Why are banks special? This poses the question for why the government pays special attention to the banking firms rather than ordinary firms.

One of the most obvious reasons for why banks are special is that they are of systemic importance. By this is meant that a failure of a bank – i.e. if a bank goes bankrupt – it might set of a *domino effect*, effectively triggering a financial crisis. A financial crisis is here defined as «a disturbance to financial markets, associated typically with falling asset prices and insolvency among debtors and intermediaries, which spreads through the financial system, disrupting the market's capacity to allocate capital.» (Eichengreen, 1989) Financial crisis are widely known of having tremendous social costs in the form of unemployment, fiscal costs, and wealth losses, and avoiding them is therefore crucial. The key word when talking about systemic importance is *contagion*; «in which a small shock that initially affects one region or sector or perhaps even a few institutions, spreads from bank to bank throughout the rest of the system, and then affects the entire economy» (Allen & Gale, 2004). In layman's terms, contagion occurs through the effects of a borrower's default on his creditors. A related term is *financial fragility* indicating that a small shock can have a big effect. This fragility can stem from e.g. high *leverage*, in which a bank's operations are mainly financed through borrowed money (relative to equity).

So, why are banks so important? Banks are fundamental to the economic system in many ways. For instance, banks are financial intermediaries through *maturity transformation* – that is, they transform short-term deposits into long-term loans – thereby making sure that credit ends up in the most productive hands. Furthermore, banks «contribute to the payment system and provide liquidity and liquidity insurance to the public,» (Vislie, 2014) as well as being instruments for which the government's monetary policy works through. In a way, the banking system is at the heart of the economy, pumping money and credit throughout the economic system just as the heart pumps oxygenrich blood through our bodies. So, «when banks stop functioning, so does a modern monetary economy.» (Vives, 2010)

The uniqueness of banking can also be seen by investigating the market failures the sector is prone to. We'll focus on three different forms of market failures: externalities, market power (imperfect competition), and asymmetric information.

The banking sector has economy-wide externalities. The failure is due to the fact that the banks fail to internalize the social cost of bankruptcy and potential systemic risk. In fact, the problem related to systemic importance and contagion exemplifies the inherent fragility of the banking system, and hence the corresponding externalities one bank can impose on other banks or the system as a whole.

In ordinary markets we strive to have as much competition as possible, since full competition in a free market leads to the first best solution with marginal cost equal the marginal rate of substitution and efficient allocation of resources. In the bank sector on the other hand we don't want to have full competition. Full competition in the banking sector means that the profit will converge to zero and the charter value of the bank will therefore be low or almost nothing. With nothing to lose the banks have limited liability and there will be a moral hazard where the banks take the profit if they succeed, but don't pick up the bill if they fail. This moral hazard is different from ordinary firms since the bank gamble with other people's money. The fact that this massive billion dollar industry has an incentive to take too much

risk, if competition is too big, make the banking sector different than other firms and therefor the government will pay more attention towards them.

If an ordinary firm takes too much risk and end up defaulting there loans and go bankrupt, the negative externalities are quite small. For a bank the effect of a bankruptcy is relatively big. First of all the households loose there savings deposits and the household sector will have a negative income shock. Also, the bank will default there loans in the interbank market, which leads to losses for other banks as well. Defaulting loans in the interbank market will lead to higher uncertainty and bigger margin on the interest rate between banks. This again raises the interest rate on loans to firms and households, which leads to less investments and a higher cost on current loans. These negative externalities make banks special compared to other industries, where bankruptcy of a firm in many cases can be the most efficient.

Moreover, regulation of the banking sector is not without side effects either. Chief among these is potential moral hazard induced by protection and bailouts extended to failing institutions. The notion of too-big-to-fail is fitting. If banks know they are of systemic importance, and know that at the end of the day the government will bail them out, this would increase the problem of moral hazard further.