

# Heterogeneous Bank Funding and The Transmission of Monetary Policy \*

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## Abstract

This paper analyzes how heterogeneity in banks' funding structures shapes the transmission of monetary policy. Banks finance themselves with liabilities that differ in maturity, and I document empirically that banks with longer-maturity liabilities are less responsive to monetary policy shocks. To interpret this finding, I develop a heterogeneous-bank macroeconomic model with endogenous default and funding choices. In the model, maturity choice arises from banks' limited ability to raise new debt, due either to limited commitment or regulatory constraints. Long-term liabilities help constrained banks avoid liquidity shortfalls but entail higher funding costs. Using this framework, I quantify the aggregate implications of monetary policy and show that its effects depend critically on the distribution of banks' funding maturities.

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## 1. Introduction

Understanding how monetary policy transmits to the real economy through banks is crucial for assessing its overall effectiveness (Kashyap and Stein, 1995, 2000; Drechsler et al., 2017; Wang et al., 2022; Greenwald et al., 2024). While the existing literature emphasizes banks' asset composition and market structure, I focus instead on the liability side of their balance sheets. Specifically, I show that the maturity structure of bank funding—that is, how long the interest rates on liabilities remain fixed—plays a central role in shaping how monetary policy affects bank lending.

Empirically, I document that banks with shorter liability maturities respond more strongly to monetary tightening, reducing lending more than banks with longer-term funding. To interpret and quantify these heterogeneous effects, I develop a quantitative macro-finance model in which banks dynamically choose their funding mix and monopolistically set lending rates. In this framework, financial frictions determine how funding maturity influences banks' liquidity management and credit supply. Because banks that are more financially constrained rely more heavily on long-term debt, a monetary tightening reduces the present value of their outstanding liabilities, relaxing their funding constraints and enabling them to expand lending by roughly one percentage point relative to others.

I begin by describing the maturity structure of U.S. commercial banks' liabilities using Call Reports data, focusing on two main sources of long-term funding: time deposits and other borrowed money.<sup>1</sup> Together, these two categories represent about one-third of banks' funding. On average, their maturities are around 13 months—classified as long-term liabilities under U.S. banking regulation—and their average interest rates are 1.36 percentage points higher than those on deposits, reflecting both the absence of insurance and the longer commitment period.

I then examine how the maturity of liabilities shapes banks' lending responses to monetary policy shocks. Building on prior studies that exploit cross-sectional differences in banks' characteristics, such as asset liquidity (Kashyap and Stein, 2000) and market power (Drechsler et al., 2017), I show that funding maturity is another key source of heterogeneity. Using

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<sup>1</sup>Other Borrowed Money is a Call Report category for non-deposit debt. By definition, deposits and repos—wholesale interbank short-term loans—have zero maturity.

unexpected changes in policy rates, I find that banks with liability maturities one standard deviation above the mean increase lending by about one percentage point relative to others after a policy tightening.

To assess the aggregate implications of these heterogeneous responses, I develop a general equilibrium model populated by heterogeneous banks that finance loans using deposits and long-term debt. Banks face limited commitment and capital requirements, and compete imperfectly in lending markets. Funding constraints—either imposed by regulation or endogenously determined through default risk—make maintaining stable cash flows essential to avoid illiquidity and default. Short-term liabilities, such as deposits, must be rolled over frequently, leaving constrained banks vulnerable to liquidity shocks. By contrast, long-term debt smooths cash flows over time but comes with higher borrowing costs due to lack of insurance. Hence, liability maturity serves as a liquidity-hedging mechanism for constrained banks.

The calibrated model reproduces key features of U.S. banks, including leverage, funding shares, and spreads, and matches two empirical correlations not targeted in calibration: the positive relationships between (i) leverage and maturity, and (ii) loan losses and maturity. These patterns indicate that banks with longer maturity funding are more financially constrained—an insight that helps explain the heterogeneous lending responses observed in the data.

I then simulate the effects of an unexpected 1 percentage point increase in the risk-free rate. The model reproduces the empirical heterogeneity: banks with longer-maturity debt expand lending relative to short-term-funded banks. For these constrained banks, the decline in the market value of long-term debt raises equity and relaxes borrowing constraints, offsetting the higher cost of new funding. The model generates a semi-elasticity of loans to lending rates of -1.94 and an imperfect pass-through of 0.6. Counterfactuals show that removing funding frictions amplifies the aggregate lending decline by 27–70 percent, underscoring the importance of financial frictions for monetary policy transmission.

In summary, this paper demonstrates that banks' funding maturity, though long recognized as a balance-sheet characteristic, is central to understanding how monetary policy transmits through the banking system. By linking existing measures of maturity to financial constraints and lending dynamics, the analysis provides a unified framework for interpreting both the

cross-sectional and aggregate effects of policy shocks. The findings emphasize the need to consider the liability side of banks' balance sheets—not just their assets—when evaluating monetary policy.

## Related Literature

This paper provides an empirical and quantitative analysis of the role of banks' funding in transmitting monetary policy. It thereby contributes to four strands of the literature.

First, it adds to the vast literature on the interaction between banks and interest rates (Bernanke and Blinder, 1992; Van den Heuvel et al., 2002; Jiménez et al., 2014; Drechsler et al., 2017, 2021; Wang et al., 2022). While the empirical evidence supports a strong link between monetary policy and bank lending, the traditional explanations often focus on regulatory constraints such as bank reserves and capital requirements (Bernanke and Blinder, 1988; Kashyap and Stein, 1995). Wang et al. (2022) propose a structural estimation of the quantitative impact of banks' market power on monetary policy transmission. Building on their framework, I extend the model by introducing heterogeneous banks with endogenous default decisions and by explicitly modeling long-term liabilities consistent with the data. In contrast to their setup, the stock of outstanding long-term liabilities is crucial for understanding the aggregate impact of monetary policy—not only because such liabilities are unsecured, but because they hedge banks against interest rate risk.

Second, this paper contributes to the literature on financial frictions and the transmission of aggregate shocks. Beginning with the seminal work of Kiyotaki and Moore (1997) and Bernanke et al. (1999), the financial accelerator literature has emphasized the role of balance sheet constraints in amplifying shocks. Following the Great Recession, this framework has been extended to the financial sector (Gertler and Karadi, 2011; He and Krishnamurthy, 2013; Brunnermeier and Sannikov, 2014; Gertler and Kiyotaki, 2015). More recently, some papers have explored heterogeneous responses of financial intermediaries to aggregate shocks (Coimbra and Rey, 2024; Goldstein et al., 2024). While my model shares their focus on the transmission of shocks through the financial sector, the key distinction lies in the source of heterogeneity. Rather than stemming from differences in leverage, as in their models, heterogeneity in my framework arises from the composition of banks' liabilities, particularly their maturity structure.

This paper is also related to the subset of models that introduce default risk in general equilibrium (see, for example, Arellano et al. (2019); Gertler and Kiyotaki (2015); Ottonello and Winberry (2020); Amador and Bianchi (2024)). In these models, limited commitment to repay debt constrains leverage and amplifies shocks by restricting borrowing during downturns. My model shares this mechanism but adds a new dimension: banks' limited commitment also compels them to hold liquidity buffers to withstand adverse states. These buffers are maintained through the issuance of long-term debt, emphasizing that the composition—not merely the level—of debt is central to understanding banks' liquidity management. Consistent with this mechanism, Choudhary and Limodio (2022) document that liquidity shocks influence the maturity of banks' loan portfolios.

Third, this paper contributes to the growing literature on the aggregate implications of bank regulation, particularly regarding capital requirements and financial stability (see, for example, Corbae and D'Erasco (2021); Begenau and Landvoigt (2022); Lee et al. (2024)). These studies examine how regulation affects financial stability by shaping banks' risk-taking and credit allocation. Corbae and D'Erasco (2021) show that tighter capital regulation enhances stability but increases market concentration. Begenau and Landvoigt (2022) find that changes in capital regulation can spill over positively to shadow banking by reducing its risk-taking, as reduced subsidies from deposit insurance lower the competitive advantage of regulated banks. Lee et al. (2024) study the effects of Basel III in South Korea and find that higher capital requirements led to a 25 percent decline in credit from regulated banks, offset by a similar increase from non-bank (shadow) institutions. Using a general equilibrium model with heterogeneous banks and firms, they show that Basel III accounts for most of the decline in regulated bank lending and roughly three quarters of the rise in shadow lending, the latter driven by general equilibrium spillovers. Building on this literature, my contribution introduces endogenous default decisions and funding choices shaped by financial frictions. Unlike models that emphasize deposits, my framework highlights banks' cash-flow smoothing motives and how these interact with regulation to determine balance sheet composition, offering a more nuanced view of how policy changes propagate through the banking sector.

Finally, this paper relates to the literature on default risk and debt maturity (see, for example, Chatterjee and Eyigunor (2012); Bocola (2016)). In the sovereign default literature, the choice of debt maturity reflects a trade-off between rollover risk and debt dilution under

limited commitment (Sánchez et al., 2018). In the corporate context, papers such as Diamond and He (2014); Crouzet et al. (2016); Crouzet (2017); Dangl and Zechner (2021) examine how firms manage their maturity structures. In my model, the fact that deposits are rolled over each period makes banks' exposure to rollover risk central to their decision to issue long-term debt. The framework also connects to recent studies examining how debt maturity shapes the transmission of aggregate shocks, including Gomes et al. (2016) for inflation shocks and Jungherr et al. (2024) for monetary shocks. By focusing on banks' maturity choices, my model highlights the importance of debt composition in understanding how monetary policy propagates through the banking system.

## 2. Empirical Analysis

This section is structured as follows: First, I demonstrate that the average maturity of time deposits and other borrowed money exceeds one year, classifying them as long-term debt. Second, I show that borrowing interest rates are higher for long-term liabilities. The longer maturity may explain their higher interest rates, as they are not FDIC-insured. Under default risk, longer maturity contracts become a more expensive source of funding. Finally, I show that bank lending responds heterogeneously based on the maturity structure of their liabilities.

### Data Description and Main Definitions

I use U.S. bank-level data from the Uniform Bank Performance Report (UBPR), which covers all FDIC-insured commercial banks, savings banks, and savings associations. The dataset includes quarterly Call Reports from each insured bank, standardizing several bank-specific ratios.<sup>2</sup> I rely on the UBPR for the consistency of its definitions, using quarterly data from December 2002 to March 2023.

Deposits, comprising checking and savings accounts, are subject to reserve requirements and are considered a traditional and reliable source of bank funding. Federal Deposit Insurance Corporation (2024) identifies these liabilities as stable and cost-effective, thanks to FDIC

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<sup>2</sup>For more details on the FFIEC's UBPR and the construction of these variables, see <https://cdr.ffiec.gov/public/DownloadUBPRUserGuide.aspx>.

insurance and the nature of depositors. Since Fed funds purchases and repo operations also serve as short-term funding sources, I group them with deposits.

Long-term liabilities include time deposits and other borrowed money.<sup>3</sup> These liabilities, except for small time deposits, are not FDIC-insured, making them more exposed to interest and credit risks, which contributes to their higher funding costs (Martin et al., 2018).

