# Bank liquidity and credit frictions

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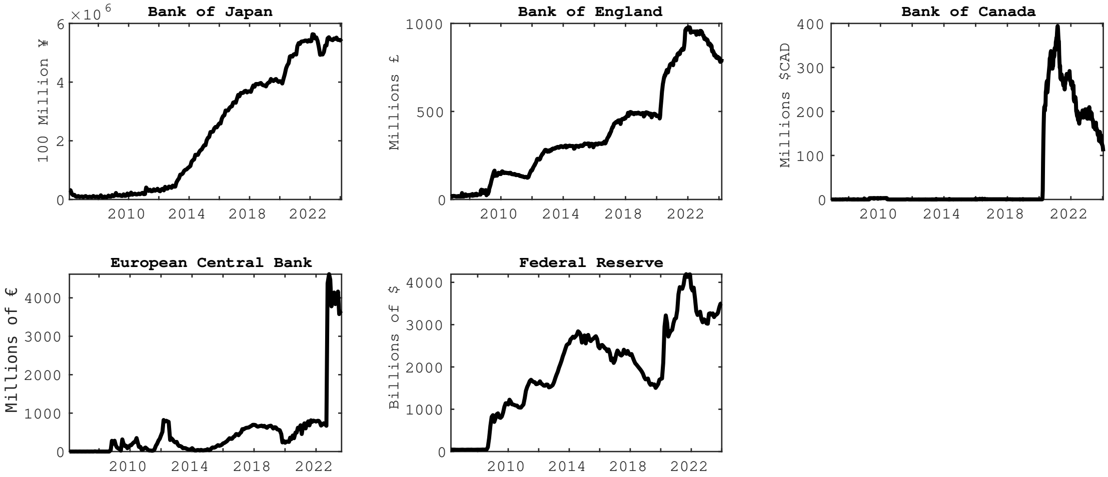
# Sky-rocketing banking sector liquidity




Shows central bank reserve balances / deposit facility use

# Monetary policy implementation has evolved since the Great Moderation

Expanded toolkit – balance sheet policies, more prominent role for forward guidance, credit easing policies etc

Implementation of ‘conventional’ monetary policy also shifted, e.g.:

- ECB – fixed allotment auction $\longrightarrow$ fixed rate, full allotment
- US: interest on reserve balances
- Negative interest rates

These policies contributed to a big increase in banking sector excess reserves

# Bank liquidity and the credit channel

Increasing banking sector liquidity and UMPs have had an unclear affect on bank lending

Central banks injected huge amounts of liquidity, but banks often increase excess reserves rather than increase lending:

- 2008–2009 excess reserves in US $\uparrow$ while lending standards were tightened (source: SLOOS)
- 2010–2012 lots of liquidity in eurozone banking sector without increasing lending in stressed economies

# Bank liquidity and lending

- More (less) liquidity tends to increase (decrease) lending: Kashyap, Rajan & Stein (2002) (see also Adrian & Shin 2010, Carpenter, Demiralp & Eisenschmidt 2014)

- Sometimes the impact of liquidity is ambiguous, it depends on:
  - balance sheet of banks (Berger & Bouwman 2009, Disyatat 2011, Cornett et al. 2011, Gambacorta & Marques-Ibanez 2011)
  - profitability of lending (Disyatat 2011)
  - risk in the economy (Joyce, Tong & Woods 2011, Gambacorta & Marques-Ibanez 2011)

- Acharya, Eisert, Eufinger & Hirsch (2019) find in the EZ, increased liquidity (via balance sheet policies) $\rightarrow$ banks help more cash and low interest assets, but <u>did not increase loans</u>
  - See also Gambacorta & Marques-Ibanez (2011), Joyce, Tong & Woods (2011), Loutskina (2011), Disyatat (2011), Iyer et al. (2014)

# Lending to SMEs

Lending to SMEs seized up in eurozone

- Continued despite easing of sovereign debt crisis
- Despite easy monetary conditions
- Driven by credit supply rather than demand (Holton, Lawless & McCann 2013)
- Iyer, Peydró, da Rocha-Lopes & Schoar (2014) find 'no overall positive effects of central bank liquidity but instead higher hoarding of liquidity'

Plenty of evidence QE boosted activity at the ZLB (Gambacorta, Hofmann & Peersman 2014)

- An important channel was an increase in lending (Rodnyansky & Darmouni 2017, Ferrando, Popov & Udell 2019)
- But evidence that smaller firms remained credit constrained (Acharya, Eisert, Eufinger & Hirsch 2019, Finnegan & Kapoor 2023)

# Aim of Paper

Build a model to rationalise some of this evidence

- The ambiguous link between liquidity and lending
- Small business lending frictions

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Use this to study:

- Role of monetary policy (interest rates and UMPs)
- Interaction between liquidity and credit frictions

# Credit channel of monetary policy

There is a huge literature on credit channel of monetary policy:

- Starting point: Bernanke & Blinder (1988) shows how increased reserves translate to higher lending in IS/LM model
- Bernanke & Gertler (1995) highlight two distinct channels: *bank-lending* channel and *balance-sheet* channel
- Balance sheet channel: e.g., Bernanke & Gertler (1989), Gertler & Gilchrist (1994), Bernanke, Gertler & Gilchrist (1999), Iacoviello (2005)
- Bank lending channel: e.g., Gertler & Kiyotaki (2010), Cúrdia & Woodford (2010), Brunnermeier & Sannikov (2014), Holden, Levine & Swarbrick (2020)

I build on a literature that studies the impact of information frictions in bank lending (see, e.g, Diamond 1984, Kiyotaki & Moore 1997, Ioannidou et al. 2022)

- In particular, adverse selection and credit rationing: Stiglitz & Weiss (1981), Eisfeldt (2004), Bolton, Santos & Scheinkman (2011), Martin & Taddei (2013), Kurlat (2013), Benhabib, Dong & Wang (2018), Bigio (2015) Chang (2018), Ikeda (2020)

