SECTION II
FINANCIAL INSTITUTIONS

Overview

In this section of the book, we look at three different types of financial institutions, each with a varying degree of government guarantees:

- Chapter 4, "What To Do About the Government Sponsored Enterprises?", focuses on a set of institutions, namely Fannie Mae and Freddie Mac, that receive government guarantees without any real price. These guarantees impose huge costs on the system, most importantly through the moral hazard they create. The chapter explains how these costs manifested themselves in the current financial crisis and how to avoid their recurrence in future.
- Chapter 5, "Enhanced Regulation of Large, Complex Financial Institutions", considers financial firms that may or may not have explicit guarantees, but certainly implicit ones through the "too-big-to-fail" policy. The chapter traces back the history of LCFIs, the current regulatory environment, a regulatory structure recently proposed by the U.S. Treasury, and proposes an alternative framework that creates and empowers a dedicated regulator for LCFIs to charge them a "tax" for systemic risks they impose on rest of the financial sector and the economy.

The last chapter of this section, Chapter 6 – "Hedge Funds", looks at these institutions as an example of the "shadow banking system" that is mostly unregulated and receives little or no support from the U.S. government. It argues that hedge funds play an important role in financial markets, primarily as a liquidity provider, but because they receive no guarantees, it is not clear why hedge funds need to be regulated. The exception arises when a hedge fund is in fact a large, complex financial institution (in spirit of Chapter 5's discussion) and therefore is likely to impose a systemic risk externality on rest of the system