Economic Analysis of Financial Regulation
ECON 4673
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Answers

1. *Why are deposit insurance and other types of government safety nets important to the health of the economy?*

   A government safety net helps prevent bank runs and bank panics, and helps overcome reluctance by depositors to put funds in the banking system. Deposit insurance also helps to eliminate a contagion effect, in which both good and bad banks could become insolvent in the event of a bank panic. Without confidence in the banking system, such bank panics can cause a collapse of the financial system and severely inhibit investment and economic growth.

2. *Suppose a bank fails. How much does a depositor receive from their $350,000 deposit if the FDIC uses the payoff method? How does your answer change if the FDIC uses the purchase and assumption method? Which method costs the taxpayers more?*

   Under the *payoff method*, the FDIC must payout $250,000 but may pay out more, up to the original $350,00 value of the deposit, depending on the amount of proceeds received when the bank is liquidated. Under the *purchase and assumption* method, the bank is completely absorbed and all accounts are paid their full value. Actuarially, the *payoff method* costs the insurance fund less. If, however, depositors fear a loss under the *payoff method*, they will be less likely to maintain account balances in excess of $250,000 in a single bank.

3. *What are the two forms of restrictions on banking competition that were previously enshrined in U.S. law. How did the financial system benefit from those restrictions? What are two disadvantages of those restrictions on the banking industry?*

   Two forms of restrictions on banking competition previously used in the United States are restrictions on branch banking and legislation preventing nonbanks from engaging in banking businesses. Those restrictions limited competition in the banking industry which improved the financial health of banks and decreased the incentives of banks to engage in risky behavior. Two disadvantages from restrictions on competition in the banking industry include the following 1) financial institutions will likely be less efficient; and 2) consumers will likely pay higher fees.

4. *What are the three entities that regulate banks?*

   The three entities that regulate banks are the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and the Comptroller of the Currency.

5. *How does a financial institution's appetite for risk change as its level of equity falls? How should the FDIC respond to that change?*

   A bank with less equity is more likely to engage in risky behavior. When the bank's equity falls to low levels, the FDIC is required to intervene early and aggressively.

6. *Calculate the leverage ratio for a bank with the following balance sheet? Is this bank considered to be well capitalized?*

Assets		*Liabilities/Equity*	
Required reserves	*35*	*Checkable deposits*	*350*
Excess reserves	*65*	*Nontransaction deposits*	*214*
Business loans	*500*	*Bank equity*	*36*

   The leverage ratio (LR) for the bank is

   $$LR = \text{Bank equity}/\text{Total asset} = 36/600 = 6\%$$

   Since the leverage ratio is above 5%, the bank is considered to be a well-capitalized bank.

7. *What are disclosure requirements in the financial industry? What entity imposes the disclosure requirements and on what type of companies are they imposed on? How do those disclosure requirements improve the health of the financial system?*

   Disclosure requirements compel financial firms to adhere to standard accounting principles and disclose a wide range of information about the firm's portfolio. The Securities and Exchange Commission (SEC) imposes disclosure requirements on any publicly-traded company. Increased disclosure requirements reduce the incentive for financial firms to engage in risky activities and allow investors to make informed decisions.