# Interest rate corridors and liquidity management

Traditionally, central banks could implement monetary policy via:

- OMOs
- setting reserve requirements
- setting interest rates on standing facilities in corridor system

With abundant liquidity, the corridor system became more important

- ECB already has corridor system in place
- Fed began paying IoER during GFC, moving towards corridor system
- As liquidity rose, many central banks moved to a floor system

> See Bindseil (2000) (theory of bank liquidity management), Whitesell (2006) (corridor system), and Goodfriend (2002) (comparison of frameworks: RR vs corridors)

# Corridor system 1/2

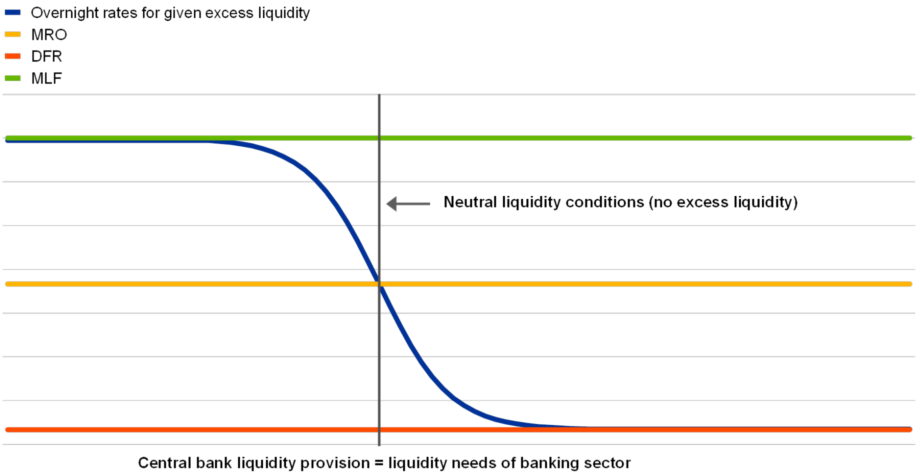
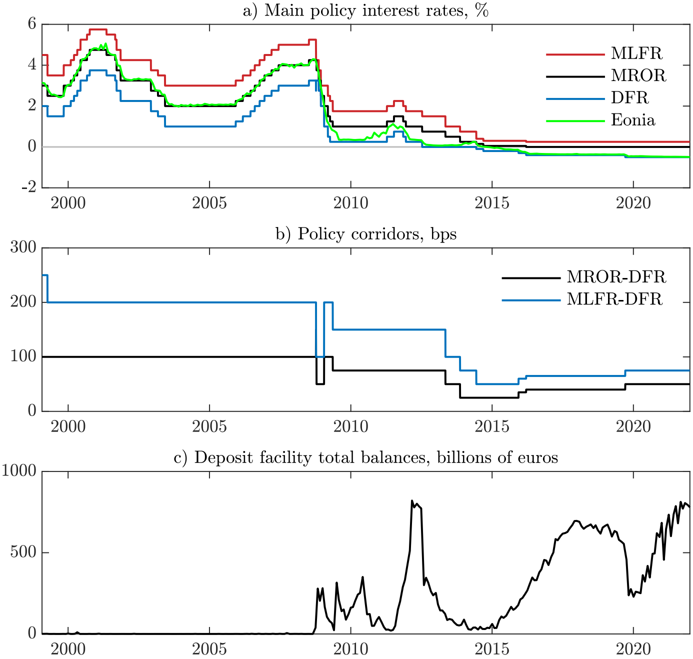



Figure: From Eisenschmidt, Kedan & Tietz (2018) (ECB Economic Bulletin 2018(5))

# Corridor system 2/2

- Width of interest rate corridor to manage the volatility of overnight rate (Bindseil & Jabłecki 2011)
  - Narrow corridor $\rightarrow$ low volatility
  - Wide corridor $\rightarrow$ high interbank market volumes
- High reserve balances $\rightarrow$ floor becomes more important
  - Floor (CB deposit rate) becomes main policy interest rate
  - Deposit rate lowered to incentivize increased lending to real economy
  - Draghi (2015): "cuts in the rate on the deposit facility vastly improve the transmission of our monetary policy"

# ECB interest rates



# This paper

It is very early stage – comments very welcome!

This paper:

- presents a model with endogenous excess reserves
- the interest on reserves affects banks incentives
- we'll see that liquidity injections impact lending conditions via:
  - affecting bank profitability
  - altering the incentive structure when banks face adverse selection
- it is not the volume of liquidity that matters, it is bank profitability, and the interaction with information frictions
- QE can have a positive or negative impact on lending
- always positive at the ZLB

# Model Overview

New Keynesian (Calvo) model frictional bank lending:

- Households are standard
- Follow Swarbrick (2023) – Stiglitz & Weiss (1981) information problem (see also, e.g., Ikeda 2020)
- Some firms have private information
- Each period draw either risky/safe projects (risk of productivity $\omega^i$)
- Expected productivity the same $\rightarrow$ $1 = \omega_t^s = p_t \omega_t^r$
- Banks can separate borrowers using loan approval
- When risk is high, banks can ration credit and hold excess reserves (paying CB deposit rate)

# Firms

Want to focus on bank lending channel/credit friction affecting **SMBs**

- Assume some projects verifiable safe, some unverifiable safe / risky
- Small firms characterised as being unable to i) diversity risk, ii) having unverifiable information
- All require 1 unit of external finance
- Refer to firms with private information **small firms**, others are **large firms**
- Firm entry costs – firm entry until firm value = costs
- Cobb-Douglas production function