### Aggregate Time Series of Banks Funding

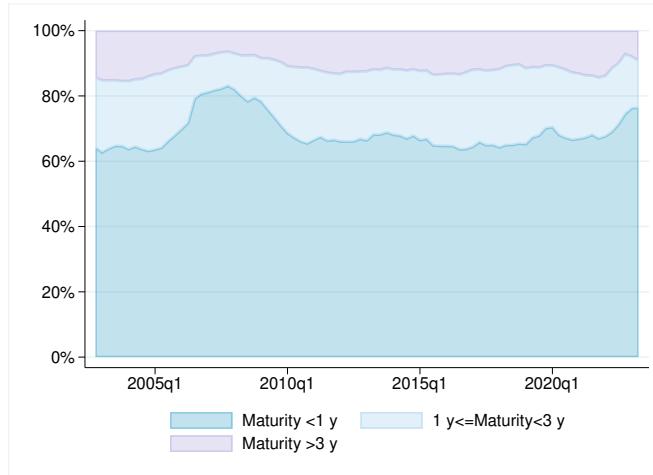
To examine the maturity composition of banks' time deposits and other borrowed money, I begin by showing that these liabilities function as long-term debt. Figure 1 displays a distinct maturity profile for time deposits and other borrowed funds, contrasting sharply with the shorter maturity of standard deposits and repos.

Throughout the sample period, roughly 65% of time deposits and other borrowed money mature within one year, with the remaining 35% extending beyond one year —demonstrating a significant long-term orientation compared to the immediate liquidity of deposits and repos. A calculation of the average maturity of these liabilities shows that they are indeed long-term, with an average maturity of 13 months, which, by banking regulation, defines them as long-term. Thus, for simplicity, I will refer to these liabilities as such.

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<sup>3</sup>Time deposits mainly include certificates of deposit and brokered deposits. Other borrowed money refers to bank funding sources apart from deposits, such as Federal Home Loan Bank advances and other borrowings. See FFIEC 031 and FFIEC 041 forms, Schedule RC-M item 5 for details.

Figure 1: Long-term Liabilities by Maturity



*Notes:* The figure plots bank liabilities' composition by the maturity bracket. The data is from the U.S. Call Reports covering 2003 to 2023 at the quarterly frequency.

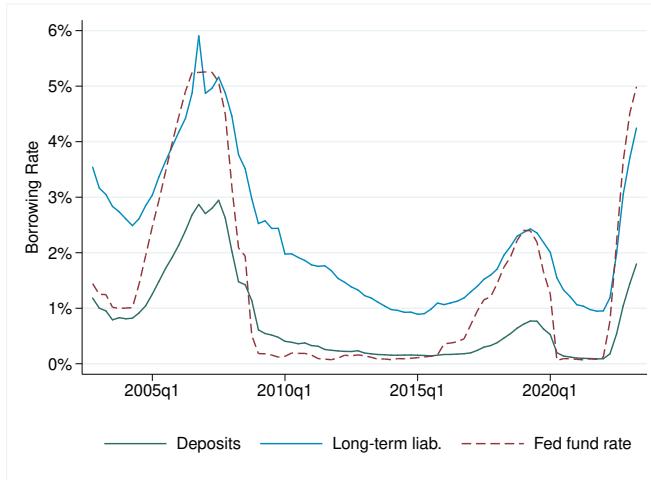
Another essential characteristic of long-term debt is its uninsured status. Figure A.3 in the appendix breaks down long-term liabilities, showing that approximately 60% consists of large time deposits (exceeding FDIC insurance limits) and other borrowed money, both of which are not protected by FDIC insurance. Consequently, long-term debt is exposed to default risk, adding a risk component compared to insured short-term liabilities.

To illustrate the implications of this default risk on banks' funding costs, I compare the average borrowing rates of deposits and long-term liabilities from 2003 to 2023. The average borrowing rate is calculated by dividing total interest expenses by the quarterly average stock of each liability type. For reference, the figure also includes the Fed funds rate.

As shown in Figure 2, interest rates for long-term liabilities are significantly higher than those for deposits, averaging 1.35% over the sample period. In Figure A.2 in the appendix, I further decompose borrowing rates for deposits and long-term liabilities, highlighting that increased funding costs for long-term debt are primarily due to other borrowed money, which is unsecured, while time deposits are partially secured. This suggests that both default risk and maturity may influence the cost of long-term liabilities.

The longer maturity helps explain the observed difference in borrowing costs between deposits and long-term liabilities. A combination of default risk, longer maturity, and banks' inability

Figure 2: Borrowing Rates



*Notes:* The figure plots the average borrowing rate by different liabilities and the Fed fund rate. The average borrowing rate is measured by the interest expense divided by the quarterly average stock of the liability. The data is from the U.S. Call Reports covering 2003 to 2023 at the quarterly frequency.

to commit to limiting future borrowing make long-term debt more expensive due to debt dilution.<sup>4</sup> However, since banks are not required to roll over long-term debt each period, it mitigates their liquidity risk relative to deposits, creating a trade-off between these funding sources.

To highlight the importance of long-term debt for commercial banks, I examine their funding composition. In the appendix, I present the breakdown of banks' liabilities into deposits (plus repos) and long-term debt. Figure A.1 indicates that long-term debt is a substantial funding source for banks, comprising roughly 35% of total liabilities.

Having established that long-term debt is a prominent funding source for banks, I now examine the distribution of its maturity between banks. This analysis highlights how long-term liabilities contribute to significant heterogeneity within the banking sector.

### Commercial Banks Maturity

I utilize data from the Call Reports, which provide detailed information on banks' interest rate risk exposure. Banks are required to report the maturity of their liabilities across several

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<sup>4</sup>Debt dilution is a well-known issue in the sovereign debt literature; see Chatterjee and Eyigunor (2012).

predefined brackets: liabilities maturing within one year, between one and three years, and beyond three years.

By assigning a midpoint to each bracket, I calculate the weighted average maturity of liabilities for each bank. Specifically, I use the following formula to capture the overall maturity profile:

$$M_{j,t} = \sum_{b \in \mathcal{B}} \frac{m_b \text{debt}_{b,j,t}}{\text{debt}_{j,t}} \quad (1)$$

where  $m_b$  denotes the mid-point of bracket  $b$ ,  $\text{debt}_{b,j,t}$  is the amount of debt in bracket  $b$  of bank  $j$  at time  $t$ , and  $\text{debt}_{j,t}$  is the total debt of bank  $j$  and time  $t$ . Savings and checking accounts, which I refer to deposits, have zero maturity by definition. This methodology is based on the approach proposed by English et al. (2018), with a slight modification: my series is reported in yearly terms, and for the upper brackets, I add a year to the lower bound of the bracket.<sup>5</sup>

I follow a similar procedure to estimate the average maturity of long-term liabilities, which allows for a direct comparison between overall bank liabilities and the subset of long-term liabilities.

Table 1 presents summary statistics for the maturities of both overall liabilities and long-term liabilities. A key takeaway is that while the average maturity of total bank liabilities is less than a year, long-term liabilities have a significantly longer maturity, averaging around 1.1 years (or approximately 13 months). This is a crucial distinction, as I will refer to liabilities with a maturity above one year as "long-term".

Table 1: Summary Statistics Maturity

	mean	std dev	p5	p25	p50	p75	p95
Maturity of Liabilities	0.45	0.25	0.11	0.26	0.41	0.60	0.95
Maturity of Long-term	1.14	0.40	0.59	0.84	1.08	1.38	1.87

*Notes:* Moments for maturity are estimated using the full sample. Maturity construction follows English et al. (2018) but at yearly terms. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency.

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<sup>5</sup>For further details on the methodology, refer to English et al. (2018).

## How does funding maturity affect bank lending?

In this subsection, I investigate how the maturity structure of banks' liabilities influences their lending response to monetary policy shocks. Specifically, I study the heterogeneous pass-through of monetary policy via banks' funding decisions.

To estimate the dynamics of this heterogeneous response, I apply a Jordà (2005)-style local projections approach, specified as:

$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h(M_{j,t-1} - \bar{M}_j)\varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (2)$$

where  $h \geq 0$  is the horizon of the local projection,  $\alpha_{j,h}$  and  $\alpha_{t,h}$  are bank and time fixed effects, respectively, and  $M_{j,t}$  represents the maturity of bank liabilities. The term  $\varepsilon_t^m$  is the monetary policy shock constructed by Jarociński and Karadi (2020), purged of information shocks by zeroing out movements correlated with stock market responses.

My coefficient of interest  $\beta_h$  captures the interaction effect of liability maturity on the average bank-level response to a monetary policy shock. I normalize the within-bank variation by the sample standard deviation for interpretability. The vector  $X_{j,t-1}$  of bank-level controls contains log of total assets, return on assets, the long-term share of liabilities, leverage, the share of non-performing loans, the share of short-term investments, and the interacted variable  $M_{j,t}$ .

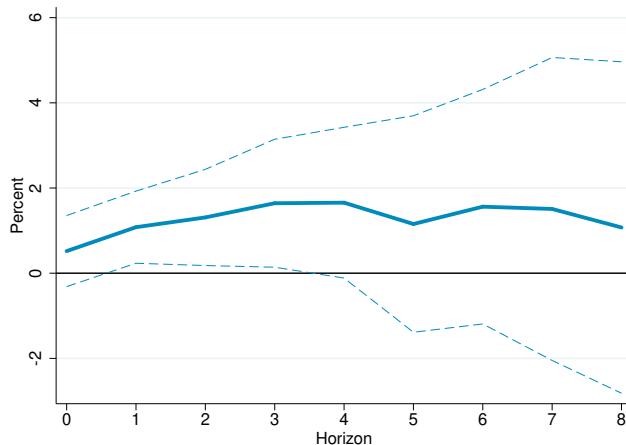
By demeaning the maturity variable within banks, my approach isolates the effects of changing liability maturity rather than differences in inherent bank characteristics. If banks exhibit a specific linear response to monetary policy, the typical approach of interacting  $M_{j,t-1}$  and  $\varepsilon_t^m$  might reflect permanent heterogeneity across banks, as discussed in Ottonello and Winberry (2020). While my economic model assumes banks are ex-ante homogeneous (see Section 3), in reality, banks may exhibit ex-ante heterogeneity in their sensitivity to monetary policy. For instance, distinct market risks and differing levels of market power in loan markets can drive these differences in responsiveness. In sum, demeaning the banks' maturity ensures that the estimated impact reflects how individual banks adjust their lending in response to monetary shocks when they experience atypical liability maturities. This allows for a more precise view of the role of funding maturity in monetary policy transmission.

Several studies have measured the aggregate response of lending to monetary policy changes.

Using only Call Reports limits my ability to observe price changes independent of demand fluctuations, potentially biasing aggregate or average effect estimates. Studies using bank-firm loan data for Spain, such as Jiménez et al. (2012) and Ivashina et al. (2022), estimate the semi-elasticity of loans to interbank rates to be  $-1.39$  and  $-1.88$ , respectively. For the U.S. credit market, Bassett et al. (2014) reports a demand elasticity of commercial and industrial loans around  $-1.68$ .

Figure 3 illustrates the impulse response of loans to a 1% shock in the Fed funds rate over a horizon of 8 quarters. The results from local projections highlight a new insight in the literature: the maturity structure of banks' liabilities plays a significant role in moderating the effects of monetary policy. Specifically, banks with longer-term liabilities exhibit comparatively lower sensitivity to policy changes, with each percentage point of the shock yielding about a one-percentage-point increase in responsiveness. To contextualize these findings, a relative semi-elasticity one point higher markedly dampens the transmission of monetary policy effects.

Figure 3: Heterogeneous Lending Response to Monetary Shock



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

To assess the robustness of the main findings, I re-estimate the local projections under alternative specifications, as reported in Appendix B.3. Although the estimates display minor

quantitative differences, the qualitative results remain robust at the 10% significance level. I also examine whether the heterogeneity in lending responses can be explained by the maturity of banks' assets or by the maturity gap between assets and liabilities. When I measure the effect of the maturity gap without controlling for bank-specific responses—equivalently, without removing the bank-specific mean—the decline in lending is more pronounced for banks with larger maturity gaps. In contrast, when I estimate the same regression using bank-specific responses directly, the results lose statistical significance. This pattern suggests that the maturity gap reflects an ex-ante source of heterogeneity rather than an ex-post adjustment, consistent with the modeling assumptions in Abad et al. (2024). Overall, the findings point to a more limited role for interest rate risk, in line with the empirical evidence reported by Drechsler et al. (2021).

