

Written Exam for the M.Sc. in Economics summer 2016

Economics of Banking

Master's Course

12. August 2016

(3-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.

This exam question consists of 2 pages in total

1. A bank has had unsatisfactory results from credits offered for production of musical performances. Even though the shows tend to have a good attendance, the producers point to the need for giving away free tickets, for offering rebates to selected groups and for arranging special events for the media, all this reducing the revenue to an extent that the bank in many cases must accept a renegotiation of the credit. Taken as a whole, the bank loses money on these loans.

It is suggested that the reason for this unsatisfactory situation is that the bank does not monitor the sale of tickets or the number of seats occupied. Give an explanation of why information of this type might improve the situation for the bank.

The bank wants to consider alternative ways of administering the credits, since the access to information about revenues did not result in a substantial improvement. Give a suggestion for an alternative way of regulating the relationship between the bank and this type of borrowers.

2. In a country with a highly concentrated bank sector the banks typically hold rather small liquid reserves and meet the ordinary daily withdrawals of their depositors by short term credits with other banks or the central bank.

To make banks hold a larger cash reserve the government introduces a tax on the short term loans. It is argued that this tax will be paid only by banks which fail to hold reasonable reserves, and therefore it will not result in changed loan rates.

Give an assessment of this argument by sketching a model for loan and deposit interest rate determination in the market described above.

3. After a period of financial distress with several bank failures, there is increased public concern about the earnings of the banks, which are consistently obtaining large profits. It is suggested that a specific tax on bank profits should be introduced which limits the profits to a fixed small percentage of the total assets. However, to allow for a consolidation of the banks after a recent crisis, the new rules should be applied only after one year.

The banks argue that this new rule will lead to more rather than fewer bank failures, at least in the short run, since the restrictions on the profits from bank activity makes it less desirable to be in the banking business. Give a theoretical argument, which supports this viewpoint.

In the course of this discussion, it is pointed out that it might be bank managers' incomes rather than bank owners' profits that matter for the risks taken by the bank. How does this change the above reasoning?