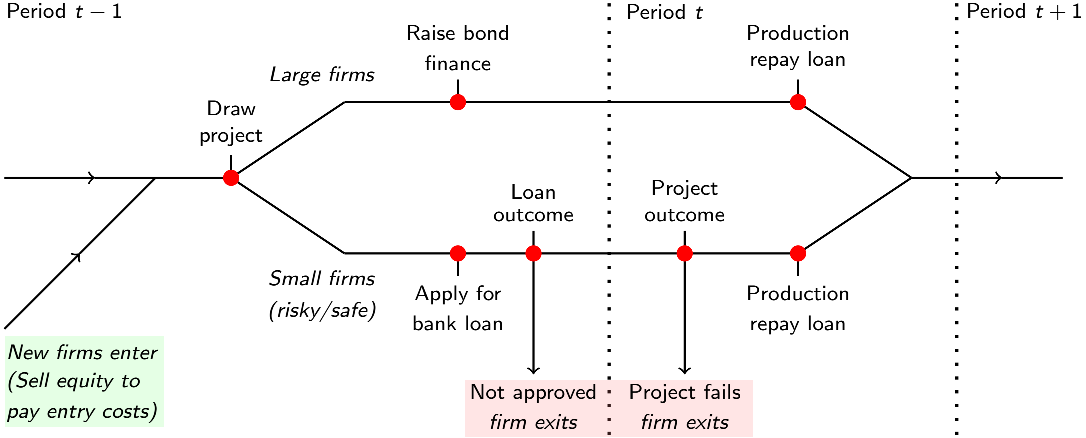
Large firms:

- No information problem, so raise finance in bond market

Small firms:

- Banks do a better job screening borrowers

# Firm dynamics



# Banks and lending 1/2

- Separate borrowers using loan approval
  - Abstract from collateral and loan size
  - Loan terms are repayment rate $\tau_t^i$ and approval rate $x_t^i$

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$$R_{t+1}^s - \tau_t^s \geq 0 \tag{1}$$

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- Safe **individual rationality** (IR) constraint binds (ignoring aggregate uncertainty)

$$R_{t+1}^s - \tau_t^s \geq 0 \tag{1}$$

- Risky **incentive compatibility** (IC) constraint binds

$$\underbrace{x_t^r p_{t+1}\left(R_{t+1}^r - \tau_t^r\right)}_{\text{Surplus choosing risky loan}} \geq \underbrace{x_t^s p_{t+1}\left(R_{t+1}^r - \tau_t^s\right)}_{\text{Surplus choosing safe loan}} \tag{2}$$

# Banks and lending 2/2

- Consider IR and IC with no aggregate uncertainty (and using $p_t R_t^r = R_t^s$):

$$\tau_t^s = R_{t+1}^s \tag{3}$$

$$x_t^r p_{t+1} \left(R_{t+1}^r - \tau_t^r\right) = x_t^s p_{t+1} \left(R_{t+1}^r - \tau_t^s\right)$$

$$\Rightarrow \quad \tau_t^r = R_{t+1}^r - \frac{x_t^s}{x_t^r} \left(1 - p_{t+1}\right) R_{t+1}^r \tag{4}$$

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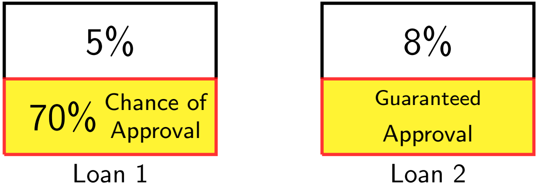
- Illustrative numbers:



| | | | | | |
|---|---|---|---|---|---|
| abound | **10.6% APR** We've got them to guarantee this loan rate. If you're accepted, this is the rate you will get | **£254.05 /mth** Over 4 years at rep APR | **£2194.4** Total interest cost | **100%** Acceptance chance | More info |
| HSBC UK | **6.9% APR** Representative | **£238.03 /mth** Over 4 years at rep APR | **£1425.5** Total interest cost | **80%** Acceptance chance | More info |
| HSBC UK | **6.4% APR** Representative | **£235.86 /mth** Over 4 years at rep APR | **£1321.21** Total interest cost | **30%** Acceptance chance | More info |
| Sainsbury's Bank | **6% APR** Representative | **£234.12 /mth** Over 4 years at rep APR | **£1237.87** Total interest cost | **0%** Acceptance chance | More info |

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- Illustrative numbers:

| Loan 1 | Loan 2 |
|---|---|
| 5% | ↑ 8% |
| ↓70% Chance of Approval | Guaranteed Approval |

- When risk is high, banks can ration credit and hold excess reserves (paying CB deposit rate)

# Banks

Using central banks liquidity and HH deposits:

- banks post loan contracts specifying **interest rate** $\tau_t^i$ and **approval probability** $x_t^i$
- $\tau_t^i$ and $x_t^i$ chosen solve:

$$\max_{\substack{x_t^s, x_t^r \\ \tau_t^s, \tau_t^r}} \mathbb{E}_t \left[ \frac{\Lambda_{t,t+1}}{\Pi_{t,t+1}} \left( \lambda x_t^s \left( \tau_t^s - \boxed{R_t^*} \right) + (1-\lambda) x_t^r \left( p_{t+1}^r \tau_t^r - \boxed{R_t^*} \right) \right) \right] \tag{5}$$

$$\text{s.t.} \quad \text{IC \& IR constraints} \tag{6}$$

$$\lambda x_t^s + (1-\lambda) x_t^r \leq \bar{x}_t \tag{7}$$

$$0 \leq x_t^s \leq x_t^r \leq 1 \tag{8}$$

- IR constraint binds for safe firms (no expected profits)
- IC constraint binds for risky firms (earn expected profits to reveal type)
- IC, IR also $\Rightarrow \tau_t^r \geq \tau_t^s$ , $x_t^r \geq x_t^s$
- $R_t^*$ is opportunity cost of funds (e.g., interest on reserve balances)