The empirical evidence suggests a correlation between banks' funding structure and monetary policy transmission. However, it does not provide insight into the underlying mechanism behind these patterns observed in the data. To better understand this evidence, I consider an infinite-horizon equilibrium model of the banking industry with three sectors: entrepreneurs, households, and banks.

### 3. Model

In this model, entrepreneurs face a static discrete choice problem when deciding whether to finance a risky project using bank loans. Households are competitive and can save through deposits or long-term liabilities. Banks act as intermediaries between households and entrepreneurs by accepting funds and providing loans. The economy has a unique final good, and all variables are in consumption terms of the final good.

In the model, banks face several frictions with different implications for transmitting monetary policy through their financial intermediation. First, imperfect competition in the loan market leads banks to choose their loan rates to maximize profits. Second, banks are subject to government regulation. Capital regulation requires banks to optimize their lending and funding intertemporally to preserve their cash reserves as a buffer against future capital inadequacy. Third, long-term liabilities are a costly funding source for banks. The higher cost of long-term liabilities is due to two factors: (i) they have longer maturity; (ii) they are more exposed to default risk.

The model borrows elements from Corbae and D’Erasco (2021), which accounts for the regulatory constraints; Wang et al. (2022), which proposes a dynamic model of the bank’s market power; and Ottonello and Winberry (2020) for the endogenous default decisions of banks.

## Households

The economy features a representative household whose lifetime utility is given by

$$E_0 \left[ \sum_{t=0}^{\infty} \beta^t \log(C_t) \right].$$

where  $\beta$  is the discount factor and  $C_t$  is their consumption. The household owns all banks in the economy. I study the perfect foresight transition paths with respect to aggregate states, so the stochastic discount factor and the real interest rate are linked through the Euler equation for savings,  $\Lambda_{t+1} = \frac{1}{R_{f,t}}$ , where  $R_{f,t}$  is the risk-free rate set by the monetary authority.

The household supplies labor to firms at wages  $W_t$  and rents capital via entrepreneurs after they pay their bank loans. The household has a limited supply of labor  $\bar{L} = 1$ . It also saves by buying deposits,  $D$ , and long-term liabilities,  $B$ , from banks. They receive dividends from the banks and are taxed lump-sum. They fund new banks by transferring some equity, denoted by  $\bar{n}$ , so they can start their operation.

## Firms

A representative firm rents capital from entrepreneurs at rate  $R_{k,t}$  and hires labor at wages  $w_t$  to operate a constant return-to-scale production technology.

$$Y_t = \bar{p} L_t^{1-\theta} K_t^\theta \tag{3}$$

where  $\bar{p}$  is a capital quality shock, which I will later explain.

The static firm problem is to solve their operational profit:

$$\bar{p} L_t^{1-\theta} K_t^\theta - W_t L_t - R_{K,t} K_t. \tag{4}$$

Solving for the labor and capital choices, we have the following first-order conditions:

$$W_t = (1 - \theta)\bar{p}\left(\frac{K_t}{L_t}\right)^\theta \quad (5)$$

$$R_{K,t} = \theta\bar{p}\left(\frac{L_t}{K_t}\right)^{1-\theta} \quad (6)$$

Given that  $L_t = 1$ , in equilibrium, the maximization of the firm implies that the wages and the capital rent are  $W_t = (1 - \theta)\bar{p}K_t^\theta$  and  $R_{K,t} = \theta\bar{p}K_t^{\theta-1}$ . Entrepreneurs at the individual level will face an idiosyncratic return on capital, which will be explained next.

## Entrepreneurs

The entrepreneurial sector consists of two-period entrepreneurs who fund themselves through bank loans. Each entrepreneur belongs to a distinct bank pool, and there is no inter-bank competition or mobility. I call this pool the client pool of bank  $j$ . This assumption of market power is in line with recent empirical evidence that banks' market power affects the pass-through of monetary policy to the supply of loans (see, Scharfstein and Sunderam (2016); Drechsler et al. (2017)).

Each pool contains a unit mass of entrepreneurs, and entrepreneurs are indicated as  $i \in [0, 1]$ . Entrepreneurs are risk-neutral agents who maximize their expected profit, which is given back to the household.

In period  $t$ , entrepreneurs borrow  $\bar{k}$  units of the final good from banks to purchase risky capital claims. The capital claim price is equal to  $Q_t$ . Thus, the amount of capital claims purchased with the bank loan is equal to

$$ki_t = \bar{k}.$$

The capital claims might return

$$R_{E,t+1} = \theta K_t^{\theta-1} + (1 - \vartheta)$$

units of dividends per unit of loan.  $R_{K,t+1}$  is the aggregate capital return tomorrow, and

$(1 - \vartheta)$  is the amount of non-depreciated capital sold at a price on I refer to  $R_{E,t+1}$  as the return on the capital claim of entrepreneurs. In case of failure, the return is equal to zero.

Entrepreneurs have an idiosyncratic return if they invest in the project and it succeeds. I denote the idiosyncratic return by  $x_t^i$ , and it is their private information.  $x_t^i$  is in terms of the borrowed amount  $\bar{k}$ . This implies that banks cannot set different interest rates for their client pool.  $x_t^i$  is known at the beginning of each period  $t$ .

Suppose that this entrepreneur belongs to a client pool  $j$  affected by common probability  $p_{t+1}^j$ . Then, in the next period, the project returns (per unit of loan):

$$\begin{cases} R_{E,t+1} + x_t^i & \text{with prob } p_{t+1}^j \\ 0 & \text{with prob } 1 - p_{t+1}^j \end{cases} \quad (7)$$

in the successful and unsuccessful states, respectively. The entrepreneur's gross return is  $R_{E,t+1} + x_t^i$  in the successful state and 0 in the unsuccessful state, implying that the capital is lost.<sup>6</sup> The success of the project, which occurs with probability  $p_{t+1}^j$ , is independent and identically distributed across entrepreneurs, capturing the pool's non-diversifiable risk.<sup>7</sup> This guarantees that the failure rate on each pool will be equal to  $p_{t+1}$  for the next period. Aggregating every bank pool  $j$  would mean that the unconditional probability of failure is equal to  $\bar{p}$ , which is the aggregate capital quality.

In this environment, entrepreneurs within a bank pool  $j$  cannot move to another bank to borrow from them. Then, taking the gross lending rate  $R_{\ell,t}^j$  as given, the entrepreneurs in that pool will decide whether to finance using bank loans. They must repay  $R_{\ell,t}^j$  if they borrow from the bank.

The entrepreneur has limited liability at the project level, so the project return net of interest payment is bounded from below by zero. Table 2 summarizes the return and costs of the investor's investment problem. Since  $x_t^i$  is given for each entrepreneur, their expected payoff on investing decreases with the loan rate  $R_{\ell,t}^j$ .

Entrepreneurs cannot fully repay their debt if their projects fail, as  $R_{\ell,t}^j > 1$ . In this case,

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<sup>6</sup>This setup for the return on investments is similar to Coimbra and Rey (2024). The setup implies that the gross capital return is equal to  $R_{K,t} + \bar{p}(1 - \vartheta)$ , thus I refer to  $\bar{p}$  as a capital quality shock.

<sup>7</sup>The characterization of this failure rate is similar to Vasicek (2002), which is used for regulation motives.

Table 2: Entrepreneur's Problem (conditional on investing)

	Receive	Pay	Probability
Success	$(R_{E,t+1} + x_t^i)$	$R_{\ell,t}^j$	$p_{t+1}^j$
Failure	0	0	$1 - p_{t+1}^j$

they will default on their loans. From the bank's perspective, these entrepreneurs become delinquent, and the bank takes control over the capital claim, which equals zero.

Under these conditions, we have that the expected payoff of entrepreneur  $i$ , conditional on their borrowing from the bank at rate  $R_{\ell,t}^j$ , is equal to:

$$\pi_t(R_{\ell,t}^j) = E_t \{ p_{t+1}^j [R_{E,t+1} - R_{\ell,t}^j + x_t^i] \bar{k} \}.$$

Assume that if entrepreneurs do not invest in capital, they do not receive  $x_t^i$ . Then, entrepreneurs maximize the following

$$U^e = \max_{h \in \{0,1\}} h \pi(R_{\ell,t}^j)$$

where  $h$  denotes the discrete choice of investing in capital. Therefore, entrepreneurs invest in capital if and only if

$$R_{E,t+1} + x_t^i \geq R_{\ell,t}^j, \quad (8)$$

The return per capital plus their idiosyncratic return is higher than the lending rate.

**Loan Demand.** Since there is no inter-bank competition or mobility in the credit market, each bank  $j$  will face a unique loan demand function. Taking the entrepreneurs' investment decision from Equation 8, and the distribution of  $x^i$ , we can describe bank  $j$ 's loan demand (per capital unit) by:

$$\ell^d(R_{\ell,t}^j, R_{E,t+1}) = \text{Prob}(x_t^i \geq R_{\ell,t}^j - R_{E,t+1}) \bar{k}. \quad (9)$$

This demand for loans is characterized by the marginal entrepreneur, whose idiosyncratic dividend equals  $x^* = R_{\ell,t}^j - R_{E,t+1}$ . Since  $x^i$  is independently distributed and follows a known distribution, the loan demand function is characterized by the complementary cumulative

distribution function (ccdf) of  $x$  at the point  $x^*$ . Due to this, the demand for loans is increasing in entrepreneurial returns  $R_{E,t+1}$  and decreasing in the loan rate  $R_{\ell,t}^j$ . Intuitively, as capital return increases or loan rates decrease, it becomes more attractive for entrepreneurs to invest independently of their idiosyncratic dividend.

## Banks

There is a constant unit measure of banks owned by the household. Banks are indexed by  $j \in [0, 1]$ . A manager operates at most one bank and decides entry, default, loans, and funding. The manager's objective is to maximize the lifetime stream of dividend payments  $div_t$  using the manager's discount factor

$$E_0 \left[ \sum_{t=0}^{\infty} \sigma^t \Lambda_t div_t \right],$$

where  $\Lambda_t$  represents the household stochastic discount factor at time  $t$ , and  $\sigma \in (0, 1]$  is the myopia parameter from the bank manager. This assumption introduces the possibility of agency problems through managerial myopia when  $\sigma < 1$  along the lines of Corbae and D'Erasco (2021). To obtain a well-defined distribution of banks, I need a condition that guarantees  $\sigma \Lambda_{t+1} R_{f,t} < 1$ , a standard assumption in incomplete market models, where  $R_{f,t}$  is the risk-free rate.

**Assets:** To model the solvency risk of a bank, the first consideration is its assets. Bankers invest in loans with an agreed-upon interest, denoted by  $R_{\ell,t}^j$ . Let  $\ell_{t-1}$  be the loan amount financed by bank  $j$  in the previous period at interest rate  $R_{\ell,t-1}^j$ . Then, bank  $j$ 's assets are given by the equation:

$$a_t^j = p_t^j R_{\ell,t-1}^j \ell_{t-1} \tag{10}$$

In the above equation,  $p_t^j$  is the mass of repaying loans. Defaulted loans are realized as losses on the bank's balance sheet. The variable  $1 - p_t^j$  captures the loan charges-offs. I assume that the process for  $\log(p_t^j)$  is persistent and follows a truncated AR(1) process.

