Monetary Policy Transmission, Bank Market Power, and Wholesale Funding Reliance

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January 15, 2021

Latest version

Abstract

This paper studies how market concentration in the banking sector and wholesale funding reliance affect the transmission of monetary policy shocks to mortgage rates. Using US bank- and loan-level data, I find that banks at the 90th percentile of the wholesale funding reliance in concentrated markets transmit 61 basis points to mortgage rates, in response to a monetary policy shock that raises the policy rate by 100 basis points. Banks at the 10th percentile of the wholesale funding reliance in competitive markets transmit 108 basis points to mortgage rates. To explain this disparity between competitive and concentrated markets, I build a quantitative New Keynesian model with a monopolistically competitive banking sector that has a costly access to wholesale funding. My model, relative to a basic New Keynesian model with a perfectly competitive banking sector, dampens the transmission of monetary policy on mortgage rates, consumption and housing prices. The model is qualitatively consistent with the empirical results where banks with greater reliance on wholesale funding transmit monetary policy differently depending on their market concentration. I find that in response to an increase of 100 basis points, mortgage rates rise by 22 basis points and housing prices fall by 0.7%. The partial rise in the mortgage rate dampens the fall in borrowers' consumption by 1.5 percentage points. I then study monetary policy transmission under the Basel III Liquidity Coverage Ratio rule that limits excessive reliance on wholesale funding in the banking sector. I find that high market power banks with greater reliance on wholesale funding respond strongly to a contractionary monetary policy on mortgage rates. My findings provide new insights into how monetary policy affects mortgage rates through the interaction between competing forces in the banking sector and the cost of providing mortgage loans.

JEL Codes: E44, E52, G21

Keywords: Monetary policy transmission, market power, wholesale funding reliance

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I am extremely grateful for Serdar Ozkan, Margarida Duarte and Michelle Alexopoulos for guidance, advice and encouragement. This paper has benefited from discussions with Stephen Ayerst, Murat Celik, Alexandre Corhay, Jim Goldman, Burhan Kuruscu, Cory Langlais, Baxter Robinson, Xu Tian, as well as seminar participants at the University of Toronto Macro Brown Bag Seminar Series and Ryerson University. Any remaining errors are my own.

1 Introduction

Mortgage rates offered by the banking sector are a critical channel through which monetary policy affects economic activity. Mortgages tend to be households' dominant source of credit, as housing is the largest asset on most homeowners' balance sheets. Although monetary policy influences the cost of bank funding, banks set mortgage rates. Thus, the efficacy of monetary policy depends on borrowers' exposure to changes in mortgage rates that have been passed through the banking sector. In particular, market concentration in the banking sector and wholesale funding reliance are important features to understand the effects of policy rate changes on economic activities. The composition of short-term funding varies by market concentration and it is vital to issue new mortgage loans; it is comprised of deposits from households and wholesale funding from institutional investors.

In this paper, I examine how market concentration and wholesale funding reliance affect the transmission of monetary shocks on mortgage rates, housing prices, output, and consumption. I make two main contributions to the literature on the transmission of monetary policy. First, I empirically show how wholesale funding reliance and market concentration in the banking sector affect the transmission of monetary policy to mortgage rates. To do so, I document new panel regression results using bank and loan-level micro data. The interaction between wholesale funding reliance and market concentration has been understudied in monetary policy transmission literature. Second, I develop a model that accounts for the empirical patterns to quantify the imperfect pass-through of monetary policy shocks to mortgage rates on the aggregate economy. In my model, high market power banks with less costly access to wholesale funding partially respond to monetary policy by lowering markups so that pass-through is lower.

I estimate how monetary policy transmission to mortgage rates depends on the combination of a bank's market concentration (measured by the Herfindahl-Hirschman index (HHI) in a local deposit market) and its wholesale funding reliance (defined as wholesale funding over retail deposits). Concentrated markets are the 90th percentile of the HHI in deposits and the least concentrated markets, which I call competitive markets, are the 10th percentile of the HHI in deposits. My identification comes from variations across banks after controlling for metropolitan statistical area (MSA) fixed effects. I document that in response to an increase of 100 basis points (bps) in monetary policy, banks at the 90th percentile of the wholesale funding reliance distribution in concentrated markets transmit 61 bps, whereas banks in competitive markets transmit 116 bps. Market concentration has a larger impact on mortgage rates than wholesale funding, but the interaction between wholesale funding reliance and market concentration changes the direction of transmission on mortgage rates. Banks in competitive markets transmit monetary policy more as they rely more on wholesale funding, whereas banks in concentrated markets transmit less as they rely more on wholesale funding. These findings suggest that wholesale funding is an expensive form of funding in competitive markets because they have enough deposits, but it partially mitigates deposit shortfalls in concentrated markets and smooths the pass-through onto mortgage rates.

To explain these empirical findings, I extend the model of Greenwald (2018) to include monopolistically competitive banking sector with costly access to wholesale funding. Greenwald (2018) presents a New Keynesian model with a mortgage refinancing option, and the size of new loans is limited by the value of the underlying collateral and by the ratio of the mortgage payment to income. In Greenwald (2018)'s model, savers and borrowers intermediate funds among themselves. I extend this framework to include a monopolistically competitive banking sector that faces financial frictions. Banks engage in maturity mismatch by lending long-term mortgages and borrowing short-term funding with costly access to wholesale funding. Banks have dividend-smoothing motives where they incur convex costs if they deviate from the target level. In my model, the size of new loans is limited only by the value of the underlying collateral.

I calibrate the steady state of the model to match moments from US microeconomic data. Given the importance of banking in the mechanisms, the calibration pays particularly close attention to matching bank-portfolio moments including wholesale funding, dividend adjustment costs, and elasticity of substitutions in mortgages and deposits. The model generates key business cycle moments that closely match mortgage and deposit rate volatilities, the correlation between mortgage rates and housing prices, and consumption and output volatilities. I run an empirical specification on simulated data from the calibrated model and find that model-implied regressions are qualitatively consistent with the data. Monetary policy transmission is higher for banks that have a greater reliance on wholesale funding in competitive markets relative to banks in concentrated markets.

I examine the ability of my model to analyze how market power and wholesale funding reliance replicate the empirical features of the data. Following a contractionary monetary policy, banks with market power reduce their markups to mitigate the effects of falling loan demand, which dampens the monetary policy transmission on mortgage rates. In the model, consistent with the data, mortgage rates respond less for banks with high market power. Monetary tightening increases short-term funding and banks face a decrease in their profits from intermediation. Since banks have dividend-smoothing motives, they have to adjust their dividends by raising deposits and cutting wholesale funding. Monetary tightening raises the opportunity cost of relying on wholesale funding and increases the response of monetary shocks to mortgage rates through the changes in the composition of wholesale funding reliance. I use the model to examine how a costlier access to wholesale funding affects the response of mortgage rates following a contractionary monetary policy. I find that quantitatively, banks with higher wholesale funding costs charge higher mortgage rates and issue fewer loans. Banks with costlier access to wholesale funding do not borrow from wholesale funding but partially increase deposit rates to attract deposits. A rise in short-term funding rates lowers banks' funding; thus, banks with costlier access to wholesale funding make fewer loans and charge higher mortgage rates.

I quantify the role of banking in the transmission of monetary policy through the mortgage market. In a basic New Keynesian model (Iacoviello, 2015), banks costlessly transform savings into loans. I find that, under my model, following an increase of 100 bps in a monetary policy shock, mortgage rates rise by 22 bps, whereas the pass-through is 100% in a basic New Keynesian model. I show that the imperfect pass-through on mortgage rates dampens the fall in borrowers' consumption by 1.5 percentage points (pps) and the fall in housing prices by 1.2 pps relative to a New Keynesian basic model. The mechanism that generates imperfect pass-through of changes in the policy rate to mortgage rates relies on: i) banks have market power in deposit and mortgage markets, ii) banks engage in maturity-mismatch, and iii) banks face wholesale funding and dividend adjustment costs. When the Federal Reserve increases policy rate, banks' short-term funding costs increase. The opportunity cost of relying on wholesale funding is higher than the opportunity cost of borrowing from deposits, because banks partially raise deposit rates while the rate on wholesale funding increases perfectly. As a result, wholesale funding falls relative to deposits. Banks' funding falls as a result of the rise in deposit rates and the policy rate; thus, banks partially transmit monetary policy to mortgage rates.

Reliance on wholesale funding increases liquidity risks during times of market disruption because wholesale funding is susceptible to bank runs. Bank assets including mortgages are illiquid and long term and the maturity mismatch between assets and short-term funding leaves banks vulnerable. To understand how the transmission of monetary policy works under Basel III Liquidity Coverage Ratio that restricts excessive reliance on wholesale funding, I model the liquidity regulation as an increase in the cost of accessing wholesale funding. I find that banks with high market power that rely excessively on wholesale funding are affected the most by this regulation. During a monetary tightening, banks with high market power cannot borrow via wholesale funding. As a result, banks increase deposits by increasing their deposit rates. Lower bank funding reduces their new issuances of mortgages and amplifies the increase in mortgage rates relative to banks with low market power.

I extend the analysis to unconventional monetary policy by raising the inflation target in order to provide policymakers with more room to cut rates before reaching the zero lower bound. The inflation target shock has a persistent effect on mortgage and deposit rates, while Taylor rule has a transitory effect. I find that inflation rate rises under an inflation-targeting shock because of the construction of the shock, whereas inflation rate falls under the Taylor rule. The deposit rates rise more in an inflation-targeting environment, so banks rely more heavily on wholesale funding relative to banks under the Taylor rule. The decline in housing prices is amplified by 0.4 pps, and the fall in borrowers' consumption is amplified by 0.5 pps.

Related Literature

The first contribution of the paper is to study how the interaction between bank concentration and the composition of wholesale funding reliance affect the transmission of monetary policy on mortgage rates. Recent studies have focused on bank market power and wholesale funding reliance (Drechsler, Savov, and Schnabl (2017), Choi and Choi (2019), Scharfstein and Sunderam (2016), Wang, Whited, Wu, and Xiao (2020)), however, the interaction between market concentration and wholesale funding reliance in the mortgage market has been missing. Following a monetary tightening, banks with market power over deposits optimally contract their deposit supply in order to earn a higher deposit spread (Drechsler, Savov, and Schnabl, 2017). Banks borrow from an alternative source of funding–wholesale funding–when the retail deposit supply falls. Choi and Choi (2019) study how loans contract when it is costly to replace retail deposits with wholesale funding. I follow the lead of Drechsler, Savov, and Schnabl (2017) and Choi and Choi (2019) in putting deposit concentration and wholesale funding, respectively, at center stage, but highlight a complementary mechanism: banks with a greater reliance on wholesale funding in concentrated markets transmit monetary shocks less often relative to banks in competitive markets.

The second focus of the paper is the extension of the New Keynesian model with a monopolistically competitive banking sector with costly access to wholesale funding. My model closely follows Greenwald (2018), who studies how the structure of the mortgage market influences macroeconomic dynamics, and Polo (2018), who embeds a banking sector into a standard New Keynesian model. Polo (2018) focuses on deposit pass-through, whereas I study mortgage pass-through in order to evaluate monetary policy shocks. I allow banks to have market power in deposits and mortgage loans (Piazzesi, Rogers, and Schneider, 2019) rather than relegating a passive role to the banking sector. My paper complements papers that have developed models of banking frictions in a general equilibrium context (Gertler and Karadi (2011), Gertler and Kiyotaki (2010), Meh and Moran (2010), Dib (2010), Angeloni and Faia (2013), Gerali et al. (2010)). Gerali et al. (2010) build a New Keynesian model with a banking sector with sluggish adjustment of retail rates due to Calvo frictions in the rate setting. I confirm the sluggishness empirically and use a quadratic adjustment cost in order to have an imperfect pass-through to mortgage rates. Unlike standard New Keynesian literature, which typically assumes frictionless household capital markets with one-period borrowing, my model features collateral requirements and long-term fixed nominal payments that can be refinanced at some cost (Garriga, Kydland, and Šustek, 2017). Garriga, Kydland, and Šustek (2019) study how monetary policy affects the economy through the cost of new mortgage borrowing and real payments on outstanding debt. My paper incorporates maturity mismatch, market power in mortgages and deposits, and a choice between deposit and wholesale funding into a New Keynesian model.

The seminal papers on the bank lending channel of monetary policy, such as Bernanke and Blinder (1988, 1992) and Kashyap and Stein (1995b), rely on reserve requirements. Kashyap and Stein (1995b) study whether the impact of Federal Reserve policy on lending behavior is stronger for banks with less liquid balance sheets. Their main mechanism relies on the idea that by drawing on their stock of liquid assets, banks with large values of this ratio should be better able to buffer their lending activity against shocks in the availability of external finance. They find strong evidence of an effect for small banks. I conduct an analogous exercise but analyze market concentration and the composition of funding rather than bank size and looking at the effect on mortgage rates. Lastly, my empirical results on the state-dependence of interest rate pass-through connect to work investigating the time-varying effects of monetary policy (Boivin and Giannoni (2006), Galí and Gambetti (2009), Boivin, Kiley, and Mishkin (2010)). The results of this literature that uses aggregate data and VARs are ambiguous, partly because of the high level of aggregation. I use micro-data on bank rates instead to highlight a mortgage credit channel via the banking sector to capture the effect of a monetary policy transmission mechanism.

The third focus of the paper analyzes the transmission of monetary policy through banks' balance sheets. My paper is mainly about banks, but it connects to recent work on monetary policy in incomplete markets that studies heterogeneity in household balance sheets (Kaplan, Moll, and Violante (2018), Auclert (2019)). Di Maggio et al. (2017) study household balance sheets and mortgage contract rigidity for monetary policy pass-through. They find that areas with a larger share of ARMs are more responsive to lower interest rates, which induces a significant increase in car purchases. Berger et al. (2018) argue that fixed-rate prepayable mortgage contracts lead to path-dependent consequences of monetary policy. Beraja et al. (2019) demonstrate that the time-varying regional distribution of housing equity influences the aggregate consequences of monetary policy through its effects on mortgage refinancing. Hedlund et al. (2017) quantify the joint role of housing and mortgage debt in the transmission of monetary policy. They find that the transmission of monetary policy depends on the distribution of mortgage debt, and monetary policy is more effective in a high-LTV environment. Guren et al. (2018) analyze how mortgage design interacts with monetary policy and find that designs that raise mortgage payments in booms and lower them in recessions do better than fixed-rate mortgage payments. I contribute to the monetary policy transmission literature by analyzing the mortgage credit channel through the heterogeneity in banks' market concentration and wholesale funding reliance.

Outline

The paper is organized as follows: in Section 2, I use loan- and bank-level data to document heterogeneous mortgage rate responses to monetary policy shocks. Section 3 introduces the basic model in which the banking sector is perfectly competitive. Section 4 describes the New Keynesian framework with a monopolistic banking sector, followed by discussion on the qualitative insights of the model in Section 5. I calibrate and assess the model in Section 6. Section 7 presents quantitative results, followed by counterfactuals in Section 8. Section 9 concludes.

2 Empirical Analysis

In this section, I document that banks with a greater reliance on wholesale funding in a concentrated market are less responsive to changes in monetary policy relative to banks in a competitive market. I find that banks in a concentrated market transmit 38 to 55 bps fewer than banks in a competitive market in response to a contractionary monetary policy shock. Banks in a competitive market transmit monetary policy more as they rely more on wholesale funding whereas banks in a concentrated market transmit monetary policy fewer as they rely more on wholesale funding.

2.1 Data Description

My dataset runs from the first quarter of 2000 to the first quarter of 2014. I obtain bank balance sheet data for all US commercial banks from Statistics on Depository Institutions. I use loan-level data about mortgage rates, credit score, and loan-to-value ratio from Fannie Mae's Single Family Loan Performance Data and Freddie Mac's Single Family Loan-Level Data. I use unanticipated monetary shocks from Nakamura and Steinsson (2018), where they employ a high-frequency identification approach. These shocks consist of the first principal component of unanticipated changes in prices of five federal funds and eurodollar futures over 30-minute windows around FOMC announcements. Nakamura and Steinsson (2018) construct a monetary policy shock that has a positive 100 bps impact on the changes in the first-year Treasury yields. The sample is from January 2000 to March 19, 2014, excluding the financial crisis from July 2008 to June 2009.

Definition of Key Variables

Local market concentration: I use variation in deposit market concentration, which is measured using a standard Herfindahl-Hirschman index (HHI). This measure is used by bank regulators and the US Department of Justice to evaluate the effect of bank mergers on competition:

$$\text{HHI}_{mt} = \sum_{b\in\{m\}} \Big(\frac{dep_{bmt}}{\sum_{b\in\{m\}} dep_{bmt}}\Big)^2$$

HHI_{mt} is calculated by summing up the squared deposit market shares of all banks b that operate in a given MSA m in a given quarter t. I calculate the HHI from the Statistics on Depository Institutions capturing 7,176 banks in 380 MSAs from the first quarter of 2000 to the first quarter of 2014. I calculate HHI before merging mortgage rates with bank balance sheet information in order to capture the actual market concentration. A lower number indicates a lower level of concentration and hence a higher level of competition.

For robustness, I also measure market concentration using the Home Mortgage Disclosure Act (HMDA) for mortgage market and the Summary of Deposits (SOD) for deposit market. Figure 16 in appendix A.1.1 shows the distribution of HHI in mortgage and deposit markets. Mortgage market concentration in HMDA has mean of 0.17 and standard deviation of 0.15. Deposit market concentration in SOD has mean of 0.28 and standard deviation of 0.22. I do not use these datasets as they are yearly, whereas the Statistics on Depository Institutions and Fannie Mae and Freddie Mac are at the quarter level.

Wholesale funding reliance: $\text{WFR}_{bmt} = \frac{\text{wholesale funding}}{\text{retail deposits}}$ for bank b, MSA m in quarter t. Wholesale funding consists of repurchase agreement, time deposit, brokered deposit, foreign deposit, and federal funds. Retail deposits consist of checking, savings, and small-time deposits. Wholesale funding is easier to access with infinite supply, but reliance on wholesale funding increases liquidity risks during market disruption. Retail deposits are guaranteed by the government and are risk-free, but they are limited by savers' supply of deposits.

Summary statistics My working sample includes 35 banks with an asset size greater than 100 million in 65 MSAs with an average population of 7 million. I lose observations as the Fannie Mae and Freddie Mac dataset provide micro data for the largest 35 banks in the US. Based on the unique bank identifier, I construct panel data for each bank in each quarter and MSA. For example, the identifier for Bank of America in Philadelphia is different from Bank of America in New York. A mortgagor in Philadelphia does not borrow mortgage loans from New York. I construct a panel-level dataset at the bank level by weighting the loan-level interest rates with the volume of loans. Table 9 presents summary statistics from my working sample. Banks in my sample hold 27% of total deposits, 38.4% of retail deposits, 24% of mortgage loans, and 27% of wholesale funding from the universe of US banks in the Call Reports. My dataset consists of banks with a size greater than $1 billion, with an average mortgage rate of 5.4% and an average deposit rate of 0.02%. Borrowers have an average credit score of 743, with an average loan-to-value ratio (LTV) of 73%. With respect to liability, 59% is retail deposits and 37% is wholesale funding. The average HHI is 0.43 with a standard deviation of 0.26. Mortgage loans are 55% of all loans and 35% of assets.

