

Homework Assignment 9 solution.

1. Banks typically hold more liquid assets than most other types of businesses. Explain why?

Banks face liquidity risk – risk of not being able to meet withdrawals from demand deposit accounts because of lack of cash (the most liquid asset). Most of the liabilities of a typical commercial bank are short-term (very liquid). Bank has to have some significant liquidity on the asset side to insure against liquidity risk.

2. Small banks in rural areas tend to lend to businesses and individuals in the same area. Explain the benefits and costs of this practice.

The benefit of this practice is that bank possesses significant local knowledge and can manage credit risk more successfully because of that (idiosyncratic risk associated with individual borrowers). The downside is excessive exposure to the similar borrowers – bank is too exposed to area-wide risks because of insufficient diversification.

3. Why is it important for banks to carefully monitor the maturity structure of its assets and liabilities?

Banks face interest rate risk. If interest rate changes bank's profits will change if the maturity structures of assets and liabilities are mismatched (which they typically are). The rate-sensitive assets and liabilities are typically those with short maturities. If the interest rate goes up, the interest-rate-sensitive assets will be earning more income and rate-sensitive liabilities will cost more at the same time. If there is more rate sensitive liabilities than assets, the income rise will be smaller than cost rise.