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

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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?
The authors construct and test a new Weighted Average Cost of Liabilities (WACL) to measure banks’ effective funding costs. They propose an alternative benchmark for bank funding costs. The innovation lies in considering 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:
  o Collateral availability
  o ELA
  o changes in composition vs changes in cost
  o declining speed of adjustment reflecting deleveraging?
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