Written Exam for the M.Sc. in Economics summer 2015

Economics of Banking

Master's Course

7. August 2015

(3-hour closed book exam)

Please note that the language used in your exam paper must correspond to the language of the title for which you registered during exam registration. I.e. if you registered for the English title of the course, you must write your exam paper in English. Likewise, if you registered for the Danish title of the course or if you registered for the English title, which was followed by "eksamen på dansk" in brackets, you must write your exam paper in Danish.

This exam question consists of 2 pages in total

1. After a number of cases where banks have experienced unexpectedly large withdrawals from depositors, it is contemplated to introduce a regulation which will reduce or eliminate the possibility of bank runs.

Give a survey of methods for preventing bank runs and explain their weaknesses.

It is decided that the method selected for preventing bank runs should has not induce the bank to engage in risky credit arrangements. Give a suggestion for the way in which to deal with bank runs under these conditions.

2. A bank has decided to expand its credit activities in a market where the borrowers are small firms engaged in building family houses. The bank has performed a market analysis and knows that the firms have markedly different success rates, but the future performance of a firm depends on the quality of the manager and is not observable 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 also enter this market?

3. After a period of financial instability, during which several banks have been in difficulties and some have failed, it is argued that the authorities in charge of financial supervision have been to lenient, not interfering with the way, in which banks carried out their business, even when their risks were higher than what could be considered as prudent from society's point of view.

Give an explanation of why this behavior by supervisors may be justified given the conditions under which they work. Is it possible to improve the regulation without directly interfering with the investment decisions of the bank?