MACROECONOMICS

Taxing Systemic Risk

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Current financial regulations seek to limit each institution's risk. However, unless financial institutions internalize the external costs of systemic risk, they will have the incentive to take risks that are borne by others in the economy. That is, each individual firm may take actions to prevent its own collapse but not necessarily the collapse of the system. In this sense, the institution's risk is a negative externality on the system.

We advocate that systemic risk of the financial sector needs to be regulated, using a measure of an individual financial firm's contribution to systemic risk. We propose that each financial firm should be charged a "tax" based on its expected loss during a systemic crisis. In our preferred approach, individual firms would be required to buy contingent capital insurance against losses incurred during systemic crises. The cost of this insurance determines the firm's systemic risk tax.

We discuss why a joint private-public provision of such insurance has the right incentive properties to get the financial sector to internalize systemic risk. We provide an example of how such a systemic risk tax could be calculated and also discuss its relationship to other contingent capital proposals such as forced debt-for-equity conversions.

Overall, the main advantages of this approach are: (i) it forces regulators and financial firms to deal explicitly with systemic risk; (ii) it is based on tools tested and well understood by the private sector; and (iii) it reduces moral hazard in that it provides incentives for regulated firms not to contribute excessively to systemic risk.

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