Chapter 13 Practice Problems

1. Banks have been losing their advantage over other financial intermediaries in attracting customers’ funds. Why?
Other financial firms now exist that provide individuals with services typically performed by banks. Money market mutual funds offer customers access to financial instruments that pay a higher rate of interest than bank deposits, yet are still very liquid and can easily be converted into a means of payment. Banks no longer have an advantage in screening loan applicants because of the ease with which individuals can transmit information, so a customer who needs a loan can go online to get price quotes instead of going to the local bank. Discount brokerage firms provide individuals with low-cost access to the financial markets.

2. An industry with a large number of small firms is usually thought to be highly competitive. Is that supposition true of the banking industry? What are the costs and benefits to consumers of the current structure of the U.S. banking industry.
When the banking industry consisted of a large number of small firms, the industry was less competitive than it is today. This is because each small bank had a monopoly within its geographic area. As large banks branch across the country and the number of small local banks falls, consumers benefit by having access to a larger network of ATMs and by being able to engage in a wider range of financial activities through their banks. Costs to consumers have fallen as a result of increased competition. However, the level of personal service that consumers receive has declined.

3. Consider two countries with the following characteristics. Country A has no restrictions on bank branching and banks are permitted to offer investment and insurance products along with traditional banking services. In Country B there are strict limits on branch banking and on the geographical spread of a bank’s business. In addition, banks in Country B are not permitted to offer investment or insurance services.
a. In which country will the banking system be more concentrated?
Country A is likely to have a more concentrated banking system, as fewer banks could service the entire country. In Country B, branching restrictions are likely to give rise to a large number of smaller banks.

b. In which country will the banking system be more competitive?
The experience in the United States with the McFadden Act would suggest that the banking system would be more competitive in Country A. Although banking restrictions are often intended to prevent concentration and monopoly power in the banking system, the outcome in the United States was a range of small inefficient banks that faced little competition in the geographic area in which they operated.

c. In which country do you think banking products are cheaper?
In Country A, banks can take better advantage of economies of scale and scope and so banking products are likely to be cheaper.

4. Statistically teenage drivers are more likely to have an automobile accident than adult drivers. As a result, insurance companies charge higher insurance premiums for teenage drivers.
Suppose one company decided to charge teenagers and adults the same premium based on the average risk level of both groups.

a. Will this company be profitable?

This insurance company is unlikely to be profitable because of the problem of adverse selection. The insurance premium based on the average risk of an accident amongst both teenagers and adults will be higher than the premium for the relatively low-risk adults alone and lower than the premium for teenagers alone. Therefore, adults will not choose to be insured by this company but teenagers will. The premium charged based on the average risk of teenagers and adults would not be sufficient to cover the claims of a teenage-only pool and so the company would not be profitable. This is an example of the lemons problem described in chapter 11.

b. Imagine that instead of the above scenario, public interest groups successfully convince legislators that charging teenagers a different premium than adults constituted discrimination. To combat this discrimination, the legislature mandated insurance companies must charge equal premiums to adults and teenagers. Speculate on the outcomes one would observe in the insurance market.

My first response would be that insurance companies will seek ways of charging teenage drivers higher premiums in a way that meets the letter of the law. For instance, insurance companies may charge higher premiums to individuals who have held drivers licenses for shorter time periods. Of course the teenager interest groups would probably argue this violated the spirit of the law and, if a court agreed, the insurance company would need to find other ways of charging younger drivers higher premiums.

If the insurance company were unable to charge younger drivers different premiums than adults, then the insurance company must raise the premium on adults and lower it for teenagers until they are equal. Upon doing this, adults will want to leave the insurance market (as the value of insurance to them is less than the value of the higher premiums) and more teenagers will want to enter the market. If this occurs, the insurance company will find that it receives many payments from high-cost teenagers and few payments from low-cost adults leading to ultimate bankruptcy for the insurance company. However, the company could try to make insurance mandatory for all drivers and thereby force adults to pay the higher rates. If the legislature agrees, then adults would be unable to leave the insurance market and, if insurance companies can charge both adults and teenagers a high enough premium, the insurance companies would stay in business. In this case, adults are subsidizing bad teenage driving.

5. Which regulatory agency has the primary responsibility for supervising the following categories of commercial banks?
   a. National banks Office of the Comptroller of the Currency
   b. Bank holding companies The Federal Reserve
   c. Non-Federal Reserve state banks State banking authorities and the FDIC
   d. Federal Reserve member state banks The Federal Reserve

6. If the bank at which you keep your checking account is owned by Saudi Arabians, should you worry that your deposits are less safe than if the bank were owned by Americans?

No, because a Saudi owned bank operating in the United States is subject to the same regulations as an American owned bank.
7. Why have banks been losing cost advantages in acquiring funds in recent years?
The rise in inflation and resulting higher interest rates on alternatives to checkable deposits meant that banks had a big shrinkage in this low-cost way of raising funds. The innovation of money market mutual funds also mean that banks lost checking account business. The abolishment of Regulation Q and the appearance of NOW accounts did help decrease this disintermediation of deposits but raised the cost of acquiring funds for American banks.

8. Why have banks been losing income advantages on their assets in recent years?
The growth of the commercial paper market and junk bond market means that corporations are no able to issue securities rather than borrow from banks, thus eroding the competitive advantage of banks on the lending side. Securitization (packaging many loans into one financial product that is parceled out and sold) has enabled other financial institutions to originate loans, again taking away some bank business.