2.2 Heterogeneity in Monetary Policy Transmission

I estimate whether the composition of bank funding and local market concentration affect the transmission of monetary policy shocks:

$$\begin{aligned}\Delta r_{mbt} = \alpha_b + \alpha_m + \beta_1 \Delta i_t + \beta_2 WFR_{bmt} + \beta_3 HHI_{mt} + \beta_4 WFR_{bmt} \times HHI_{mt} \\ +\beta_5 WFR_{bmt} \times \Delta i_t + \beta_6 \Delta i_t \times HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt} \times \Delta i_t \\ +\Gamma \text{HH Controls}_{bmt} + X \text{Bank Controls}_{bmt} + \epsilon_{mbt}\end{aligned} \quad (1)$$

where α_b is a bank fixed effect, α_m is an MSA fixed effect, and Δr_{mbt} is the change in the mortgage rate for bank b at MSA m at quarter t. The term Δi_t is the monetary shock from Nakamura and Steinsson (2018) normalized to have a +100 bps impact. The term WFR_{bmt} is the wholesale funding reliance for bank b in MSA M at quarter t and HHI_{mt} is the local deposit concentration in MSA m at quarter t. The term HH Controls$_{bmt}$ includes the FICO score and LTV ratio. The term BankControls$_{bmt}$ includes log asset, liquid asset ratio, liability interest rate, real estate and commercial and industrial loans ratio, and mortgage-backed securities (MBS) to assets ratio.

Log asset is the log of total assets used to capture bank size. To control for the liquidity of a bank's assets, liquid asset ratio defined as liquid asset to total bank asset is included. Capital ratio is the ratio of total equity to total assets resembling bank's soundness. Liability interest rate is the ratio of total interest expenses to average total liability. It captures a difference in funding costs across banks. The real estate loan ratio is a fraction of real estate loans to total loans and commercial and industrial loans ratio is a fraction of commercial and industrial loans to total loans. I include these ratios to control for differences in bank business models. I include the MBS to asset ratio to control for a bank's ability to securitize mortgages. I cluster standard errors at the bank level for correlation within banks.

The main variable of interest is

$$\frac{\partial \Delta r_{mbt}}{\partial \Delta i_t} = (\beta_1 + \beta_5 WFR_{bmt} + \beta_6 HHI^D_{mt} + \beta_7 WFR_{bmt} \times HHI^D_{mt}),$$

the response of changes in mortgage rates to changes in monetary policy shocks. I take and sum coefficients that interact with Δi_t from (1). The empirical design allows me to test how the transmission of monetary shocks to mortgage rates changes for banks with a greater reliance on wholesale funding in a concentrated market. My empirical identification comes from variation across banks after controlling for the MSA fixed effect. Deposits can be transferred across MSAs within a bank, whereas mortgage loans are location specific.

Table 1 shows that banks in a concentrated market reduce their mortgage rates by 56 bps in response to a 100 bps increase in the policy rate. One explanation is that banks reduce their markups to mitigate the effects of a fall in loan demand. Banks with a greater reliance on wholesale funding increase their mortgage rates by 0.1 bps in response to a 100 bps increase in the policy rate because wholesale funding is an expensive form of funding. The triple interaction term shows a negative effect on the mortgage rate by 0.2 bps. When monetary policy tightens, banks in concentrated markets experience deposit outflows and rely more heavily on wholesale funding. Wholesale funding smooths lending, and thus banks are able to transmit monetary policy at a lower rate.

Columns (1) and (3) in Table 1 show that market concentration does not play a statistically significant role. Geographic variation mutes the impact of monetary shocks through market concentration on mortgage rates. However, the interaction between wholesale funding and monetary policy shocks and the triple interaction are statistically significant throughout different specifications.

Table 1: Heterogeneity in monetary policy transmission

Notes: results from estimating

$$\begin{aligned}\Delta r_{mbt} = \alpha_b + \alpha_m + \beta_1 \Delta i_t + \beta_2 WFR_{bmt} + \beta_3 HHI_{mt} + \beta_4 WFR_{bmt} \times HHI_{mt} \\ + \beta_5 WFR_{bmt} \times \Delta i_t + \beta_6 \Delta i_t \times HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt} \times \Delta i_t \\ + \Gamma \text{HH Controls}_{bmt} + X \text{Bank Controls}_{bmt} + \epsilon_{mbt}\end{aligned}$$

where α_b is a bank fixed effect, α_m is a MSA fixed effect, WFR_{bmt} is wholesale funding reliance, HHI_{mt} is the HHI in deposit market, Δi_t is +100 bps monetary policy shock, HH controls include borrower's credit score and LTV and bank controls include log asset, liquidity asset ratio, liability interest rate, real estate and commercial and industrial loans ratio and MBS to asset ratio. Standard errors are clustered at the bank level. $***p < 0.01, **p < 0.05, *p < 0.1$.

	Δr_{mbt}			
	(1)	(2)	(3)	(4)
Δi_t	1.297***	1.338***	1.152***	1.164***
	(0.135)	(0.147)	(0.154)	(0.162)
HHI^D_{mt}	0.0535	0.178***	0.0501	0.0699
	(0.0325)	(0.0618)	(0.0494)	(0.0528)
$\Delta i_t \times HHI^D_{mt}$	-0.439	-0.728**	-0.499	-0.566*
	(0.286)	(0.301)	(0.319)	(0.334)
WFR_{bmt}	-0.00001	0.00001	-0.0002	-0.0002
	(0.0002)	(0.00002)	(0.00002)	(0.00002)
$\Delta i_t \times WFR_{bmt}$	0.009***	0.001***	0.001***	0.001***
	(0.002)	(0.002)	(0.003)	(0.003)
$HHI^D_{mt} \times WFR_{bmt}$	0.0007***	-0.000003	0.0006*	0.0005
	(0.0002)	(0.0002)	(0.0001)	(0.0001)
$\Delta i_t \times HHI^D_{mt} \times WFR_{bmt}$	-0.002***	-0.002***	-0.002***	-0.002***
	(0.0006)	(0.0005)	(0.0005)	(0.0005)
Bank FE	No	No	Yes	Yes
MSA FE	No	Yes	No	Yes
R^2	0.155	0.195	0.225	0.226
F	87.54	52.89	47.76	29.49
N	878	873	868	867

Even though magnitudes on wholesale funding (β_5) and triple interaction (β_7) are smaller than market concentration (β_6), I show that the interaction effect between wholesale funding and market concentration and the direct effect of market concentration play economically significant roles in table 2. Reading table 2 from left to right, we see that the direction of monetary policy transmission switches. Monetary policy transmission rises as banks rely more heavily on wholesale funding in a competitive market, whereas it falls as banks rely more heavily on wholesale funding in a concentrated market. I plug in different percentiles of market concentration and wholesale funding reliance to interpret the table 1. Table 2 shows that holding market concentration constant at the 10th percentile, the transmission rises as wholesale funding reliance increases. This is because wholesale funding is an expensive form of funding. Holding market concentration constant at the 90th percentile, we see that the transmission falls as wholesale funding reliance rises. Wholesale funding mitigates the impact of deposit outflow and results in less loan contraction. The transmission falls as the market becomes more concentrated because banks are reducing markups to mitigate the effect of loan demand.

Table 2: Heterogeneity in monetary policy transmission

	Wholesale funding reliance					
Market Concentration	P10	P25	P50	P75	P90	P90-P10
P10	1.084	1.084	1.085	1.085	1.159	0.075
P25	1.039	1.039	1.039	1.039	1.093	0.054
P50	0.9702	0.9703	0.9703	0.9705	0.9942	0.024
P75	0.8391	0.839	0.8389	0.8387	0.8049	-0.0342
P90	0.7022	0.7021	0.7018	0.7012	0.6075	-0.0947
P90-P10	-0.3818	-0.3819	-0.3832	-0.3838	-0.5515	

Notes: to understand the transmission of increase of 100 basis points in monetary policy shocks on mortgage rate, I plug in different percentiles of wholesale funding reliance and market concentration into $\beta_1 + \beta_5 WFR_{bmt} + \beta_6 HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt}$.

Empirical Analysis Takeaway The interaction between market concentration and wholesale funding reliance plays an important role when driving the heterogeneities in monetary policy transmission. Banks in a competitive market with a greater reliance on wholesale funding transmit more, whereas banks in a concentrated market transmit less to mitigate the effects of a fall in loan demand. Although wholesale funding is an expensive form of funding, it mitigates the loan supply shock in a concentrated market and smooths the pass-through on mortgage rates.

These results demonstrate that access to non-deposit funding in a concentrated market is influential in the transmission of mortgage rates; existing literature has attributed marketwide pricing power as the key driver of deposit rates. This empirical analysis informs policymakers that the effectiveness of monetary policy tools to stimulate the economy depends on the interaction effect between market concentration and wholesale funding reliance. Wholesale funding reliance is an endogenous choice; thus, a model that interlinks market concentration and wholesale funding reliance is needed to quantify the importance of imperfect monetary policy transmission on the aggregate economy. In my model, banks optimally choose between deposits and wholesale funding and have market power in the mortgage and deposit market.

3 The Basic Model

This section contains a standard New Keynesian model with a competitive banking sector to explain how monetary policy is transmitted into the mortgage market and aggregate economy. Consider a discrete time and infinite horizon economy populated by borrowers and savers. Savers work and consume. Borrowers consume, work, and demand housing, and because of their high level of impatience, they accumulate only the required net worth to finance a down payment on their home. I allow housing investment by borrowers and assume that housing is fixed in the aggregate. There is a production sector and a central bank. The production sector works under nominal rigidity, and the central bank adjusts its policy rate according to the Taylor rule. I discuss problems of the production sector and the central bank in Section 4.

Saver Each saver chooses consumption c_{st}, deposits d_t, and labor supply n_{st} to solve the following intertemporal problem:

$$\max_{c_{st},d_t,n_{st}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta_s^t \left[\log\left(\frac{c_{st}}{\chi}\right) - \frac{\left(\frac{n_{st}}{\chi}\right)^{1+\eta}}{1+\eta} \right], \tag{2}$$

where β_s^t is the discount factor, subject to the budget constraint

$$c_{st} + d_t = w_t n_{st} + \frac{(1+i_{t-1}^D)}{\pi_t} d_{t-1} + \Pi_t, \tag{3}$$

where d_t denotes bank deposits earning a predetermined, gross return $1+i_t^D$ on deposits, w_t is the real wage rate, and Π_t are profits from the intermediate firm. The expression $\pi_t \equiv \frac{P_t}{P_{t-1}}$ is the gross rate of inflation.

Borrower Each borrower chooses consumption c_{bt}, housing h_t, mortgage loan m_t, and labor n_{bt},

$$\max_{c_{bt},h_t,n_{bt}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta_b^t \left[\log(\frac{c_{bt}}{1-\chi}) + \psi \log\left(\frac{h_{t-1}}{1-\chi}\right) - \frac{(\frac{n_{bt}}{1-\chi})^{1+\eta}}{1+\eta} \right], \tag{4}$$

subject to the budget constraint and borrowing constraint, respectively,

$$c_{bt} + p_t^h(h_t - h_{t-1}) + \frac{(1+i_{t-1}^M)}{\pi_t} m_{t-1} = w_t n_{bt} + m_t, \tag{5}$$

$$m_t \leq \theta^{LTV} p_t^h h_t \tag{6}$$

where θ^{LTV} is the maximum LTV ratio and p_t^h is the housing price.

Bank The representative bank solves the following problem:

$$\max \mathbb{E}_0 \sum_{t=0}^{\infty} \beta_f^t \log c_{ft}, \tag{7}$$

subject to

$$c_{ft} + \frac{(1+i^D_{t-1})}{\pi_t} d_{t-1} + m_t = d_t + \frac{(1+i^M_{t-1})}{\pi_t} m_{t-1} + \frac{(1+i_{t-1})}{\pi_t} s_{t-1}, \tag{8}$$

where c_{ft} is the banker's private consumption after deposits have been repaid and loans have been issued. Banks hold reserves s_t in central bank at the policy rate i_t. Banks also face a capital adequacy constraint and a balance sheet constraint, respectively:

$$d_t \leq \gamma m_t. \tag{9}$$

Bank liabilities d_t are bounded by the fraction of bank assets that can be used as collateral,

$$d_t = m_t + s_t, \tag{10}$$

where liabilities are equal to loans and reserves,

$$c_{ft} - \frac{(i_{t-1} - i^D_{t-1})}{\pi_t} d_{t-1} + m_t = d_t + \frac{(i^M_{t-1} - i_{t-1})}{\pi_t} m_{t-1}. \tag{11}$$

Market clearing conditions The market clearing conditions for labor, housing and goods are respectively:

$$n_{bt} + n_{st} = n_t$$
$$h_{bt} = \overline{h}$$
$$c_{bt} + c_{st} + c_{ft} = y_t.$$

3.1 The Role of Banking

The implicit assumption in this basic model is that borrowers will always pay their debts even during declines in housing values. As a consequence, banks are insulated from movements in housing wealth. However, reductions in housing prices led to smaller repayments, and some borrowers defaulted when the collateral was worth less than the face value of debt. Smaller repayments affect banks' net worth. If banks are able to absorb these losses by raising capital or by borrowing other funding, the lack of repayment would be absorbed. If banks face credit constraints, a negative repayment shock would cause a loss for banks. Thus, incorporating a banking sector that engages in maturity mismatch by lending long-term mortgages and borrowing short-term funding with costly access to wholesale funding is needed.

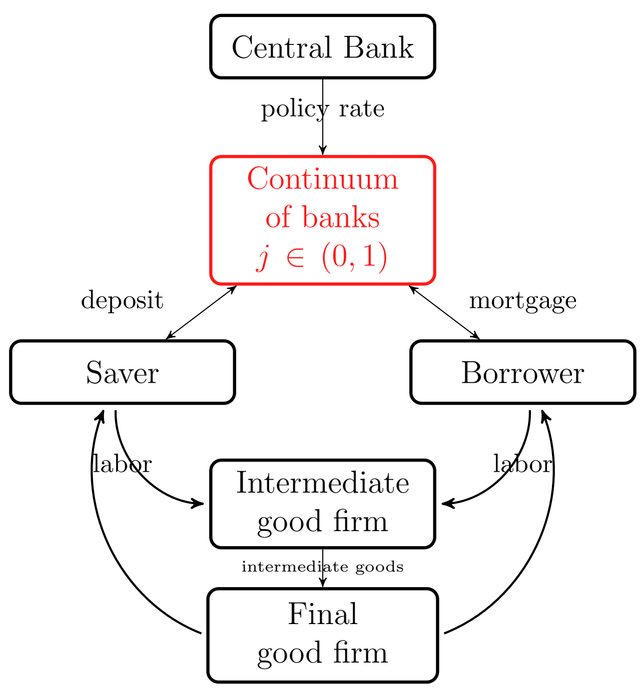
In Section 4, I discuss the problems of agents in detail. I add fixed housing stock for savers for model completeness. I incorporate a refinancing decision and a long-term mortgage structure with evolution of mortgage payments and outstanding mortgage debt. Most importantly, I allow the banking sector to have market power in deposit and mortgage markets with costly access to wholesale funding and have a dividend-smoothing motive. I need both (i) monopolistic competition and (ii) quadratic adjustment costs to generate imperfect pass-through. If the banking sector is perfectly competitive, the pass-through will be perfect. Extending the monopolistic competition into oligopolistic competition is possible, however; the former gives simplicity and captures imperfect transmission. Costly access to wholesale funding is needed so that banks do not borrow all the funding from wholesale funding.

4 Extended Model

I present a New Keynesian model with monopolistically competitive banks. Time is discrete and infinite. There are four types of agents in the economy shown in figure 1: savers, borrowers, banks, and the production sector. Households come in two types that differ in their rate of time preference. The more patient household is a saver with measure χ, and the more impatient household is a borrower with measure $1-\chi$. Savers save in short-term deposits, while borrowers take long-term mortgage loans.

Banks intermediate funds between savers and borrowers. On the asset side, banks finance long-term fixed-rate mortgage loans to borrowers, while on the liability side, they raise short-term retail deposits from savers and wholesale funding from the central bank. Banks have market power on newly issued mortgage loans and deposits. The central bank sets the nominal interest rate on wholesale funding according to the Taylor rule, while the rates on mortgage loans and deposits adjust endogeneously. Monopolistically competitive firms hire labor from households to produce intermediate goods into the final good.

Figure 1: Outline of the Model



Assets

There are three nominal assets in the economy: mortgages, deposits, and wholesale funding, and one real asset in the economy: housing. I consider a fixed-rate mortgage contract, which is the predominant contract in the US. The mortgage is a nominal perpetuity with geometrically declining payments (Chatterjee and Eyigungor, 2015). The bank lends one dollar to the borrower in exchange for $(1-\nu)^k(i^{M*}_{jt}+\nu)$ dollars in each future period $t+k$ until the mortgage is prepaid, where ν is the fraction of principal paid in each period and i^{M*}_{jt} is the equilibrium mortgage rate at origination. The borrower faces an *iid* transaction cost when refinancing. A new loan for borrower b must satisfy an LTV constraint defined by $m^*_{bt} \leq \theta^{LTV} p^h_t h^*_{bt}$, where m^*_{bt} is the balance on the new loan, θ^{LTV} is the maximum LTV ratio, p^h_t is the housing price, and h^*_{bt} is the quantity of new housing purchased.

To finance their assets, banks collect short-term nominal deposits from savers and wholesale funding from the central bank. The rate on wholesale funding is the policy rate set by the central bank. Wholesale funding is perfectly substitutable and pays the same rate $1 + i_t$ in period $t + 1$ per dollar invested in t. The rate on wholesale funding is the policy rate set by the central bank. Deposits are imperfectly substituted by banks because of their market concentration. One dollar of deposits pays a rate $1 + i^D_{jt}$ in period $t + 1$ per dollar saved in t.

The final asset in the economy is housing, which produces a service flow each period. Both types own housing; however, only the borrower takes a mortgage to purchase a house. A constant fraction δ of the house value must be paid as a maintenance cost at the start of each period. The borrower's and saver's housing are denoted by $h_{b,t}$ and $\bar{H}_s$, respectively. The saver's demand for housing is fixed, so that borrowers do not rent from savers at equilibrium. Also, Landvoigt, Piazzesi, and Schneider (2015) find that overall house price movements over the boom-bust period were primarily driven by the lower end of the price distribution, where borrowers tend to be more credit constrained. There is a total housing stock $\bar{H}$ where the price of housing fully characterizes the state of the housing market.

Both households are subject to proportional taxation of labor income at rate τ_y. All taxes are returned in lump-sum transfers. Interest payments on the mortgage are tax deductible.

Preferences Saver s is endowed with n_s units of labor in each period and supplies labor elastically. Savers have a discount factor β_s and have separable preferences over consumption of the final good c_{st} and stock of housing $\bar{H}_s$ and disutility from labor n_{st}, based on the period-utility function,

$$U(c_{st}, n_{st}) = \log\left(\frac{c_{st}}{\chi}\right) + \psi \log\left(\frac{\bar{H}_s}{\chi}\right) - \xi_s \frac{\left(\frac{n_{st}}{\chi}\right)^{1+\eta}}{1+\eta}.$$

Borrower b derives utility from consumption of the final good c_{bt} and housing h_{bt-1} and disutility from labor n_{bt} based on the period-utility function, separable in all arguments,

$$U(c_{bt}, h_{bt-1}, n_{bt}) = \log\left(\frac{c_{bt}}{1-\chi}\right) + \psi \log\left(\frac{h_{bt-1}}{1-\chi}\right) - \xi_b \frac{\left(\frac{n_{bt}}{1-\chi}\right)^{1+\eta}}{1+\eta}.$$

The parameter ψ governs the weight on housing services, $\xi_s(\xi_b)$ is the weight on disutility from labor supply for the saver (borrower), and η is the inverse Frisch elasticity of labor supply. Weights on disutility from labor supply are allowed to differ, so that the two types supply the same amount of labor in steady state.