**Resources.** Bankers use their cash-on-hand ( $n$ ), deposits ( $d$ ) and long-term liabilities ( $b$ ) to finance new loans  $\ell(R_{\ell,t}^j, R_{E,t+1})$  at interest rate  $R_{\ell,t}^j$ .

Assuming that long-term liabilities have a longer maturity than a period, a fraction  $\lambda$  of its

principal is paid back every period while  $1 - \lambda$  remains outstanding. Debt holders receive a coupon payment of  $c$  for the outstanding amount. Deposits are short-term contracts that fully mature every period.

Conditional on their liabilities and loan portfolio, we can determine the bank's cash-on-hand at each period, which is given by:

$$n_t^j = a_t^j \omega_t^j - d_t^j - (\lambda + c)b_t^j - \psi. \quad (11)$$

Here,  $d_t^j$  is the deposit payout inherited from a previous period,  $(\lambda + c)b_t^j$  is the payment on maturing long-term liabilities plus the coupon,  $a_t^j$  is the bank's assets,  $\omega_t^j$  is an idiosyncratic shock affecting the bank's assets valuation, and  $\psi$  is a fix operating cost.<sup>8</sup> I assume this shock is i.i.d. across time and banks, and it follows a log-normal process,  $\log(\omega_t^j) \sim N(0, \eta_\omega)$ . This valuation shock is a simplified way of capturing the fact that banks have non-performing loans on their balance sheets that have yet to be realized as losses.

At the beginning of the period, the bank's equity is given by their cash-on-hand minus the amount outstanding of debt discounted at present value, i.e.,

$$e_t^j = n_t^j - q_{b,t}^{rf}(1 - \lambda)b_t^j, \quad (12)$$

where  $q_{b,t}^{rf}$  denotes the risk-free price of long-term liabilities. This assumption implies that when evaluating a bank's equity at fair value, its liabilities are also considered at fair value rather than at market value. This is in line with the fact that for the capital tier 1 ratio, banks can add gains from changes in the fair value of their liabilities.<sup>9</sup> This can create discrepancies between the fair value and the market value of equity.

Banks use their cash on hand and liabilities to finance new loans, which yields the following resource constraint:

$$div_t^j + \ell^d(R_{\ell,t}^j, R_{E,t+1}) = n_t^j + (q_{d,t} - \zeta)d_{t+1}^j + q_{b,t}(b_{t+1}^j - (1 - \lambda)b_t^j) \quad (13)$$

Here  $\ell^d(R_{\ell,t}^j, R_{E,t+1})$  is the loan demand of bank  $j$ , which comes from the entrepreneur's

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<sup>8</sup>This shock on assets return helps me generate cross-sectional heterogeneity, similar to Ottonello and Winberry (2020). It is also helpful to match the default rates observed in the data.

<sup>9</sup>See Schedule RC-R item 10.a from the reporting Forms 031 and 041.

problem and is described by Equation 9,  $b_{t+1}^j - (1 - \lambda)b_t^j$  is the net issue of long-term liabilities and  $d_{t+1}^j$  is the amount of deposits raised.  $q_{d,t}$  and  $q_{b,t}$  are the pricing of deposits and long-term liabilities, respectively, endogenously determined as discussed in the following subsection. Lastly,  $\zeta$  is a linear cost of issuing deposits.

Using the cash-on-hand equation 11 and fair value equity 12, we can determine next period equity by <sup>10</sup>

$$e_{t+1}^j = a_{t+1}^j - \psi - d_{t+1}^j - (\lambda + c + (1 - \lambda)q_{b,t+1}^{rf})b_{t+1}^j.$$

A key friction in the model is the assumption that banks are unable to issue equity, which necessitates that dividends must always be non-negative, expressed as:

$$div_t^j \geq 0.$$

This constraint prevents banks from raising equity to substitute deposits or long-term liabilities for funding their lending activities. Additionally, it highlights the limited liability of banks, as they have the option to default on their debt, resulting in equity holders losing their entire investment.

The next important ingredient in my model is regulation, namely, capital requirement

$$e_{t+1}^j \geq \kappa a_{t+1}^j. \quad (14)$$

Equation 14 implies that the bank's fair value equity at the beginning of the next period has to be no smaller than a fraction  $\kappa$  of their total asset. Due to the no-equity investment and the capital constraints, banks will need to smooth their cash-holding to avoid states with low liquidity and, thus, default.

Lastly, I follow Title 12, "Banks and Banking", of the Code of Federal Regulations, which states that proposed dividends cannot exceed a bank's net income and restrict dividends to

$$div_t^j \leq E_t[a_{t+1}^j - \ell^d(R_{\ell,t}^j, R_{E,t+1})].$$

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<sup>10</sup>Here I am implicitly assuming that valuation shock, for example, unrealized losses from non-performing loans, does not interact with the requirements over capital tomorrow. This is in line with the reporting on capital tier ratio from Schedule RC-R, for which only unrealized losses on securities and debt securities are accounted.

A similar assumption is made by Corbae and D’Erasco (2021). In my setup, it guarantees that the value function is bounded and concave.

Lastly, notice that all constraints are linear on the constant  $\bar{k}$ . Therefore, we can normalize all variables at the bank level by  $\bar{k}$ . Consequently, to solve the bank problem, we are only required to know aggregate variable  $R_{E,t+1}$  in the steady state. As a simplification to speed up the computational process, I calibrate the steady  $R_{E,t+1}$  to match the banks’ markups, while  $\bar{k}$  is obtained as a residual of the entrepreneur return.

## Debt Pricing

Households competitively lend resources to banks at the price schedules  $q_d(p_t, R_{\ell,t}, d_{t+1}, b_{t+1})$  and  $q_b(p_t, R_{\ell,t}, d_{t+1}, b_{t+1})$ .

Banks cannot distinguish between the types of debt on which they default. If they default on deposits, they must also default on long-term liabilities, and vice versa. The default decision of the banker is denoted by  $\delta(p_t, n_t, b_t)$ , where  $(p_t, n_t, b_t)$  is the bank’s state variables.

One of the differences between deposits and long-term liabilities is due to the lack of insurance for the latter. To account for the insurance, I assume there is a priority for guaranteeing the repayment of banks’ debt holders in case of default, particularly for deposits.<sup>11</sup> The process occurs as follows: whenever a bank defaults, the deposit holders gain control of the bank’s assets. In this case, assets are liquidated with a recovery rate given by a parameter  $\gamma \in (0, 1)$ . Whatever remains after the liquidation of assets for depositors is then transferred to long-term debt holders; that is, they receive  $\max\{0, \gamma a_t \omega_t - d_t\}$ .

Banks are required to pay insurance premiums to a regulator, net the recovery on the assets. The premium is fair and considers the bank’s lending, debt, and default decisions. Consequently, we have a net price on deposits. After liquidation, the remaining unrecovered assets are transferred lump sum to the household; thus, there is no welfare loss on default.

Since the household holds these liabilities, they are discounted by  $\Lambda_t$ . Consequently, the

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<sup>11</sup>This assumption respects the hierarchy of debt holders according to the FDIC.

price of deposits, net insurance premium, is

$$\begin{aligned} q_d(p_t, R_{\ell,t}, d_{t+1}, b_{t+1}) &= E_t\{\Lambda_{t+1}[1 - \delta(p_{t+1}, n_{t+1}, b_{t+1})] \\ &\quad + \delta(p_{t+1}, n_{t+1}, b_{t+1}) \min\{1, \gamma\omega_{t+1}a_{t+1}/d_{t+1}\}\} \end{aligned}$$

Similarly, the price of long-term liabilities is equal to

$$\begin{aligned} q_b(p_t, R_{\ell,t}, d_{t+1}, b_{t+1}) &= E_t\{\Lambda_{t+1}[1 - \delta(p_{t+1}, n_{t+1}, b_{t+1})][\lambda + c + (1 - \lambda)q_{b,t+1}] \\ &\quad + \delta(p_{t+1}, n_{t+1}, b_{t+1}) \min\{1, \max\{0, \gamma\omega_{t+1}a_{t+1} - d_{t+1}\}/b_{t+1}\}\}, \end{aligned}$$

where  $q_{b,t+1}$  is the price next period.

Because there is no secondary market for these liabilities, banks may repurchase their own long-term debt directly. In this case, the cost of repurchasing those liabilities is given by

$$Z(b', b) = \max\{0, q_b(p_t, R_{\ell,t}, d_{t+1}, b_{t+1}) - q_{b,t}^{rf}\},$$

which implies a net expense equal to the price of a risk-free bond.

### **Bankers' Recursive Problem**

Since the banker's recursive problem is the same across banks, I drop the index  $j$  to denote the bank's  $j$  problem. The variables  $(p, n, b)$  summarize the banker's state space. Bankers lack commitment, as they can default on their debt obligations. Then, the value of the bank's operation is given by:

$$V(p, n, b) = \max_{\delta \in \{0,1\}} (1 - \delta)V^c(p, n, b)$$

where  $\delta$  is the default decision of the bank,  $V^c(\cdot)$  is the continuation value of the banking operation, and the value for the banker of the banker defaults equals zero.

The continuation value is associated with the following recursive problem:

$$\begin{aligned}
V^c(p, n, b) &= \max_{R_\ell, d', b'} \text{div} + E_{p'|p}[\sigma \Lambda_{t+1} V(p', n', b')] \\
\text{s.t. } \text{div} &= n - \ell^d(R_\ell, R'_E) + (q_d - \zeta)d' + q_b(b' - (1 - \lambda)b) - Z(b', b)\mathbb{I}_{b' < (1 - \lambda)b} \geq 0 \\
a' &= p'R_\ell \ell^d(R_\ell, R'_E) \\
e' &\geq \kappa a' \\
e' &= a' - \psi - d' - (\lambda + c + (1 - \lambda)q_b^{rf})b' \\
n' &= a'\omega' - d' - (\lambda + c)b' - \psi \\
\text{div} &\leq E_{p'|p}[a' - \ell^d(R_\ell^j, R'_E)]
\end{aligned}$$

## Exit and Entry

Exit from the market is endogenous, depending on the bank's default decision. The mass of entrant banks  $\mu_e$  equals the mass of exiting banks in each period. A banker is endowed with  $\bar{n}$  initial equity to start the banking operation and zero debt.

Each new bank inherits a previous bank's pool of entrepreneurs, thus maintaining the same distribution of shocks in the economy. This captures that these new banks enter the markets left vacant by an incumbent bank's exit.

## Monetary Authority

Lastly, to close the model, I describe the problem of the monetary authority that sets the real interest rates.

**Monetary Authority.** The monetary authority sets the real risk-free interest rate  $R_{f,t}$  according to

$$\log(R_{f,t}) = -\log(\beta) + \varepsilon_t^m \quad (15)$$

and  $\varepsilon_t^m$  is the monetary policy shock.

## Equilibrium

I define the equilibrium for this economy in the steady state and the transition to an unexpected aggregate shock to interest rate, with perfect foresight on the transition path.

**Law of motion of distribution of banks.** Before defining the equilibrium, I characterize the law of motion of the distribution of banks in the steady state, with an analogous characterization for the transition path.

Consider the set of optimal policies conditional on the states  $(p, n, b)$ :

$$R_\ell^*(p, n, b), d^{*\prime}(p, n, b), b^{*\prime}(p, n, b),$$

where  $R_\ell^*(p, n, b)$  is the optimal lending rate,  $d^{*\prime}(p, n, b)$  is the optimal deposit policy, and  $b^{*\prime}(p, n, b)$  is the optimal long-term liability policy.

