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REMARKS

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"The horses and the carriage"

Fourth Research Workshop of the Task Force on Banking Analysis for Monetary Policy of the MPC

The better understanding of the relationship between monetary policy and banking is not only important from a monetary policy perspective but also from a financial stability perspective. Therefore, I expect that this workshop improves the understanding of these two perspectives.
The agenda names a host of critical issues in this respect:

- The effects of the prolonged period of very low interest rates and unconventional monetary policy including the continued central bank balance-sheet expansion
- on banks' incentives to generate loans,
- profitability and
- their cost of equity.

As a consequence, the workshop also contributes to the international and inter-institutional debate about the interaction between monetary policy and financial stability. Let me start with a question: Are financial stability and monetary policy two horses that try to pull the carriage "economy" in opposite directions?
To answer that question I will critically assess some statements that are often mentioned in public discussions, but some of them do not seem to be well-grounded.

When looking at those two economic and political strands, that are very different in their targets and instruments, the question raises: Is there a conflict of interest between monetary policy and macroprudential policy?

The institutional assessments vary. On the one hand, ECB, Fed and IMF support the „separation principle".
They track different targets: monetary policy aims at price stability, while macroprudential supervision aims at maintaining financial stability. With that, they follow the spirit of the

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Tinbergen rule: different instruments for different objectives. And in that sense, macroprudential policy is a reasonable complement to monetary policy.
The IMF states that "leaning against the wind" is primarily the responsibility of macroprudential supervision and not of monetary policy. Within the economic and monetary union a single monetary policy requires an additional instrument to address the asynchronous credit cycles in the EA Member States. The national macroprudential mandate therefore increases the degrees of freedom of the single monetary policy.

On the other hand, the BIS has a different view on the interaction of monetary policy and macroprudential policy. Let me quote Mr. Caruana, General Manager of BIS:
"It would be rather elegant if some kind of "separation principle" allowed monetary policy to concentrate exclusively on the business cycle, while prudential and macroprudential policies dealt with the financial cycle. Unfortunately, we don't think this describes the real world."[1]
Hence, in the BIS' understanding, macroprudential supervision on its own is insufficient – monetary policy needs to contain the build-up of financial booms. Raising rates too late and/or too slowly can fuel financial booms; which then lead to very costly busts. Hence, monetary policy should pay greater attention to financial booms and busts. In their view monetary easing of advanced economies even has led to imbalances in emerging economies.

I think these two economic and political strands have to be seen complementary, not conflicting. Focusing on financial stability can help to mitigate unintended consequences caused by monetary policy. Unconventional monetary policy incorporates some relevant transmission channels that influence financial stability:

- The risk taking channel: Monetary policy reduces the risk-free interest rate.
- The portfolio effect: Via the portfolio switching channel monetary policy influences prices and yields in other financial segments (like equity markets).
- The duration channel: The rise of bond and equity prices might not be sustainable; with a rising interest level they sharply decline. Prices show a boom and bust evolution.
- Furthermore, inflation expectations increase.

Hence, by complementing monetary policy macroprudential policy can widen the room for maneuver for monetary instruments and reduce the conflicts of interest within the monetary policy. Furthermore, monetary policy and financial stability do not contradict each other as they address different specific targets. Monetary policy addresses the level of the (risk-free) interest rate while the macroprudential policy has an impact on the interest rate of bank intermediated credit via its impact on intermediation costs. Intermediation costs are those costs that banks add on to the risk-free interest rate in the context of internal fund transfer prices. Therefore, macroprudential policy addresses the mispricing of liquidity and capital costs. This means, that overall credit growth at rates that do not cover the refinancing and risk costs are harmful from a macro-economic perspective.