4.1 Representative Saver's problem

Each saver chooses consumption c_{st}, labor supply n_{st}, and deposits d_{st} to maximize the expected present discounted value of utility:

$$\max_{c_{st},n_{st},d_{st}} \mathbb{E}_0 \left[\sum_{t=0}^{\infty} \beta_s^t U\left(c_{st}, n_{st}\right) \right], \tag{12}$$

subject to the budget constraint

$$c_{st} + d_{st} \leq \underbrace{\left(1-\tau_y\right) w_t n_{st}}_{\text{labor income}} - \underbrace{\delta p_t^h \bar{H}_s}_{\text{maintenance}} + \frac{(1+i_{t-1}^D) d_{st-1}}{\pi_t} + \underbrace{\Pi_t}_{\text{profits}} + T_{st}, \tag{13}$$

where w_t is the real wage, τ_y is a linear tax on labor income rebated at the end of the period T_{st}, and Π_t are profits from banks and the intermediate firm. The saver pays a maintenance cost at a constant fraction δ of house value at price p_t^h. She gets a return i_{t-1}^D on deposits from period $t-1$ to t. The expression $\pi_t \equiv \frac{P_t}{P_{t-1}}$ is the gross rate of inflation between $t-1$ and t.

4.2 Representative Borrower's Problem

Each borrower chooses consumption c_{bt}, labor supply n_{bt}, new housing h_{bt}^*, new mortgage loans m_{bt}^*, and refinancing ρ_t to maximize the expected present discounted value of utility,

$$\max_{c_{bt},h_{bt},n_{bt},m_{bt}^*,\rho_t} \mathbb{E}_0 \left[\sum_{t=0}^{\infty} \beta_b^t U\left(c_{bt}, h_{bt-1}, n_{bt}\right) \right], \tag{14}$$

subject to the budget constraint

$$\begin{aligned} c_{bt} \leq \underbrace{\left(1-\tau_y\right) w_t n_{bt}}_{\text{labor income}} &- \underbrace{\frac{((1-\tau_y) x_{bt-1} + \tau_y \nu m_{bt-1})}{\pi_t}}_{\text{payment net of deduction}} + \underbrace{\rho_t \left(m_{bt}^* - (1-\nu) \frac{m_{bt-1}}{\pi_t} \right)}_{\text{new issuance}} \\ &- \underbrace{\delta p_t^h h_{bt-1}}_{\text{maintenance}} - \underbrace{\rho_t p_t^h \left(h_{bt}^* - h_{bt-1}\right)}_{\text{housing purchases}} + T_{b,t} - \underbrace{\iota(\rho_t, m_{b,t}^*)}_{\text{transaction cost}} . \end{aligned} \tag{15}$$

The borrower's labor income $w_t n_{bt}$ is taxed at rate τ_y which she gets in a tax rebate as T_{bt}. The interest payments on the mortgage are tax deductible, but principal payments are not. When a borrower refinances, she needs to pay all of her non-repaid loans in order to receive newly issued mortgages and a transaction cost $\iota(\rho_t, m_{b,t}^*)$. She pays the maintenance cost of housing and the difference between the new house and old house if she chooses to refinance.

Her new borrowing is subject to the LTV constraint:

$$m_{b,t}^* \leq \theta^{LTV} p_t^h h_{b,t}^*, \tag{16}$$

where m_{bt}^* is the balance on the new loan for borrower b in period t, θ^{LTV} is the maximum LTV ratio, p_t^h is the housing price and h_{bt}^* is the quantity of new housing purchased for borrower b in period t.

The mortgage principal consists of new loans m_{bt}^* if borrowers refinance and non-repaid loans if borrowers do not refinance:

$$m_{bt} = \rho_t m_{bt}^* + (1-\rho_t)(1-\nu)\frac{m_{bt-1}}{\pi_t}. \tag{17}$$

The mortgage payment she makes in each period t consists of

$$x_{bt} = \rho_t(i_t^{M*} + \nu)m_{bt}^* + (1-\rho_t)(1-\nu)\frac{x_{bt-1}}{\pi_t}. \tag{18}$$

If a borrower chooses to refinance, she pays new loan rate i_t^{M*} and principal ν toward her new loan m_{bt}^*. If she does not refinance, then she pays toward a non-repaid loan.

The law of motion for housing is

$$h_{bt} = \rho_t h_{bt}^* + (1-\rho_t)\,h_{bt-1}. \tag{19}$$

4.3 Bank's Problem

Banks are owned by savers. Each bank $j \in [0,1]$ enters period t with total payments to be collected from borrowers on outstanding mortgages x_{jt-1}, total principal on outstanding mortgages m_{jt-1}, and payments on short-term funding $(1+i_{jt-1}^D)d_{jt-1}$ and $(1+i_{t-1})b_{jt-1}$. New mortgages and loans that are not repaid are funded by retail deposit d_{jt} and wholesale funding b_{jt}.

$$m_{jt} = d_{jt} + b_{jt} \tag{20}$$

Asset	Liability
Outstanding debt (m_{jt})	Short-term deposit (d_{jt}, b_{jt})

Table 3: Balance sheet

Banks engage in maturity transformation by issuing long-term mortgages to borrowers and borrowing short-term retail deposits from savers and wholesale funding from the central bank. Banks issue new mortgages m_{jt}^*. Banks' cash flow in period $t+1$ is

$$x_{jt} + d_{jt+1} + b_{jt+1} - m_{jt}^* - (1+i_{jt}^D)d_{jt} - (1+i_t)b_{jt} \geq 0 \tag{21}$$

Inflow	Outflow
Nominal mortgage payment (x_{jt})	Short-term deposit payment $(1+i_{jt}^D)d_{jt}$, $(1+i_t)b_{jt}$
Short-term deposit (d_{jt+1}, b_{jt+1})	New issuance (m_{jt}^*)

Table 4: Cash flow in $t+1$

The endogenous state variables for the bank's problem are total payments to be collected from borrowers on outstanding mortgages x_{jt-1} and total principal on outstanding mortgages m_{jt-1}. The laws of motion for these state variables are given by

$$m_{jt} = m^*_{jt} + (1-\nu)\frac{m_{jt-1}}{\pi_t} \tag{22}$$

$$x_{jt} = (i^{M*}_{jt} + \nu)m^*_{jt} + (1-\nu)\frac{x_{jt-1}}{\pi_t} \tag{23}$$

Banks have market power over newly issued mortgages and deposits:

$$m^*_{jt} = \Big(\frac{1+i^{M*}_{jt}}{1+i^{M*}_t}\Big)^{-\theta^M} m^*_t, \tag{24}$$

$$d_{jt} = \Big(\frac{1+i^{D}_{jt}}{1+i^{D}_t}\Big)^{-\theta^D} d_t, \tag{25}$$

where θ^M is the elasticity of substitution for mortgages between banks, m^*_t is the aggregate mortgage in the economy, and i^{M*}_t is the aggregate mortgage rate index. The term θ^D is the elasticity of substitution for deposits between banks, d_t is the aggregate deposit in the economy, and i^D_t is the aggregate deposit rate index. The CES aggregator may be an inaccurate representation of reality where households borrow from all banks. Ulate (2019) shows that a heterogeneous borrower with stochastic utility and extreme value shocks works as a microfoundation for the CES aggregator in the case of a homogeneous borrower. I show this in appendix A.6.

The bank's objective is to maximize the expected present discounted value of net real dividends paid to savers. Each period the bank chooses deposit rate i^D_{jt} and new mortgage rate i^{M*}_{jt},

$$\max_{i^D_{jt}, i^{M*}_{jt}} \mathbb{E}_0 \left[\sum_{t=0}^{\infty} \Lambda^s_{t+1} div_{jt+1}\right], \tag{26}$$

where

$$div_{jt+1} = \frac{1}{\pi_{t+1}}\left[x_{jt} - m^*_{jt} - i^D_{jt}d_{jt} - (i_t + \frac{\phi^B}{2}\frac{b_{jt}}{d_{jt}})b_{jt}\right] - \frac{\kappa^{div}}{2}(div_{jt} - \overline{div})^2 \tag{27}$$

subject to the balance sheet constraint (20), laws of motions (22), (23), mortgage (24), and deposit demand (25). Banks incur a quadratic financing cost ϕ^B when accessing wholesale funding to compensate for any deposit shortfalls. The cost is higher than the current federal funds rate. Banks also pay a quadratic dividend adjustment cost κ^{div} when deviating from a target level. When dividends are below the target level, banks have a motive to bring profits closer to the target. Otherwise, banks pay a higher rate on short-term deposits and build a bigger deposit base.

4.4 Productive Technology

The production side of the economy is populated by a competitive final good producer and a continuum of intermediate good producers owned by the saver. The final good producer uses a continuum of differentiated inputs indexed by $\omega \in [0,1]$ purchased from intermediate goods producers at prices $p_t(\omega)$, to operate the technology

$$y_t = \Big(\int_0^1 y_t(\omega)^{\frac{\theta-1}{\theta}} \Big)^{\frac{\theta}{\theta-1}}. \tag{28}$$

CES demands for each intermediate good ω are

$$y_t(\omega) = \Big(\frac{p_t(\omega)}{p_t}\Big)^{\theta} y_t, \tag{29}$$

and $p_t = (\int_0^1 p_t(\omega)^{1-\theta} d\omega)^{\frac{1}{1-\theta}}$ is the price of the final good.

Intermediate good producers operate a linear production function,

$$y_t(\omega) = a_t n_t(\omega),$$

to meet the final good producer's demand, where n_t is labor hours and a_t is total factor productivity, which evolves according to

$$\log a_{t+1} = (1-\phi_A)\mu_A + \phi_A \log a_t + \epsilon_{A,t+1},$$

where $\epsilon_{A,t+1}$ is a TFP shock. Intermediate good producers are subject to price stickiness of the Calvo. A fraction $1-\phi$ of firms are able to adjust their price each period, while the remaining fraction ϕ update their existing price by the rate of steady state inflation.

4.5 Monetary Authority

The monetary authority adjusts the policy rate $1+i_t$ in response to deviations of inflation and output from the steady-state level (π and y):

$$\log(1+i_t) = \phi_r \log(1+i_{t-1}) + (1-\phi_r)\left[(\psi_y(\log y_t - \log y) + \psi_\pi(\log \pi_t - \log \pi)\right] + \epsilon_t, \tag{30}$$

where $\epsilon_t \sim N(0, \sigma_R)$ represents a zero-mean normally distributed monetary policy shock with standard deviation $\sigma_R = 0.0025$.

4.6 Equilibrium

A competitive equilibrium is a sequence of allocations $(c_{st}, c_{bt}, n_{st}, n_{bt})$, endogenous states $(m_{t-1}, x_{t-1}, h_{t-1})$, mortgage origination and funding decisions (m_t^*, b_t, d_t), and housing, refinancing decisions (h_{bt}^*, ρ_t) and prices $(w_t, \pi_t, p_t^h, i_t, i_t^D, i_t^{M*})$ that satisfy borrower, saver, bank and firm optimality, and the following market clearing conditions:

$$n_{bt} + n_{st} = n_t$$

$$h_{bt} + \bar{H}_s = \bar{H}$$

$$c_{bt} + c_{st} + \delta p_t^h \bar{H} + f(div_t) = y_t$$

$$\left[\int_0^1 (m_{jt}^*)^{\frac{\theta^{M*}-1}{\theta^{M*}}} dj\right]^{\frac{\theta^{M*}}{\theta^{M*}-1}} = (1-\chi)m_{bt}^* = m_t^*$$

$$\left[\int_0^1 (d_{jt})^{\frac{\theta^D-1}{\theta^D}} dj\right]^{\frac{\theta^D}{\theta^D-1}} = \chi d_{st} = d_t$$

$$\int_0^1 b_{jt} = 0.$$

Due to Walras's law, once the market for deposit and mortgage has cleared, the market for wholesale funding will be cleared automatically. This completes the description of the model.

5 Mortgage Credit Channel of Monetary Policy

Before performing the quantitative analysis, I theoretically characterize the mortgage credit channel through which monetary policy affects the mortgage rate via the banking sector in my model. This section illustrates the mechanism that generates imperfect pass-through of the policy rate to the mortgage rate.

A contractionary monetary policy shock is transmitted to the aggregate economy via (i) intertemporal substitution effects, (ii) general equilibrium effects where a contractionary shock lowers aggregate demand and labor income, and (iii) the interaction of higher cost of issuing loans and competing forces. In this section, I focus on the latter where monetary tightening raises banks' funding costs and the steepness depends on

Figure 2 plots the marginal benefit (MB) and marginal cost (MC) of issuing loans as a function of mortgages. The marginal benefit of issuing mortgages is derived from the optimality condition of the mortgage:

$$\Omega_{jt}^M = \mathbb{E}_t \left[\frac{\Lambda_{t+1}^s}{\pi_{t+1}} \{(1-\nu)\Omega_{jt+1}^M - \Omega_{jt+1}(\nu + i_t + \phi^B \frac{b_{jt}}{d_{jt}})\}\right],$$

where $\Omega_{jt+1} = \frac{1}{1+\kappa^{div}(div_{jt+1}-\bar{div})}$ and $div_{jt+1} = \frac{1}{\pi_{t+1}}\left[x_{jt} - \nu m_{jt} - i_{jt}^D d_{jt} - i_t b_{jt}\right]$. After rearranging equations in steady state,

$$i^{M*} = a - \frac{\Gamma}{\kappa \Omega^M} \phi^B \frac{m}{d},$$

where $a = \bar{div} - \frac{1}{\kappa^{div}} + (i^D d + ib)\frac{\nu}{m^*} - (\nu + i - \phi^B)\frac{\Gamma}{\kappa^{div}\Omega^M}$ and $\Gamma = \frac{\beta}{1-\beta(1-\nu)}$. The mortgage rate is related negatively to mortgage loans, so MB is downward sloping.

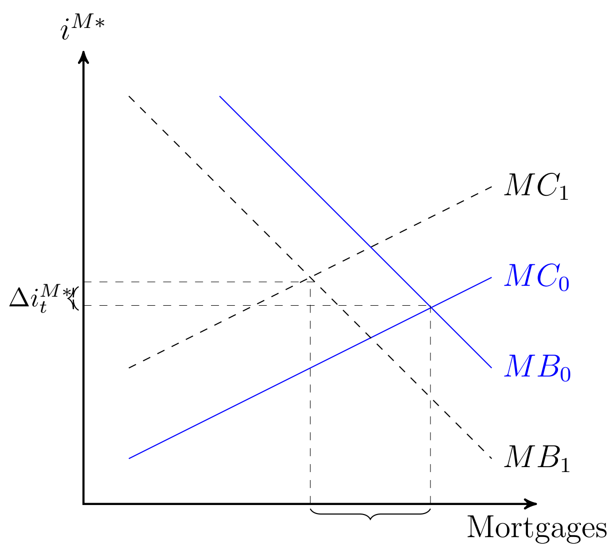
The marginal cost of issuing new mortgages is derived from the optimality condition of new mortgage loans:

$$1 + i^{M*} = \underbrace{\frac{\theta^M}{\theta^M - 1}}_{\text{markup}} \Big(1 + i - \phi^B + \phi^B \frac{m}{d}\Big).$$

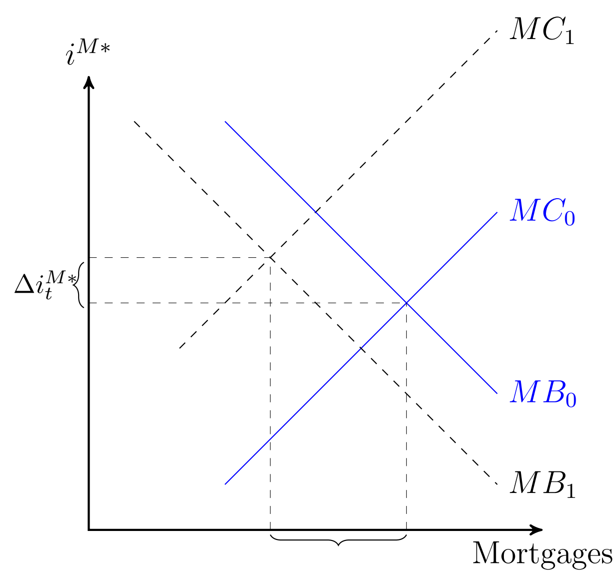
The mortgage rate is correlated positively to mortgage loans, and MC is upward sloping.

To illustrate the key economic mechanisms, I compare how these curves shift following a contractionary monetary policy shock for two examples of banks. Panels (a) and (b) of figure 2 show banks with high and low levels of market power, respectively. Banks' market power determines the steepness of the curve, while access to wholesale funding and monetary policy shocks determine the magnitude of the shift.

A contractionary monetary policy shock lowers aggregate demand, which decreases income and shifts MB downward. Now, borrowers can only afford loans of the same amount at a lower rate. As a result, banks receive lower payments on mortgages. The contractionary monetary shock increases banks' funding cost and shifts MC upward. Banks with a high level of market power have a flatter MC curve and a lower cost in accessing wholesale funding. Monetary tightening squeezes the profit margin, which constrains banks in making new loans and requires them to obtain outside funding to finance. Falls in mortgage loans are lower for banks with a high level of market power. Monetary policy is dampened by market power, but amplified by reliance on wholesale funding.



(a) High Market Power



(b) Low Market Power

Figure 2: Mortgage Credit Channel of Monetary Policy

6 Calibration

This section describes the calibration procedure. Times is quarterly. The calibrated parameter values are presented in Table 5. While some parameters are set to standard values, a number of others are calibrated to match a set of moments computed for the period from 2000Q1 to 2014Q1. Two parameters (κ^{div}, ϕ^B) are specific to my model.

Borrower and Saver I set a number of parameters to standard values in the macroeconomics literature. The IES is set to 1 (log-utility), and I choose an inverse Frisch elasticity of labor supply of 1. The weights on labor disutility, ξ_b and ξ_s, are set such that households supply the same labor equal to 1/3 in steady state. The saver discount factor β_s is calibrated to match the 2000-2014 average of 10-year interest rates.

I calibrate the fraction of borrowers χ to match the Survey of Consumer Finances. I classify borrower households in the data to be homeowners with a mortgage and mortgage yielding $\chi = 0.319$. I calibrate the log of housing stock $\log \bar{H}$ and log of saver housing demand $\log \bar{H}_s$ so that the price of housing is unity at steady state and the ratio of saver house value to income is the same as in the 2004 SCF.

I calibrate the housing preference weight ψ to 0.2 to target a housing expenditure share of 20% (Davis and Ortalo-Magné, 2011). I set $\theta^{LTV} = 0.85$ as a compromise between the mass bunching at 80% and the masses constrained at 90%. The housing maintenance cost is set to $\delta = 0.004$ to match an annual depreciation rate of 1.5% (Kaplan, Mitman, and Violante, 2017). The linear labor tax is set to the average marginal individual income tax rate estimated by Mertens and Montiel Olea (2018) over 1946-2012.