Notice that  $R_\ell^*(p, n, b), d^{*\prime}(p, n, b), b^{*\prime}(p, n, b)$  can be empty as banks might not satisfy the non-negative dividend constraint, and, thus, default. If the banker defaults on their debt, a new bank enters this economy with initial equity  $\bar{n}$  and no long-term liabilities while keeping the same pool of clients, i.e., the same  $p$ . In equilibrium, the mass of entering banks equals the mass of defaulting, keeping the mass of banks equal to one over time.

Let  $\mu$  denote the bank distribution of this economy with respect to  $(p, n, b)$ . The mass of exiting banks is equal to

$$\mu^e = \int \delta^*(p, n, b) d\mu(p, n, b),$$

where  $\delta^*$  is the default strategy of the bank.

Consider the following notation for the law of motion of net worth:

$$n'(p', \omega', p, n, b) = n'(p', \omega', R_\ell^*(p, n, b), d^{*\prime}(p, n, b), b^{*\prime}(p, n, b)),$$

which is described in the bank's problem. I denote the indicator function for the next period states as

$$\mathbb{I}(p', \omega', n', b' | p, n, b) = \begin{cases} 1, & \text{if } (p', \omega', n', b') = (p', \omega', n'(p', \omega', p, n, b), b^{*\prime}(p, n, b)) \\ 0, & \text{otherwise} \end{cases}$$

We can describe the subsequent period distribution of incumbent banks according to:

$$\mu'_i(p', n', b') = \int (1 - \delta^*(p, n, b)) \mathbb{I}(p', \omega', n', b' | p, n, b) G(\omega') F(p' | p) d\mu(p, n, b),$$

where  $\mathbb{I}$  is an indicator function I described before,  $G(\omega')$  and  $F(p' | p)$  are the transition probabilities of the exogenous states  $\omega$  and  $p$ , respectively. Similarly, the subsequent period distribution of entrant banks evolves according to:

$$\mu'_e(p', n', b') = \int \delta^*(p, n, b) \mathbb{I}(p', \omega', n', b' | p, \bar{n}, 0) G(\omega') F(p' | p) d\mu(p, n, b).$$

Notice that since the new bank inherits the pool of exiting banks, the entrant distribution depends on the shock  $p$ . Lastly, this economy's distribution of banks evolve according to:

$$\mu'(p', n', b') = \mu'_i(p', n', b') + \mu'_e(p', n', b').$$

In this economy, a stationary bank distribution is such that:

$$\mu^*(p, n, b) = \mu'(p, n, b) = \mu(p, n, b).$$

The stationary distribution  $\mu^*(p, n, b)$  remains unchanged over time, satisfying the equilibrium condition where the inflow and outflow of banks balance out.

**Capital Market Clearing.** The last step before defining the equilibrium is characterizing the market clearing on the capital market. Consider a distribution of operating banks  $\mu(z, n, b)$ . Like before, denote  $R_\ell^*(z, n, b)$  the lending rate policy conditional on  $(z, n, b)$ . Denote the loan supply of each bank as  $\ell^s(p, n, b) = \ell^d(R_\ell^*(z, n, b), R'_E)$ . Since banks can default, the loan supply mass also accounts for entrant banks. Therefore, we can define the aggregate loan supply by

$$L^s = \int [1 - \delta^*(p, n, b)] \ell^s(p, n, b) d\mu(p, n, b) + \int \delta^*(p, n, b) \ell^s(z, \bar{n}, 0) d\mu(p, n, b),$$

the first term is the loan supply of incumbent banks, and the second is the loan supply of entrant banks.

Finally, given the price of capital of one, we must have that

$$K' = L^s, \tag{16}$$

where  $K'$  denotes aggregate capital tomorrow.

**Definition 1.** A stationary competitive equilibrium is a set of value functions  $V(p, n, b)$ ; decision rules  $R_\ell(p, n, b), d'(p, n, b), b'(p, n, b)$ , measure of banks; debt price schedules  $q_d(p, R_\ell, d', b')$ ,  $q_b(p, R_\ell, d', b')$ ; borrowing decision  $\ell(R_\ell^j, R_E')$ ; and prices  $P$  such that

- Entrepreneurs maximize their utility, given the interest of their bank  $R_t^j$ , consistent with their utility function and borrowing decision;
- Banks policies for loan rates  $R_\ell(p, n, b)$ , deposits  $d'(p, n, b)$ , and long-term liabilities  $d'(p, n, b)$ , consistent with their maximization problem;
- Household price defaults competitively and optimizes its decision;
- Firms Maximize their profit
- The distribution of banks is consistent with their decision rules;
- All markets clear.

One of the state variables of interest in the distribution of banks according to their state variables  $(p, n, b)$ . As previously highlighted during my empirical exercise, banks' lending responses are heterogeneous depending on their share of long-term funding. Therefore, according to it, the distribution of banks will have aggregate implications for monetary policy transmission.

## 4. Model Mechanism

Before delving into the quantitative analysis, I examine the transmission mechanism of monetary policy through banks' liabilities maturity. This is done by looking at the bank's dynamic decisions. The problem is formulated around a bank's choices of three key decision variables: the loan interest rate  $R_\ell$ , deposits  $d'$ , and long-term liabilities  $b'$ . I characterize the equilibrium behavior of banks in terms of the three associated first-order conditions.

For simplicity, I focus on two main constraints, the no-equity and capital constraints, while abstracting from any debt dilution effects on future bond prices and the iid shock.

**Deposits.** The first-order condition with respect to the deposits  $d'$  is

$$\begin{aligned} & \left( q_d + \frac{\partial q_d}{\partial d'} d_{t+1} + \frac{\partial q_b}{\partial d'} (b' - (1 - \lambda)b) \right) (1 + v_{\text{div}}) - v_{\text{cap}} \\ & \quad - E_{p'|p} [(1 - \delta(p', n', b')) (1 + v'_{\text{div}} + v'_{\text{cap}}) \sigma \Lambda'] = 0 \end{aligned} \quad (17)$$

where  $v_{\text{div}}$  and  $v_{\text{cap}}$  are the Lagrangian multipliers associated with the dividend and capital constraints, respectively.

This condition illustrates the trade-off between the costs and benefits of deposit funding. Deposits expand banks' available resources, thereby relaxing both the resource and dividend constraints. However, they reduce the equity value in the following period, tightening the capital constraint. This effect, captured by  $-v_{\text{cap}}$ , can offset the initial relaxation of resources. As the capital constraint tightens, the Lagrange multiplier  $-v_{\text{cap}}$  limits deposit growth. Examining the first-order condition for long-term liabilities reveals why banks facing stricter financial constraints favor longer-term debt instruments.

**Long-term Liabilities.** The first-order condition with respect to the long-term Liabilities  $b'$  is

$$\begin{aligned} & \left( q_b + \frac{\partial q_b}{\partial b'} d' + \frac{\partial q_b}{\partial b'} (b' - (1 - \lambda)b) \right) (1 + v_{\text{div}}) - v_{\text{cap}} (c + \lambda + (1 - \lambda)q_b^{rf'}) \\ & \quad - E_{p'|p} [(1 - \delta(p', n', b')) (1 + v'_{\text{div}} + v'_{\text{cap}}) (c + \lambda + q'_b) \sigma \Lambda'] = 0 \end{aligned} \quad (18)$$

Like deposits, long-term liabilities ease the resource and dividend constraints but have a smaller impact on the capital constraint. This difference arises because long-term liabilities aren't entirely rolled over, as shown by  $c + \lambda + (1 - \lambda)q_b^{rf'} \leq 1$ . Consequently, banks with tighter capital constraints are more inclined to finance operations through long-term liabilities despite their higher cost.

**Loan rate.** The first-order condition with respect to the loan rate  $R_\ell$  is

$$\begin{aligned} & \left( -1 + \frac{\partial q_d}{\partial \ell^d} d' + \frac{\partial q_b}{\partial \ell^d} (b' - (1 - \lambda)b) \right) (1 + \nu_{\text{div}}) \\ & + \nu_{\text{cap}} (1 - \kappa) p'_{\text{low}} R_\ell \left( 1 + \frac{1}{\frac{\partial \ell^d}{\partial R_\ell} \frac{R_\ell}{\ell^d}} \right) \\ & + \mathbb{E}_{p'|p} \left[ (1 - \delta(p', n', b')) (1 + \nu'_{\text{div}} + \nu'_{\text{cap}}) \sigma \Lambda' p' R_\ell \left( 1 + \frac{1}{\frac{\partial \ell^d}{\partial R_\ell} \frac{R_\ell}{\ell^d}} \right) \right] = 0. \quad (19) \end{aligned}$$

Here, banks need to consider the worst-case scenario of credit repayment for the capital requirement to be valid for all other states; thus, explicitly, I consider the collateral constraint in the state where the repayment share is the lowest.

The first component of the equation captures the tightening of the resource and dividend constraint coming from increasing the bank's lending, netting the benefit on debt pricing. Because banks are monopolistic, whenever setting loan rates, they take into account the effect on their loan demand, as captured by the elasticity  $\frac{\partial \ell^d(R_\ell, P)}{\partial R_\ell} \frac{R_\ell}{\ell^d(R_\ell, P)}$ . This elasticity also influences capital constraints, as a larger asset base will relax them. Finally, the last term captures the bank's expected marginal revenue along with the associated markup.

To understand the heterogeneous impact of monetary policy on banks, it's essential to identify which banks are more dependent on long-term liabilities. The first-order conditions suggest that banks with tighter collateral constraints rely more heavily on such liabilities for funding. When a monetary shock occurs, a portion of this debt—specifically  $1 - \lambda$ —remains outstanding. This debt, issued initially at lower rates with fixed coupon payments, loses value as it is discounted at a higher rate. Consequently, for a given amount of cash-in-hands, banks experience a positive equity effect as both the market and book values of their debt obligations decline.

For constrained banks, the combination of holding long-term debt and this equity improvement more than compensates for the rise in funding costs. This dynamic enables these banks to expand their lending in response to the monetary shock.

## 5. Quantitative Analysis

In this section, I explore the quantitative implications of my model. First, I calibrate my model to match the targeted moments of distribution in the U.S. banking sector. I then show how the model can match additional moments of the cross-section of banks. Third, I show that the model can replicate the heterogeneous response to an unexpected interest rate shock. Lastly, I conduct counterfactual analyses with the model, highlighting the importance of maturity for the transmission of monetary policy.

### Computation

The model described in Section 3 features heterogeneity across banks and important nonlinearities. All nonlinearities arise from the bank's problem due to the endogenous default decision and the sometimes binding constraints. Due to these nonlinearities, I rely on global methods to solve the model (value function iteration). In the transition dynamics, the aggregate state variables, such as asset prices, depend on the distribution of banks  $\mu$ , an infinite dimensional object. Therefore, I focus on the transition with perfect foresight. The reason is that for banks to make their decisions, they just need to know the aggregate return on these projects  $R_{E,t+1}$ , which depends on the distribution of banks.

Even after reducing the problem to a perfect foresight transition, the model features three individual state variables at the bank level:  $(p, n, b)$  and three choice variables  $(R_\ell, d', b')$  and is therefore subject to the curse of dimensionality.<sup>12</sup> The algorithm for solving the model relies on graphics processing units (GPUs) to highly parallelize the solution.

### Parameterization

The model calibration involves two steps. Initially, a set of parameters is directly obtained from the data, followed by estimating a second set using the Simulated Method of Moments (SMM). As detailed later, the chosen set of moments aims to align with the financial frictions encountered by banks. It's important to note that in the model, one period corresponds to a quarter, meaning that all information presented from this point on is quarterly.