In the context of financial regulation it is often hypothesized that, financial regulations – particularly higher capital requirements – would increase banks' cost of funding.
Let me develop on this. Funding costs are priced in the interaction of profitability, asset quality and capitalization. Colleagues from the OeNB[2] in an IMF paper have shown new evidence on

[1] Monetary policy for financial stability. Keynote speech by Jaime Caruana at the 52nd SEACEN Governors' Conference, Nov 2016 (http://www.bis.org/speeches/sp161130a.pdf)

this empirical relationship by using CDS spreads as a proxy for funding costs and analyzing an unbalanced panel of 54 large banks from six countries that cover the period from 2004Q4 to 2013Q4. The results show that funding costs are statistically and economically significantly associated with bank solvency: A 100 bps increase in effective regulatory capital ratios is associated with a decrease in funding costs of about 110 bps. The study concludes that stronger capitalization reduces funding costs.
A sound capital basis being the foundation for a stable financial system is common sense between all international institutions involved in financial stability matters (like BoE, BIS or IMF and of course SSM, EBA and ECB which states in the current Financial Stability Report: "The global financial crisis underlined the need for greater resilience – including more and higher-quality capital."[3])

So based on this results does financial regulation come without costs? No but, financial regulation makes costs more transparent and first of all changes the distribution of costs across society. To minor extent it might also cause additional costs by "red tape".
But assessing the costs of financial regulation is not trivial. The misallocation of costs across society leads to suboptimal incentive structures which in turn cause substantial social costs. Financial regulation aims to internalize negative externalities: costs that have been socialized by banks – i.e. implicit government guarantees – need to be transferred back into the banks' balance sheets. But this does not constitute additional social costs. Frankly speaking, cleaning-up the mess after a financial crisis is much more costly than avoiding it in the first place. Hence, overall social costs are lowered by financial regulation.

A core question regarding the interaction of the current monetary policy and the banking sector is: How does the low interest environment affect bank profitability?
There are positive and negative effects. Positive effects are triggered by the increase of portfolio values due to the lower interest rates and the partial reduction of funding costs; while the effects on interest margins are negative. With a prolonged low interest environment the negative effect outweighs the positive effect - unless banks accomplish to increase their credit margins. In the first session on bank profitability we will hear the results of a recent OeNB study[4] that shows that Austrian banks' margin decrease with the short term interest rate. A drop of 100 bps in the reference rate is associated with a drop of 16bps in net interest margin.

Coming back to capital: Banking capitalization is not only relevant from a financial stability perspective. But also supports monetary policy measures as empirical analysis show. Here, the results of a topical study of the National Bank of Belgium[5] are very interesting: Monetary policy transmission works better if banks are better capitalized.
First of all, the Belgian colleagues show that European credit support policies have been successful in stimulating credit flow of banks to private sector. And second, better capitalized

[2] Schmitz W.S., Sigmund M., Valderrama L. (2016): Bank Solvency and Funding Cost: New Data and New Results. IMF WP (forthcoming)
[3] ECB (2016): Financial Stability Review. Nov. 2016. https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201611.en.pdf?f0feb4db4cc3aacc6f824b829c4f27d4
[4] Kerbl S., Sigmund M. (2016): From low to negative rates: an asymmetric dilemma. OeNB Financial Stability Report 32. Dec. 2016. https://www.oenb.at/Publikationen/Finanzmarkt/Finanzmarktstabilitaetsbericht.html
[5] National Bank of Belgium (2016): The transmission mechanism of credit support policies in the Euro Area. Working Paper Research No 302. Oct 2016. https://www.nbb.be/doc/ts/publications/wp/wp302en.pdf

banks have on average responded more to the credit support policies of the Eurosystem as a result of more favorable size, retail and liquidity effects.

An Austrian Study[6] supports the finding that poorly capitalized banks are less responsive to monetary policy changes. This topical study is based on a unique data set that matches data of non-financial firms (that answered a questionnaire concerning credit limitations they faced by their banks) with rating information on this firms as well as data on their major bank.

Of course the major question in this context is about the optimal level of capital banks need to hold. So what is a sufficient capital basis for banks in the long run? I would like to see that from a functional perspective: A bank is sufficiently capitalized, when – even after a major external shock has materialized – the bank is still able to refinance itself on the market at reasonable spreads. Banks on their own define what reasonable spreads are from their perspective as spreads differ depending on size, business model and region.
Hence, investors that fund European banks rather than regulators or supervisors define the long-term optimal level of capitalization. This means also that there is an upper limit for bank capitalization. Above a certain level you will not find anybody to invest in bank shares.

