Monetary Policy and Bank Lending Terms: Evidence from a Survey of US Loans

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Monetary Policy and Bank Lending Terms

This paper

What is the consequence of expansionary monetary policy (conservative as well as unconservative) on banks’ risk taking?

Idea:
• Credit channel of monetary policy
• Banks that are more interest rate sensitive or worse capitalized should react stronger

Main Finding:
• Lending terms are eased as a consequence to a interest rate cut
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Main regression

\[ \text{Spread}_{kit} = \alpha_i + \lambda_j + \beta \text{Fed funds rate}_t + \theta X_{kit} + \mu Y_{it} + \rho Z_{jt} + \sigma M_t + \varepsilon_{kit}, \]

- \( \text{Spread}_{kit} \) is the interest spread of loan \( k \) by bank \( i \) during quarter \( t \) (new loans)
- \( \text{Fed funds rate}_t \) is the target federal funds rate
- \( X_{kit} \) is loan size and loan risk rating (bank’s internal ratings)
- \( M_t \) is macroeconomic variables
- \( \alpha_i \) are bank specific FEs
- \( \lambda_j \) are state specific FEs

Identification assumption: no unobservable variables affecting loan demand and monetary policy decisions
A lower Fed fund rate (more FED treasury holdings) results in a lower loan spread (easing of credit conditions) holding for the internal credit risk constant.
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Result II:

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans spread</td>
<td>0.546***</td>
<td>0.040**</td>
</tr>
<tr>
<td></td>
<td>(0.103)</td>
<td>(0.017)</td>
</tr>
<tr>
<td>Dummy for secured</td>
<td></td>
<td></td>
</tr>
<tr>
<td>loan</td>
<td></td>
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</tbody>
</table>

Target federal funds rate x short-term deposits / deposits

Target federal funds rate x Leverage ratio

Federal Reserve treasury holdings x Bank Securities

Effect is more pronounced for banks:

- Which are ex-ante more sensitive to interest rates
- Which have a weaker balance sheet (measured by capital ratio)
- Which are more sensitive to the fluctuations in the price of treasury securities (measured by fraction of Treasury and MBS securities in the trading account to total assets)
Contribution to the literature:

- „This paper is the first to study the impact of both short-term interest rates as well as large-scale asset purchases on bank lending terms to the corporate sector. “
- „Our paper also contributes to the recent literature on the risk-taking of monetary policy (Jimenez et al. 2014; Becker and Ivashina 2015; Di Maggio and Kacperczyk, 2016; Dell’Ariccia et al. 2017). “
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Comment 1: Contribution

- What do we learn from this paper in addition to current literature?
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Comment 2: Interpretation

Result of main specification:
Holding constant for internal credit risk rating (and other controls) banks charge lower spread if interest rates fall

Can we interpret this as „conventional monetary policy being associated with changes in the quality of bank credit (consistent with a risk-taking channel of monetary policy)”?  
• No! Main concern wrt leverage ratio is that banks take the highest risk within a risk category  
• No! Banks may shift to overall lower credit ratings  
• No! If expectations about future macro conditions (unobservable) as well as interest rate cuts coincide
Two main challenges:

• Monetary policy decision might be endogenous wrt loan demand/supply

• Disentangle loan demand and supply
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Comment 3: Identification

Two main challenges:

• Monetary policy decision might be endogenous wrt loan demand/supply
  – Focus on Spain (ECB follows core countries)
  – Event studies: FOMC meetings

• Disentangle loan demand and supply
  – Change in relative lending quantities (Khwaja/Mian)
  – Discontinuities of credit limits for different FICO scores
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Comment 3: Identification

This paper adds macro and loan level control (i.e. banks’ internal loan assessment) to address identification concerns

But

• Interest rates are not changed without a reason!
  – Unobservable (forward looking) assessment affects monetary policy decisions
  – Changes in Fed Fund rate is not an exogenous policy shock

• Loan demand is likely to be low if Fed rate is lowered
  – Difficult to interpret all findings to a bank supply effect

• Credit ratings: through the cycle versus point in time?
Monetary Policy and Bank Lending Terms Suggestions

• Reconcile findings on capital ratio and risk-taking with your other paper
• Evidence on ex-post riskiness (return on loans would be great)
• Focus on deviations of a Taylor rule or a specific event (e.g. Lehman) as a policy experiment
• Are findings driven by „Deposit channel“ (see paper by Itamar Drechsler, Alexi Savov and Philipp Schnabl)?
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Conclusion

• Very topical paper with important policy conclusion

• New evidence on risk-taking channel

• Provide further explanation on interpretation of results