Banks I take the half of the average non-interest expenditures excluding expenditures on premises or rent per dollar of assets of banks in the Call Report over the period 2000 to 2017. I set $\nu = 0.435\%$ to match the average share of principal paid on existing loans.

The scale of the dividend adjustment cost κ^{div} affects the degree of pass-through. I set it to 0.147 to match the average pass-through of the policy rate to mortgage rates. Market power in mortgages and deposits is targeted for periods 2000 to 2006, 2007 to 2009, and 2010 to 2014. The values θ^M and θ^D are calibrated from the mortgage and deposit pricing equations $\theta^M = \frac{1+i^{M*}}{i^{M*}-i}$, and $\theta^D = \frac{1+i^D}{i^D-i}$. θ^M is set to to match mortgage rates of 3.6%, 3.45%, and 2.56%, while θ^D is set to match deposit rates of 0.0182%, 0.0184%, and 0.006%. The federal funds rates are 3.21%, 2.45%, and 0.12%, respectively. The wholesale funding adjustment cost ϕ_b is calculated from the no-arbitrage condition for deposits.

Other Parameters The remaining parameters are taken from the literature. In the Taylor rule, interest rate smoothing $\phi_r = 0.89$ (Campbell, Pflueger, and Viceira, 2014), inflation reaction $\psi_\pi = 1.5$, output reaction $\psi_y = 0$, and trend inflation π is set to 1.008. The steady state of productivity is set to $\mu_A = 1.099$ to have steady state output equal to 1. The persistence of productivity ϕ_A is set to 0.964 (Garriga, Kydland, and Šustek, 2017).

Table 5: Parameter values

Parameter	Name	Value	Internal	Source
		Household		
Frisch elasticity	η	1.0	N	Standard
Borrower discount factor	β_b	0.965	N	Greenwald (2018)
Saver discount factor	β_s	0.987	N	Avg. 10Y rate, 2000-2014
Fraction of borrowers	χ	0.4	N	SCF 2004
Housing preference	ψ	0.2	N	Davis and Ortalo-Magné (2011)
Borrower's labor disutility	ξ_b	7.809	Y	Borrower's labor supply 1/3
Saver's labor disutility	ξ_s	5.683	Y	Saver's labor supply 1/3
Housing maintenance cost	δ	0.004	N	Depreciation of housing 1.5% pa
Max LTV	θ^{LTV}	0.85	N	Greenwald (2018)
Income tax rate	τ^y	0.24	N	
Log housing stock	$\log \bar{H}$	4.230	Y	$p^h_{ss} = 1$ SCF 2004
Log saver housing stock	$\log \bar{H}_s$	1.914	Y	SCF 2004
		Bank		
Mortgage amortization	ν	0.435%	N	Greenwald (2018)
EOS for mortgage	θ^M	42/61/18	Mortgage rate of 5.7%/4.15%/5.88%	
EOS for deposit	θ^D	-34/-42	Deposit rate of 0.028%/0.007%	
Div. adjustment cost	κ^{div}	0.1468	Y	Average mortgage rate
Wholesale funding cost	ϕ^B	0.00852	Y	No arbitrage condition for deposits
		New-Keynesian block		
Variety elasticity	θ	6.0	N	Standard
Calvo pricing	ϕ	0.75	N	Standard
Productivity (mean)	μ_A	1.099	Y	$y_{ss} = 1$
Productivity (pers.)	ϕ_A	0.964	N	Garriga et al. (2017)
		Monetary policy: Taylor rule		
Steady state inflation	π_{ss}	1.008	N	Standard
Taylor weight inflation	ψ_π	1.5	N	Standard
Taylor weight output	ψ_y	0.964	N	Standard
Interest rate smoothing	ϕ_r	0.89	N	Campbell et al. (2014)
Inflation target (pers.)	$\phi_{\bar{\pi}}$	0.994	N	Garriga et al. (2017)

Notes: this table shows the subset of parameters that are fixed in the calibration and subset of parameters that are calibrated to match targeted moments.

6.1 Model Assessment

Before presenting the main results of the paper, I show that the model performs well along dimensions that were not targeted in the calibration. Table 6 shows mortgage rate and deposit rate volatilities, correlation between mortgage rate and housing price, output volatility, relative volatility consumption, and relative volatility aggregate consumption. It shows the difference between the basic model in which banking is perfectly competitive and the extended model in which banking is monopolistically competitive with quadratic adjustment costs.

Table 6 suggests that the extended model has a relatively good fit in terms of business cycles. In particular, the extended model delivers a relative volatility consumption exactly to the data counterpart. It also exhibits output volatility and relative volatility aggregate consumption that are relatively less volatile than the data. Table 6 shows that the extended model is capable of replicating a relevant set of bank pricing moments. The model delivers a deposit rate volatility exactly to the data. However, the correlation between mortgage rate and housing price is below the empirical counterpart due to fixed housing.

Table 6: Unconditional Business Cycle Statistics

Moments	Description	Basic	Extended	Data
sd(i^M)	Mortgage rate volatility	1.69	0.63	1.18
sd(i^D)	Deposit rate volatility	0.09	0.02	0.02
corr(i^M,p^H)	Correlation mortgage rate and house price	-0.99	-0.95	-0.48
sd(Output)	Output volatility	0.05	0.03	0.07
sd(C_b)/sd(C_s)	Relative volatility consumption	0.57	0.98	0.98
sd(C)/sd(Y)	Relative volatility agg. consumption	1.15	1.02	1.05

Notes: this table shows a set of untargeted moments related to business cycles. Data moments are computed from quarterly frequency for the period 2000-2014 using Bureau of Economic Analysis (BEA), Federal Housing Finance Administration (FHFA), Consumer Expenditure Survey (CEX), Fannie Mae, Freddie Mac and Call Reports.

6.1.1 Response to Monetary Policy Shocks

To check that the model generates reasonable dynamics, I compare the responses of bank variables to a monetary policy shock in the model and the data. For the model version, I compute impulse responses from the linearized solution around the deterministic steady state. For the data version, I apply the local projection method of Jorda (2005). Specifically, for each forecast horizon $h \geq 0$ and each variable of interest y, I run the regression

$$y_{bt+h} = \alpha_{bh} + \alpha_{mh} + \beta_h \Delta i_t + \Gamma_h^{'} X_{bt-1} + u_{bt+h}, \tag{31}$$

where the variable of interest y_{bt+h} is the mortgage rate and mortgage loans. The term Δi_t is the monetary policy shock, and X_{bt-1} includes bank and household controls. In this specification, the fitted coefficient $\hat{\beta}_h$ represents the estimated response of the y variable to a 100 bps increase in a monetary policy shock h quarters after impact.

Figure 3 shows model and data impulse responses for the mortgage rate along with their 90% confidence bands. The graph describes the response of the increase in the monetary policy shock by 100 bps. Overall, despite the model's relative parsimony, the model and data responses match up well, generating paths in the same direction and of similar magnitudes. The model abstracts from habit persistence and labor market frictions. If these features were added, the model would replicate the hump-shape.

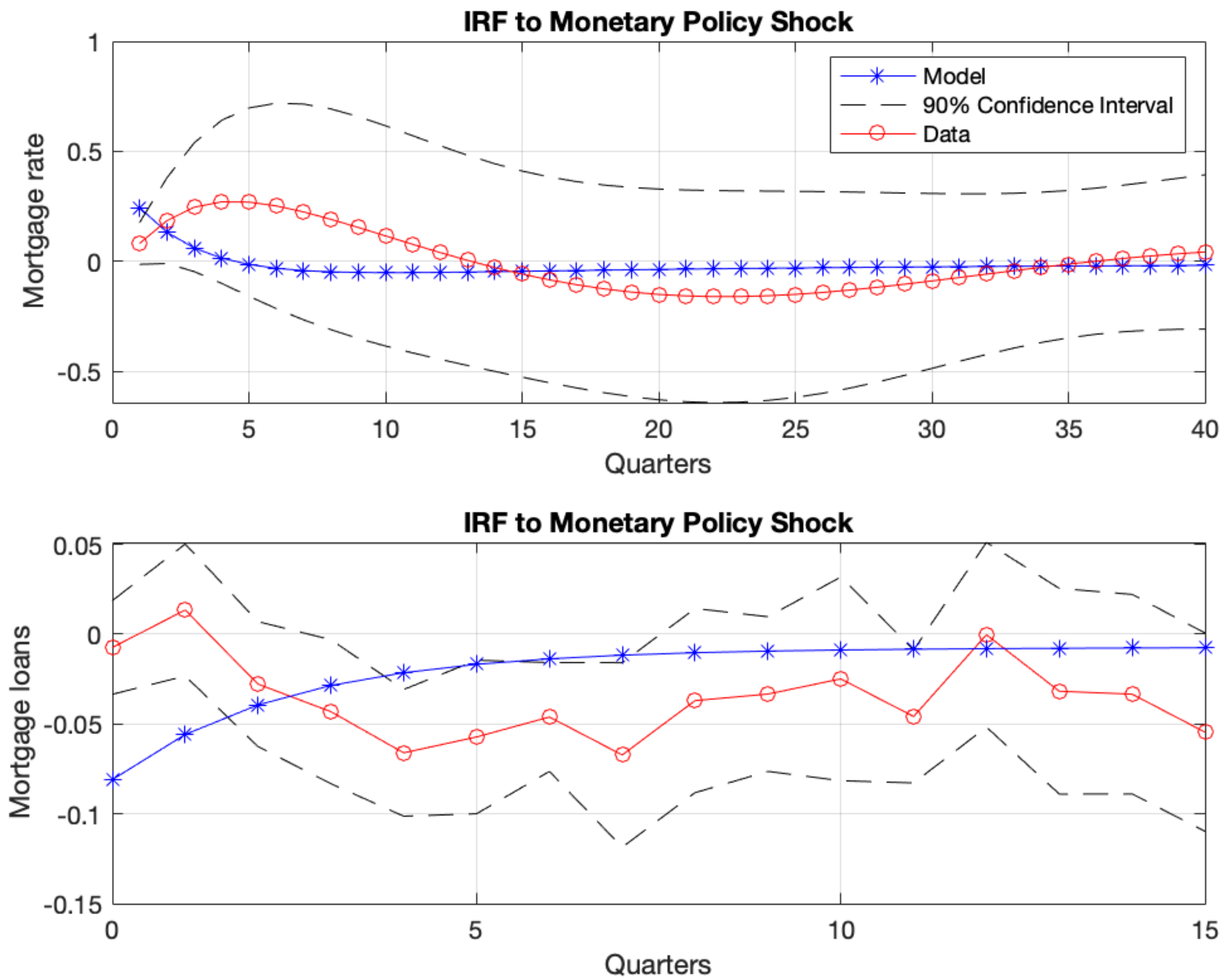


Figure 3: Response to +100 bps Monetary Policy Shock, Model vs. Data Projections

Notes: the relative contribution of each force to the response of bank variables following increase in monetary policy shock by 100 bps.

6.1.2 Model-Implied Regression Coefficients

To directly compare our model to the data, I simulate the model in response to a contractionary monetary shock and estimate my empirical specification on the simulated data:

$$\Delta i_{jt}^{M} = \alpha_j + \beta WFR_{jt}\Delta i_t + \Gamma' Z_{jt-1} + \varepsilon_{jt}.$$

I assume that the high-frequency monetary shocks Δi_t are the innovations to the Taylor rule in the model. I estimate the empirical specification using wholesale funding reliance WFR_{jt} in cases with banks with high and low levels of market power.

Columns (1) and (2) of table 7 show that banks with a high level of market power with a greater reliance on wholesale funding are less responsive to monetary policy in the model, as in the data. In the data, banks with a greater reliance on wholesale funding in a concentrated market transmit 0.3 bps, and in the model, it is 0.02 bps. Columns (3) and (4) estimate the same regression for banks with a low level of market power. Banks with a greater reliance on wholesale funding in a competitive market respond more to monetary policy shocks. The R^2 of the regression is lower in the data than in the model, indicating that the data contain more unexplained variations than the model. Regression coefficients from the model are aligned with the empirical findings qualitatively.

Transmission is different for low and high market concentration, because the composition of funding varies by market concentration. Low market power banks have higher transmission because they have fewer deposit and higher wholesale funding reliance. The rise in policy rate is higher than the rise in deposit rates, thus the higher transmission.

Table 7: Empirical results, model vs. data

	Mortgage rate			
	High market power		Low market power	
	Data	Model	Data	Model
	(1)	(2)	(3)	(4)
Wholesale funding×Monetary Policy	-0.003*	-0.0002	0.2192***	0.0227
	(0.0014)		(0.0623)	
R^2	0.02	0.07	0.02	0.07

Notes: Columns (1) and (3) show the results from running the specification $\Delta i^M_{jt} = \alpha_j + \beta WFR_{jt}\Delta i_t + \Gamma' Z_{jt-1} + \varepsilon_{jt}$ where all variables are defined in the notes for Table 1. Columns (2) and (4) estimate this empirical specification on the simulated data.

7 Quantitative Analysis

This section illustrates how the features of the model transmit nominal interest rates to mortgage rates, which further affect the aggregate economy. These quantitative results are obtained by linearizing the model around the deterministic steady state and computing impulse responses to positive monetary policy and negative productivity shocks. I compare the response of a New Keynesian model in which banking is perfectly competitive to a model in which market power and adjustments costs in the banking sector are included. Overall, I find that monopolistic banking with costly access to wholesale funding dampens monetary policy shocks on mortgage rates and the aggregate economy.

7.1 Monetary Policy Shocks

I study the effect of an unexpected one-time increase in an annualized shock to the Taylor rule by 100 bps followed by a perfect foresight transition back to steady state. Figures 4 and 5 show the impulse response functions of banks and real variables. A New Keynesian model with perfectly competitive banking corresponds to the line with red asterisks, and the extended model corresponds to the line with blue circles. Impulse response functions (IRFs) are expressed as percentage deviations from steady state for all variables, except for the deposit rate, policy rate, mortgage rate, and inflation rate, whose values are plotted in annualized levels in percentage points.

Figure 4 shows that a monetary policy shock is dampened on mortgage rates where mortgage rates rise by 22 bps in the extended model. The mortgage rate is dampened because of market power and costly access to wholesale funding. This value is consistent with the results in Polo (2018) who finds that mortgage rates rise by 40 bps. Banks in Polo (2018) has market power only in deposit and has no access to wholesale funding. The response of mortgage rate is lower than the empirical result because the model abstracts from other channels of housing finance such as HELOC, household default and saver's housing demand and housing stock are fixed. Following a contractionary shock, deposit rates increase by 60 bps and banks attract deposits by 0.15%. Since the rate on wholesale funding rises fully while deposit rates rise partially, banks cut wholesale funding by 0.6%. Because of dividend adjustment costs, banks want to internalize their profit margin so that the rise in the policy rate leads to a fall in wholesale funding. A policy shock affects the composition of wholesale funding reliance and a fall in new mortgage loans is amplified by 1 pps in the extended model.

The intuition behind these results is that a rise in the policy rate partially increases deposit rates. The opportunity cost of holding wholesale funding relative to the deposit rate is higher. As the policy rate increases, the bank passes through part of the additional increase in its marginal cost of funds to the rate on new mortgages, which leads to a decrease in new mortgage origination. Changes in bank funding lower the issuance of new mortgage loans, and thus banks make loans at higher rates.

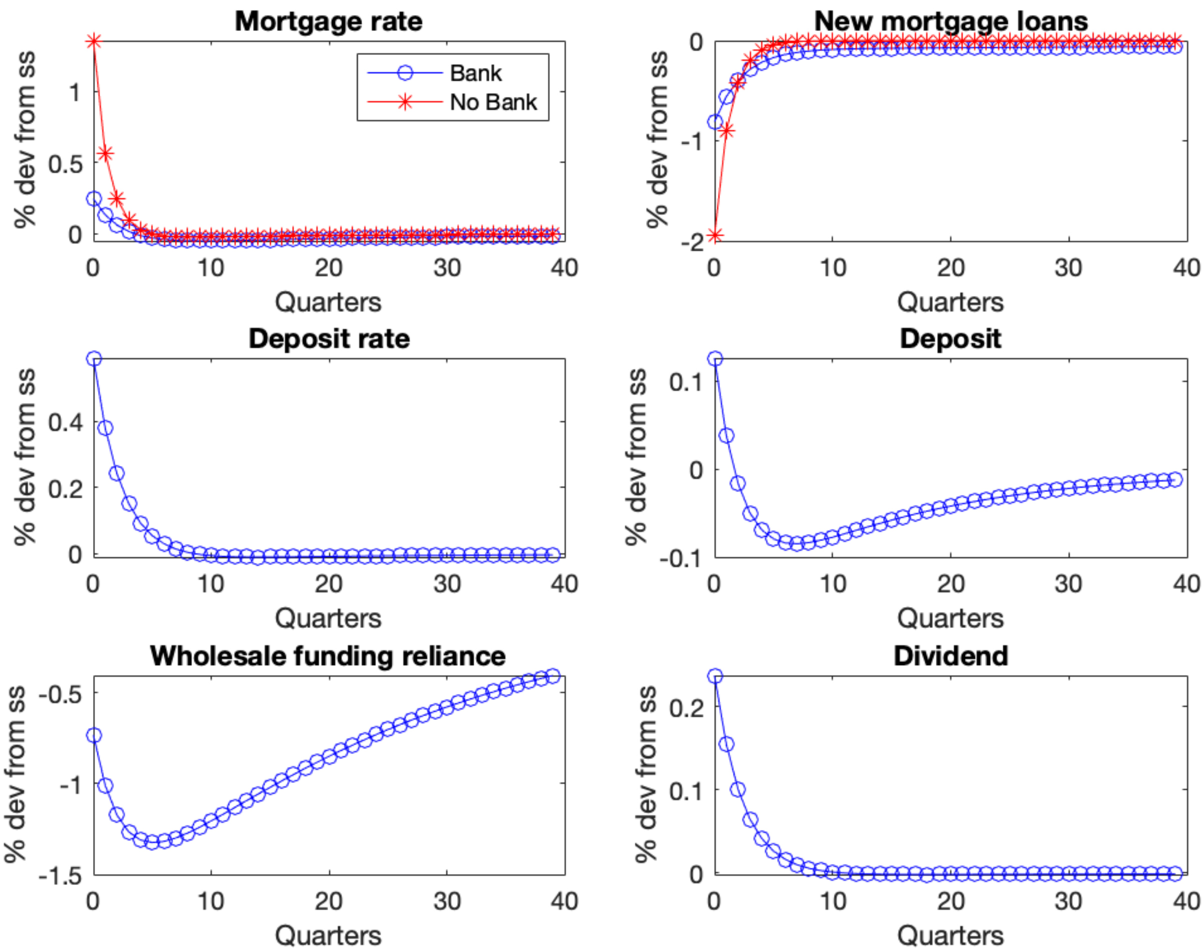


Figure 4: Response to a +100 bps monetary policy shock

Notes: This figure depicts the impulse response functions of some of the main variables to an increase in monetary policy shock by 100 bps. The x axis is given in quarters and the y axis is given in percent deviation from steady state for mortgage rate, new mortgage loans, deposit rate, deposit, wholesale funding reliance and bank dividend. Mortgage and deposit rates are in annualized percentage points.