# Banks first-order conditions

Solution to the problem yeilds:

$$\mathbb{E}_t\left[\frac{\Lambda_{t,t+1}}{\Pi_{t,t+1}}\left(p_{t+1}R^r_{t+1}-R^*_t\right)\right]=\varrho_t-\psi_t\frac{1}{1-\lambda}+\varphi^r_t\frac{1}{1-\lambda} \tag{9}$$

$$\mathbb{E}_t\left[\frac{\Lambda_{t,t+1}}{\Pi_{t,t+1}}\left(\left(\lambda+(1-\lambda)\,p_{t+1}\right)R^s_{t+1}-R^*_t\right)\right]=\varrho_t+\varphi^r_t-\varphi^s_t \tag{10}$$

And

$$\varphi^s_t,\varphi^r_t,\varrho_t,\psi_t\geq 0 \tag{11}$$

$$\lambda x^s_t+(1-\lambda)\,x^r_t\leq\bar{x}_t \tag{12}$$

$$0\leq x^s_t\leq x^r_t\leq 1 \tag{13}$$

$$\varphi^s_t x^s_t=\varphi^r_t\,(1-x^r_t)=\varrho_t\left(\bar{x}_t-\lambda x^s_t-(1-\lambda)\,x^r_t\right)=0 \tag{14}$$

$$\psi_t\,(x^r_t-x^s_t)=0 \tag{15}$$

# Monetary policy

Standard Taylor rule

$$r_t^{mro} = \bar{r} + \gamma_\pi \left(\pi_{t-1,t} - \pi^*\right) + \gamma_y \left(y_t - \bar{y}\right) \tag{17}$$

- Think of this as the central bank setting the main refinancing rate at regular full -allotment auctions
- Interest rate on HH deposits $R_t = R_t^{mro}$ in equilbrium

Central bank also has two standing facilities

- Deposit facility paying $R_t^{df}$ (excess reserves)
- Lending facility charging $R_t^{lf}$

We also allow the bank to conduct QE through purchasing assets from HHs — more on this if time

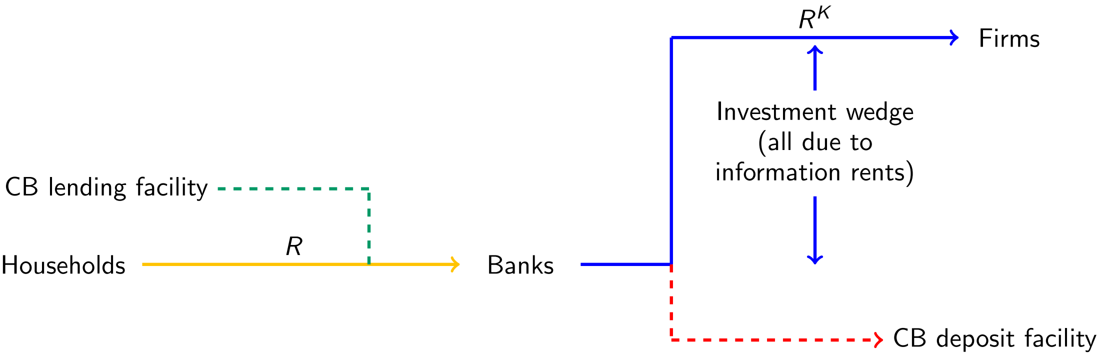
# Interest rates

*Benchmark – efficient financial markets*

$$\text{Households} \xrightarrow{\quad R \quad} \text{Banks} \xrightarrow{\quad R^K \quad} \text{Firms}$$

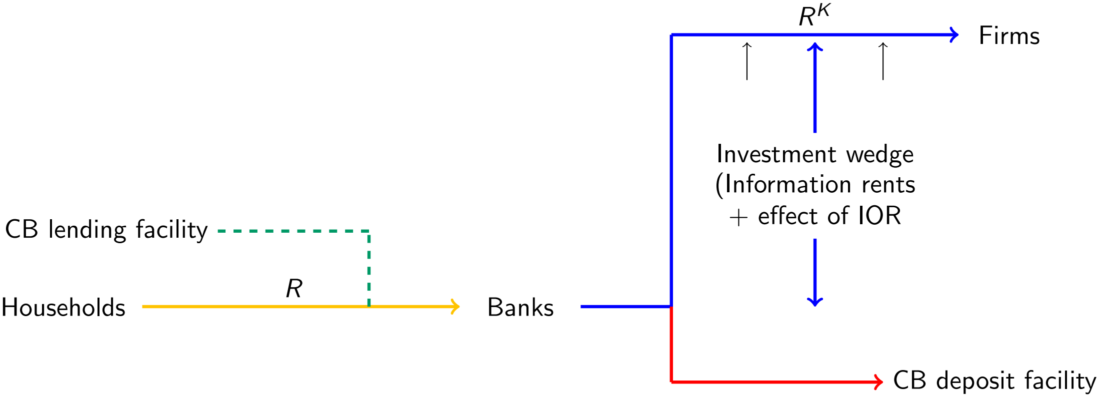
# Interest rates

*Benchmark – credit frictions, no excess liquidity*



# Interest rates

*Benchmark – credit frictions, with excess liquidity*



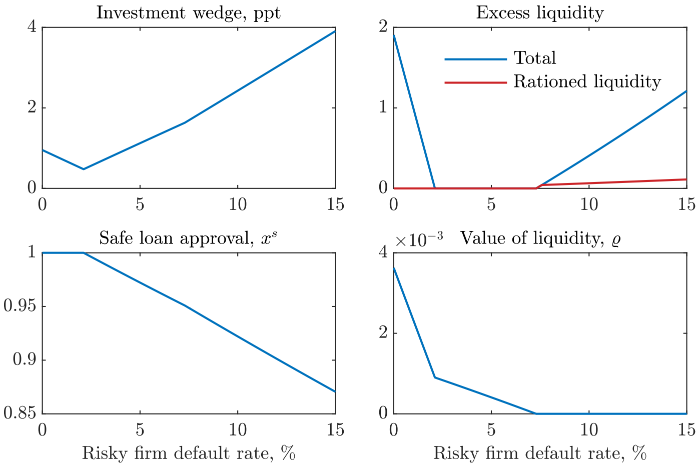

Note: interest rate corridor only matters when banks hold excess reserves

# Excess liquidity can arise from two sources

1. More liquidity available than firms looking for loans at equilibrium interest rates
   - Depends on risk and entry costs
   - Lower risk $\rightarrow$ lower firm profits
   - Low profits + high entry costs = few firms
   - Fewer firms $\rightarrow$ less investment $\rightarrow$ higher marginal return on capital
   - Excess liquidity in banking sector and positive spread

