

Irani, Iyer, Peydro, and Meisenzahl (2020) estimate leakage elasticities in the market for syndicated (corporate) lending in the US. Their results also suggest substitutability. Their study is set against the backdrop of new, tougher capital requirements that were about to be introduced under Basel III. Banks in their sample are heterogeneous in the shortfall of current capital from future required levels. They show that banks with greater shortfalls reduced their retention of syndicated loans, and that this gap was filled partly by non-bank lenders.

This body of work points convincingly to the stylized fact that the activities of regulated and unregulated intermediaries are *gross substitutes*. Two further recent papers are consistent with this conclusion: First, Xiao (2020) structurally estimates the responses of the market share of traditional banks and shadow banks to monetary policy innovations. Importantly, and in line with other results above, Xiao finds that the market share of shadow banks increases at times when the market share of traditional banks falls (in this case, this happens when the central bank raises interest rates). Second, Tang (2019) finds that another emergent class of non-bank intermediaries, namely peer-to-peer lending platforms, act as a natural substitute to bank credit.

According to the theory we reviewed above, this pattern of substitutability implies that regulation of traditional banks ought to be sub-Pigouvian, i.e., to stop short of the traditional first-best goal of aligning social and private marginal costs, as long as we believe that risky lending by unregulated intermediaries imposes negative externalities (i.e., distortions  $\delta_k^2 > 0$  in our notation above) on the economy.

Many recently developed methodologies suggest that the externalities imposed by risky intermediation are indeed negative across the board (see, for example, Acharya, Engle and Richardson (2012), Miles, Yang and Marcheggiano (2012), and Adrian and Brunnermeier (2016)). However, it is not obvious that unregulated intermediation is *always* undesirable. One relevant case study by Allen, Qian, Tu and Yu (2019) shows that entrusted loans, a common type of shadow lending in China, expands in times when credit is tight overall. Instead of banks lending directly to risky firms they lend to well-capitalized firms that in turn lend to risky firms. The effect of this is to put an extra buffer of equity in between the risky firm and the bank. This suggests that a shift in activity from regulated banks to alternative shadow channels may make the system as a whole more stable in bad times. In that case, shadow lenders can impose a positive externality (i.e., distortions  $\delta_k^2 < 0$  in our notation above) on the economy, which means that regulation should be super-Pigouvian and encourage some leakage to the shadow sector.

In summary, there is now a wide body of theory and empirical evidence that has helped to make the study of “unintended consequences” of financial regulation more rigorous. The theoretical equations help us to evaluate whether policy should become tougher or weaker in the presence

of unregulated activity. Based on the available evidence, we would conclude that one has to evaluate those equations on a case-by-case basis. Most evidence from the US suggests that policy should be marginally weaker than the classical Pigou principle suggests, in order to avoid too much substitution into shadow banking. On the other hand, some of the evidence from China suggests that it might sometimes be worth encouraging such substitution, for example, by imposing more stringent restrictions on the regulated segment of the system.

## 4 Banking Networks and Contagion

The previous two sections focus on the stability and prevalence of non-bank intermediaries. Another aspect of financial architecture that drives overall financial stability is the structure of networks between banks, for example, the structure of interbank market exposures. Indeed, the issue of financial architecture and stability first came to the fore in the early literature on contagion that the architecture of banking networks (e.g., Allen and Gale (2000), Freixas, Parigi and Rochet (2000), and Dasgupta (2004)). In this section, we review this literature and the more detailed analysis of network structures that has followed it. We then give an explicit theoretical example, based on recent work by Acemoglu, Ozdaglar, and Tahbaz-Salehi (2015)), that highlights some of the key aspects of banking networks that determine financial stability.

The theoretical literature on banking networks and contagion has evolved in three strands. First, Allen and Gale (2000) propose one of the first formal studies of contagion in banking networks. In their model, the exposures between banks are endogenous and determined in equilibrium. Banks choose to hold claims on each other due to imperfectly correlated regional liquidity shocks. A key result is that contagion, whereby relatively small shocks to one institution cause distress among other institutions, is possible as an equilibrium phenomenon, and that complete networks are more robust than concentrated ones. Dasgupta (2004) extends this analysis to dynamic interactions.