Figure 5 shows the key aggregate variables to a contractionary monetary policy shock. The shock increases the nominal rate and real interest rate because prices are sticky. An increase in the deposit rate stimulates savers' consumption, whereas an increase in the mortgage rate amplifies the fall in borrowers' consumption by 1.5 pps. The fall in output is dampened by 1 pps, and the decline in housing prices is attenuated by 1.2 pps in the banking model.

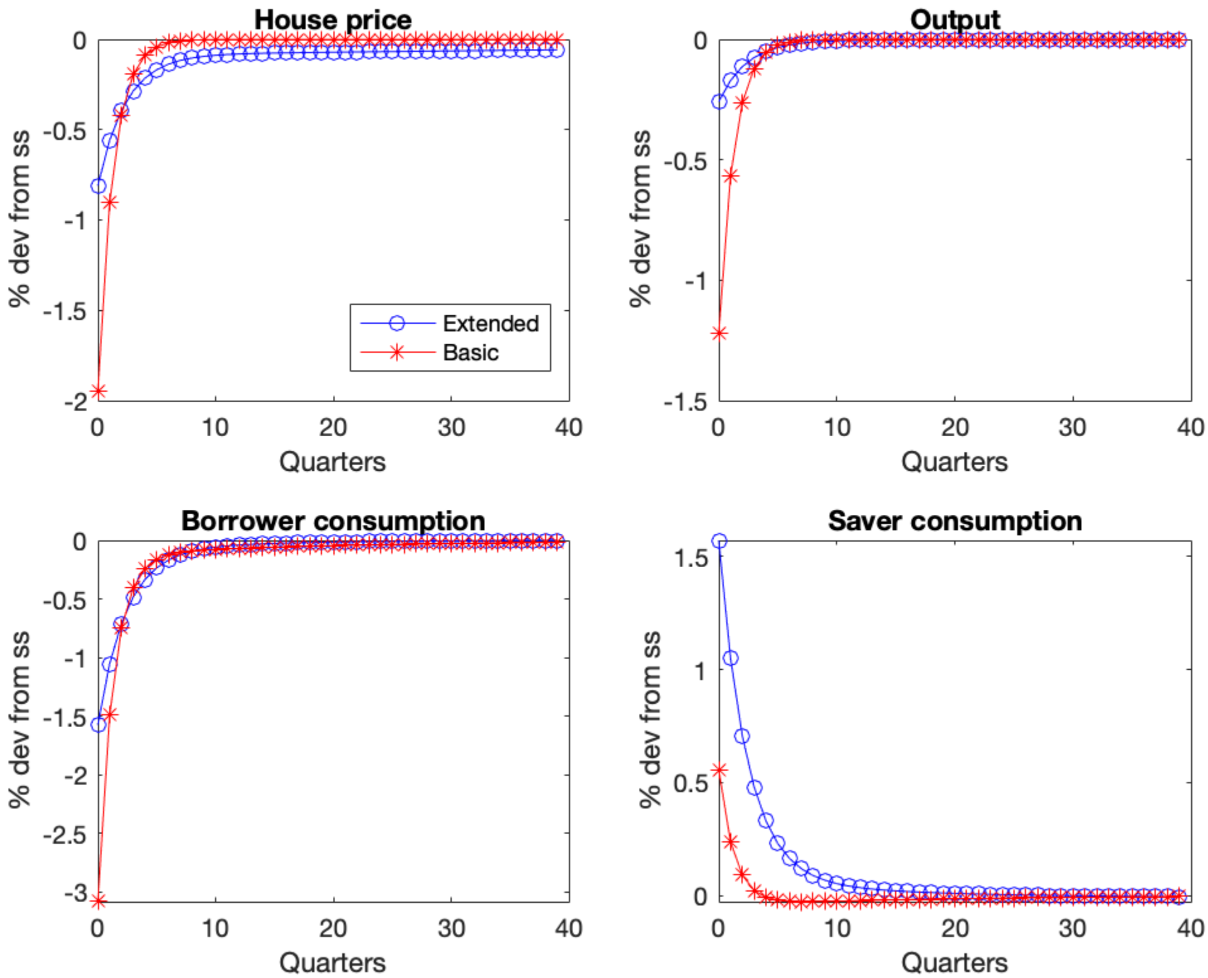


Figure 5: Response to a +100 bps monetary policy shock

Notes: This figure depicts the impulse response functions of some of the main variables to an increase in monetary policy shock by 100 bps. The x axis is given in quarters and the y axis is given in percent deviation from steady state for house price, output, labor and consumption.

7.2 Sensitivity analysis

7.2.1 Dividend adjustment cost

Figure 6 shows that deposit rates rise slightly more for banks that have a high adjustment cost relative to for banks without any adjustment cost. The mortgage rate rises the most by 50 bps and new mortgage loans fall by 0.8% for banks with a high adjustment cost. Banks with a higher adjustment cost borrow from deposits and do not rely on wholesale funding. Banks with no adjustment cost increase deposits and shrink wholesale funding. The rise in the price of wholesale funding is greater than the deposit rate; thus banks shrink wholesale funding. Banks with no adjustment cost observe a rise in dividends because they are paying an extra cost to build a bigger deposit base.

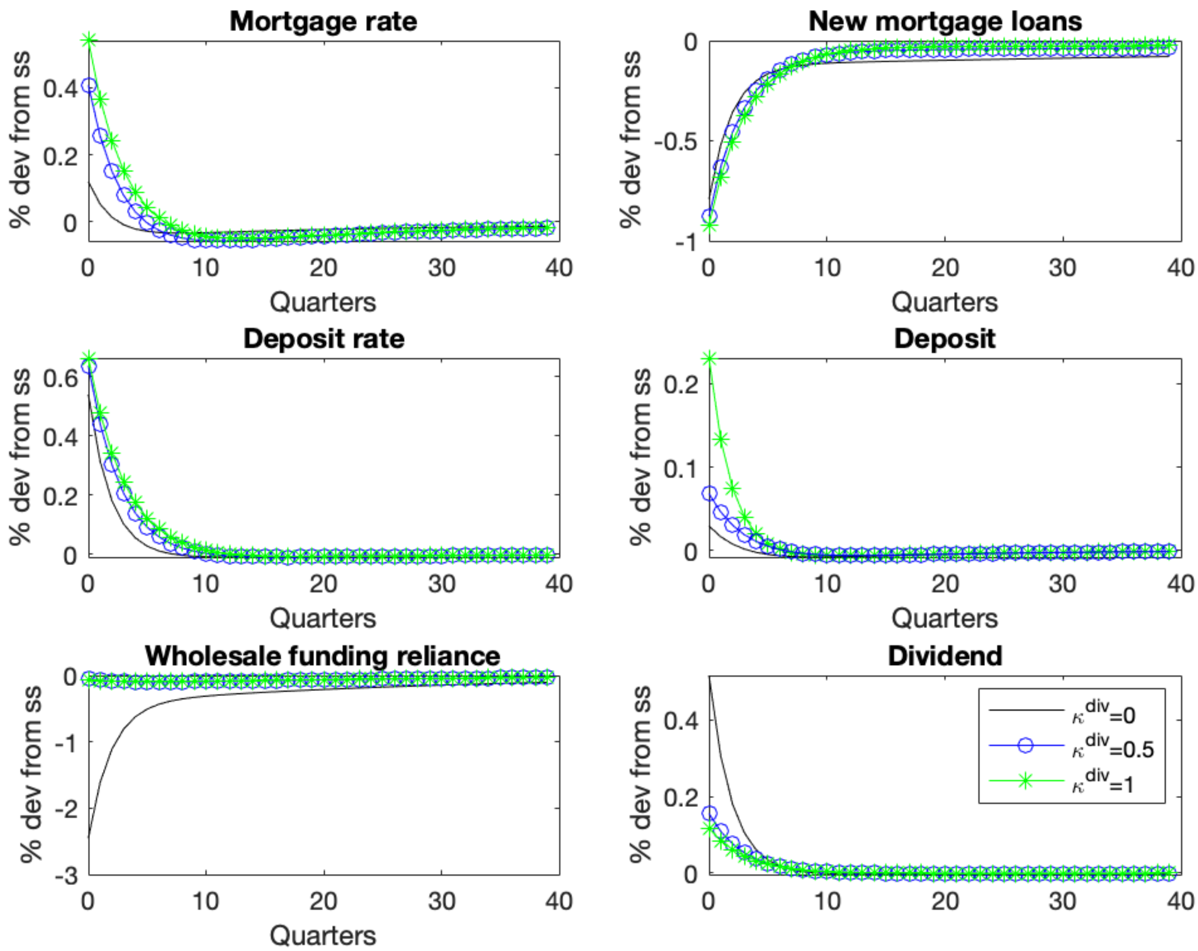


Figure 6: Response to a +100 bps monetary policy shock: Sensitivity analysis in dividend adjustment cost

Figure 7 shows that housing prices fall by 0.9% for banks with a high adjustment cost. Housing prices fall the most for banks with a high adjustment cost because the cost of bank funding has risen. Output and borrowers' consumption fall the most for banks without any adjustment cost. Savers' consumption rises slightly more for banks with an adjustment cost because of the rise in the deposit rate.

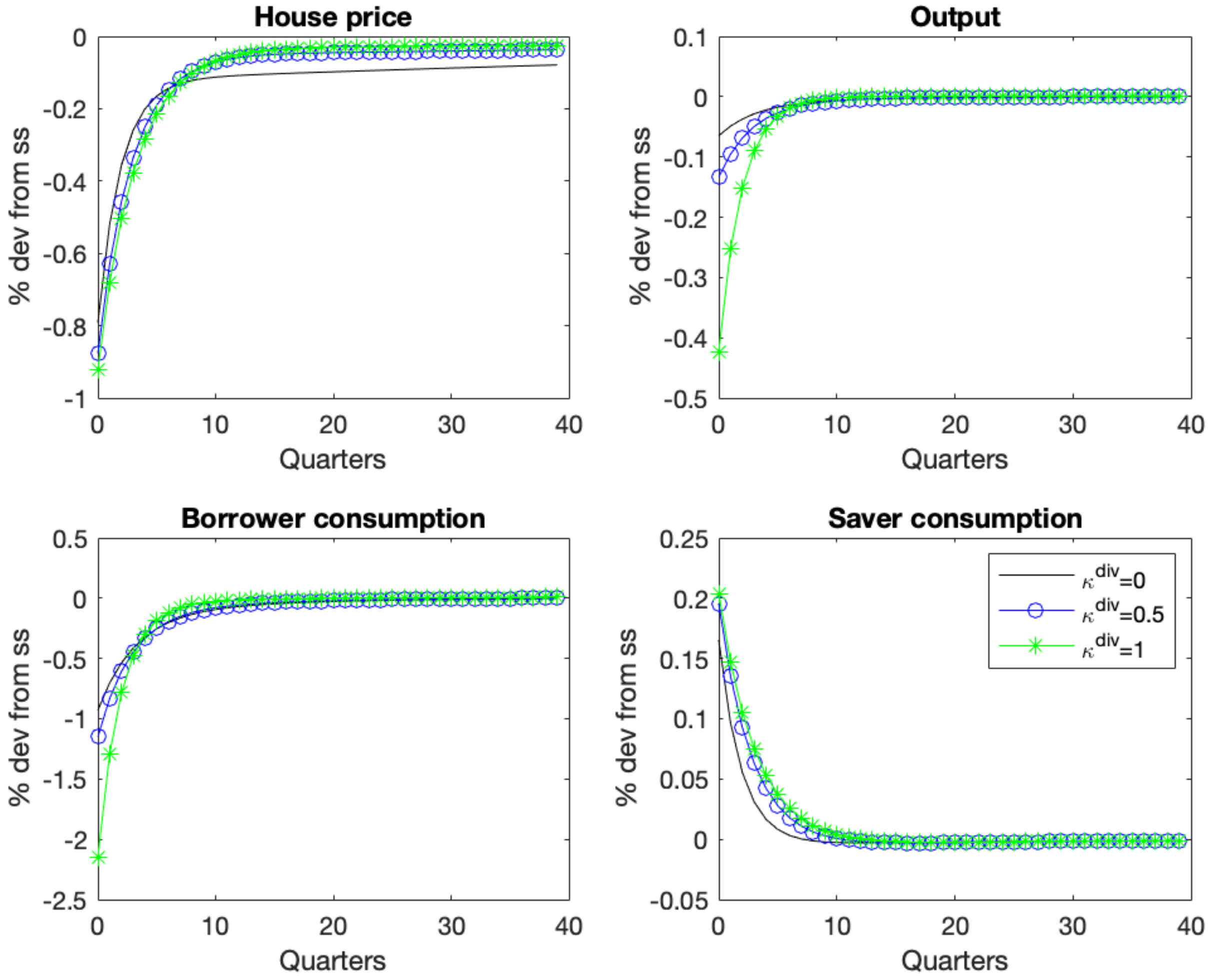


Figure 7: Response to a +100 bps monetary policy shock: Sensitivity analysis in dividend adjustment cost

7.3 Productivity Shocks

In this section, I evaluate the model to Polo (2018)'s quantitative results by shocking the economy with a negative 1% productivity shock. Figures 8 and 9 show impulse response functions of real and bank variables to a negative 1% productivity shock. The decrease in productivity increases firms' marginal costs and through the nominal rigidity leads to an increase in inflation. The central bank increases the nominal rate, and mortgage and deposit rates rise. The rise in the mortgage rate increases by 15 bps in the banking model. This value is in line with the evidence presented by Polo (2018). He finds that the mortgage rate increases by 20 bps after a negative 1% productivity shock. Because of the rise in mortgage rate, newly issued mortgages fall by 0.03% and housing prices fall by 0.02%. Borrower's consumption falls by 0.2% because of the rise in the mortgage rate, and savers' consumption rises by 0.4% from the increase in deposit rates. Although the fall in borrower's consumption is consistent with

Polo (2018)'s result, saver's consumption is in the opposite direction. Saver's consumption falls by 0.6% and deposits fall by 0.8% when deposit rates increase by 0.1% because savers shift their deposits into bonds. As a result, banks in Polo (2018)'s model originate fewer mortgage loans and housing prices fall by 0.2%. Overall, these results imply that market power and costly access to wholesale funding matter for understanding the responses of mortgage rates and economic activities to changes in monetary policy.

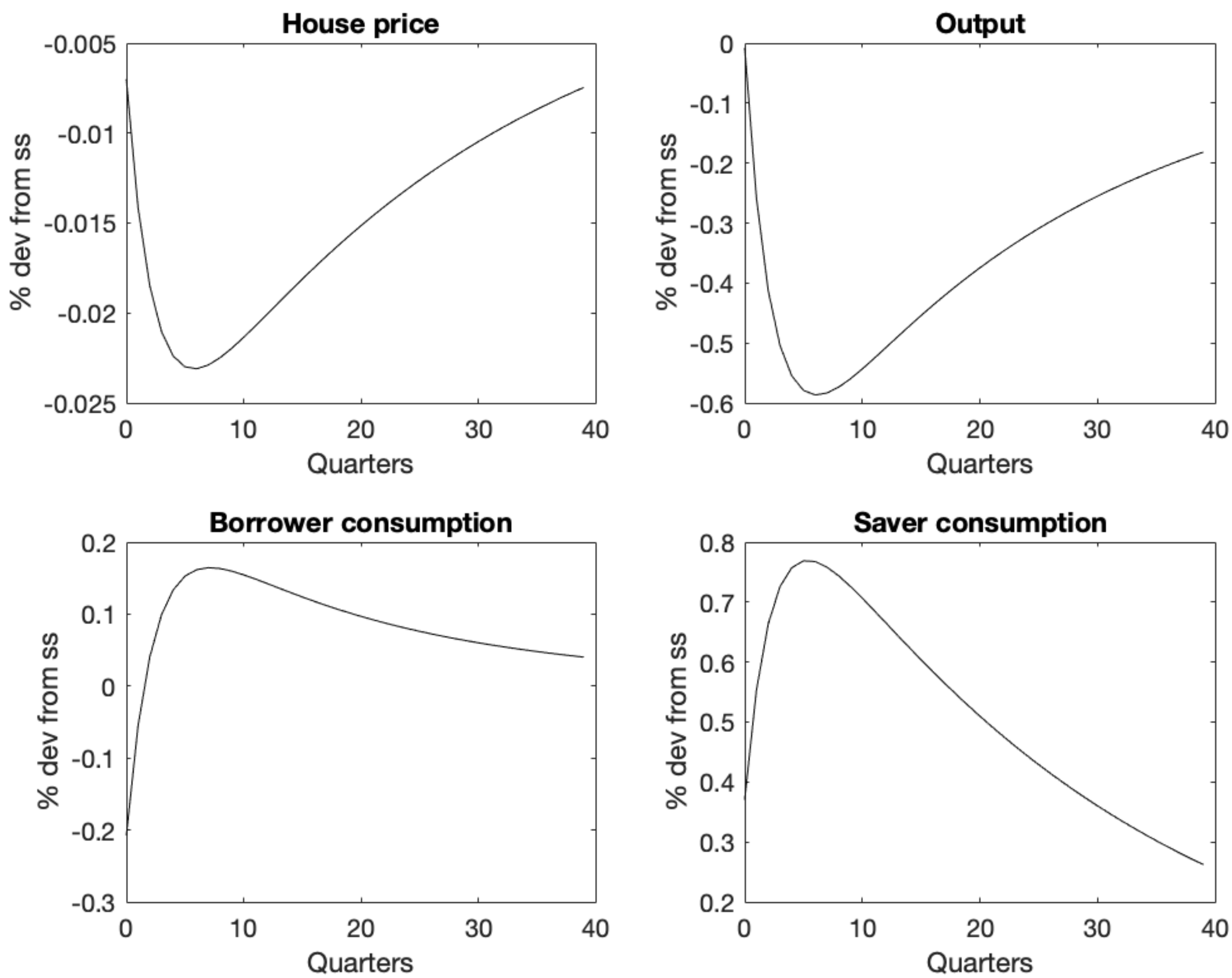


Figure 8: Response to a -1% TFP shock

Notes: This figure depicts the impulse response functions of some of the main variables to a -1% TFP shock under perfect and imperfect transmission. The x axis is given in quarters and the y axis is given in percent deviation from steady state for house price, output, labor and consumption. Inflation rate, real rate and nominal rate are in annualized percentage points.

