Risk Sharing, Risk Taking and Crises

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Abstract

This paper explores the tension between risk sharing and risk taking linked to securitization. Financial development typically leads to an increase in securitization that helps financial institutions to share idiosyncratic risk. By increasing expected returns, risk sharing tends to reduce the incentive to pay monitoring costs and spurs a wave of easy lending. This generates an increase in credit access, but at the same time makes financial institutions more exposed to risk. As a result, small aggregate shocks may generate large financial crises.