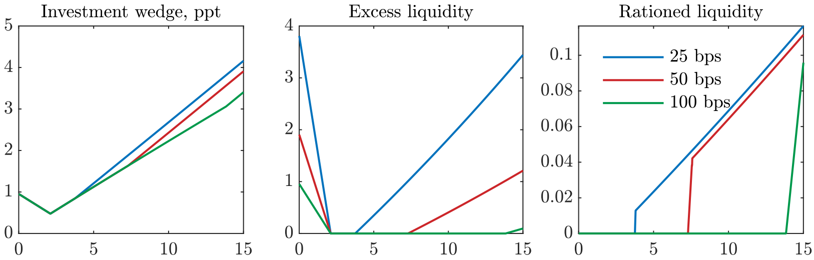
2. Banks ration credit due to high level of risk
   - To raise risky loan interest rates, banks must lower approval of safe loans
   - I.e., cannot only tighten standards on high-interest rate loans
   - Safe borrowers rationed
   - Banks hold excess reserves instead

# Comparative statics – effect of risk




Result: large region with no excess reserves – the interest rate corridor has no role

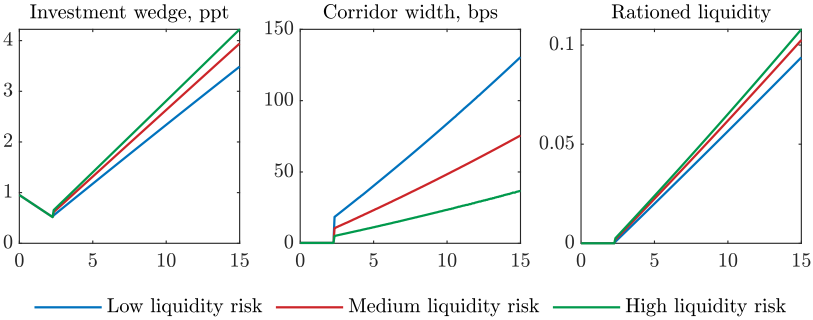
# Comparative statics – role of corridor




Result: changes in deposit rate only affect economy through the effect on credit rationing.

x axis is risky firm default rate.

# Provisional results – optimal corridor width




x axis is risky firm default rate.

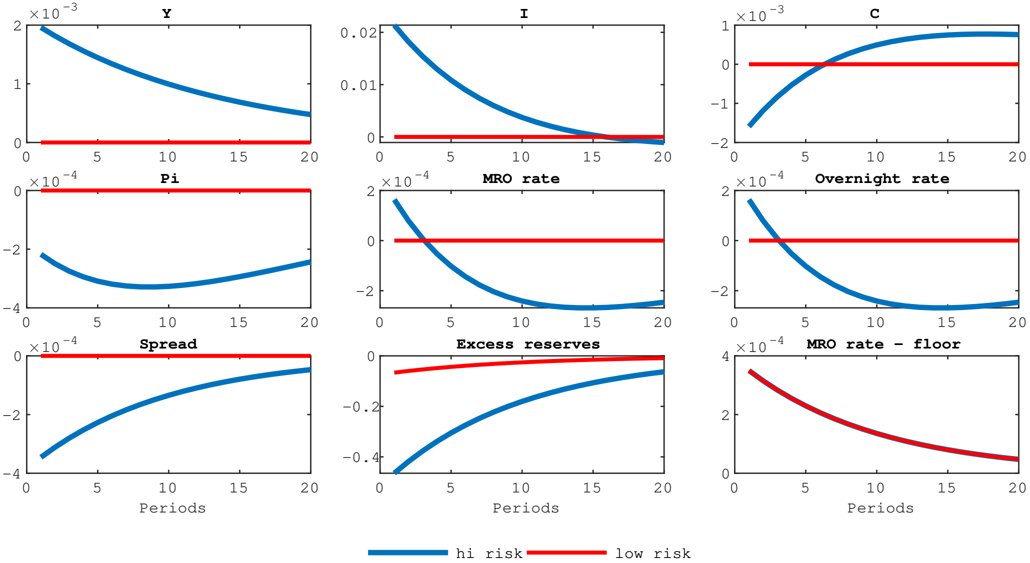
# Dynamics

To evaluate the model dynamics, we compute impulse response functions:

- To temporary widening of the corridor
  - Interest on reserves falls
  - No impact in low-risk economy (no holding excess reserves)
  - Increased lending in high-risk economy (banks holding excess reserves)

- QE shock – modeled as a fall in the overnight interest rate below MRO
  - Two possible effects:
  - Standard channel: expansion via lower interest rates
  - Profitability channel: contraction as banks incentive to lend falls, can ratio credit and hold higher reserves

# Temporary widening of corridor




Note: shows deviations from SS % or ppt (inflation/interest rates). Excess reserves are reserves/loans ratio

# Quantitative Easing

Example implementation:

Central Bank

| *Liabilities* | *Assets* |
|---|---|

Bank

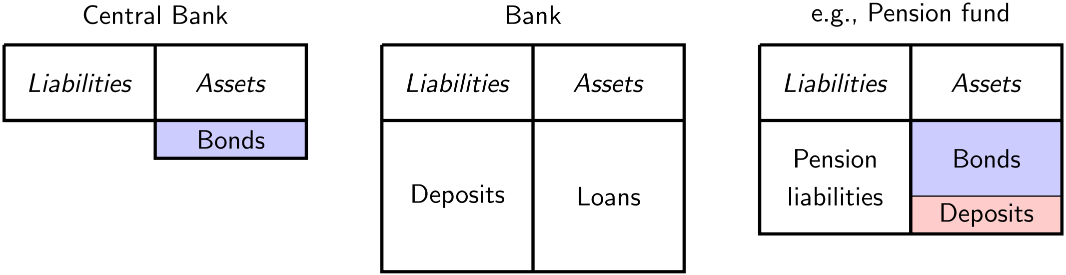
| *Liabilities* | *Assets* |
|---|---|
| Deposits | Loans |

e.g., Pension fund

| *Liabilities* | *Assets* |
|---|---|
| Pension liabilities | Bonds |

# Quantitative Easing

Example implementation:



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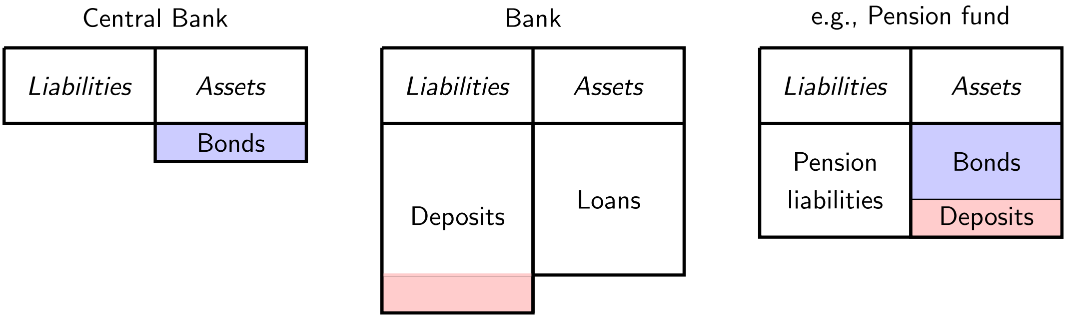

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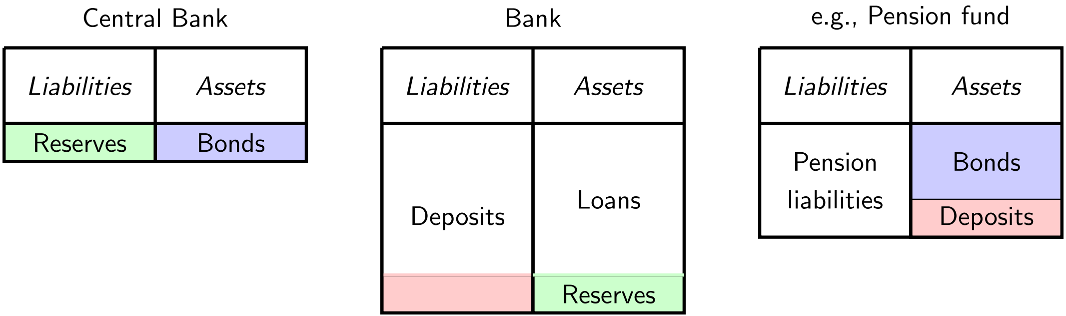



- Lowers the return on bank assets
- $\Rightarrow$ money markets only clear at a lower overnight rate
- Overnight rate moves towards the floor (interest on reserves)

# Quantitative Easing

The equilibrium interest rate depends on the volume of banking sector liquidity

- Suppose the CB purchases assets from HHs or injects bank liquidity directly
- Banks will take liquidity as long as expected return = expected funding cost
- Expected bank return ($L_t$ is loans, $S_t$ is Assets = loans + reserves):

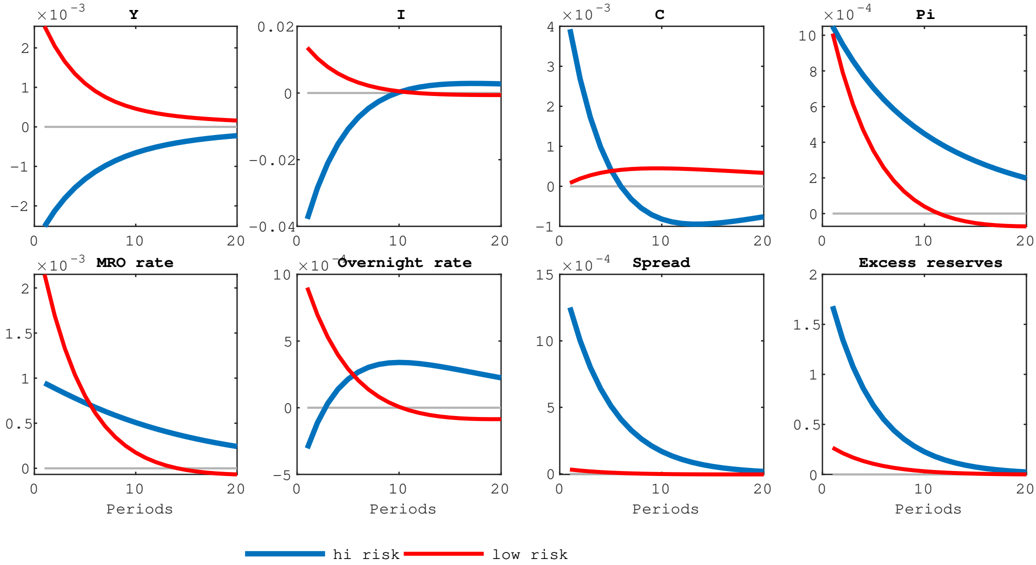
$$1 = \mathbb{E}_t \left[ \frac{\Lambda_{t,t+1}}{\Pi_{t,t+1}} \left( \underbrace{\left[ \lambda x_t^s + (1-\lambda)\left(1 - (1-p_{t+1})\, x_t^s\right) \right] R_t^s \frac{L_t}{S_t}}_{\text{Return on lending}} + \underbrace{\left(1 - \left(\lambda x_t^s + (1-\lambda)\right) \frac{L_t}{S_t}\right) R_t^*}_{\text{Return on reserves}} \right) \right]$$

