ECONOMICS OF BANKING

Re-Exam 2024

Outline of solution

1. The theoretical problem background is reorganization or closing of banks, Chapter 17. The situation described is dealt with in the model of Repullo, where either the lender of last resort or the deposit insurance must decide whether or not to close down a bank in trouble. Depending on the which institution is given the the competence to close a troubled bank, one may indeed expect that in some cases where banks have only moderate liquidity problems, they will be allowed to continue their activity even if there assets are dubious. In addition, the cost structure of the institutions may lead to postponement of their action (the Mailath-Mester model).

To prevent unwanted short-term consequences of the closing down of a bank, something happening when its losses exceed the equity, it is desirable that some of its debtors will have accepted losing their debts in case of insolvency, so that the remaining debt becomes small enough to make it possible to reconstruct the bank with new owners. Rules obliging the banks to maintain a certain percentage of its debts in this form would therefore fulfil this purpose.

2. The theoretical background is Chapter 5 on the loan contract, possibly also Chapter 6 on credit rationing. The case is one of asymmetric information, and the asymmetry pertains not so much to the final results of the investment as to the activity or effort of the borrower. A loan contract with incentives for the entrepreneur to put up as much effort as possible is considered in the model of Innes, where an efficient contract stipulates the repayment as the full outcome of investment when the latter is below a given threshold, and no repayment at all if it is above.

In the second part of the problem, the action of the borrower has lost its importance, and if any asymmetry remains, it must be related to the reporting of outcome, and the loan contract should be restructured correspondingly, typically to the standard contract. If no asymmetry remains, the contract should reflect only the attitude towards risk of lender and borrower.

3. The theoretical background is access to credits, dealt with in Chapter 6 and for the second part also in Chapter 1. The situation described fits well with that of the Stiglitz-Weiss model, as does the conclusions that many potential borrowers consider the credit as too expensive, combined with the widespread occurrence of defaults among actual borrowers, so that average repayment rates to banks is small even when nominal repayment rates are high. This means that both sides of the debate are right, and the basic problem of credit rationing should be solved by other means in addition to the repayment rate, possibly separating high and low risk borrowers using combinations of repayment rate and collateral.

The association of banks will be succesful in reducing rates and improving access to credits if its members accept some degree of joint reliability for the loan repayments. This will reduce the riskiness for the bank at it will be willing to extend credits to the members and a lower rate. The reliability for other members' debts will be a cost to the individual borrower in a addition to the repayment of own debts, but even so the situation is improved due to the increased access.