

Written Exam at the Department of Economics summer 2021

## **Economics of Banking**

Final Exam

24. August 2021

(3-hour closed book exam)

**This exam question consists of 2 pages in total**

### **Falling ill during the exam**

If you fall ill during an examination at Peter Bangsvej, you must:

- submit a blank exam paper.
- leave the examination.
- contact your GP and submit a medical report to the Faculty of Social Sciences no later than five (5) days from the date of the exam.

### **Be careful not to cheat at exams!**

You cheat at an exam, if during the exam, you:

- Make use of exam aids that are not allowed
- Communicate with or otherwise receive help from other people
- Copy other people's texts without making use of quotation marks and source referencing, so that it may appear to be your own text
- Use the ideas or thoughts of others without making use of source referencing, so it may appear to be your own idea or your thoughts
- Or if you otherwise violate the rules that apply to the exam

**1.** In a small region the main sources of income are tourism and fishery. Most of the firms are served by two local banks, funded mainly by deposits of the citizens of the region.

It is expected that the general business climate will be more unstable in the future than it has been previously. This may result in needs for quick restructuring of the enterprises in the form of new entertainment facilities for tourists and new equipment types in the fishery, and failure to catch up with these new demands may lead to widespread defaults. For the banks to be able to meet these challenges, the financial authorities contemplate an increase in the capital ratio for the banks in the region. The overall attitude in the country is that the financial sector should not expect to be helped out in the case of distress but should rather sort out their problems internally.

Give a brief description of the use of capital ratios in the regulation of banks, and give an assessment of the extent to which the contemplated increase will serve its purpose.

Are there other types of regulation which could be put in place by the financial authorities to improve the robustness of the regional banks?

**2.** An industry complains that its access to credit is too limited, pointing to many unfortunate cases of competent entrepreneurs having to abandon plans of setting up a firm due to the high interest rates on loans to this type of industry. On the other hand, the banks have had to accept many losses on credits to firms in the industry and argues that interest rates must be high in order to cover these losses.

Give a brief sketch of a theoretical framework which can encompass both of the above observations. What can be done to improve the situation?

It is known that entrepreneurs with a long experience are able to reduce the risk of large losses, but the competition rules does not allow banks to charge lower rates to established firms than to new ones. A closer analysis shows that what matters is a fundamental knowledge of the production process which is obtained by experience but which could also be acquired by theoretical studies. How can this be used to improve the availability of cheap credits?

**3.** After some time with growing dissatisfaction of depositors over negative interest rates, it is decided that banks should be allowed to set up separate departments, where deposits are guaranteed a nonnegative interest rate but are not covered by deposit insurance. The assets funded by these deposits are to be kept separate from the other assets of the bank, and there will be no capital regulation for these assets.

Explain briefly the workings of a deposit insurance. What will be the disadvantages of not having a deposit insurance for the new type of deposits?

It is proposed that the bank should change the deposit contracts to marketable deposit certificates based on the payoffs of the asset. Would this increase the earnings of the banks?