- This lowers average bank return, so will only clear at lower interest rate

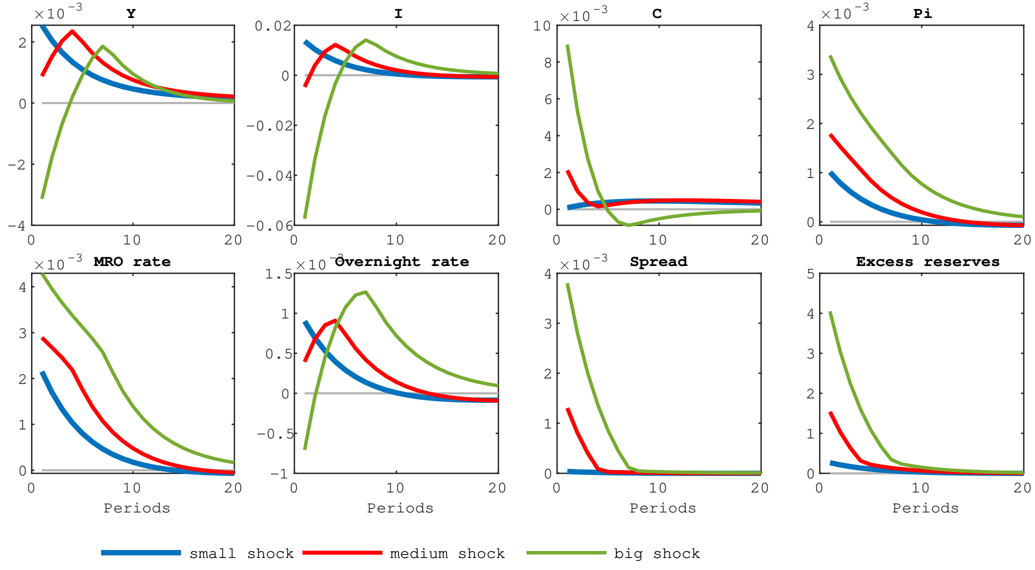
Two competing effects

- With lower interest rates, banks pass on to more favourable lending conditions: lending $\uparrow$
- As equilibrium interest rate $\downarrow$ but CB deposit rate unchanged, incentive to ration credit: lending $\downarrow$

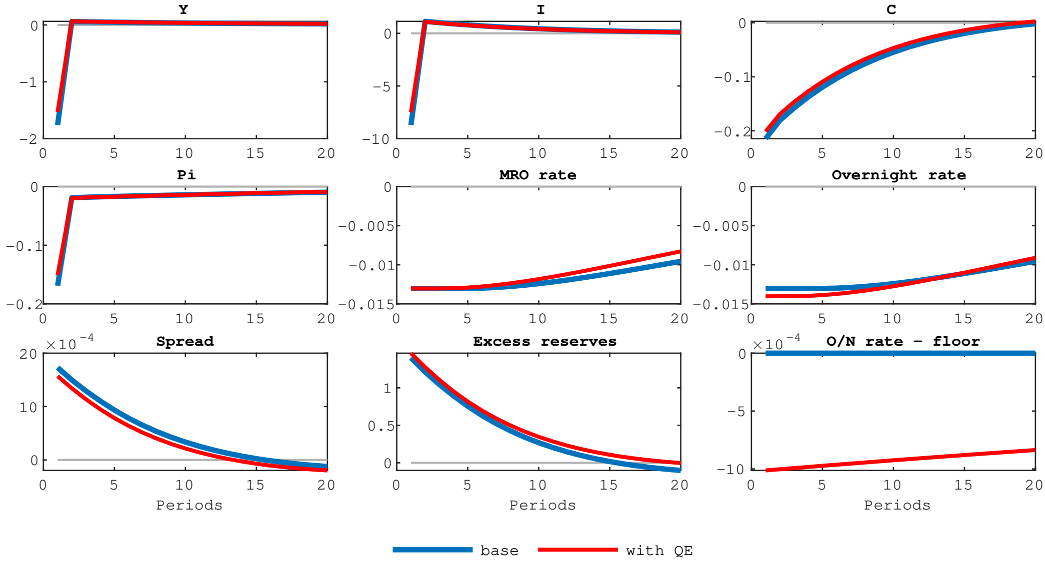
# QE programme -- high risk vs. low risk economy



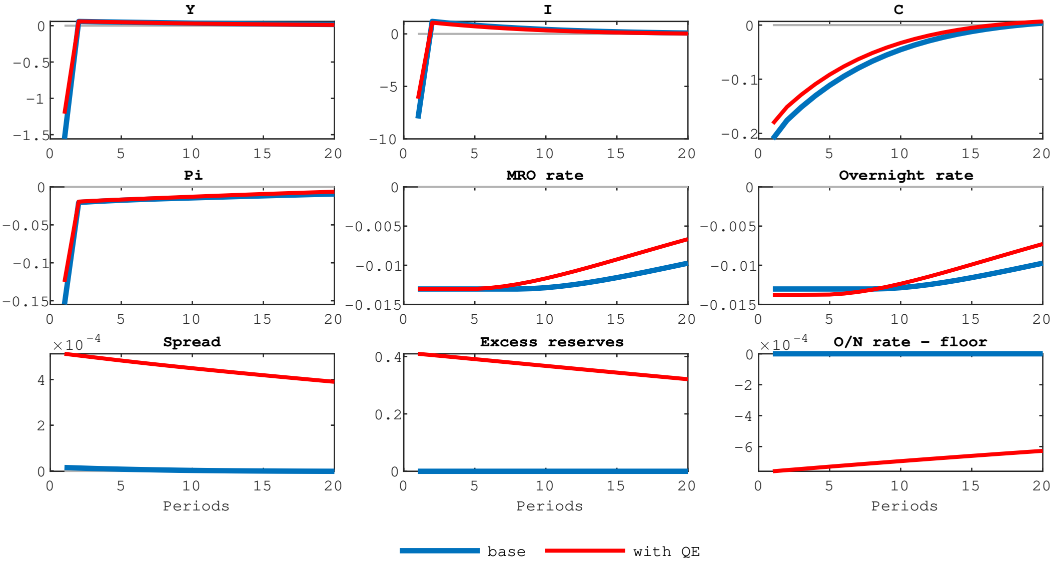
# QE -- low risk economy, programme size effect



