Written Exam for the M.Sc. in Economics, Winter 2010/2011 (16.12.2010)

Economics of Banking, Hints for solution

1. The relevant part of the curriculum is (mainly) Chapter 7 on the borrower-lender relationship. The basic problem with the contracts described is the risk of insufficient repayment explained by unsatisfactory price movements in the stock market. Since the bank has no possibilities of controlling the borrower, the incentives for correct reports on the ability to pay must such that no physical control is involved. The most immediate possibility is to let the renewal of the borrower-lender relationship depend on the borrowers previous record of repayment, so the failure to repay will lead to termination of the relationship.

Under the new and changed circumstances the bank will be able to control the reports of the borrower, even if this may be costly. This points to the use of the standard contract for regulating the borrower-lender relationship.

There may be several explanations of the renewal of loans even when non-performing, one possibility is that the bank uses “evergreening” which means that it temporarily disguises the nonperforming loans as long-term investments (Chapter 16).

2. The relevant part of the curriculum is Chapter 15. It is seen from the description of the problem, that the troubles of the bank are connected with the depositors' worrying about the possibility of getting their deposit back in due course. One method which is known to make the bank immune against runs is to change the form of the deposits, so that depositors get marketable shares which yield a dividend which is scaled so as to cover the usual demands for deposits at the early stage. However, since this arrangement solves the bank run problem by doing away with the classical bank taking deposits from the general public, it should be supplemented by such a classical bank satisfying the demands of "narrow banking" in the sense that the claims against the bank can be satisfied at any moment, since the bank invests only in absolutely liquid securities. Actually, also the other bank satisfies the narrow banking rules, at least in principle.

3. There are several possible explanations, one of these tmay be based on the model of riskiness and competition (by Matutes and Vives, note to Chapter 13), where the banks weigh the risk taking, which may ultimately lead to bankruptcy, against the loss of future incomes from running the bank. In can be argued, that the planned policy will reduce future incomes from banking and thereby increase incentives for taking risks in the attempt to obtain extraordinary profits in the current period, before the new policy is implemented.