

Written Exam at the Department of Economics summer 2018

Economics of Banking

Final Exam

28 May 2018

(3-hour closed book exam)

Answers only in English.

This exam question consists of 2 pages in total

NB: If you fall ill during an examination at Peter Bangsvej, you must contact an invigilator in order to be registered as having fallen ill. In this connection, you must complete a form. Then you submit a blank exam paper and leave the examination. When you arrive home, you must contact your GP and submit a medical report to the Faculty of Social Sciences no later than seven (7) days from the date of the exam.

Be careful not to cheat at exams!

- You cheat at an exam, if during the exam, you:
- Make use of exam aids that are not allowed
- Communicate with or otherwise receive help from other people
- Copy other people's texts without making use of quotation marks and source referencing, so that it may appear to be your own text
- Use the ideas or thoughts of others without making use of source referencing, so it may appear to be your own idea or your thoughts
- Or if you otherwise violate the rules that apply to the exam

1. A small bank has traditionally offered credits to the local business community. Interest rates have been moderate, and there have been only occasional losses on the credit arrangements. On the other hand, the earnings of the bank have for some time been considered as unsatisfactory. A new direction proposes to extend the activities to the business communities of neighboring regions. Here the interest rates can be set at a higher level, however the losses may be higher. Also, the bank has decided that it cannot distinguish in its credit policy between local and non-local borrowers. Give a suggestion for a suitable credit policy.

It turns out that other banks have experienced similar problems and also want to extend their activity to the same potential costumers. What will happen?

2. After a major financial crisis, it has been decided to reorganize the system of deposit insurance. In particular, it has been observed that many small banks defaulted during the crisis as a result of their involvement in the housing construction market which suffered much during the crisis. As a consequence it has been proposed that the insurance premium should depend on the deposits of the banks in a degressive way, constituting a larger fraction for small than for large banks.

Comment on this arrangement from a theoretical point of view. Does it address the problem which was evidenced by the recent defaults?

It turns out that after the defaults and some mergers and acquisitions in the banking sector, there are only a few banks left, each of them very large. What are the implications for the new system of payment for deposit insurance?

3. As a new line of business, a bank is offering credits for local producers of sparkling wine. The credits are used to finance growing of grapes and the production of the sparkling wine. Experience shows that the grape harvest displays large variations in size and quality between years and localities, and the bank expects that some of the small producers may default if the harvest is unsatisfactory. The latter situation can however only be verified by the bank if it employs an expensive consulting service.

How should the relationship between bank and borrower be formulated under these circumstances?

Due to new technical advances in satellite monitoring, the harvest conditions in each locality can be followed using a freely downloadable app. Will this give rise to changes in the loan contracts, and if so, which changes?