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Understanding Systemic Risk in Global Financial Markets

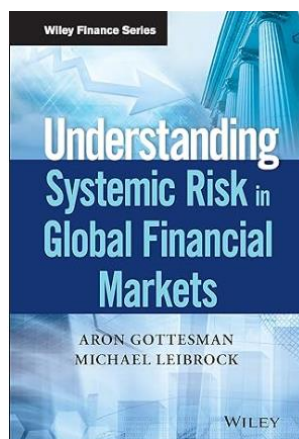
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Understanding Systemic Risk in Global Financial Markets

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A Book Review of Understanding Systemic Risk in Global Financial Markets

Written by Aron Gottesman and Michael Leibrock

Introduction

The Global Financial Crisis (GFC) was the worst economic crisis since the Great Depression of 1929. While the Great Depression started in the stock market, the GFC began in the housing market. The GFC proved that the failure of one financial institution can lead to a domino effect due to interconnectedness, which microprudential policies at that time failed to account for. This birthed the use of macroprudential supervision and oversight which instead takes a systemwide approach, ultimately changing the way academics, policy makers and regulators view of financial stability and financial regulation.

The book aims to provide a comprehensive examination of systemic risk in financial markets, alongside a toolkit of early warning indicators of a systemic event in financial markets. While macroprudential policies became a buzzword in financial stability after the GFC, mentions of its importance initially came in 1979 at the Cooke Committee, the predecessor of the Basel Committee on Banking Supervision (Clement 2010). The authors describe the evolution of regulation surrounding the GFC and key indicators of a possible systemic event, acknowledging that the next crisis is not an if, but when. This is emphasised by noting that predicting a new trigger leading to financial crisis is impossible. A great example, which confirms the authors' argument, is the COVID-19 recession. Instead, what the authors provide are patterns which occur before and during a crisis as well as how these were addressed. While regulation has evolved since the GFC, further developments will be necessary as the financial environment is continuously changing with new risks emerging. Similarly, some indicators in the simple toolkit suggested by the authors would also need to be updated as the book was published in 2017 before COVID-19 and the technological advancement of artificial intelligence (AI) risks, which now pose new threats to the financial system. While the authors seek to provide an understanding of systemic risk, a key variable is mentioned. The environment is always changing, meaning new risks can always develop. This means that although the book is useful in familiar risk environments, there is a possibility that its content cannot be applied to new sources of risk. The key takeaway is that while a crisis may be unavoidable; the impact can be reduced.

The topic itself is timely and is excellent reading for anyone new to regulation or seeking to expand his/her knowledge on historical financial events and their link to future potential events.

The book is organized as followed:

- Chapters 1 – 3 introduce the topic and provides a historical overview of previous financial crises
- Chapters 4-6 provide a more detailed analysis of systemic risk
- Chapters 7-8 explore US and international regulation after the crisis
- Chapters 9-14 describe the elements of financial risk management
- Chapters 15 and 16 tie the previous chapters together

Systemic Risk

The authors commence by noting that before the 2007/8 crisis, the study of systemic risk was limited to academia and few regulators. This contributed to a significant gap in the literature on financial crises. However, since then, stakeholders around the world have been monitoring these risks. The text is one of the many in the growing literature seeking to fill this gap on the topic. The reading provides a concise but comprehensive overview of historical systemic events highlighting similarities and inspects the GFC from different angles. This includes non-conventional ideologies, making it a good read in comparison to other publications on the topic. A few definitions are provided to define systemic risk as there is no settled terminology. These definitions state that systemic risk stems from developments which threaten the financial stability of an economy. Examples of this include downturns in the stock market or the real estate market. Historically, many asset bubbles have been observed in the real estate market, one example being Japan's real estate bubble which is referred to as the "The Lost Decade" (Stern and Saxonhouse 2003). Another example is the 1977 crisis experienced by Spain, which was Spain's worst crisis until the GFC.

Comparisons are given while delving into the history of systemic events. Although the financial markets differ from many years ago, there are some key similarities. Dating back to 1636 until present, asset bubbles, real estate and banking crises have been common drivers of systemic events. It is also noted by the authors that no single event has caused a widespread event, however a series of underlying issues allowed for spill-overs into other sectors and countries leading to systemic events. One of the key premises of neoclassical

frameworks in economics is that individuals are rational. However, erratic investor behaviour leading to rapid credit growth is argued to be the cause of the asset bubble of the GFC (Hoffman, Post and Pennings 2013). While this is partially correct where the investors played a role, the authors neglected to place equal emphasis in the role of mortgage lenders who provided the access to the credit.

The Global Financial Crisis as a Systemic Event

The book's description of Wall Street's high-risk appetite is adequately assessed with due attention paid to the creation of the synthetic collateralised debt obligations (CDOs), where fees were earned on these investments. Notably, such questionable ethical practices are argued to be a key driver of the crisis (Santoro and Strauss 2013). This led to failures of large financial corporations, including Lehman Brothers Holdings Inc., once ranked the fourth largest investment bank, further exacerbating the crisis. This led to the involvement of the US congress which then passed the Emergency Economic Stabilization Act.

