ECONOMICS OF BANKING

Ordinary Exam 26.05.2026

Outline of answers:

1. The description of the interbank market should contain at least the following:

– An explanation of the way in which borrowing from and lending to other banks can simplify the decisions about liquidity reserves given that the bank has less than perfect knowledge of depositors' future decisions about withdrawals of funds. Banks with momentary need of liquidity may borrow from other banks, and banks with surplus liquidity may obtain an interest payment by lending to the others.

– A brief treatment of the problems caused by asymmetric information: a bank wanting to cover a liquidity shortage with a loan from another bank may have assets the quality of which is not observable by the other banks. This gives rise to adverse selection since banks with high quality assets but needing liquidity may prefer to liquidate assets rather than paying high rates in the interbank market.

If the decision about reconstructing a bank is to be taken by the other banks, it cannot be excluded that the decisions about loans to banks needing short-time liquidity will be influenced by possible games from a subsequent takeover and elimination of a competitor. This means that the conditions for offering loans become more restrictive, and asking for a loan in the interbank market may be seen as having unpleasant consequences, all pointing towards a less active use of the interbank market.

2. The initial part deals with the background for having a mandatory deposit insurance: The need arises due to the possibility of bank runs, where depositors in doubt about the ability of the bank to pay back their deposits according to their contracts decide to get as much as possible back immediately, thereby causing the bank to default. If the deposits are fully insured, then the depositors will know that their deposits are paid back in any case, and the need for running the bank disappears.

Deposit insurance has however side effects, the most important one being moral hazard in the form of excessive risk-taking, as the bank management will not be restricted in the composition of the loan portfolio by the fear than depositors will choose other banks. To reduce the size effects deposit insurance will cover only deposits of a certain size.

In the present case, the part of the deposits not covered by will not be reimbursed by the deposit insurance, something which seemingly did not prevent the deposits from keeping their funds in the bank. But it must be presumed that the sums can be withdrawn with very short notice, and if there are many such funds, the withdrawal may give rise to a servere liquidity crisis for the bank. Consequently, the bank would be expected to propose some other solutions to the depositors, either as in investment pool or possibly in the form of repo trades in securities.

The proposal that the bank should post a collateral of securities with the central bank for the amount of the deposits not covered by deposit insurance is a next-best solution compared to giving the depositors full the ownership in the form of repo trades. The collateral will be seized by the central bank in the case of a default, but the depositors will get access only on pair with other creditors and not immediately as in the case of deposit insurance. In addition, the need for posting collateral limits the possibilities of the bank to employ the funds for more profitable investments.

3. The situation outlined, where the payoffs in of the firms may vary considerably, may be approximately described by a Stiglitz-Weiss model where firms have more or less identical average payoff but differ in their deviations from this average. Here the phenomenon of adverse selection may be observed, since firms with small variation and low risk of default may choose not to apply for credit due to the high interest rates, whereas the firms with large variability of payoff may accept the high rates. This means that the complaints are largely well-founded, since otherwise well-functioning firms are offered credits only on terms which makes it unprofitable to engage in production.

To regulate the market, subsidizing the payment of interest may be used. Alternatively the loan contract could be modified to one where the repayment rate is reduced but the bank gets an upside in the form of a percentage of the payoff.

With the changed political setup, the payoff structure of the firms change, since the payoff is fixed but the probability of getting it differs among firms. This means that situation now is best described by a deMeza-Webb model, where banks due to their mutual competition tend to offer credits also to firms which are socially ineffective, so that there is an oversupply of credits. This is the opposite of what was found above, and regulation should change accordingly, using taxes rather than subsidies.