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

by A. Illes, M. Lombardi and P. Mizen

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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)

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- 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

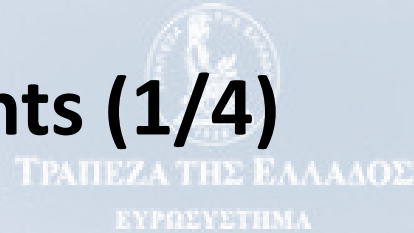
Quick recap of the paper (2/3)

- **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)

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- **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)

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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?



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Thank you for your attention