

**Homework Assignment 10 solution.**

1. (2 point) Explain how technological advances can prevent regulatory agencies from enforcing restrictions on bank branching?

**Technological advances allow banks to operate across state borders without actually setting up a brick-and-mortar branch. For example, large banks can issue credit cards to customers in all 50 states without opening a branch in each of them. These days it is not necessary to visit your bank very often – you can access your account 24/7 to pay your bills (most banks offer 24/7 internet banking), you can get cash from ATMs anywhere anytime, you can arrange that your employer deposits your paycheck directly to your account.**

2. (1 point) Describe the nature of the economies of scope large financial institutions hope to achieve by expanding beyond traditional banking services.

**The economies of scope happen if it is cheaper for a financial institution to produce and sell two or more services together than it is to produce and sell them separately. The economies of scope can happen, for example, because the information produced in the process of providing one service can be used again when providing other services. A bank that produced some information about a potential borrower who requested a car loan can use this information to provide other types of services to this individual. This bank won't have to learn as much about this individual if he will ask for a mortgage.**

3. (2 points) Explain why the profitability of traditional banking has declined and how banks have responded.

**Banks enjoyed advantages over other types of financial intermediaries in cost of funds because interest rate ceiling regulations (Regulation Q). Competition from new financial instruments such as money market mutual funds resulted in the disintermediation (process of people taking their deposits out of banks and into more profitable investments). Banks responded with interest-paying checking deposits that increased bank costs. The development markets for junk bonds, commercial paper, and securitized assets eroded banks' income advantages. Banks have responded by making riskier loans (commercial mortgages and funding for takeovers and buyouts) and have moved into more off-balance-sheet activities.**

4. (2 points) Why countries with more generous deposit insurance can be more likely to suffer from financial crises?

**Insurance creates moral hazard – insured have low incentives to behave in a cautious manner (invest in safe assets). If insurance is more generous, the moral**

**hazard problem is more pronounced (banks would seek high risk investments because they know that they would be saved if investments do not work out).**

5. (2 points) What important changes in banking have occurred as the result of low cost information technology? Give at least two examples.

**Information technology lowers the costs of making and processing financial transactions. Banks can either improve the way they provide services or create completely new services. There are many examples: ATM (the same teller services done by a machine rather than a person, plus ability to use the services 24/7), credit cards (credit line that is significantly safer than getting a small consumer loan from a bank in cash), debit cards (easier and safer substitute for checks), internet bill paying, securitization (banks package illiquid assets such as mortgages into liquid tradable securities and sell them).**

6. (1 point) Why U.S. banking system is considered dual?

**Banks can either be chartered by state authorities or federal authorities. This dual regulatory system gives the reason the banking system is also called dual.**