The Uniform Bank Performance Report (UBRP) is my primary source for calibrating the

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<sup>12</sup>In the Appendix C, I cover how I compute the policies and steady-state distribution of banks.

model. I aggregate commercial bank-level data to the Bank Holding Company (BHC) level.<sup>13</sup> Data on bank failures is collected from FDIC.

I first parameterize the stochastic process of loan losses.<sup>14</sup> I obtain the gross bank loan losses over total loans and then create a variable equal to one minus the gross losses while removing both time- and bank-fixed effects. Then I estimate the following autoregressive equation:  $\log(p_{j,t}) = \mu_p + \mu_t + \rho_p \log(p_{j,t-1}) + u_{j,t}$ , with  $u_{j,t} \sim N(0, \eta_p^2)$ . Once the parameters  $\mu_p$ ,  $\rho_p$ , and  $\eta_p$  are estimated, I discretize the process using the method proposed by Tauchen (1986), truncating the value for  $p$  in such a way that it never exceeds one.

For the transitions with the interest rate shock, I estimate the following:  $\log(p_{j,t}) = \mu_p + \rho_m \Delta r_{f,t-1} + \rho_p \log(p_{j,t-1}) + \rho_m \varepsilon_t^m + u_{j,t}$ , with  $u_{j,t} \sim N(0, \eta_p^2)$ , where I instrumentalize the variation of the Fed fund rate using the high frequency shocks. This parameter,  $\rho_m$ , is proposed by Wang et al. (2022) to capture that realized loan losses decrease with the aggregate interest rate. This is based on the idea that risk-taking decreases with interest rates.

An essential parameter for the model is the average maturity of long-term liabilities. To obtain this, I use the share of liabilities with a maturity of less than a year, a combination of time deposits, and other borrowed money. For maturities above one year, I use the total liabilities information. I construct the weighted average maturity at the bank level and use the asset-weighted average maturity obtained.

I parametrize the loan demand function by assuming that  $x_t^i$  follows a logistic distribution, resulting in the following functional form for the loan demand:

$$l^d(R_{\ell,t}, R_{E,t+1}) = \frac{1}{1 + \exp(\alpha(R_{\ell,t} - R_{E,t+1}))}, \quad (20)$$

$\alpha$  is the sensitivity of loan demand to interest rate, and  $R_{E,t+1}$  is the return on capital.<sup>15</sup>  $\alpha$  and  $R_{E,\star}$  are endogenously calibrated in the steady. While  $\bar{k}$  is retrieved as a residual of the steady state capital returns, using the aggregate loan supply.

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<sup>13</sup>Note that the matching between commercial banks and the BHC is done using the relationship table from the FFIEC. Additional information about the merger process is provided in the Appendix.

<sup>14</sup>For this part, I utilize the realized gross loan losses, and net loan losses can be negative, which does not align with the model setup.

<sup>15</sup>This representation of loan demand is similar to the ones in Wang et al. (2022); Jiang (2023), with the difference being the aggregate return on capital. A similar functional form for loan demand is obtained if I assume a linear utility function with GEV shock.

Intuitively, investing becomes more attractive when the asset returns increase. In turn, this increases the demand for loans, and under this logistic distribution, the demand becomes less sensitive to loan rates for a given interest rate  $R_{\ell,t}$ . Since aggregate loan supply is directly associated with the asset's price, if the loan supply decreases due to a monetary policy, the loan demand shifts upwards due to the decrease in the asset's price, offsetting the initial drop.

The last five parameters are the aggregate risk-free rate, recovery rate on assets, coupon rate, and capital requirement ratio. Because interest rates have implications for the distribution of long-term liabilities, I take the average Fed fund rates between 2002 and 2023, excluding observations where the rate was below 20 basis points per year. I assume a recovery rate of 0.40, which is slightly higher than the 51% to 55% found by Correia et al. (2023). The coupon payment is chosen to match a 5-basis point interest rate spread between deposits and long-term liabilities in a risk-free environment.<sup>16</sup> The capital requirement ratio is taken to match the tier 1 capital ratio of 6%. The capital share  $\theta$  is taken from the literature and set at 0.35, while the depreciation rate  $\vartheta$  is set to 0.083 to match the maturity of the average loan of 3 years.<sup>17</sup> Table 3 presents the externally calibrated parameters.

Table 3: Fixed Parameters

Parameter	Name	Source	Value
$R - 1$	Interest Rate	Mean Fed Fund Rates	0.6%
$\mu_p$	Mean of Repayment Share	Mean of Gross Loans Charge-offs	-0.09%
$\rho_p$	Repayment Share Persistence	AC Gross Loans Charge-offs	0.59
$\eta_p$	SD Repayment Share	SD Gross Loans Charge-offs	0.28%
$\rho_m$	Response of Capital Shock to Interest rate	Elasticity of Gross loans to Fed Rate	0.216
$1/\lambda$	Maturity	Maturity of long-term Liab.	4.57
$\gamma$	Recovery rate on Assets	Correia et al. (2023)	40%
$c$	Coupon Payment	Term Premium of 5 bp	0.45%
$\kappa$	Capital Requirement	Tier 1 Capital Ratio	6%
$\theta$	Capital Share	Literature Standard	0.35
$\vartheta$	Depreciation of Capital	Matching Loan Maturity	8.33%
$\bar{n}$	New bank equity	Constrained within the Model	0.03

*Notes:* Parameters exogenously fixed in the calibration

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<sup>16</sup>This choice for the 5-basis point is associated with both the liquidity premium of deposits and the term premium.

<sup>17</sup>Geelen et al. (2024) provides empirical evidence that debt maturity is positively correlated with the asset life. In the sense that firms try to match the maturity of their assets and their debt.

## Moments

In this subsection, I assess whether the model can accurately approximate the targeted and untargeted moments. I start with the endogenously calibrated parameters in the steady state. I then describe the targeted moments and their relationships with the banks' frictions and present the model fit. Lastly, I present the untargeted moments as external validity of the model.

Table 4 shows the estimated parameters inside the model. Due to the lack of competition across banks, the parameter dictating the interest rate sensitivity of the loan demand,  $\alpha$ , is higher than the one estimated by Wang et al. (2022). The myopia parameter estimated by the model is close to the one in Corbae and D'Erasco (2021), which generates high leverage in the banks' balance sheets. The fixed operating cost corresponds to around 0.2% of average lending in a steady state.

Table 4: Endogenous Parameters

Parameter	Name	Value
$\alpha$	Interest rate sensitivity	181
$R_{E,*} - 1$	Median return on Claim	2.05%
$\sigma$	Manager Myopia	0.98
$\psi$	Fix Operation Cost	$15 \times 10^{-4}$
$\eta_\omega$	Std of asset shock	0.025
$\zeta$	Deposit Issuing Cost	$10^{-4}$

*Notes:* Parameters are chosen to match the moments in Table 5.

The moments chosen align with each friction that banks face. For example, as banks operate in imperfectly competitive markets, their lending rate reflects the elasticity of their loan demand. Thus, I estimate the data equivalent to the markup and use its mean and standard deviation as targeted moments.

Also, in the model, an essential factor to consider is the endogenous default decision of banks. Due to the lack of insurance, long-term liabilities are exposed to default risk, and as a result, their borrowing rates include default premiums. In contrast, the FDIC insures deposits, so they do not necessarily face the same default risk.

Table 5: Moments

Moment (all in percentage)	Description	Data		Model	
		Mean	SD	Mean	SD
<b>Interest rates (quarterly)</b>					
$E[p'R_\ell - R_{\text{borrow}}]$	Spread btwn loan and borrowing	1.25	0.22	1.26	0.20
$E[q_b^{-1} - q_d^{-1}]$	Spread btwn deposits and long-term	0.33		0.37	
<b>Funding</b>					
$\frac{q_b b' (1/\lambda)}{q_b b' + q_d d'}$	Maturity of funding	1.81	1.01	1.60	0.64
$E[\frac{q_b b' + q_d d'}{\ell}]$	Leverage	89.49	2.74	87.41	4.39
<b>Risk</b>					
$E[\delta]$	Default rate	0.14		0.08	

*Notes:* Moments are estimated using the full sample.  $R_{\text{borrow}} = \frac{d' q_d^{-1} + b' q_b^{-1}}{d' + b'}$  is the weighted average borrowing rate. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. See Appendix B.3 for the definition of the variables.

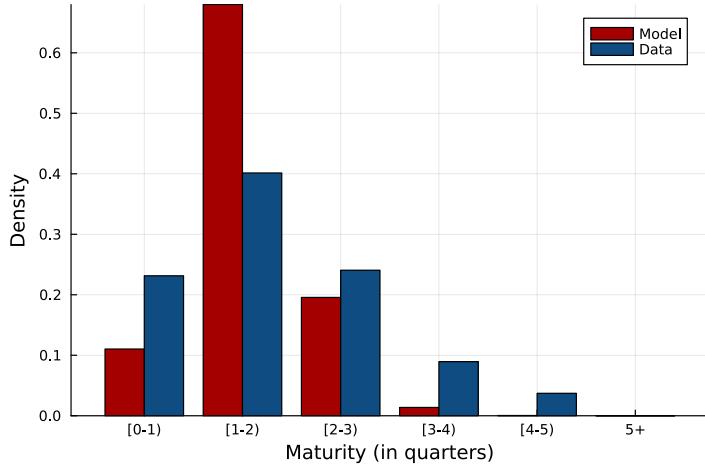
I measure default risk by focusing on the difference between deposits and long-term liabilities rates. Additionally, the failure rate of banks is another indicator of default risk.

Lastly, I focus on banks' funding decisions. Banks can fund themselves using retained earnings or debt. I target the average leverage and its standard deviation, as they provide insight into the regulatory constraints that determine how much leverage banks can take. A critical aspect of the calibration is the share of long-term liabilities over total debt, corresponding to the banks' maturity. I target both the mean and standard deviation of long-term liabilities share.

Table 5 presents the model fit compared to the data moments. Overall, the model does a good job of matching the markups. The spread between long-term and deposit borrowing rates is higher in the data, around ten basis points. This discrepancy is due to the ten basis point differences in my model's default rate from the data. The model almost matches the average leverage and its standard deviation. The model also has a good match for the share of long-term funding and its standard deviation.

Now, I look at the untargeted moments regarding long-term funding. First, I check how well my model matches the maturity distribution across banks and time. Figure 4 compares the model implied maturity distribution with the distribution of the panel of commercial banks. The model does a good job of matching the distribution of maturities. As explained

Figure 4: Banks' Distribution



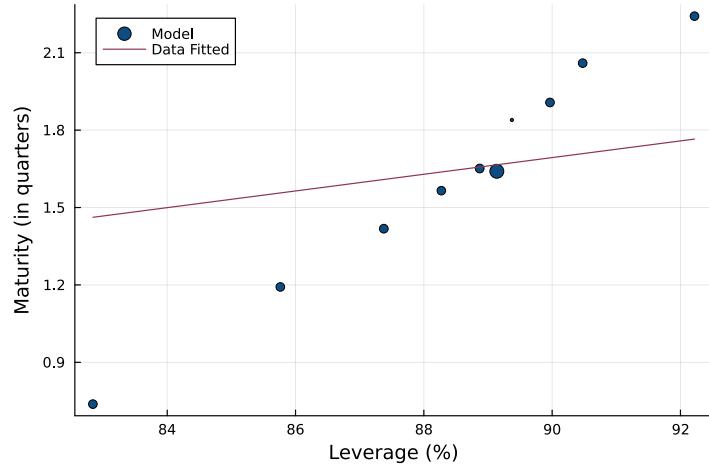
*Notes:* The figure compares the maturity distribution implied by the model to that for the panel of commercial banks. The data is from the U.S. Call Reports covering 2002-2023, using quarterly data.

in Section 2, banks with a higher maturity are the ones to cut their lending less when there is a positive monetary shock. Thus, matching the maturity distribution is crucial to understanding the pass-through of monetary policy through banks.