Second, many papers have studied the vulnerability of banking networks. This literature typically takes a network of exposures as exogenously given, and characterized the types of shocks (e.g., localized losses) that the network can withstand without generating contagion. In early work in this vein, Freixas, Parigi and Rochet (2000) discuss chain reactions in an interbank market, and Eisenberg and Noe (2001) show that even unsystematic negative shocks can reduce the value of financial firms who are exposed to each other via a clearing mechanism. This literature was revived after the financial crisis of 2008. Gai and Kapadia (2010) pointed out an important property of financial networks that they call “robust-yet-fragile”: A network that can withstand shocks in good times is not necessarily also a network that avoids vulnerabilities in bad times. Elliott, Golub and Jackson (2014) study the effects of financial integration (more exposure to counterparties) and diversification (number of counterparties per bank). The nature of robustness and fragility is characterized starkly in Acemoglu, Ozdaglar and Tahbaz-Salehi (2015), on which we base our detailed examples below.

Two recent papers connect the literature on vulnerability to other aspects of financial stability: Greenwood, Landier and Thesmar (2015) argue that fire sales can lead to spillovers across banks.



This connects the contagion literature to the wider literature on fire sales and amplification in competitive equilibrium models, which we have reviewed in Section 3. Zhou (2018) connects contagion via exposures to panic-driven financial crises, and argues that panics can exacerbate the adverse effects in interbank networks in a crisis.

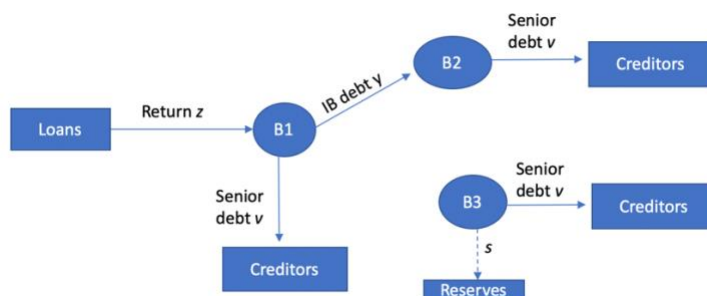
A third, recent line of research has combined the study of vulnerability in banking networks with endogenous network formation. Babus (2016) shows that the risk of contagion can be significantly reduced if there is a possibility of mutual insurance between banks *ex ante*. Farboodi (2017) argues that the amount of risk generated by banks can nonetheless be excessive from a social perspective. Farboodi studies a model where banks at the front of intermediation shares (i.e., close to the end borrower) get a larger share of the surplus that lending generates. This creates an incentive for banks with risky investments opportunities to connect with each other, to the point where this behaviour generates potential contagion and reduces social surplus. Acemoglu et al. (2020) study endogenous contracting between banks, and show that the anticipation of contagion is sufficient to generate credit freezes, in which banks cease lending to each other.

We now move on to a more concrete example of vulnerability and discuss how it relates to the available empirical evidence.

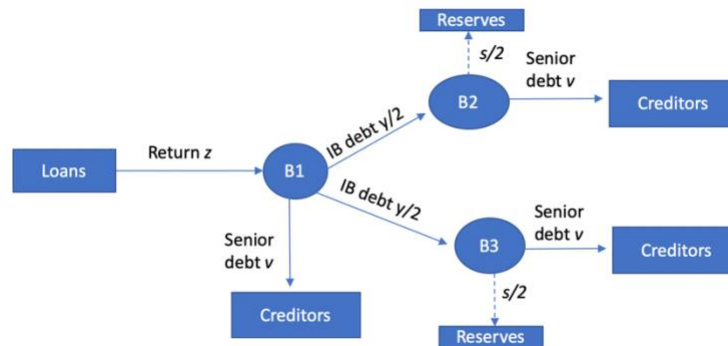
#### 4.1 Contagion of Banking Crises

A simple example, adapted from Acemoglu, Ozdaglar and Tahbaz-Salehi (2015), illustrates the potential for contagion in interconnected banking systems. Take a system with three banks called *B1*, *B2* and *B3*, with the following balance sheets: On the asset side, *B1* has investments in the real economy which yield a random return  $z$ . On the liability side, *B1* owes a total of  $y$  to banks *B2* and *B3* on the interbank market. The assets of *B2* and *B3*, in addition to their claims on *B1*, are safe reserves worth  $s$  in total. Finally, all three banks owe  $v$  to other senior creditors outside the network, such as holders of repurchase agreements or depositors. Assume that  $v < s$ , so that total reserves are enough to cover one bank's deposits.

