The divergence of bank lending rates from policy rates after the financial crisis: the role of bank funding costs

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28/11/2018

EBA Research Workshop

Outline of discussion

1. Motivation of the paper
2. A quick recap of the paper
3. Some thoughts

Motivation of the paper

- During the crisis, policy rates brought down to zero…
- …but lending rates did not follow as would have been expected.
- Why?
- The paper discusses the issues raised by and related to this puzzle:
  - Opportunistic behaviour on behalf of banks?
  - Need to repair impaired monetary policy transmission mechanism?
  - Structural break in the relationship between monetary policy and lending rates?

Quick recap of the paper (1/3)

- The authors construct and test a new *Weighted Average Cost of Liabilities (WACL)* to measure banks' effective funding costs.
- Propose *an alternative benchmark* for bank funding costs
- 11 European countries (2003-2017)
- Innovation: they take into account the whole range of liabilities used by banks to acquire funds (deposits, debt securities, covered bonds, funding from central bank operations) and their associated costs.
- They multiply the costs by the share of the corresponding liabilities on banks' balance sheets in every period
- The weights average across liability types, not over time, i.e. they are time-varying

Quick recap of the paper (2/3)

- Short-term and long-term WACL
- WACL (stock) and WACL (flow)
- WACL against policy rate
- WACL against lending rates (NCF & residential)
- Short and long-run relationships (cointegration analysis)
- Structural breaks
- Dynamic heterogeneous panel using WACL, using its components, on full sample, on 3 subsamples
- Panel VAR to explore link between WACL and monetary policy

Quick recap of the paper (3/3)

- The authors find that:
  - Lending rates, policy rates and funding costs (WACL) co-moved prior to the crisis
  - Post crisis the relationship breaks down
  - Not simply a case of allowing for a structural break
- However, the relationship between funding costs (WACL) and lending rate ***is*** stable throughout the sample period
- Can infer that, while the policy rate was a good proxy for funding costs pre-crisis, it is not post-crisis.
- WACL is a better measure of bank funding costs.
- Key conclusion: should focus on the cost composition of bank liabilities to steer the dynamics of lending rates.

Some thoughts (1/4)

- A very polished paper
- A lot of work
  - Constructing the weights
  - Rich panel aspect
- Excellent motivation and literature review
- A very clear presentation of rigorous econometric exercises
- Strongly recommend that you read it

Some thoughts (2/4)

- Paper very rich in content – enough for two papers!

  Lots of findings and policy implications

  Could further highlight them in the last section

- A number of theories disproved: opportunistic bank behaviour, market power, inability/laziness in screening potential borrowers.

- Regarding the WACL:
  - Collateral availability
  - ELA
  - changes in composition vs changes in cost
  - declining speed of adjustment reflecting deleveraging?

Some thoughts (3/4)

In future research, may consider the *spread* between WACL and the policy rate (traditional measure of banking costs)

- **What does it reflect?**
  - **An indication of shift from normal to stressed regime?**
  - **A measure of the degree of impairment of the monetary policy transmission mechanism?**
    - **useful for tailoring unconventional measures**
    - **to the extent that monetary policy and macroprudential policy may be complementary, could be an indication that macroprudential policy should step in, to complement monetary policy**
    - **cross-country dimension?**

Some thoughts (4/4)

- **How does the spread between the WACL and the policy rate relate to lending volumes? Much of the adjustment was through volumes rather than prices.**
- **Does it *lead* changes in lending volumes? (branch-based lending a slow process) If so would be valuable for monetary policy.**
- **How does it correlate with the financial cycle - which often leads the real cycle?**
- **Depending on its lead/lag properties, could it be useful for setting countercyclical macroprudential policy, e.g. for deciding on the optimal timing of releasing the countercyclical capital buffer?**

Thank you for your attention