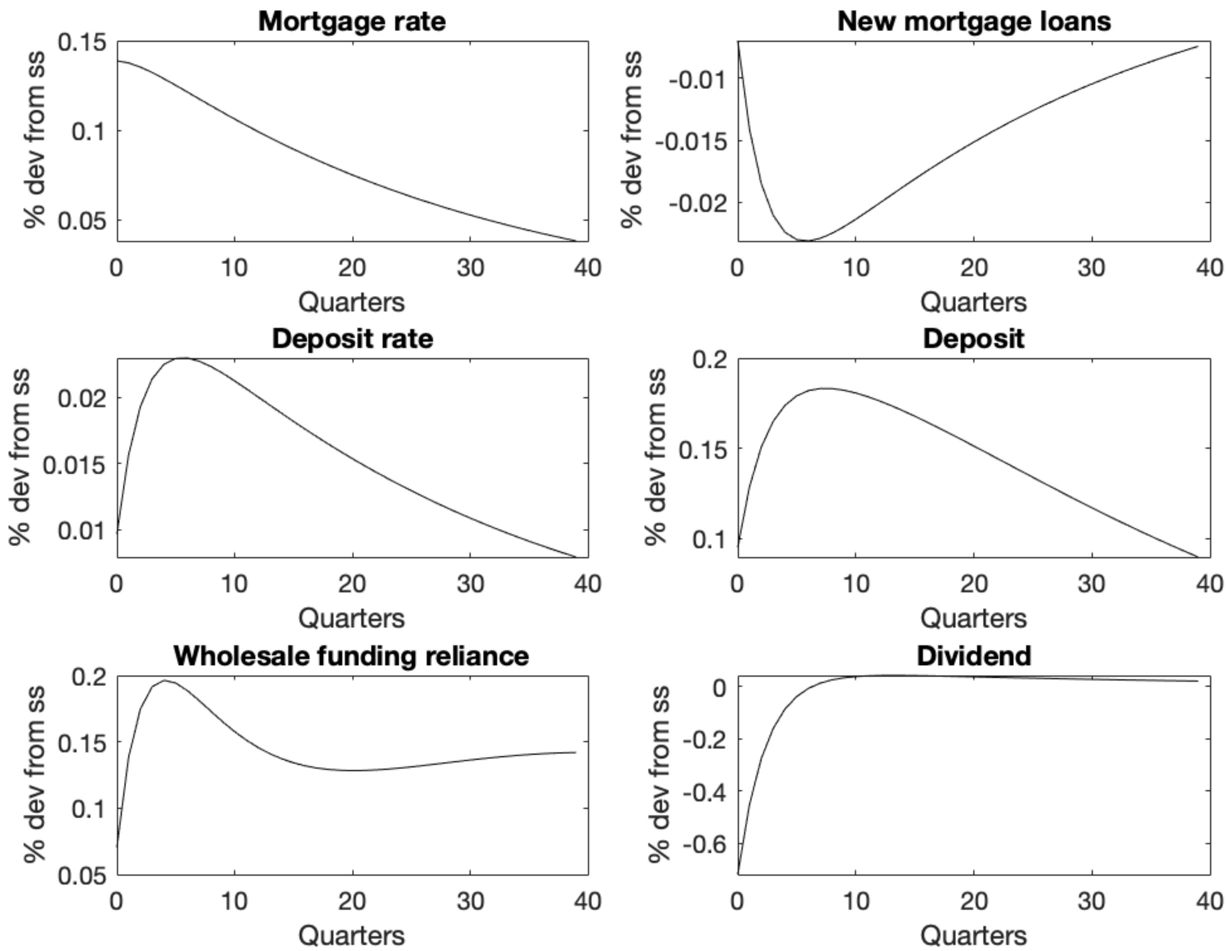


Figure 9: Response to a -1% TFP shock

Notes: This figure depicts the impulse response functions of some of the main variables to a -1% TFP shock under perfect and imperfect transmission. The x axis is given in quarters and the y axis is given in percent deviation from steady state for mortgage rate, deposit rate, new mortgage loans, deposit, wholesale funding reliance and bank dividend. Mortgage rate and deposit rate are in annualized percentage points.

8 Counterfactuals

8.0.1 Inflation Target Shock

I analyze an inflation target shock with the recent proposal in Blanco (2015) to raise the inflation target in order to provide policymakers with more room to cut rates before reaching the zero lower bound. The inflation target shock captures very persistent changes in monetary policy that are able to affect long-term nominal rates by changing short-term rates far into the future, in addition to current short-term rates. The mortgage rate has a longer horizon and inflation targeting is highly persistent and affects the term structure, whereas a Taylor rule shock affects the transitory structure. An inflation target shock moves nominal rates while influencing real rates very little, making it convenient for analyzing the effect of changing nominal rates in isolation. The monetary authority follows a Taylor rule, similar to that of Smets and Wouters (2007), of the form

$$\begin{aligned} \log(1+i_t) &= \log\bar{\pi}_t + \phi_r\left(\log(1+i_{t-1}) - \log\bar{\pi}_{t-1}\right) \\ &+ (1-\phi_r)\left[\left(\log(1+i_{ss}) - \log\pi_{ss}\right) + \psi_\pi\left(\log\pi_t - \log\bar{\pi}_t\right)\right], \end{aligned} \tag{32}$$

where the subscript ss refers to steady-state values, and $\bar{\pi}_t$ is a time-varying inflation target defined by

$$\log\bar{\pi}_t = (1-\psi_{\bar{\pi}})\log\pi_{ss} + \psi_{\bar{\pi}}\log\bar{\pi}_{t-1} + \varepsilon_{\bar{\pi},t}, \tag{33}$$

where $\varepsilon_{\bar{\pi},t}$ is a white noise process that is referred to as an inflation target shock.

Figure 10 shows that reliance on wholesale funding increases and banks' dividends fall under an inflation target shock. Interest expenses have risen, whereas deposit rates rise more than under the Taylor rule. Banks experience larger deposit outflows and thus they rely more on wholesale funding. As a result, reliance on wholesale funding increases more, and dividends fall. However, under the Taylor rule, banks do not increase their reliance on wholesale funding. Banks' dividends rise because they are paying a cost to build larger deposit bases.

Figure 11 shows that inflation falls under the Taylor rule but rises under an inflation target shock. This is a result of the nature of the shock: an inflation target shock raises the inflation rate, whereas the Taylor rule increases the nominal rate, which then decreases the inflation rate. The inflation target shock has a persistent effect on real variables and amplifies the response more than the Taylor rule.

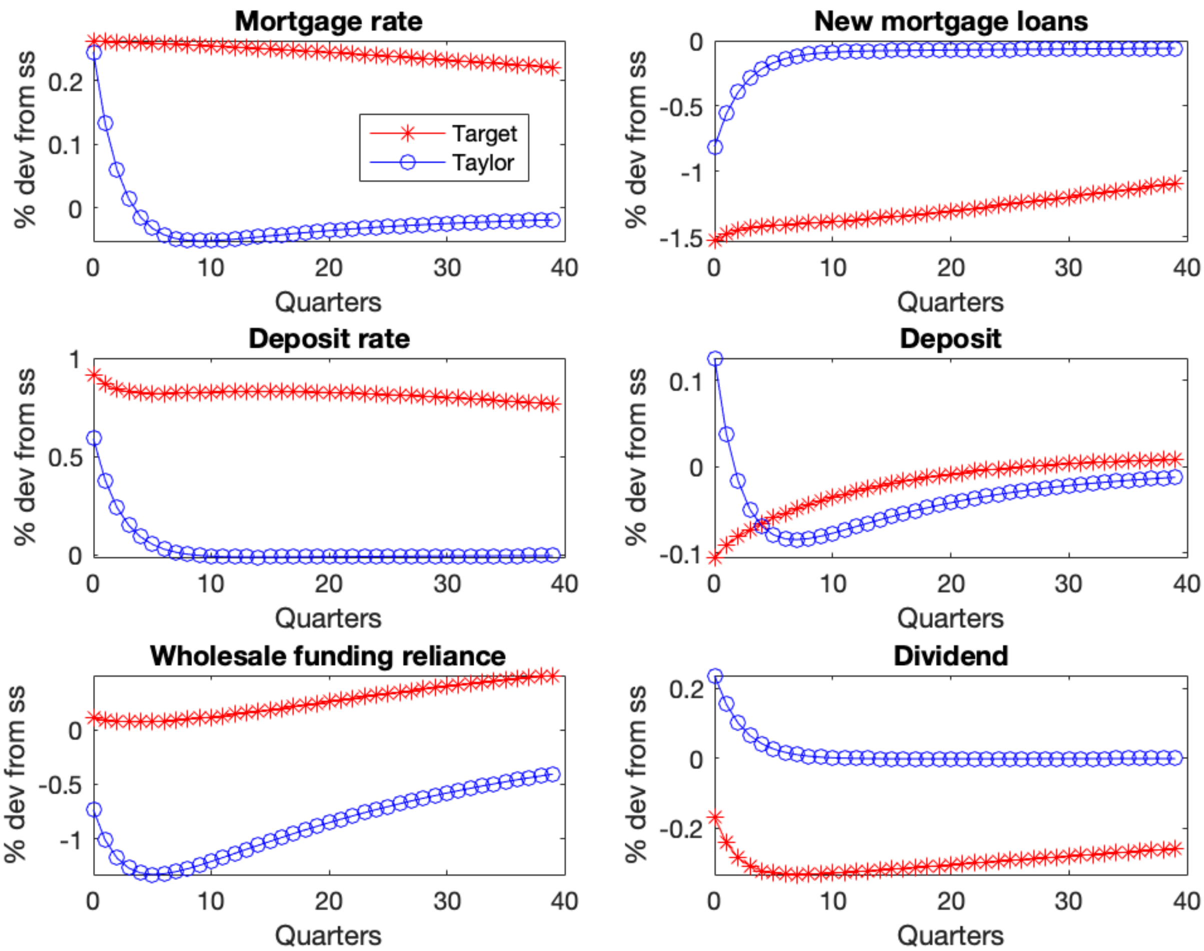


Figure 10: Response to a +100 bps monetary policy shock: Taylor rule vs Target

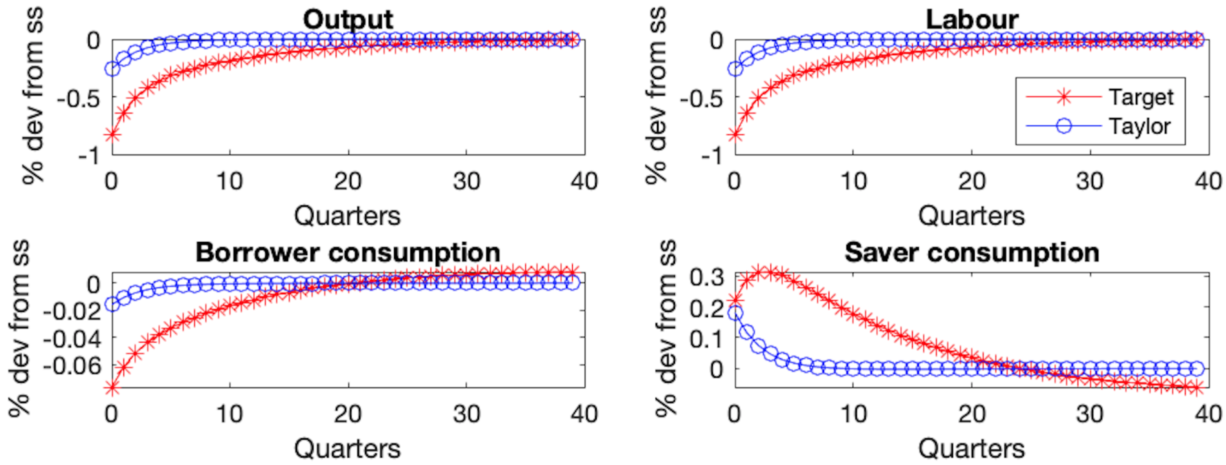


Figure 11: Response to a +100 bps monetary policy shock: Taylor rule vs Target

8.1 Basel III Liquidity Coverage Ratio (LCR)

Reliance on wholesale funding increases liquidity risks during times of market disruptions. Basel III LCR introduced a new liquidity regulation to contain excessive reliance on wholesale funding in the banking sector. It is defined as:

$$LCR = \frac{\text{High Quality Liquid Assets}}{\text{Cash Outflow}} \geq \kappa$$

where high quality liquid assets (HQLA) $= \sum_k$ Liquidity weight$_k \times$Asset$_k$ and

cash outflows $= \sum_k$ Runoff rate$_k$ $\times$ $\frac{\text{Liability}_k}{\text{Maturity}_k}$. Level 1 HQLAs include cash, central bank reserves and government securities with liquidity weight of 100%, level 2a HQLAs include GSE securities with liquidity weight of 85% and level 2b HQLAs include investment corporate and municipal bonds with liquidity weight of 50%.

Starting January 1, 2015 κ was 60% and it raises by 10% each year until it reaches 100% by January 1, 2019. Banks with assets between \$50B and \$250B are subject to 70% of Basel III LCR rule and banks with assets greater than \$250B and foreign exchange greater than \$10B face 100% of the rule. In my model, I only have GSE securities with weight of 85% and runoff rate for deposit is 0 while runoff rate for wholesale funding is 1 which gives equation $\frac{0.85m}{b} \geq \kappa$ giving the Basel III LCR requirement of $p' = 0.85m' - \kappa b'$.

Bank chooses deposit rate i^D_{jt} and new mortgage rate i^{M*}_{jt}

$$\max_{i^{M*}_{jt}, i^D_{jt}} \mathbb{E}_0 \left[\sum_{t=0}^{\infty} \frac{\Lambda^s_{t+1}}{\pi_{t+1}} \{x_{jt} - \nu m_{jt} - i^D_{jt} d_{jt} - (i_t + \frac{\phi^B}{2} \frac{b_{jt}}{d_{jt}}) b_{jt}\} - \frac{\kappa^{div}}{2} (div_{jt+1} - \overline{div})^2 \right] \tag{34}$$

subject to the balance sheet constraint (20), laws of motions (22), (23), mortgage (24), deposit demand (25) and the Basel III LCR rule

$$m_{jt} \geq \frac{\kappa}{\omega} b_{jt} \tag{35}$$

where $\omega = 0.85$ is the liquidity weight and $\kappa = \{0.7, 1\}$ is the target. Banks with assets greater than \$250B can borrow wholesale funding up to $b \in [0, \underline{\mathrm{b}}]$, whereas banks with assets between \$50B and \$250B can borrow wholesale funding up to $b \in [0, \bar{b}]$ where $\bar{b} > \underline{\mathrm{b}}$ shown in figure 12.

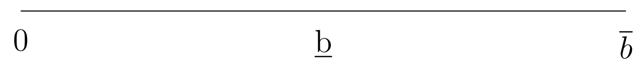


Figure 12: Threshold

Banks with a high level of market power rely heavily on wholesale funding and are more affected by the Basel III Liquidity Coverage Ratio rule. Banks with higher market power engage in wholesale funding substitution more during monetary tightening, but because of the Basel III regulation, they would need to rely more on retail deposits. Their lending is more affected by monetary tightening, and thus mortgage rates are amplified by the new regulatory constraint.

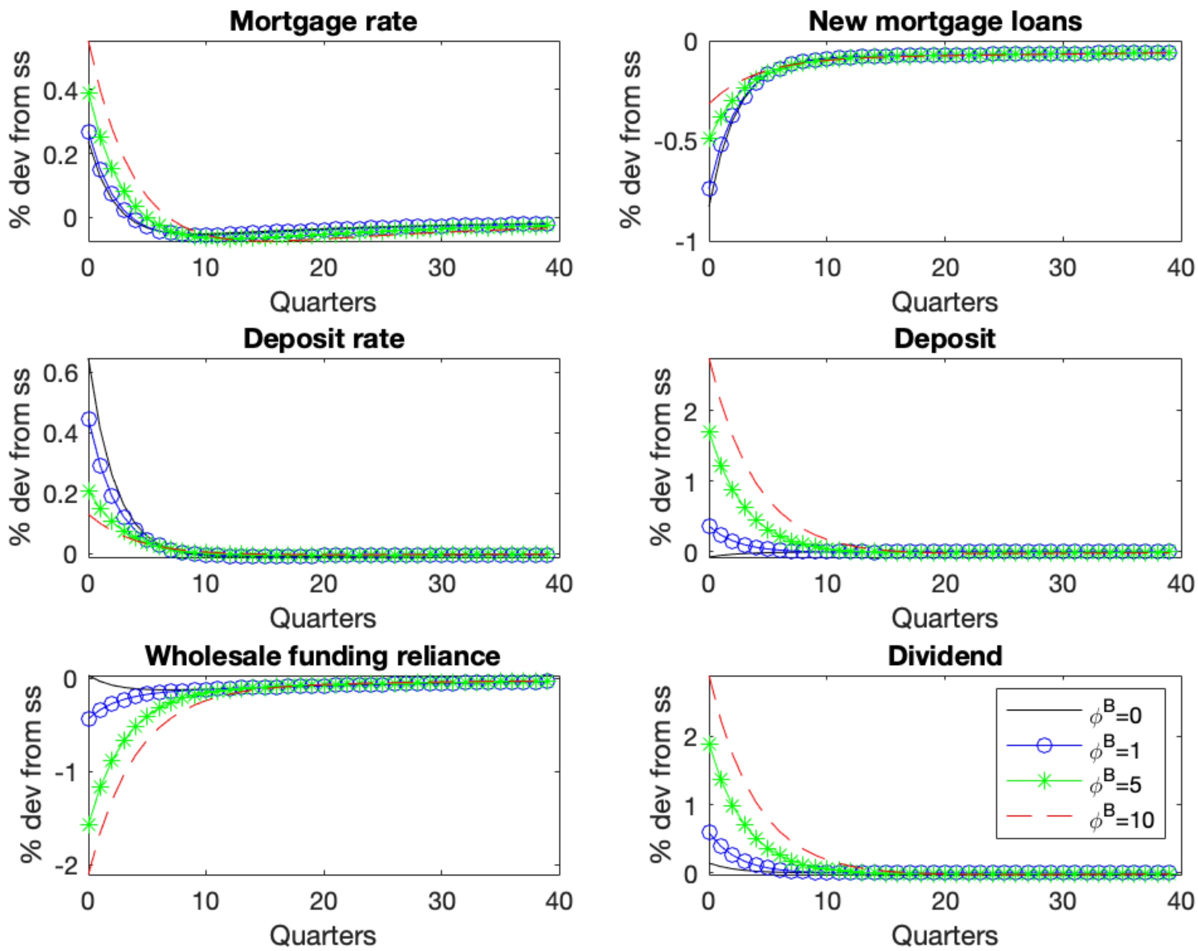


Figure 13: Response to a +100 bps monetary policy shock: Bank variables

9 Conclusion

My paper studies the quantitative importance of bank market power and wholesale funding reliance for transmitting monetary policy shocks to mortgage market and economic activities. I contribute to a literature on monetary policy transmission by relegating an active role to banking by linking bank funding with loan originations and capturing the aggregate effects of imperfect pass-through to mortgage rates. I find that imperfect monetary policy transmission on mortgage rates dampens the response of consumption, output, and housing prices.

Using a bank- and loan-level dataset, I find that in response to a 100 bps increase in the policy rate, banks at the 90th percentile of wholesale funding reliance in concentrated markets transmit 61 bps, whereas banks in competitive markets transmit 116 bps. Motivated by these facts, I build a New Keynesian model with a monopolistically competitive banking sector that has a costly access to wholesale funding. I calibrate the model to match cross-sectional bank portfolio moments. I then validate the model by showing that the model can generate a number of untargeted patterns in the data, assess the model against data projection, and document that the model-implied regression coefficients are consistent with the data.

My paper is of independent interest to policymakers who are concerned about the transmission of monetary policy to mortgage rates and the aggregate economy. It adds value to policymakers' decisions to be aware that the transmission of monetary policy shocks to mortgage rates is not perfect and that the transmission varies across banks by their degree of market concentration and composition of funding.

In the future, understanding how monetary policy transmission works via the banking sector under unconventional monetary policy is pertinent. The Federal Reserve has been heavily involved in asset and liability purchases as they have reached the effective lower bound. During the Great Recession, the Federal Reserve purchased mortgage securities from banks and has purchased Treasury securities during the COVID-19 lockdown to limit economic damage.