Figure 4a shows a “concentrated” bank network where all interbank loans come from *B2* specializes in interbank loans, while *B1* holds only safe reserves. In this case, *B1* is bankrupt if its return  $z < v + y$ . This is contagious and leads to *B2*'s failure if the value of its (junior) interbank claim is  $z - v < v$ . Thus, we get a joint failure of two banks if returns are bad enough so that  $z < \min\{v + y, 2v\}$ , but the third bank is always safe.



(a) Concentrated bank network



(b) Interconnected bank network

**Figure 4.** Examples of Contagion

Figure 4b shows an “interconnected” interbank network with the same total exposure, where both B2 and B3 lend to B1. Here, the same arguments show that we get contagion, and the failure of all three banks, if  $z < \min\{v + y, 3v - s\}$ . Since we have  $s > v$ , this threshold is always lower than the joint failure threshold in the concentrated case. Thus, the interconnected network is more robust: it takes larger losses to cause contagion, but also more fragile: when contagion hits, all banks are affected.

The results in Acemoglu et al. (2015) generalize this logic. For small losses, a concentrated “ring” network, where each bank borrows from and lends to one other bank, is the least stable, while the “complete network”, where each bank is exposed to all others, is the most stable. For large losses, neither the ring nor the complete network do well; instead, stable architectures require “pockets” of banks who are insulated from others.

## 4.2 Empirical Work on Bank Networks

An early literature considered the relationship between bank networks and financial stability. Furfine (2003) considered the US banking system; Upper and Worms (2004) analyzed Germany; Boss, Elsinger, Thurner, and Summer (2004) Austria; Degryse and Nguyen (2007) Belgium; and Cocco, Gomes, and Martins (2009) Portugal. Iyer and Peydró (2011) conduct a case study of interbank linkages resulting from a large bank failure in India due to fraud. Upper (2011) contains a survey of this literature. The main conclusion is that contagion is usually not a serious risk provided there are not significant price movements in response to the turmoil. If there are, as Cifuentes, Ferrucci, and Shin (2005) have suggested, then contagion effects can be significant.

The Global Financial Crisis resulted in many empirical papers on networks. Afonso, Kovner, and Schoar (2013) show that there is substantial heterogeneity in the structure of trading relationships in the US overnight interbank lending market. Billio, Getmansky, Lo and Pelizzon (2012) develop econometric measures of connectedness between different sectors of the financial system. They use these to argue that hedge funds, banks, broker dealers, and insurance companies have become more connected over time and this has likely increased systemic risk. Craig and von Peter (2014) show that banks do not lend

to each other directly. Instead, they form a core-periphery network by transacting with money center banks at the core. Gofman (2017) estimates a model of interbank lending in the US and investigates the effect of regulating banks' size and interconnectedness. He shows that restricting interconnectedness improves financial stability. Allen, Covi, Gu, Kowalewski, and Montagna (2020) use a network analysis to argue that the differences in interbank market usage can be explained by the trust of market participants in the stability of the country's banking sector and counterparties, proxied by the history of banking crises and failures.

## 5 Concluding Remarks

This essay has focused on two aspects of the relationship between financial architecture and financial stability that have been particularly important in the recent literature. The first focuses on the institutional structure of the financial system. While the traditional financial stability literature focused primarily on banks, much of the recent literature has focused on other types of financial intermediary. The second focuses on the network structure of the interbank market and how this affects financial stability.

Other aspects of financial architecture and financial stability are the exchange rate system and market crashes. While historically important, these have been less prevalent in recent years. Central bank swap lines have reduced the probability of currency crises, and central bank liquidity interventions have been used to support asset prices and counter financial market crashes.

Going forward, fintech is likely to considerably change the architecture of the financial system. Allen, Gu and Jagtiani (2021) survey the different aspects of fintech that will underlie such changes. The effect of these on financial stability remains an important area for future research.

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