

Written Exam for the M.Sc. in Economics 2010-I-R

**Economics of Banking**

Final Exam/ Elective Course/ Master's Course

February 18, 2010

(4-hour closed book exam)

Please note that the language used in your exam paper must correspond to the language of the title for which you registered during exam registration. I.e. if you registered for the English title of the course, you must write your exam paper in English. Likewise, if you registered for the Danish title of the course or if you registered for the English title which was followed by “eksamen på dansk” in brackets, you must write your exam paper in Danish.

If you are in doubt about which title you registered for, please see the print of your exam registration from the students' self-service system.

**1.** In a country, which has experienced several bank runs, it is decided to reconsider the problem of deciding whether to assist a troubled bank with a loan or whether to liquidate the bank. The information available is the size of the loan asked for by the bank and the information about the bank's assets which can be obtained from a 2-days audit of the bank. The decision may be taken either by the central bank as lender of last resort or by the deposit insurance organization.

Give a theory-based suggestion for the solution of this problem: Who should take the decision?

It is argued from several sides, including the banks themselves, that banks experiencing runs should be assisted in the first place by the other banks by a reconstruction and possibly take-over, and that central bank or the deposit insurer should only act in the case that the banking sector cannot solve the problem itself. How does this argument fit into the theoretical model used above?

**2.** In a situation with many defaults and rumors about banks in trouble, each bank experiences a growing frequency of customers wanting to transfer their deposits to other banks or alternative placements. It is argued that the trouble is caused by problems for the borrowers to service their debt, thus causing unexpected losses to the banks.

In order to restore confidence, government tries to convince the banks to keep the amount of credits at the previous level. Give an assessment, with suitable theoretical background of whether the banks can or shall follow this advice.

**3.** A bank contemplates a new line of business, which it wants to propose customers having large amounts in their deposit account with the bank. The bank offers a credit which is earmarked for investment in security portfolios. The portfolios are registered and followed currently on the internet, so that the bank can see their composition at any time.

How should the loan contract be set up for this particular segment of customers?

After some time, it is decided to restructure this particular service, allowing the customers the use a percentage of the loan for investment in other activities such as trading in antique furniture, paintings etc. How should the contract be adapted to be useful in this new situation?