Written Exam at the Department of Economics summer 2020

Economics of Banking

Final Exam

27. May 2020

(3-hour open book exam)

Answers only in English.

This exam question consists of 2 pages in total

The paper must be uploaded as <u>one PDF document</u>. The PDF document must be named with exam number only (e.g. '127.pdf') and uploaded to Digital Exam.

This exam has been changed from a written Peter Bangsvej exam to a take-home exam with helping aids. Notice that any communication with fellow students or others about the exam questions during the exam is considered to be cheating and will be reported. It is also considering cheating to let other students use your product.

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 country with many banks of different size, the investment policy of the banks has traditionally been conservative, concentrating on engagements with very low or no risk. Due to international agreements, the country must introduce a particular organization which steps in if a bank run is threatening. The choice is between (1) organizing a system of deposit insurance, or (2) creating a government institution which provides credits to banks which become subject to a run. Give an assessment, based on theory, of the advantages and disadvantages of the two approaches, as well as a suggestion for the choice of institution to be set up in this particular country.

The country chooses to introduce a deposit insurance. It is decided that banks should pay a premium for insuring their deposits, and a debate arises around the principles for determining this premium. Here it is argued by representatives of the larger banks that small banks should pay a higher premium relative to the size of their deposits than large banks, since they are exposed to a larger risk. Give a theory-based assessment of this argument (are small banks riskier, and should the premium depend on size of bank?)

2. A bank has decided to expand its credit activities in a market where the borrowers are small firms building family houses. The firms are typically operating only for a short time, being dissolved or reconstructed after finishing a few building projects. The bank has observed this particular area of business for some time, and the observations suggest that the builders have markedly different success rates, presumably depending on manager quality which is not easily detected when the credit is negotiated. How should the proposals for loan contracts be designed if the bank wants to avoid losses on the average? What will happen if other banks enter this market as well?

After a while, the results are considered unsatisfactory, and the records show that the projects tend to be more successful when the manager either had practical experience in building or consulted people with such experience during the construction phase. How should the contracts be revised in view of this new knowledge?

3. As a result of restrictions on the activity of restaurants, there has been a considerable increase in the sale of take-away and ready-made meals, and many small transportation firms have specialized in home delivery, each having only a few vehicles. This field of transportation activity is competitive, profits are small on the average and subject to considerable variation over time. The firms complain that they have problems in obtaining credits and that loan rates are set too high. Faced with such complaints, the banks point to a large number of cases where the borrowers defaulted on their credits, and they suggest that there are too many firms engaged in meal delivery. Give a discussion based on theory of whether they could be right.

Since the rules for road transportation security and income taxation are very strict, there is a system of registration installed which keeps full records of the activity of each vehicle in the industry. The banks argue that if they were allowed access to these data, it would improve the credit situation of the firms. Can these arguments be sustained by theory, and could there be other ways of improving the situation?