An established empirical pattern is the positive association between long-term liabilities — particularly non-core liabilities, which are composed of large time deposits and other borrowed money — and higher leverage, as documented by Hahm et al. (2013). To verify if my model replicates this relationship, I plot the model-generated correlation between leverage and liability maturity. As shown in Figure 5, the model captures this positive correlation between leverage and liability maturity.

Lastly, I examine the relationship between liability maturity and loan losses. In sovereign debt literature, long-term debt is often argued to serve as a hedge against adverse shocks and rollover risk. Similarly, from a bank's perspective, the persistence of loan losses suggests that a bank experiencing losses today is likely to face them in the near future. If the hedging rationale applies, banks might respond to potential losses by increasing their reliance on long-term funding. Figure 6 shows the model-generated scatter plot between gross loan losses and maturity, with a linear regression line for comparison with empirical data. The model aligns well with the observed positive correlation, suggesting that long-term debt may

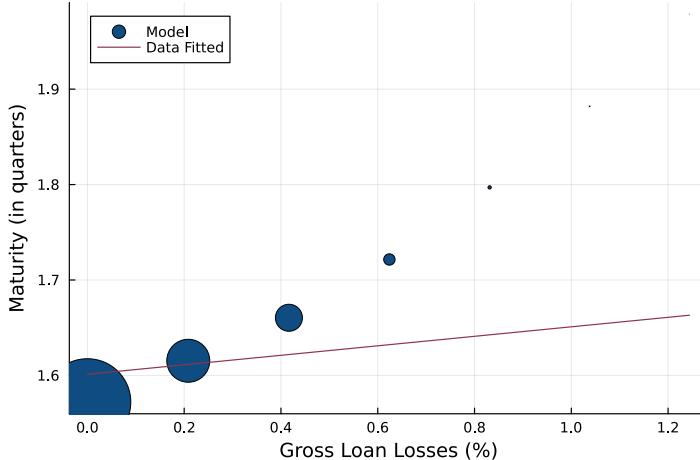
Figure 5: Scatter leverage and maturity



*Notes:* The figure plots the model-generated maturity for each binned level of leverage. The slope is obtained by regressing maturity on leverage, controlling for size, non-performing loans, return on assets, and liquidity, using bank and time-fixed effects. The data is from the U.S. Call Reports covering 2003-2023 at the quarterly frequency. The slope is centered to match the model level. Dot sizes represent the frequency of model generated moment.

indeed serve as a hedge against idiosyncratic risks.

Figure 6: Scatter gross loan losses and maturity



*Notes:* The figure plots the model-generated log maturity for each grid point of gross loan losses. The slope is obtained by regressing log maturity on gross loan losses, controlling for size leverage, return on assets, and liquidity, using bank and time-fixed effects. The data is from the U.S. Call Reports covering 2003-2023 at the quarterly frequency. The slope is centered to match the model level. Dot sizes represent the frequency of model generated moment.

### Heterogeneous Effect of Maturity

The previous subsection showed that the model successfully replicates key cross-sectional facts about the financing choices of U.S. commercial banks. The model thus provides an appropriate quantitative framework for studying the role of liability maturity in the aggregate and heterogeneous effects of monetary policy. I now demonstrate that the model can replicate my empirical heterogeneous response.

The economy is initially in the steady state and receives an unexpected shock of magnitude 25 basis points on Equation 15. In annual terms, this shock corresponds to an increase of one percentage point in the Fed funds rate. For any subsequent period, the shock follows a deterministic AR(1) process  $\varepsilon_t = \rho_\varepsilon \varepsilon_{t-1}$ , with parameter  $\rho_\varepsilon$  equal to 0.5, eventually reverting back to the steady state.<sup>18</sup> The model is simulated for sufficient periods such that the interest rate and the economy converge to the initial steady state.

In order to compare my model to the data, I simulate the differential response between two groups generated by the model. The groups are selected by the setup in the empirical

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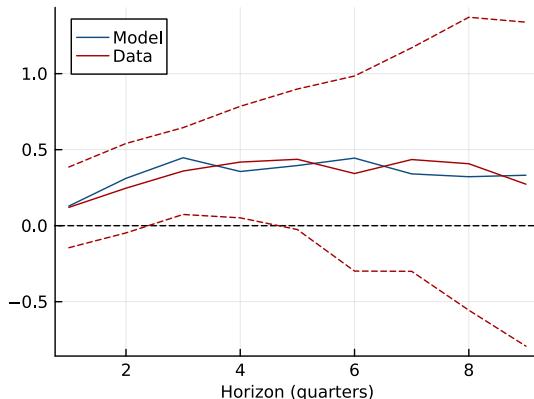
<sup>18</sup>The parameter  $\rho_\varepsilon$  comes from other papers in the literature.

exercise. I divide my model-generated bank distribution into two groups: (i) banks one standard deviation above the mean maturity and (ii) the complementary set. In terms of masses, this choice is close to the share above one standard deviation in the data, 13.24%, while in the model, the mass is equal to 14.59%.

Because in the model, these banks with higher maturity are also the ones with more leverage and riskier, this would imply different pre-trends before the monetary shock. Therefore, I focus on the deviations from the group's specific transition using steady-state policies.<sup>19</sup> I then compare it to my baseline regression by calculating the difference in each group's deviations around their transition paths.

Figure 7 presents that the model can replicate the heterogeneous transmission of monetary policy with respect to banks' maturity. First, it matches the persistent discrepancies in the data. Second, on level, it remains within the 90% confidence interval for the empirical coefficients up to eight quarters after the shock. Thus, this validates the model's ability to replicate the empirical heterogeneous response to bank lending.

Figure 7: Heterogeneous Response to Contractionary Monetary Policy Shock



*Notes:* Heterogeneous impulse responses to a  $\varepsilon_0^m = 0.0025$  innovation to the policy rate which decays at rate  $\rho_m = 0.5$ . Groups are selected according to their maturity. The blue line is the data point estimates using benchmark estimation. Dashed lines report a 90% confidence interval. Computed with perfect foresight transition in response to a series of unexpected innovations starting from the steady state.

The model can accurately replicate the empirical heterogeneity as it captures the correlation

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<sup>19</sup>Notice that since the optimal policies in the steady state guarantee a unique bank distribution if the time interval is large enough, both sub-groups would eventually converge to the same points.

between banks' maturity choice and their financial frictions. Consistent with the data, banks with longer-maturity debt tend to be more financially constrained. Importantly, these banks benefit from a significant decline in the present value of their outstanding liabilities as their future interest payments are locked in. This effect of long-term debt against interest rate increases not only increases their equity but also alleviates their funding constraints. This mitigation more than compensates for any increase in funding costs, allowing banks with a greater proportion of long-term debt to increase their lending in response to monetary policy shocks.

Since monetary shocks influence the overall structure of bank funding, see, for example, Supera (2021), understanding the distribution of funding maturities becomes essential to fully grasp how banks' lending responses vary with interest rate changes and time. This exercise highlights that banks' funding structures — particularly liability maturity — play a significant role in determining the extent of their responses to monetary policy.

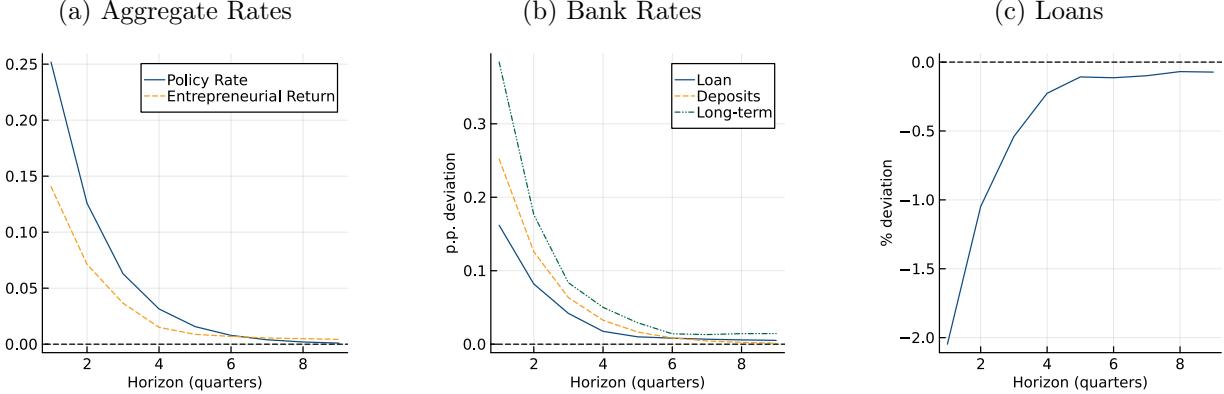
### Aggregate Transmission of Monetary Policy

Figure 8 shows the aggregate effects of this monetary policy shock. The model aggregate lending semi-elasticity to the lending rate is around  $-1.94$  using annualized interest rates, in line with the micro-level evidence for Commercial and Industrial Loans of Bassett et al. (2014). <sup>20</sup> In this model, loan rates respond less than one-to-one. The explanation for this incomplete pass-through is the increase in loan elasticity whenever banks increase their lending rate, which arises from their monopolistic behavior. The model's slope between the monetary policy and loan rates is around 0.6, which aligns with the incomplete pass-through monetary policy rate to lending rate in Commercial and Industrial loans, with substantial evidence by Scharfstein and Sunderam (2016), Drechsler et al. (2021), and Wang et al. (2022). Lastly, because it is a long-term debt, the rate increase is significantly larger than the deposit rate, which matches their data behavior.

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<sup>20</sup>For the Fed funds rate of the model, the semi-elasticity of loans is around  $-1.74$ . Jiménez et al. (2012) and Ivashina et al. (2022) estimate a semi-elasticity of loans to the interbank rates of  $-1.39$  and  $-1.88$ , respectively.

Figure 8: Aggregate Response to Contractionary Monetary Policy Shock



*Notes:* Aggregate impulse responses to a  $\varepsilon_0^m = 0.0025$  innovation to the policy rate which decays at rate  $\rho_m = 0.5$ . Computed with perfect foresight transition in response to a series of unexpected innovations starting from the steady state.

### Decomposing the Heterogeneous Effect

To understand the overall impact of bank funding, I conduct a counterfactual analysis to assess the effects of banks' funding on the transmission of monetary policy.

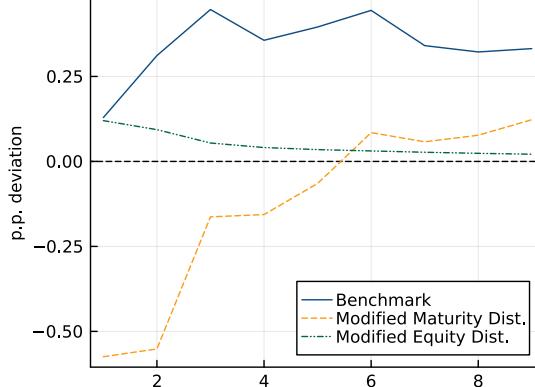
**On the Heterogeneous Transmission of Monetary Policy.** To shed additional light on the role of funding maturity in the transmission of monetary policy, I conduct a model experiment in which I exogenously eliminate long-term debt from the distribution of banks. To isolate the effect of the funding distribution, I re-run the benchmark experiment, altering only the initial distribution at the time of the shock, and compare the responses of both groups. Conversely, I perform a second exercise where I exogenously adjust banks' leverage to match the average across all banks. This second exercise helps uncover the role of the positive relationship between leverage and maturity in shaping the heterogeneous transmission of monetary policy.