Similar and connected to the issue of optimal capital level is the introduction of MREL (the Minimum Requirement for Own Funds and Eligible Liabilities) and therefore the question on how much MREL is needed?
The MREL requirement is designed to ensure a 'bail-in' of shareholders and creditors in the case of a failing bank. It safeguards that a bank has sufficient shares and debt instruments issued to absorb losses or to convert into new shares to recapitalize systemic functions. In particular, it is questionable how capital buffers are linked to the amount of MREL needed.
In my opinion, it strongly depends on the bank's individual resolution strategy. If a bank is not recapitalized in a resolution it does not need to mirror its capital buffers in the MREL amount. Moreover, if a bank in resolution is fully or close to 100% recapitalized it will also not need to include its capital buffers fully in the MREL amount as capital buffers shall absorb losses in times of stressed periods. However, the right balance of MREL has to be found to ensure that the recapitalized institute has sufficient capital to access funding markets.

Let me come to another often quoted assumption in the context of financial regulation: Higher capital requirements restrict bank credit supply.
What do we observe? Higher capital requirements cause deleveraging but without hampering credit to private sector[7]:

- Capital has contributed the lion's share to the leverage reduction in the Euro Area (88%) and Austria (73%) between Oct. 2008 and Feb. 2014.
- Contrary to popular opinion, bank funding for the real economy and for governments has increased even after the crisis, despite substantial deleveraging both in the Euro Area and in Austria.

[6] Hahn, F.R., Hölzl, W., Kwapil, C. (2016): The Credit Channel and the Role of Monetary Policy Before, During and After the Global Financial Crisis – A Micro Data Approach to the Analysis of Bank-firm Relationships. WIFO.
[7] Eidenberger J., Schmitz S.W., Steiner, K. (2014): The Priorities of Deleveraging in the Euro Area and Austria and Its Implications for CESEE. OeNB Financial Stability Report 27. July 2014.
https://www.oenb.at/Publikationen/Finanzmarkt/Finanzmarktstabilitaetsbericht.html

- The decrease in total assets was driven by reductions in interbank assets and external assets, while funding for governments and for the real economy have increased since the outbreak of the crisis.

These results go in line with an important point the OECD always makes: capital levels have increased since the crises without leading to a credit crunch.

Let me comment on this from a financial stability perspective. This deleveraging development is to be welcomed, as reduced leverage decreases both the potential for risks and the degree of financial interconnectedness and thus mitigates systemic risks and strengthens financial stability.

Hence, deleveraging takes place without constraining private sector loans. This empirical evidence is also supported by a topical EBA survey, the EBA Risk Assessment Questionnaire 2016. And I quote: "Results from the Risk Assessment Questionnaire confirm that banks plan to continue moving towards their predominantly traditional lending role in the financial sector."[8]
Further you can take out of this survey that Banks will endeavor to increase lending volumes to the corporate sector, in particular SMEs, and to households, including both residential mortgage and consumer credit loans. The strategic goal of European banks is the further increase of corporate and household loans.

To sum up, Monetary policy and financial stability are complementary.
A better understanding of how banks work and how they are steered (namely via dynamic balance sheet optimization) helps not only to implement effective micro- and macroprudential regulation but also better targeted monetary policy.
Banks and their environment have dramatically changed over the last years. Banks are not the same as before the crisis. Hence, it is essential that models and analytical tools are frequently adapted to fit the current environment.

And the conclusions regarding one of my main concerns from my perspective as a supervisor are the following:

- Higher capital requirements decrease social costs.
- Solid capitalization also improves monetary policy transmission;
- The benefits of higher capital requirements – with an upper limit – outweigh the potential costs.

Coming back to my picture of the horses and the carriage at the beginning; I would like to conclude, monetary policy and financial stability are not two horses pulling the carriage in the opposite direction – but they should coordinate well and make potential conflicts of interest transparent.
Overall the two horses look forward and together make sure that the carriage runs smoothly on a bumpy road.

Thank you for your attention.

[8] EBA (2016): Risk Assessment of the European Banking System. Dec. 2016.
https://www.eba.europa.eu/documents/10180/1315397/EBA+Risk+Assessment+Report_December+2016.pdf