Banking Industry: Structure and Competition
ECON 4673
Dr. Keen

Answers

1. *Why does the United States operate under a dual banking system?*

   Throughout the history of banking in the United States, a fear of centralized banking power has existed. All banks prior to 1863 were chartered on the state level. Lax regulation by some states led to regular bank failures due to a lack of sufficient bank capital or fraud. To stabilize the banking system, the federal government passed the National Banking Act of 1863, which created a system of federally chartered banks that were subject to greater regulation and scrutiny. Since federally chartered banks were less prone to failure, they increased in number over the years. Skepticism of centralized power in the banking industry and state bank's willingness to accept deposits allowed state banks to continue to operate profitably despite the emergence of federally-chartered banks.

2. *How does the emergence of interest-rate risk help explain financial innovation? Name two financial innovations that enabled financial institutions to reduce their interest-rate risk.*

   Large fluctuations in interest rates during the 1970s and 1980s led to a need for financial products that could help reduce the risk related to unexpected interest rate changes. Two examples of financial innovations that reduced interest-rate risk for financial institutions were adjustable-rate mortgages and financial derivatives.

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. *How do sweep accounts and money market mutual funds allow banks to avoid reserve requirements?*

   Sweep accounts enable banks at the end of the business day to technically transfer funds from checking accounts, which have reserve requirements, to another account, such as overnight securities, which do not have reserve requirements. Money market mutual funds invest deposits in short-term money market securities. Money market mutual funds, like checking accounts, have check writing functions, but unlike checking accounts, are not subject to reserve requirements.

5. *Identify the legislation that effectively prohibited banks from branching out across state lines? Name and briefly describe two financial innovations banks used to circumvent those restrictions on branch banking. What are two reasons why banks wanted to spread out across state lines? What was the name of the act that effectively removed the restrictions on interstate banking?*

   McFadden Act of 1927 effectively prohibited banks from branching out across state lines. Bank holding companies and ATMs are two financial innovations that enable banks to circumvent restrictions on interstate banking. Bank holding companies allowed a single company could own multiple banks in more than one state. ATMs, which are not considered bank branches, enabled banks to provide customers with more services over a wider geographic area. Banks wanted to spread out across state line because 1) It enabled banks to diversify their loan portfolio, which reduced their risk; and 2) Banks could take advantage of the economies of scale associated with computer and web technologies to reduce their per-unit costs. The Riegle-Neal Act of 1994 eliminated the restrictions on interstate banking.