Economics of Banking

Exam 18. February 2010

1. The basic model for the situation described is Repullo's discussion of the choice of decision maker for closing a bank, where the information about the liquidity probem is verifiable whereas the information about the quality of the banks' assets does not have this character. The model is described in the lecture notes Chapter 20, and it prescribes that for small liquidity crises the central bank should take charge, while for larger crises the decision about closure should be taken by the deposit insurance organization.

It follows from the model that the access to information is important, even if this information has subjective, non-verifiable character, and that difference in access to information can give rise to moral hazard problems. The assessment of a takeover of a troubled bank by another bank is not treated explicitly in the notes, but we expect a short discussion of whether other private banks can exploit an informational advantage, even if the solution is not the optimal one from society's point of view.

2. The theoretical basis can be taken from several different parts of the curriculum. If the liquidity crisis described has purely subjective causes, the approach descrbed can be used, at least if the interbank market is sufficiently well-functioning (Ch.15). But since the problem can be traced to the asset side of the balance, it can probably not be solved only be short-term credits to the banks involved. Therefore it should also be considered whether these banks should go through a reconstruction or liquidation. In connection with this the will be a cost connected with liquidation, which in the end may have the consequence that banks with non-performing assets can be kept floating even when it would be better to close them from society's point of view (Ch. 20).

3. This problem is about the design of the loan contract as described in the lecture notes Chapter 7. In the initial situation we have an investment, the payoff of which can be observed by the lender, so that there is no asymmetric information. In this case the optimal contract will deal only with risk sharing, so that it reflects the degree of risk aversion of the lender and the borrower (and typically, it will *not* be the standard contract).

In the subsequent situatution there is more informational uncertainty about the payoff to the borrower of the investment, so that other aspects have to be taken into consideration when the loan contract is set up, in particular with regard to the part of the investment which does not go into securities. The precise form of the contract will depend on lenders possibilities for collecting information about the payoff of the investment. If such information can be obtained, even if at a cost, one can use the standard contract, and if it cannot be obtained, the contractual relationship will have to be short term, with possibility of renewal depending on satisfactory past performance.