

## Chapter 13 – A Future of Public Utilities and Buccaneers?

The crisis of 2007-09 will change the financial system for many years to come. In the absence of new rules, policy actions during the crisis will shape private expectations and future behavior. For example, the crisis provision of public capital to specific intermediaries and the protection of their creditors will encourage expectations of future bailouts. And, the crisis-driven fusions of some of the largest intermediaries have created super-sized banks that are likely to be seen as *too big to resolve* in a future crisis (TBTR; see the Chapter 13 module: the Policy Response to Systemic Intermediaries).

In the absence of major policy changes, these developments have created moral hazards that can become sources of future financial instability.<sup>1</sup> Imagine, for example, how these developments will affect the future behavior of creditors. Potential creditors will distinguish two kinds of financial firms: TBTRs and others. In the crisis of 2007-09, governments protected creditors from losses on their loans to TBTRs that failed. In a standard bankruptcy procedure, such losses are commonplace. As a result, creditors usually screen potential borrowers and monitor their use of loaned funds to prevent losses. Instead, creditors may view large, complex intermediaries as TBTRs with implicit government guarantees.

One effect will be to accelerate concentration in the financial system. TBTRs will be able to attract funds away from other intermediaries because they will be perceived as safe in a crisis. A related effect will be to remove a creditor's incentive to charge TBTRs a premium as compensation for their riskiness (core principle 2). Unchecked, this perceived government guarantee of creditors will encourage dangerous, systemic risk-taking on the part of TBTRs.

Experience shows that an *implicit* government guarantee can quickly become an *explicit* guarantee in a crisis. For example, in July 2008, the loss of funding liquidity at the two largest government-sponsored enterprises (see Chapter 13 description of GSEs) – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) – compelled the U.S. government to place them under its direct legal control.<sup>2</sup> Together with other agencies, the GSEs account for \$5.4 trillion of U.S. residential mortgages, or nearly one half of the total. To contain the market panic, the U.S. government fully protected the GSEs' creditors at taxpayer expense. While Fannie and Freddie had existed with various forms of public support for decades, they had no explicit guarantee until their failure was imminent.

---

<sup>1</sup> Recall from Chapter 11 that a moral hazard arises when someone who is insured will behave in a way that is not in the interest of the insurer. It is caused by asymmetric information and lead to market failure.

<sup>2</sup> The formal mechanism of legal control that the government used is called a “conservatorship.”

If TBTRs' liabilities carry implicit government guarantees, their size and distorted incentives make them prime candidates for intense government scrutiny. The likely outcome is that officials will impose restrictions on their risk-taking, turning them into public utilities – institutions that provide special services that have great social value and are subject to tight rules and close public oversight. If this were to happen, TBTRs may eventually come to suffer from the common weaknesses of public utilities, whose size and bureaucratic procedures often make them unwieldy and slow to adapt. In particular, public utilities are local monopolies that typically have little incentive to respond to changing customer preferences through the development of new products and practices.

Not all intermediaries will wish to be TBTRs. Non-TBTRs may wish to grow just shy of the status that invites the scrutiny associated with the implicit government guarantee. At the same time, the profit motive would encourage non-TBTRs to take risks that rule-bound TBTRs cannot. The extreme risk-takers in this class – call them *buccaneers* – could prove highly profitable in good times, while continuing to pose systemic risks in bad times. To avoid detection, buccaneers will avoid open swashbuckling, preferring to take risks that are invisible, even if systemic. The behavior of AIG – which used over-the-counter (OTC) derivatives to sell insurance in large volume without holding reserves against the insured event – provides a dramatic example of systemic risk-taking that was opaque to counterparties and to government officials.

Naturally, this picture of a financial system populated by slow-moving public utilities and dangerous, hidden buccaneers is one that governments will wish to avoid. This means addressing the TBTR problem. One approach is to tax size, penalizing intermediaries that are too large or too difficult to liquidate in a crisis. Such fees would discourage complexity and compel the managers of these intermediaries to take account of the spillover from their behavior on others. A useful analogy is to the penalties imposed on polluters who damage the environment. In economic terms, both pollution and systemic risks are *externalities* – costs that fall on others, rather than on the producer. Such externalities often are a source of market failure: in this case, they can lead to too much systemic risk (pollution). The penalties would be designed to cause the financial polluters (in this case, TBTRs) to take account of – to *internalize* – the systemic risk that they produce.