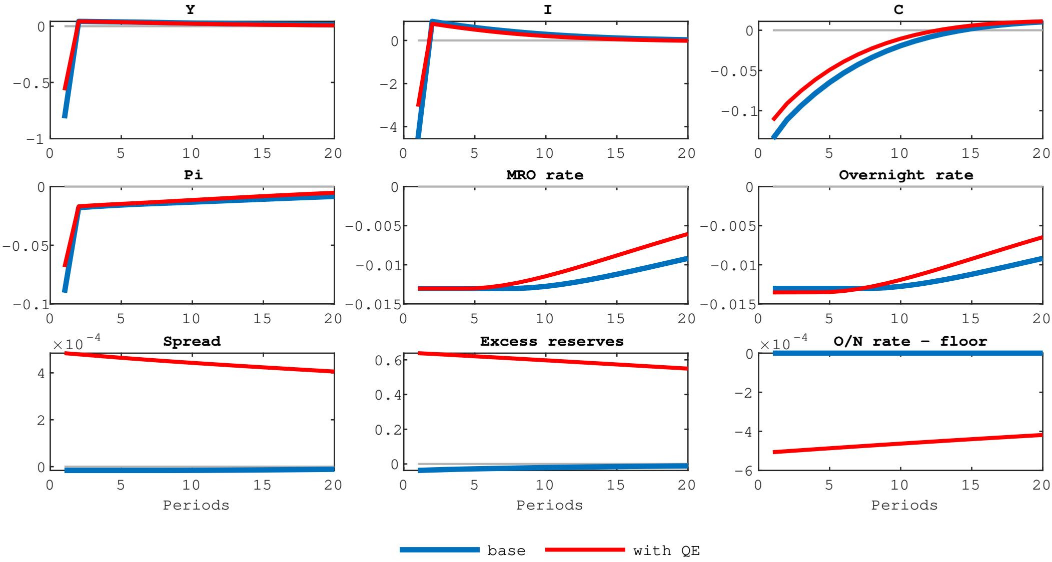
Demand shock with/without QE -- low risk economy



Demand shock with/without QE -- medium risk economy



## Demand shock with/without QE -- high risk economy



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# Firms: large and small firms

- Differentiate between large (observable projects) and small (unobservable projects) firms
- Every period, firms draw their type (large/small) and a project (risky/safe):
  1. $\lambda$ are **safe** – known return, no risk of default
  2. $1 - \lambda$ are **risky** – uncertain return, risk of default
- Project type doesn't matter for large firms as we'll assume equal NPV
- Entry costs – new firms raise equity finance to enter $\implies$ claim on future profits
- Firms must raise outside finance for ongoing investment

# Small firms

Firms raise $k$ units of outside finance (loans)

- convert to $\omega_t^i k$ units of capital, $i \in \{s, r\}$
- succeed with probability $p_{t+1}^i$, otherwise yield zero
- $\omega_t^s = p_t^s = \omega_t^r p_t^r = 1$, $\omega_t^r > 1, p_t^r < 1$

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If funded, choose labour demand to maximise period profits:

$$V_t^i = \max_{h_t\left(\omega_t^i\right)} \left\{ \frac{P_t^W}{P_t} y_t\left(\omega_t^i\right) - \frac{W_t}{P_t} h_t\left(\omega_t^i\right) - \left( \frac{\tau_{t-1}^i}{\Pi_{t-1,t}} q_{t-1} - (1-\delta)\,\omega_t^i q_t \right) k + V_t \right\} \tag{18}$$

where

$$y_t\left(\omega_t^i\right) = z_t \left[\omega_t^i k\right]^{\alpha} \left[h_t\left(\omega_t^i\right)\right]^{1-\alpha}$$

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where

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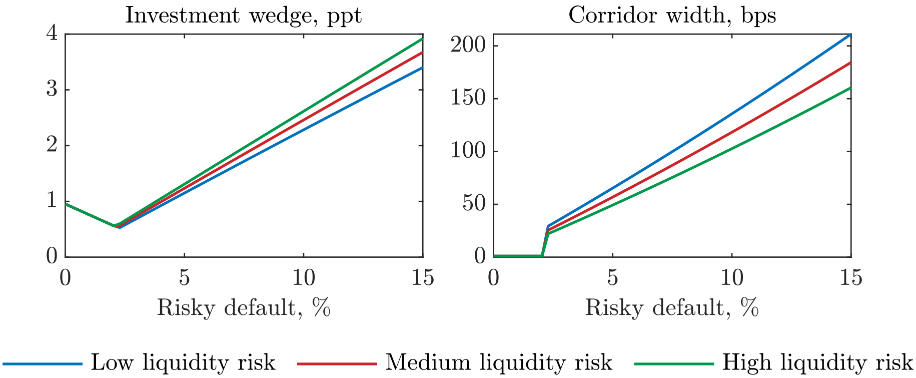
$$V_t = \mathbb{E}_t \left[\Lambda_{t,t+1} \left(\eta V_{t+1}^c + (1-\eta)\left(\lambda x_t^s V_{t+1}^s + (1-\lambda)\, x_t^r p_{t+1}^r V_{t+1}^r\right)\right)\right]$$

- $\tau_{t-1}^i$ is the loan repayment rate

# Optimal corridor



Monetary policy shock