Role of Banks in the Transmission Mechanism of Monetary Policy

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Perspectives on the role of banks in monetary policy

**Academic Perspective**
- Lending channel is not significant part of the transmission mechanism
- Scope for balance sheet channel to play an important role, but need more research needed
- Changes in bank lending can have significant impact on real output (in the context of failures)
- Banks and maturity transformation becoming less important to funding of aggregate credit

**Risk Perspective**
- Bank short-term funding mix unlikely to affect lending decisions
- Short-term changes in interest rates unlikely to affect credit access in presence of good credit underwriting standards
- Recent performance of securitization demonstrates effective screening and monitoring is important
- Needed non-traditional tools to stimulate recovery, but will they become the norm?
Academic perspective: policy affects lending and output

Fig. 2. Response of Commercial Bank Loans and Real GDP to a 1 Percentage Point Increase in the Federal Funds Rate

Source: Ashcraft, Journal of Money Credit, and Banking (2006)
Academic perspective: policy correlated with funding mix

Fig. 1. Bank Short-term Finance Mix versus the Federal Funds Rate

Source: Ashcraft, Journal of Money Credit, and Banking (2006)
Academic perspective: MBHC affiliation affects financial constraints

Source: Ashcraft, Journal of Money Credit, and Banking (2008)
Academic perspective: affiliation does not amplify impact of policy

Conclusion is that the lending channel is not an important part of the transmission mechanism of monetary policy.

Source: Ashcraft, Journal of Money Credit, and Banking (2006)
Risk perspective: FHLB advances relax constraints

Recent FHLB Advances to JPMorgan Chase, Wells Fargo, Citibank, Bank of America ($ Billions)

Source: FHLB

Risk perspective: insured brokered deposits relax constraints

Stock Market CD

The Stock Market CD is a certificate of deposit whose yield is tied to the S&P 500 Index. It gives you the opportunity to participate in the stock market's potential growth, in a limited manner, without putting your deposit at risk.

Benefits:
- Pursues higher performance; the interest generated is based on the Standard and Poor's 500 Index.
- Principal insured by the FDIC.
- 5-year term.
- Minimum opening balance: $1,000.

Additional Information:
- Once the instrument is opened, no additional deposits are allowed.
- Penalties for cancellations before maturity during the first year is 30% of the principal; 25% of the principal during the second year; 20% of the principal during the third year; 15% of the principal during the fourth year; and, 10% of the principal during the fifth year.
- The following method is used to compute interest. First, the Stock Market value of the S&P 500 Index is obtained on the business day immediately prior to the date of the opening of the account (Initial Index Value). From that moment on, the S&P 500 Index is recorded and maintained, from the date of the initial Stock Market business day of each month during the term of the account (End of Month Index Value). At maturity, the averages of the End of Month Index Values during the term are computed by adding the End of Month Values and dividing that sum by 60 to determine the Average Index Value. Then the percentage increase of the S&P 500 Index, if any, is computed by taking the Average Index Value and subtracting the Initial Index Value and dividing the result by the Initial Index Value. If the Average Index Value is equal or less than the Initial Index Value, no interest will be paid.
- If deposits are made or accounts opened using non-cash items (i.e. checks), interest begins to accrue on the business day on which the transaction takes place.
- The interest payable is 1.25 (125%) of the percentage increase in the S&P 500 to a maximum of 40%, with no guarantee of a minimum return at maturity.
- Interest will be computed at a rate based on changes in the Standard & Poor's 500 over the term and will be computed and credited only at maturity.
- Upon maturity, the account does not automatically become another Stock Market CD. At maturity it renews to a 5-year Regular CD account at the interest rate that Banco Popular offers for CD deposits of that term at the time.
Academic perspective: balance sheets amplify lending response

Fig. 1. The response of bank lending to monetary policy across balance sheet strength.

Academic response: balance sheets have large impact on lending

Fig. 2. The aggregate effect of the balance sheet channel.

• CRE loans….fixed-rate balloon loans….DSCR is a factor in evaluating risk of term default…but debt yield (NOI/Debt) is factor in evaluating maturity default.

• Leveraged loans….floating-rate balloon loans….DSCR is a factor in evaluating risk of term default…but leverage (Debt/EBITA) is factor in evaluating maturity default

• Poor underwriting in ARMs and Option ARMs contributed greatly to the housing bubble and bust, but new interagency residential mortgage loan underwriting guidance and the CSFB’s definition of Qualified Mortgage require underwriting to the highest rate

• Temporary changes in short-term interest rates unlikely to have balance sheet effects unless markets not exerting adequate risk management discipline
Academic perspective: healthy bank failures to shift loan supply

Academic perspective: healthy failures are different

Figure 1: Capital Ratios of Failing Banks (1980-2000)

Academic perspective: bank failure have lasting income effects

Risk perspective: screening/monitoring matter

Credit and Maturity Transformation
Total liabilities as percent of nominal GDP

Source: FR Financial Accounts of the US

Risk perspective: need to adjust policy tools for financial structure

- 1990-91 was slowest post-war recovery at the time
- 2001 was slowest post-war recovery at that time
- 2008-2009 now slowest post-war recovery

- Non-traditional tools were needed for policy to have desired impact in 2008-present through non-bank counterparties during the (i) crisis response and (ii) unwinding of balance sheet

- Question: As traditional banks become less important and use less maturity transformation, do the old tools remain effective?