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A Appendix

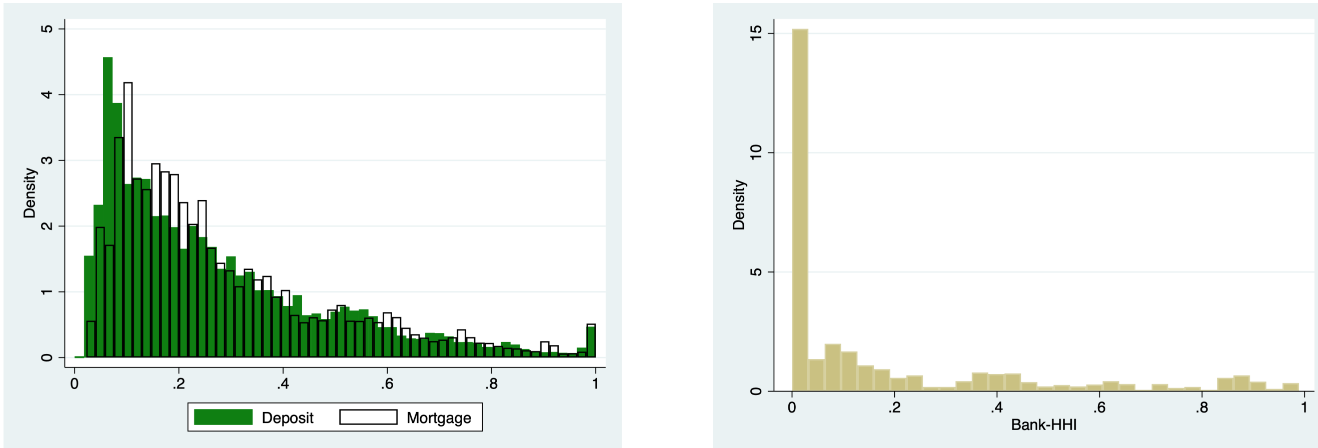
A.1 Empirics

A.1.1 Tables

Table 8: Banks

Ally Bank
Amtrust Bank
Associated Bank, National Association
Bank of America, National Association
Branch Banking and Trust Company
Capital One, National Association
Citizens Bank, National Association
Colorado Federal Savings Bank
Downey Savings and Loan Association
Everbank
Indymac Federal Bank
Fifth Third Bank
First Tennessee Bank National Association
Firstarbank, National Association
Flagstar Bank, Federal Savings Bank
Fremont Bank
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
New York Community Bank
PNC Bank, National Association
Regions Bank
Santander Bank, National Association
Sovereign Bank
The Huntington National Bank
Third Federal Savings and Loan
UnionSavingsBank
USAA Federal Savings Bank
US Bank, National Association
Wachovia Mortgage, Federal Savings Bank
Washington Mutual Bank
Wells Fargo Bank, National Association

Figure 14: Local market concentration and Bank-HHI

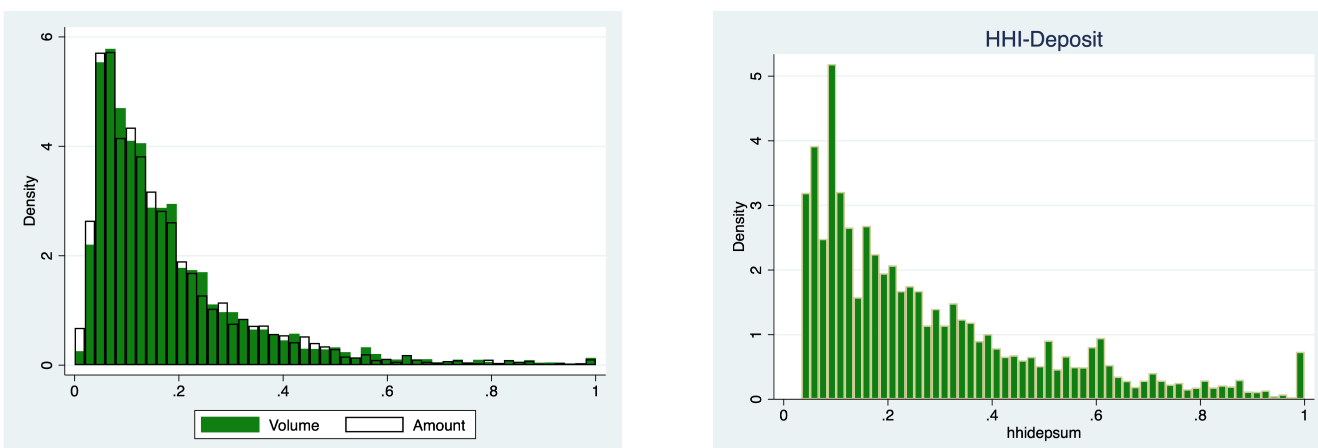


(a) Local market concentration

(b) Bank-HHI

Notes: Bank-HHI is measured by multiplying the local market concentration with the share of deposits: $\text{Bank-HHI}_{mt} = \text{HHI}_{mt} \times \left(\frac{dep_{bmt}}{\sum_{b\in\{m\}} dep_{bmt}}\right)$. Deposit (mortgage) HHI has a mean of 0.28 (0.27) and standard deviation of 0.21 (0.21). Bank-HHI in deposit (mortgage) has a mean of 0.18 (0.18) and a standard deviation of 0.27 (0.26).

Figure 15: HHI



(a) HHI-Mortgage (HMDA)

(b) HHI-Deposit (SOD)

Notes: Mortgage market concentration is constructed from the Home Mortgage Disclosure Act for loans originated in volume and amount. HHI in mortgage market has a mean of 0.17 and a standard deviation of 0.15. Deposit HHI is constructed from the Summary of Deposits and has a mean of 0.28 and standard deviation of 0.22.

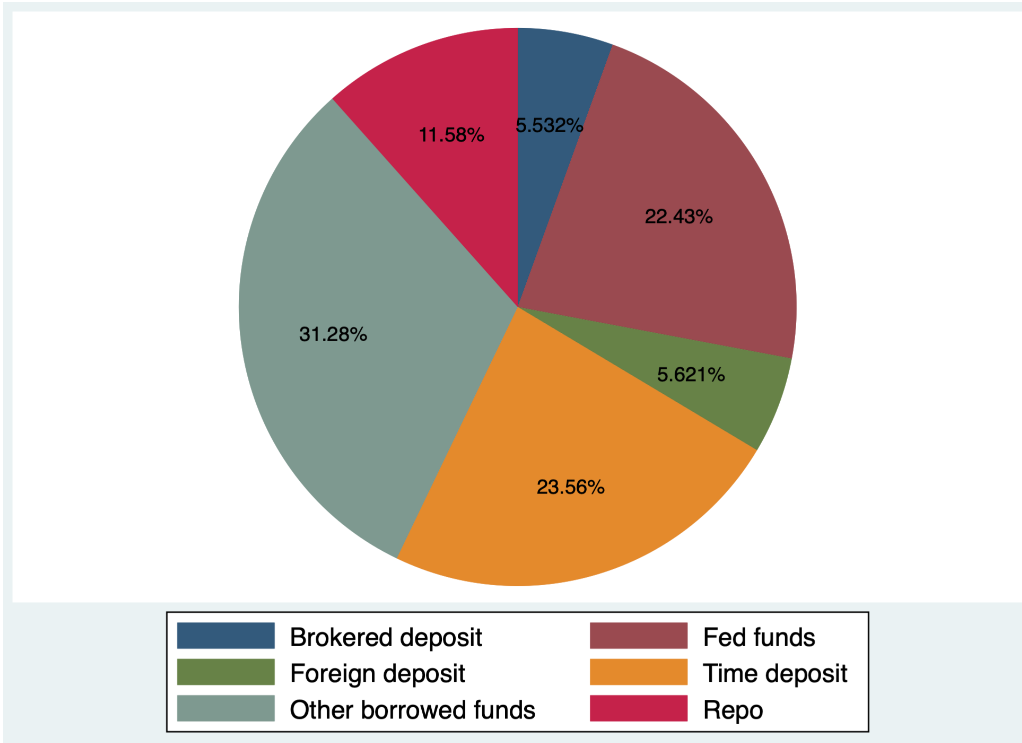


Figure 16: Composition of wholesale funding

Notes: Wholesale funding consists of 5.5% of brokered deposit, 22.4% of federal funds purchased, 5.6% of deposits held in foreign offices, 23.6% of time deposits, 11.6% of repurchase agreements (repos) and 31.3% of other borrowed funds.

Table 9: Summary statistics

Variable	Mean	Std. Dev.	Min	Max	P25	P50	P75
Wholesale funding/retail deposit	.84	1.16	.07	17.12	.35	.58	.96
Wholesale funding/liability	.37	.16	.05	1.06	.25	.35	.46
Retail deposit/liability	.59	.17	.06	.96	.49	.6	.71
Deposit rate	.02	.02	0	.1	0	.01	.02
Mortgage rate	5.4	1.3	2.77	8.47	4.19	5.61	6.26
HHI^D	.43	.26	.04	.99	.23	.35	.6
HHI^M	.42	.24	.04	.99	.24	.37	.56
MBS/Asset	.12	.09	0	.64	.06	.11	.16
Credit score	742.59	23.05	577	790.52	726.65	743.25	762.22
LTV	73.36	6.43	39.06	91.56	71.01	74.73	77.07

Summary statistics are based on the Consolidated Reports of Condition and Income (Call Reports) from 2000Q1 to 2014Q1 for US banks with size greater than $1B. All variables are quarterly. Wholesale funding includes brokered deposit, federal funds purchased, deposits held in foreign offices, time deposits and other borrowed funds. Deposit rate is an imputed measure by dividing total interest expense over total deposit. Number of observations is 1791.

A.1.2 Robustness checks

In this section, I check for robustness by using bank market power in mortgage and deposit market in response to +100 and -100 bps monetary policy shocks. Overall, market/bank concentration in deposit and mortgage show similar results. My main empirical result shows that banks located in a concentrated market pass-through less. They reduce markups to mitigate the effects of fall in loan demand. Reliance on wholesale funding substitutes deposit outflows for banks located in a concentrated market. Banks in concentrated markets are responsive to +100 bps, but not responsive to -100 bps because there is not enough competition between cash and deposits to experience deposit outflow. However, only banks with market power in mortgage is responsive to both monetary expansion and tightening. One possible explanation is that the mortgage market is concentrated in high levels of deposit while deposits can be transferred within bank.

Table 10 in appendix shows how 1% increase in wholesale funding reliance affects mortgage rate transmission. The triple interaction is statistically significant across bank variation and when there are no fixed effects. 1% increase in wholesale funding reliance in a concentrated market transmits 29 to 36 bps less to mortgage rates. Triple interaction of log of wholesale funding reliance with monetary policy shocks and market concentration has a larger effect on mortgage rates, but its interaction with monetary shocks are not statistically significant. The magnitude of bank concentration stays the same throughout different specifications.

Table 10: Heterogeneity in monetary policy transmission

Notes: results from estimating

$$\begin{aligned}\Delta r_{mbt} = \alpha_b + \alpha_m + \beta_1 \Delta i_t + \beta_2 WFR_{bmt} + \beta_3 HHI_{mt} + \beta_4 WFR_{bmt} \times HHI_{mt} \\ +\beta_5 WFR_{bmt} \times \Delta i_t + \beta_6 \Delta i_t \times HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt} \times \Delta i_t \\ +\Gamma \text{HH Controls}_{bmt} + X\text{Bank Controls}_{bmt} + \epsilon_{mbt}\end{aligned}$$

where α_b is a bank fixed effect, α_m is a MSA fixed effect, WFR_{bmt} is wholesale funding reliance, HHI_{mt} is the HHI in deposit market, Δi_t is +100 bps monetary policy shock, HH controls include borrower's credit score and LTV and bank controls include log asset, liquidity asset ratio, liability interest rate, real estate and commercial and industrial loans ratio and MBS to asset ratio. Standard errors are clustered at the bank level. $***p < 0.01, **p < 0.05, *p < 0.1$.

	Δr_{mbt}			
	(1)	(2)	(3)	(4)
Δi_t	1.323***	1.365***	1.221***	1.236***
	(0.132)	(0.148)	(0.150)	(0.157)
HHI^D_{mt}	0.0633**	0.257***	0.0763	0.109
	(0.0295)	(0.0903)	(0.0783)	(0.0913)
$\Delta i_t \times HHI^D_{mt}$	-0.576**	-0.858***	-0.653**	-0.726**
	(0.275)	(0.282)	(0.295)	(0.311)
$\log(WFR_{bmt})$	0.0015	0.0132	-0.0057	-0.005
	(0.00402)	(0.00800)	(0.0109)	(0.0120)
$\Delta i_t \times \log(WFR_{bmt})$	0.0863	0.112	0.0685	0.0651
	(0.0698)	(0.0910)	(0.0858)	(0.0915)
$HHI^D_{mt} \times \log(WFR_{bmt})$	0.0120*	-0.0200	0.0002	-0.004
	(0.00675)	(0.0168)	(0.0163)	(0.0190)
$\Delta i_t \times HHI^D_{mt} \times \log(WFR_{bmt})$	-0.296*	-0.358*	-0.265	-0.263
	(0.156)	(0.196)	(0.184)	(0.196)
Bank FE	No	No	Yes	Yes
MSA FE	No	Yes	No	Yes
R^2	0.156	0.196	0.223	0.225
F	45.90	38.67	51.10	44.58
N	871	866	862	861

Table 11: Why is mortgage only responsive? Deposits can be transferred within bank.

$$\Delta r_{mbt} = \alpha_b + \alpha_m + \beta_1 \Delta i_t + \beta_2 WFR_{bmt} + \beta_3 \text{Bank-HHI}_{mt} + \beta_4 WFR_{bmt} \times \text{Bank-HHI}_{mt}$$
$$+\beta_5 WFR_{bmt} \times \Delta i_t + \beta_6 \Delta i_t \times \text{Bank-HHI}_{mt} + \beta_7 WFR_{bmt} \times \text{Bank-HHI}_{mt} \times \Delta i_t$$
$$+\Gamma \text{HH Controls}_{bmt} + X \text{Bank Controls}_{bmt} + \epsilon_{mbt}$$

where Δr_{mbt} is the change in mortgage rate for bank b at MSA m at quarter t. Δi_t is the monetary shock from Nakamura and Steinsson (2018) normalized to have a +100 bps impact. WFR_{bmt} is the wholesale funding reliance for bank b in MSA M at quarter t and Bank-HHI$_{mt}$ is the bank market power in deposit and mortgage. HH Controls$_{bmt}$ includes FICO score and LTV. BankControls$_{bmt}$ include log asset, liquidity asset ratio, liability interest rate, real estate and commercial and industrial loans ratio and MBS to asset ratio. The empirical design allows me to test how elasticities of mortgage rates relative to monetary policy shock changes in competitive vs concentrated markets relative to banks with greater or fewer wholesale funding. $***p < 0.01, **p < 0.05, *p < 0.1$. **Only bank market power in mortgage is statistically significant in response to monetary policy shocks.** The main interested variable is:

$$\frac{\partial \Delta r_{mbt}}{\partial \Delta i_t} = (\beta_1 + \beta_5 WFR_{bmt} + \beta_6 \text{Bank-HHI}_{mt} + \beta_7 WFR_{bmt} \times \text{Bank-HHI}_{mt}).$$

	(1)	(2)	(3)	(4)
	+100 bps		-100 bps	
	$\Delta r_{mbt}(HHI^M_{mt})$	$\Delta r_{mbt}(HHI^D_{mt})$	$\Delta r_{mbt}(HHI^M_{mt})$	$\Delta r_{mbt}(HHI^D_{mt})$
Δi_t	0.952***	0.899***	-1.856***	-1.816***
	(0.125)	(0.126)	(0.427)	(0.432)
WFR$_{bmt} \times \Delta i_t$	0.029	0.031	-0.207	-0.178
	(0.026)	(0.0636)	(0.026)	(0.142)
Bank-HHI$_{mt} \times \Delta i_t$	-0.152	0.069	0.151	0.953
	(0.353)	(2.284)	(0.533)	(1.34)
WFR$_{bmt} \times \Delta i_t \times$ Bank-HHI$_{mt}$	-0.359*	-0.308	1.346**	-0.538
	(0.205)	(0.140)	(0.539)	(1.409)
R^2	0.222	0.202	0.222	0.185
N	867	977	867	919

Table 12: Why is local market concentration unresponsive to -100 bps? Not enough competition between cash and deposits.

$$\Delta r_{mbt} = \beta_1 \Delta i_t + \beta_2 WFR_{bmt} + \beta_3 HHI_{mt} + \beta_4 WFR_{bmt} \times HHI_{mt}$$
$$+\beta_5 WFR_{bmt} \times \Delta i_t + \beta_6 \Delta i_t \times HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt} \times \Delta i_t$$
$$+\Gamma \text{HH Controls}_{bmt} + X\text{Bank Controls}_{bmt} + \epsilon_{mbt}$$

where Δr_{mbt} is the change in mortgage rate for bank b at MSA m at quarter t. Δi_t is the monetary shock from Nakamura and Steinsson (2018) normalized to have a +100 bps impact. WFR_{bmt} is the natural logarithm of wholesale funding in bank b, MSA M at quarter t and HHI_{mt} is the local market concentration in MSA m at quarter t. HH Controls_{bmt} includes FICO score and LTV. $\text{BankControls}_{bmt}$ include log asset, liquidity asset ratio, liability interest rate, real estate and commercial and industrial loans ratio and MBS to asset ratio. The empirical design allows me to test how elasticities of mortgage rates relative to monetary policy shock changes in competitive vs concentrated markets relative to banks with greater or fewer wholesale funding. The triple interaction is responsive only to +100 bps monetary policy shock. $***p < 0.01, **p < 0.05, *p < 0.1$. The main interested variable is:

$$\frac{\partial \Delta r_{mbt}}{\partial \Delta i_t} = (\beta_1 + \beta_5 WFR_{bmt} + \beta_6 HHI_{mt} + \beta_7 WFR_{bmt} \times HHI_{mt}).$$

	(1)	(2)	(3)	(4)
	+100 bps		-100 bps	
	$\Delta r_{mbt}(HHI_{mt}^M)$	$\Delta r_{mbt}(HHI_{mt}^D)$	$\Delta r_{mbt}(HHI_{mt}^M)$	$\Delta r_{mbt}(HHI_{mt}^D)$
Δi_t	1.167***	1.164***	-2.32***	-2.271***
	(0.161)	(0.162)	(0.669)	(0.663)
$\text{WFR}_{bmt} \times \Delta i_t$	0.0005**	0.001***	-0.001	-0.001
	(0.0002)	(0.0003)	(0.001)	(0.001)
$\text{HHI}_{mt} \times \Delta i_t$	-0.598*	-0.566*	0.898	0.704
	(0.348)	(0.334)	(1.296)	(1.198)
$\text{WFR}_{bmt} \times \Delta i_t \times \text{HHI}_{mt}$	-0.002**	-0.002***	0.002	0.002
	(0.0005)	(0.0005)	(0.003)	(0.002)
R^2	0.223	0.226	0.181	0.181
N	867	867	919	919

A.1.3 Data Sources and Description

In this section, I begin by describing the different datasets used in this paper. I then detail how the relevant variables were computed.