The authors provide an analysis of investor behaviour to assist readers in understanding their contribution to the failure of financial institutions. As stated in the book, the Minsky's Three-Part Model analyses financial vulnerability attributed to three types of borrowers. These types of borrowers which exacerbated the crisis fall under the Ponzi borrowers; these types cannot afford debt payments and depend on the asset's appreciation to keep them afloat. Interestingly, the Rational Expectations Theory is discussed and arguably, this theory can be considered the backbone of economics, where consumers are described as rational decision makers. It is mentioned that financial crises tend to debunk this theory, and this is also argued by Bilginsoy (2014).

Theories in behavioural economics are discussed to provide a few explanations for the behaviour observed which led to the crisis. The authors discuss the anchoring heuristic theory where investors anchor their belief to the initial information given regardless of evidence in changes to these facts. This makes it impossible to make a rational decision. This approach is not considered in the study of mainstream economics, but is usually featured in behavioural economics and its impact on financial markets. (Chen 2023).

Despite the authors' focus on the United States, small open economies (SOEs) can learn the lessons on how the crisis spilled over into the real sector. The asset bubble did not occur in

smaller economies like Barbados during the GFC. However, there was an indirect impact through tourism. Understanding the indicators of a recession through the financial market is still important for SOE's.

Supervision and Regulation

While the lack of rational decisions contributed to the crisis, it is also highlighted that there was a major gap in supervision, which was the level of interconnectedness of financial institutions. This data being reported signified the shift from microprudential regulation to macroprudential regulation. Microprudential supervision proved to be ineffective to prevent systemic risks, with the ultimate objective being consumer protection. In contrast, macroprudential policies aim to protect the economy.

The authors describe microprudential policies as stand-alone policies for financial institutions, assume risks are exogenous and disregards the collective impact of interactions between institutions. Macroprudential policies on the other hand address the financial system as a whole, and is described as microprudential tools with a macroprudential approach. The authors specify that capital adequacy is a key measure for individual firms' ability to meet financial obligations during losses. Capital adequacy is a major concern from the macroprudential perspective to ensure financial stability during unfavourable economic conditions. Other tools include leverage ratio requirements, liquidity coverage ratios and stress testing.

Regulation in the US consists of a range of regulatory organizations. This has led to instances of some financial institutions being regulated by multiple agencies. This is noted to cause competition where financial institutions choose the most lenient regulator. It would have been interesting if special note was made on the impact of choosing easier regulators, or if this potential impact is negligible. Overall however, the themes stem from the international regulatory regimes such as the Financial Stability Board and the Basel Accords.

Significantly Important Banks

Some entities have greater impact in comparison to others. Entities whose failure could threaten financial stability are considered systemically important financial institutions (SIFI's). These entities are considered too big to fail, making their failure an economic disaster. Interconnectedness between these institutions cause a domino effect of failures

among institutions. Regulators have been chastised on their failure to identify these entities which led to the financial crisis of 2007/8. Globally systemically important banks (G-SIB) are banks whose failure impacts the global economy. The authors provide some indicators to identify these G-SIBS based on the Basel Committee's approach. This list consists of size, interconnectedness, complexity and cross-jurisdictional activity.

The authors proceed to discuss the Volker Rule, the title of the Dodd-Frank Act Section 619 where banks are prohibited from sponsoring hedge funds as well as proprietary trading. This is due to a moral hazard situation where the activities may be beneficial to the financial institution but costly to the US government. This rule is not without criticism however, as it has been under scrutiny for not considering the changes in financial markets as well as its impact on bank customers.

Counterparty failures are noted to have the potential to lead to a financial distress and a systemic event. This emphasizes interconnectedness as a key risk to the financial system. This led to the Title VII of the Dodd-Frank Act, created to promote financial stability. However, this act has been criticized as being too costly to follow all its regulations. These changes have spawned OTC derivatives like derivative exchanges. This has allowed regulators to understand the product to enhance regulation.

The Basel Accords and Financial Stability

Continuing the topic of financial stability, the authors highlight the Basel Accords, regulators key framework for the prevention financial stability, and discuss their evolution. . Another development noted is the Fed's response to the GFC in comparison to the Great Depression. While the "lender of last resort" stepped in with regards to the GFC, an alternative view of the free banking approach is briefly discussed where legal restrictions are removed which should in theory, allow a panic-proof system. This occurs when there is no central bank and commercial banks are unregulated. While there is a small niche who believes in this system's effectiveness, the GFC displayed the consequences of gaps in regulation, emphasizing the importance of regulators.

Conclusion

The book is comprehensive and concise. It however lacks criticism of mortgage lenders in comparison to the analysis provided on the borrowers themselves. An appropriate

digestible description of the systemic risk and regulation is provided from the authors. An important takeaway is that while some crises were similar, risks continue to evolve. This emphasizes the statement by the authors, the next crisis is not an if, but when, and also with the evolution of the Basel Accords. With that considered, the toolkit provided is only relevant for risks that have already emerged from similar triggers mentioned. New developments such as mitigation of cyber risk would not fit into the toolkit. For the information in the book to remain relevant, the authors would need to introduce new editions with relevant information every few years. Despite this absence, regulators in small open economies can use this to understand the importance of regulatory oversight especially in the current ever-changing financial market.

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