Written Exam at the Department of Economics summer 2023

Economics of Banking

Final Exam

30.5.2023

(3-hour closed book exam)

Answers only in English.

This exam question consists of 2 pages in total

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1. A number of banks have had unexpected withdrawals, typically by depositors with large sums of money on their current accounts. It is argued that these withdrawals would not have happened if the deposit insurance had covered all deposits independent of their size, and that the restricted coverage of deposit insurance prevents its proper functioning as a means of reducing risks in the financial sector. Give an assessment of this argument.

It is observed that the large depositors increasingly turn to shadow banking, and there is widespread concern about the stability of the financial system. Discuss whether this concern may be justified.

2. A country has some medium-sized banks and several smaller ones. All the banks have been active in financing new businesses, but many of these failed, and it is suggested that the attempts of the banks to obtain a reasonable market share have contributed to the problems. The banks compete with each other both for depositors and for borrowers using credits for investment in production.

Give a theoretical explanation of why a large number of banks may induce more risk-taking in the banks, and discuss whether or not this explanation applies to the case considered.

It is argued that instead of restricting competition one might increase the capital ratio for the banks, thereby forcing them to choose less risky assets. Discuss whether this argument holds, both generally and in the present case.

3. A bank has developed a particular line of business, offering credits to be used for purchase of mortgage deeds and real estate bonds to be deposited with the bank. Traditionally the interest rate on such credits has been set to the current interbank rate plus a small markup. It is known to the bank that customers in this business line are mainly small-scale investors who strive to avoid risk as far as possible.

The bank management considers the contracts as old-fashioned and wants to investigate improvements for either the bank or the borrowers. Give an assessment based on relevant theory.

The bank now decides to extend its loan offers to include credits for security portfolios to be managed by the borrowers themselves, given that portfolio managers often obtain larger gains when they work on their own. How should the contracts be formulated for this type of loans?