Consumer Expenditure Survey (CEX). It is an annual rotating panel survey for US households elaborated by the Bureau of Labor Statistics available since 1996. Interviews are conducted on a monthly basis, but each household is interviewed every three months up to five times. On each interview, a household provides information about consumption during the three months prior to the month of the current interview. On the fifth interview, households also provide information on wealth variables, in particular, whether they hold "stocks, bonds, mutual funds, and other such securities". I construct total average annual expenditures by housing tenure: homeowner without mortgage and homeowner with mortgage.

Federal Housing Finance Administration (FHFA). It is an index that measures changes in single-family house prices based on data covering all 50 states and over 400 American cities. It is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages have been purchased or securitized by Fannie Mae or Freddie Mac since January 1975.I use quarterly purchase-only indexes to construct housing price.

Table 13: Data Definitions

Name	Definition	Source	Code
Output	Real GDP	BEA	GDPC1
House Price	All-Transactions House Price Index	FHFA	USSTHPI
Saver consumption	Homeowner without mortgage	CEX	CXUTOTALEXPLB0804M
Borrower consumption	Homeowner with mortgage	CEX	CXUTOTALEXPLB0803M

Sources for the various macroeconomic data used in the paper are Bureau of Economic Analysis (BEA), Federal Housing Finance Administration (FHFA) and Consumer Expenditure Survey (CEX).

A.1.4 Treasury relation

Table 14: Nakamura and Steinsson 2018 Replication

I document the relationship between Treasury bond and mortgage rates and monetary policy shocks. Monetary policy shocks have almost 1-to-1 relationship for Treasury bonds with maturity less than 10 years. For 10 year Treasury bond and 30 Year mortgage rate, the monetary policy shock passes through half. $***p < 0.01, **p < 0.05, *p < 0.1$.

	(1)	(2)	(3)	(4)	(5)	(6)
	Δi_t^M	1Y Treasury	2Y Treasury	3Y Treasury	5Y Treasury	10Y Treasury
Δi_t	0.508**	1.583***	1.216***	1.010***	0.793***	0.535***
	(0.230)	(0.204)	(0.235)	(0.248)	(0.235)	(0.189)
R^2	0.030	0.133	0.080	0.055	0.034	0.018
F	4.871	60.49	26.65	16.55	11.39	7.965
N	157	414	414	414	414	414

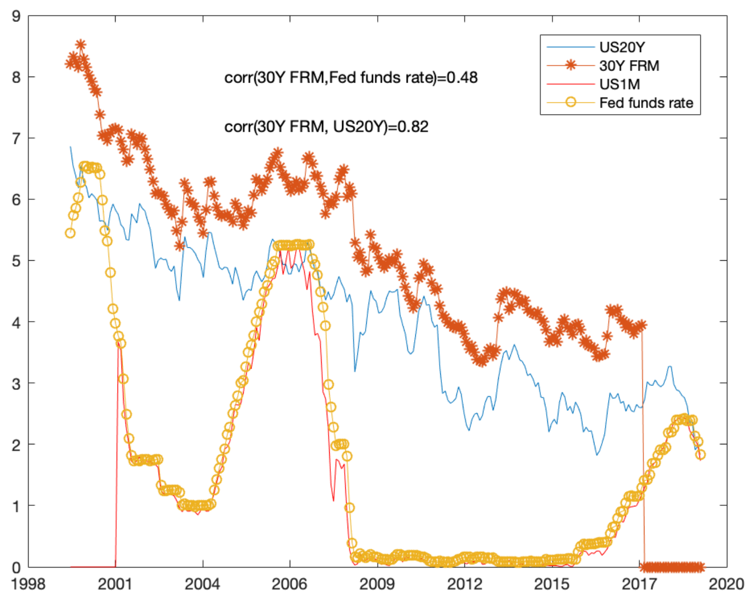
Table 15: Treasury Yields on mortgage rate

I document the relationship between Treasury bond and mortgage rates and monetary policy shocks. The pass-through of treasury bonds on mortgage rates is around 17%. $***p < 0.01, **p < 0.05, *p < 0.1$.

	(1)	(2)	(3)	(4)	(5)
			Δi_t^M		
1Y Treasury	0.149**				
	(0.0599)				
2Y Treasury		0.177***			
		(0.0577)			
3Y Treasury			0.178***		
			(0.0567)		
5Y Treasury				0.173***	
				(0.0583)	
10Y Treasury					0.159**
					(0.0686)
R^2	0.047	0.060	0.059	0.052	0.037
F	6.176	9.445	9.876	8.792	5.338
N	116	116	116	116	116

Figure 17: Federal funds rate, Treasury bonds, 30Year Fixed-Rate Mortgage

20 year Treasury bonds and 30 year fixed rate mortgage are 82% correlated, while policy rate and 1 month Treasury bonds are 62% correlated. The policy rate and 20 year Treasury bonds are 65% correlated.



A.2 Basic Model Solution

Saver Optimality The optimality conditions yield standard first-order conditions for consumption and labor supply:

$$\mathbb{E}_t\Big(\beta_s \frac{\Lambda^s_{t+1}}{\pi_{t+1}}(1+i^D_{jt})\Big) = 1$$

$$\Big(\frac{n_{st}}{\chi}\Big)^{\eta} = \frac{w_t}{c_{st}}$$

where $\Lambda^s_{t+1} = \frac{u^c_{st+1}}{u^c_{st}}$

Borrower Optimality Denote with λ_{bt} the multiplier associated with the borrowing constraint normalized by the marginal utility of consumption. The optimization conditions for loans, housing and labor are respectively:

$$(1-\lambda_{bt})\frac{1}{c_{bt}} = \beta_b \mathbb{E}_t\Big(\frac{1+i^M_t}{c_{bt+1}}\Big)$$

$$p^h_t(1-\lambda_{bt}\theta^{LTV})\frac{1}{c_{bt}} = \beta_b \mathbb{E}_t\Big(\frac{\psi c_{bt+1}}{h_t(1-\chi)} + p^h_{t+1}\Big)\frac{1}{c_{bt+1}}$$

$$\Big(\frac{n_{bt}}{1-\chi}\Big)^{\eta} = \frac{w_t}{c_{bt}}$$

Bank Optimality Denote with λ_{ft} the multiplier on the capital adequacy constraint normalized by the marginal utility of consumption. The optimality conditions for deposits and loans are respectively:

$$1 - \lambda_{ft} = \mathbb{E}_t\Big(\beta_f \frac{c_{ft}}{c_{ft+1}}(i_t - i_t^D)\Big)$$

$$1 - \gamma\lambda_{ft} = \mathbb{E}_t\Big(\beta_f \frac{c_{ft}}{c_{ft+1}}(i_t^M - i_t)\Big)$$

A.3 Extended Model Solution

Saver Optimality

Intratemporal condition

$$-\frac{U_{st}^n}{U_{st}^c} = (1-\tau_y)\, w_t \tag{36}$$

Euler equation

$$1 = (1 + i_t^D)\mathbb{E}_t\left[\frac{\Lambda_{st+1}}{\pi_{t+1}}\right] \tag{37}$$

where $\Lambda_{s,t+1} \equiv \beta_s \frac{U_{st+1}^c}{U_{st}^c}$

Tax

$$T_{st} = \tau_y w_t n_{st} \tag{38}$$

Profits

$$\Pi_t = div_t + y_t - w_t n_t \tag{39}$$

Borrower Optimality

$$P_t^h = \frac{U_{b,t}^h}{U_{b,t}^c} + \mathbb{E}_t\left[\Lambda_{b,t+1} P_{t+1}^h(\theta^{LTV} + 1 - \delta)\right] \tag{40}$$

where $\Lambda_{b,t+1} \equiv \beta_b \frac{U_{bt+1}^c}{U_{bt}^c}$

$$-\frac{U_{b,t}^n}{U_{b,t}^c} = (1-\tau_y)\, w_t \tag{41}$$

Euler equation for new borrowing is

$$1 = \Omega_{bt}^M + \Omega_{bt}^X i_t^{M*} + \lambda_t \tag{42}$$

where λ_t is multiplier on borrowing constraint.

$$\rho_t = \Gamma_\gamma\{\underbrace{(1 - \Omega_{bt}^M - \Omega_{bt}^X i_{t-1}^M)(m_{bt}^* - \frac{(1-\nu)m_{bt-1}}{\pi_t})}_{\text{new debt incentive}} - \underbrace{\Omega_{bt}^X(i_t^{M*} - i_{t-1}^M)}_{\text{interest rate incentive}}\} \tag{43}$$

where

$$\Omega^M_{bt} = \mathbb{E}_t\left[\frac{\Lambda_{bt+1}}{\pi_{t+1}}\{\nu\tau_y + \rho_{t+1}(1-\nu) + (1-\rho_{t+1})(1-\nu)\Omega^M_{bt+1}\}\right] \tag{44}$$

$$\Omega^X_{bt} = \mathbb{E}_t\left[\frac{\Lambda_{bt+1}}{\pi_{t+1}}\{(1-\tau_y) + (1-\rho_{t+1})(1-\nu)\Omega^X_{bt+1}\}\right] \tag{45}$$

Bank Optimality

Perfect pass-through

Deposit rate:

$$1 + i^D_{jt} = \frac{\theta^D}{\theta^D - 1}(1 + i_t) \tag{46}$$

Mortgage rate:

$$1 + i^{M*}_{jt} = \frac{\theta^M}{\theta^M - 1}\Big(1 - \nu + \frac{\Omega^M_{jt}}{\Omega^X_{jt}}\Big) \tag{47}$$

$$\Omega^X_{jt} = \mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\{(1-\nu)\Omega^X_{jt+1} + 1\}\right] \tag{48}$$

$$\Omega^M_{jt} = \mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\{(1-\nu)\Omega^M_{jt+1} - (\nu + i_t)\}\right] \tag{49}$$

No-arbitrage conditions:

$$\mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\right] i_t = \mathbb{E}_t\Lambda_{t+1}\left[\Omega^M_{t+1} + i^{M*}_{jt}\Omega^X_{t+1} - 1\right] \tag{50}$$

$$i^D_{jt} = i_t \tag{51}$$

Imperfect pass-through

Deposit rate:

$$1 + i^D_{jt} = \frac{\theta^D}{\theta^D - 1}\left[1 + i_t + \frac{\phi^B}{2}\right] \tag{52}$$

Mortgage rate:

$$1 + i^{M*}_{jt} = \frac{\theta^M}{\theta^M - 1}\Big(1 - \nu + \frac{\Omega^M_{jt}}{\Omega^X_{jt}}\Big) \tag{53}$$

$$\Omega^X_{jt} = \mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\{(1-\nu)\Omega^X_{jt+1} + \Omega_{jt+1}\}\right] \tag{54}$$

$$\Omega^M_{jt} = \mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\{(1-\nu)\Omega^M_{jt+1} - \Omega_{jt+1}(\nu + i_t + \phi^B\frac{b_{jt}}{d_{jt}})\}\right] \tag{55}$$

$$\Omega_{jt+1} = \frac{1}{1+\kappa^{div}(div_{jt+1} - \bar{div})} \tag{56}$$

No-arbitrage conditions:

$$i^D_{jt} = i_t - \frac{\phi^B}{2} \tag{57}$$

Firm Optimality

$$x_{1t} = u'(C_t)mc_t y_t + (\phi\beta)E_t(1+\pi_{t+1})^{\theta}x_{1t+1} \tag{58}$$

$$x_{2t} = u'(C_t)y_t + (\phi\beta)E_t(1+\pi_{t+1})^{\theta-1}x_{2t+1} \tag{59}$$

$$1+\pi^{\#}_t = \frac{\theta}{\theta-1}(1+\pi_t)\frac{x_{1t}}{x_{2t}} \tag{60}$$

$$(1+\pi_t)^{1-\theta} = (1-\phi)(1+\pi^{\#}_t)^{1-\theta} + \phi \tag{61}$$

$$\mathcal{D}_t = (1-\phi)(1+\pi^{\#}_t)^{-\theta}(1+\pi_t)^{\theta} + \phi(1+\pi_t)^{\theta}\mathcal{D}_{t-1} \tag{62}$$

$$mc_t = \frac{w_t}{a_t} \tag{63}$$

$$y_t = \frac{a_t n_t}{\mathcal{D}_t} \tag{64}$$

A.4 Basel III Liquidity Coverage Ratio (LCR)

Deposit rate:

$$1+i^D_{jt} = \frac{\theta^D}{\theta^D-1}\left[1+i_t+\lambda\kappa+\frac{\phi^B}{2}\right] \tag{65}$$

where

$$\lambda = \frac{1}{\kappa}\left(\frac{\phi^B}{2} - i_t + i^D_{jt}\right) \tag{66}$$

Mortgage rate:

$$1+i^{M*}_{jt} = \frac{\theta^M}{\theta^M-1}\left(1-\nu+\frac{\Omega^M_{jt}}{\Omega^X_{jt}}\right) \tag{67}$$

$$\Omega^X_{jt} = \mathbb{E}_t\left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}}\{(1-\nu)\Omega^X_{jt+1} + \Omega_{jt+1}\}\right] \tag{68}$$

$$\Omega^M_{jt} = \mathbb{E}_t \left[\frac{\Lambda^s_{t+1}}{\pi_{t+1}} \{(1-\nu)\Omega^M_{jt+1} - \Omega_{jt+1}(\nu + i_t + \phi^B b_{jt} - \lambda(\omega - \kappa))\} \right] \tag{69}$$

$$\Omega_{jt+1} = \frac{1}{1 + \kappa^{div}(div_{jt+1} - \bar{div})} \tag{70}$$

A.5 Dixit-Stiglitz aggregator

Mortgage market Borrower seeks a total amount of mortgage loans equal to M^*_t, he borrows an amount M^*_{jt} from each bank j and faces the following constraint:

$$M^*_t = \left[\int_0^1 {M^*_{jt}}^{\frac{\theta^M - 1}{\theta^M}} dj \right]^{\theta^M/(\theta^M - 1)} \tag{71}$$

which indicates that the loans he gets from individual banks are aggregated via a CES aggregator into the total mortgage loans he obtains. θ^M is the elasticity of substitution between banks and it is assumed to be greater than one. Each bank charges borrower a net mortgage interest rate i^{M*}_{jt}. Demand for the borrower can be derived from minimizing over M^*_{jt} the total repayment (including principal) due to the continuum of banks j:

$$\min_{M^*_{jt}} \int_0^1 (1 + i^{M*}_{jt}) M^*_{jt} dj \tag{72}$$

subject to the constraint given above.

The FOC wrt M_{jt} yields mortgage demand:

$$M^*_{jt} = \Big(\frac{1 + i^{M*}_{jt}}{1 + i^{M*}_t} \Big)^{-\theta^M} M^*_t \tag{73}$$

where $1 + i^{M*}_t = \left[\int_0^1 (1 + i^{M*}_{jt})^{1-\theta^M} dj \right]^{\frac{1}{1-\theta^M}}$.

Deposit market Savers want to maximize total repayment from deposits subject to total deposits as aggregated through a CES aggregator.

$$\max_{D_{jt}} \int_0^1 (1 + i^D_{jt}) D_{jt} dj \tag{74}$$

s.t

$$D_t = \left[\int_0^1 D_{jt}^{\frac{\theta^D - 1}{\theta^D}} dj \right]^{\theta^D/(\theta^D - 1)} \tag{75}$$

The FOC wrt D_{jt} yields deposit demand:

$$D_{jt} = \Big(\frac{1 + i^D_{jt}}{1 + i^D_t} \Big)^{-\theta^D} D_t \tag{76}$$

where $1+i_t^D = \left[\int_0^1 (1+i_{jt}^D)^{1-\theta^D} dj\right]^{\frac{1}{1-\theta^D}}$. $\theta^D < -1$ is the elasticity of deposit substitution across banks $j \in [0,1]$, which means that savers put more deposits in a particular bank the higher that bank's deposit rate is.

A.6 Microfoundation of Bank CES

It may be an inaccurate representation of reality where households borrow from all banks. Ulate (2018) presents how a model where each consumer chooses to borrow from a single bank and is subject to an stochastic utility of borrowing from each bank can deliver the same demand for loans as the CES approach. The different stochastic utilities across individuals of borrowing from specific banks can be due to proximity, switching costs, tastes or asymmetric information.

Assume there is a borrower that lives for two periods, denoted 1 and 2. The borrower has a total income of $\bar{Y}$ in the second period and consume in both periods. To consume in period 1, this borrower must borrow against her future income $\bar{Y}$ through one of a continuum of banks between zero and one. The decision process happens in two stags. In the first stage, the borrower decides which bank she wants to borrow from and in the second stage she chooses the amount she wants to borrow. The direct utility function of the borrower conditional on her choice of bank j is

$$U(C_{0j}, C_1) = ln(C_{0j}) + \beta ln(C_1)$$

The first period, second period and aggregate budget constraints of the borrower are:

$$C_{0j} = B_j$$
$$C_1 = \bar{Y} - (1+i_j^m)B_j$$
$$(1+i_j^m)C_{0j} + C_1 = \bar{Y}$$

where $1+i_j^m$ is the mortgage rate charged between periods 1 and 2 by bank j. The solution to this problem is:

$$C_{0j} = \frac{\bar{Y}}{(1+\beta)(1+i_j^m)}$$
$$C_1 = \frac{\beta\bar{Y}}{1+\beta}$$

and indirect utility is

$$v(1+i_j^m) = (1+\beta)(ln(\bar{Y}) - ln(1+\beta)) + \beta ln(\beta) - ln(1+i_j^m).$$

As in Anderson et al.,(1988) assume that the first stage is described by a stochastic utility approach

$$V_i = v(1+i_j^m) + \mu\epsilon_j$$

where μ is a positive constant and ϵ_j is random variable with zero mean and unit variance. ϵ_j is iid with type-1 extreme value distribution, then the probability of a borrower choosing bank j is:

$$Pr(j) = Pr\left(V_j = \max_r V_r\right) = \frac{e^{v\left(1+i_j^m\right)/\mu}}{\int_0^1 e^{v(1+i_r^m)/\mu} dr} = \frac{\left(1+i_j^m\right)^{-\frac{1}{\mu}}}{\int_0^1 \left(1+i_r^m\right)^{-\frac{1}{\mu}} dr}$$

as in McFadden (1973). Substituting $1/\mu$ for $\theta^m - 1$ gives

$$Pr(j) = \frac{\left(1+i_j^m\right)^{1-\theta^m}}{\int_0^1 \left(1+i_r^m\right)^{1-\theta^m dr}} = \left(\frac{1+i_j^m}{1+i^m}\right)^{1-\theta^m}$$

where i^m is the aggregate loan rate. Multiplying C_{0j} by this probability gives:

$$C_{0j}Pr(j) = \frac{\bar{Y}}{(1+\beta)(1+i^m)} \left(\frac{1+i_j^m}{1+i^m}\right)^{-\theta^m}.$$

If we interpret $C_{0j}Pr(j)$ as the amount borrowed from bank j once the whole population of consumers are taken into account and denote this by M_j then

$$M_j = \left(\frac{1+i_j^m}{1+i^m}\right)^{-\theta^m} M$$

which is the same expression we get directly from the CES aggregator. This shows that a heterogeneous borrower approach with stochastic utility and extreme value shocks works as a microfoundation for the CES aggregator in the case of a homogeneous borrower.