Voluntary assignment 2

This is the second of the two voluntary assignments. The answer (2-3 pages) should be sent as pdf by email to me before Tuesday, April 30, at 12.00.

Problem 1

A company has over the years undertaken an obligation of retirement payments to its employees, and these payments are expected to be due over the next 10 years. A bank is contemplating to take over these payment if in exchange it gets full disposition over a portfolio of real estate bonds belonging to the company which have 5 years left to maturity. The bank is allowed to change the composition of the portfolio but it is crucial for the agreement that the obligations to employees are always matched by the assets represented by the portfolio.

The interest rate is expected to unstable in the future with deviations that are frequent but small. Explain what the bank must do to satisfy the obligations of the company.

Due to a shift in global business conditions it is now expected that future deviations of the interest rate from its present level will be much greater. How does this influence the above considerations?

Problem 2

In a country with several banks there has been widespread discontent with low or even negative deposit rates, while loan rates have been high throughout the recent period. It has been argued that this phenomenon is due to a lack of competition in the financial sector. The banks point to the a general low level of the riskfree rate of interest in the market, combined with the risks of the loans which must be counteracted by high interest rates.

The government now intervenes setting a minimal interest rate on deposits. Give a discussion based on the theory of banking of what will be the result of this policy on loan and deposit interest rates and on the risk profile of the financial sector.

The deposit rate floor is criticized as an unnecessary interference in the market, and it is proposed that the problem with negative rates should be solved through increased competition by a policy of supporting the establishment of new banks. Compare the two policies and give a suggestion as to which one is best for society.

Problem 3

In a small country with an economy based mainly on agriculture but with some industrial production as well, there are two banks serving the community. In order to have as much competition in the banking sector as possible, both banks have been urged to offer credits to both agriculture and industry.

Since a general economic downturn is expected in a few years, the government is concerned about the stability of its financial system, and it has therefore recommended to the central bank, which is an independent organization, that a bank with liquidity problems should have access to short-term loans as long as this is in accordance with responsible central bank policy. Give a theory-based discussion of whether this can secure financial stability and what could go wrong.

It is argued that it might be a better idea to introduce a system of deposit insurance with a suitable policy for collecting the insurance premium. Compare the two approaches with a view to the specific business structure in the country.