The exercise proceeds as follows. Let  $(p, n, b)$  be the bank state variable in the steady state. Then, for each state I change its measure  $\mu(p, n, b)$  to  $\mu(p, \tilde{n}, 0)$  where the new cash-on-hand equals

$$\tilde{n} = n - (1 - \lambda)q_b(p, n, b)b,$$

where  $q_b(p, n_j, b_j)$  representing the long-term debt pricing given the bank's optimal policies.

Figure 9: Counterfactual of Response to Contractionary Monetary Policy Shock



*Notes:* Impulse responses to a  $\varepsilon_0^m = 0.0025$  innovation to the policy rate, which decays at rate  $\rho_m = 0.5$  for benchmark and counterfactual distributions. In the counterfactual distribution, I eliminate the decrease in outstanding debt or the differences in leverage. Computed with perfect foresight transition in response to a series of unexpected innovations starting from the steady state.

Intuitively, this setup ensures that, when the shock hits, there is no effect on banks' equity stemming from their stock of outstanding debt.<sup>21</sup>

Figure 9 presents the benchmark heterogeneous impulse responses alongside their counterfactual counterparts. Mirroring the empirical exercise, once the effect of outstanding debt is eliminated in the model, the decline in lending becomes significantly sharper for those banks that would otherwise benefit from the shock. This result arises because banks that rely more on long-term debt are also typically the most leveraged. By removing the relaxation of their financial constraints, an increase in interest rates instead tightens these banks' constraints, making them more sensitive to monetary policy changes. However, if all banks are set to have identical leverage in the shock period, the positive effect observed for banks with higher funding maturity quickly dissipates, as the relaxation channel is weakened.

The capacity of the model to replicate the empirical heterogeneity relies on two factors. First, the model needs to capture this positive relationship between leverage and long-term debt. Second, the relaxation of the financial constraint of these banks must offset the increase in

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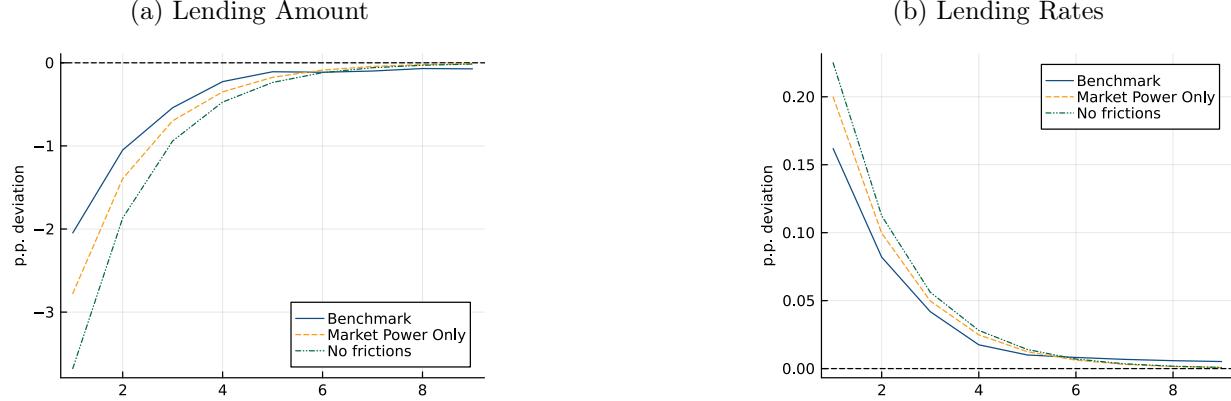
<sup>21</sup>Due to numerical approximations, the aggregate variables in this modified steady state do not precisely match those in the benchmark steady state. To address this, I control the transition of the distribution while holding steady-state policies fixed. The distribution converges to the steady state by the second period.

funding costs. If these two occur, we can match the heterogeneity that we find in the data.

**On the Aggregate Implications of Frictions.** Lastly, to assess the role of financial frictions—and thus funding heterogeneity—in the aggregate transmission of monetary policy, I eliminate the frictions faced by banks. In the first exercise, I keep only loan market power, which would imply an incomplete pass-through of interest rate increases to lending rates. To compare it to the benchmark model, I assume that there is a stationary distribution of repayment states. This exercise is possible as market power allows for different rate setting across banks. In the last exercise, I shut down market power, which implies that banks perfectly pass through interest rate increases to their lending. Because banks can no longer set different lending rates, I assume all banks face the same shock to their loan portfolios.

Figure 10 plots the counterfactual alongside the benchmark. The figure makes apparent how crucial these frictions are for understanding the aggregate response of banks to monetary policy changes. In the absence of frictions, although aggregate lending is higher, its response is much more sensitive than what is observed empirically. First, with only market power, although there is a similar incomplete pass-through to the lending, the cumulative decrease in lending over a 10-quarter horizon is around 27% larger than the benchmark of my model. By eliminating all friction, with the complete pass-through of interest rates, the cumulative decrease in lending is 70% higher than the benchmark.

Figure 10: Counterfactual of Aggregate Response to Contractionary Monetary Policy Shock



*Notes:* Impulse responses to a  $\varepsilon_0^m = 0.0025$  innovation to the policy rate, which decays at rate  $\rho_m = 0.5$  for benchmark and counterfactual distributions. In the first counterfactual, I eliminate all banking frictions, but loan market power. In the second, I eliminate all frictions. Computed with perfect foresight transition in response to a series of unexpected innovations starting from the steady state.

These results suggest a potentially powerful mechanism underlying the transmission of monetary policy: banking frictions play a critical role in shaping the aggregate response of the banking sector. Of course, a limitation of the current analysis is that it considers only extreme counterfactuals, abstracting from banks' funding structures and cash holdings. Naturally, a valuable extension would be to explore how variation in the funding distribution, even if treated as exogenous, could be incorporated to more accurately capture the aggregate implications across different funding structures. This would lead to a deeper understanding of how changes in banks' funding over time influence the transmission of monetary policy

## 6. Conclusion

In this paper, I have shown that banks' maturity dampens lending response to monetary policy. My argument had two components. First, using bank-level data, I showed that banks with higher maturity in their liabilities are less responsive to monetary policy shocks, that is, they decrease their lending relatively less. Second, I built a heterogeneous bank model with default risk, market power, and capital regulation that is quantitatively consistent with these empirical results. In the model, banks that tend to fund their lending with long-term debt either have more leverage or face larger loan losses. I interpret these connections through the financial frictions that banks face. Due to capital requirements, banks must smooth their cash flow over time, and this is done by funding their operations with long-term liabilities. Although more financially constrained, these banks are less responsive to monetary policy because they observe a decrease in the present value of outstanding debt stock. This reduces their leverage and allows them to increase their lending relatively more. Finally, in my counterfactual analysis, I highlighted that assessing the distribution of funding structure is crucial to understanding the aggregate effects of policies, as financial friction plays a determining role in the aggregate response to lending.

In summary, this paper emphasizes the critical role of banks' funding structures, especially the maturity of their liabilities, in influencing their responses to monetary policy. By incorporating balance sheet constraints and heterogeneity in funding choices, the model not only replicates key empirical patterns but also provides new insights into the transmission of monetary policy through the banking sector. These findings emphasize the importance of considering the full range of banks' funding sources when designing monetary policy.

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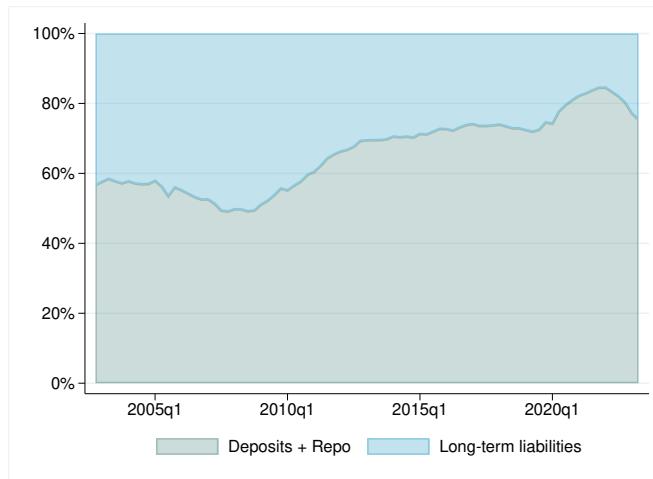
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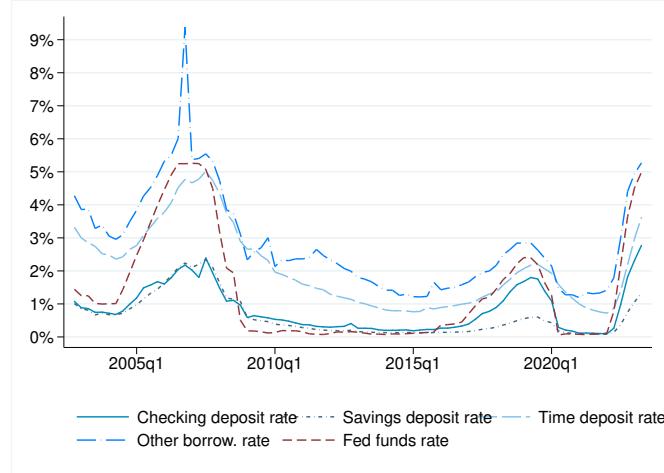
## A. Appendix Additional Plots

Figure A.1



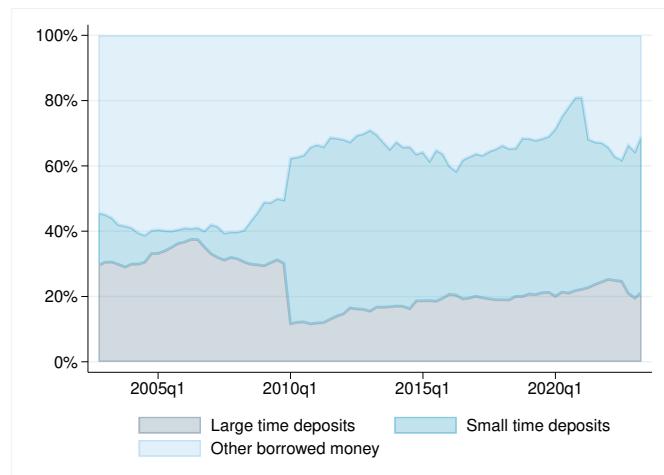
*Notes:* The figure plots the composition of debt funding for the commercial banking sector. The data is from the U.S. Call Reports covering 2003 to 2023 at the quarterly frequency.

Figure A.2



*Notes:* The figure plots the average borrowing rate by different liabilities and the Fed fund rate. The average borrowing rate is measured by the interest expense divided by the quarterly average stock of the liability. The data is from the U.S. Call Reports covering 2003 to 2023.

Figure A.3



*Notes:* The figure plots the composition of long-term liabilities for the commercial banking sector. The data is from the U.S. Call Reports covering 2003 to 2023 at the quarterly frequency.

## B. Empirical Appendix

### B.1. Data Sources

**Uniform Bank Performance Reports.** Data from the Call reports is obtained from the Uniform Bank Performance Reports, which is supplied by the FFIEC, for years between 2002 and 2023. The UBPR covers all FDIC-insured commercial banks, savings banks, and savings associations. The dataset compiles quarterly call reports from each insured bank and constructs standardized measurements for several bank-specific ratios. All definition are provided by the UBPR. I follow the approach of Paul (2023) to aggregate bank subsidiaries at the Bank Holding Company (BHC) level. The FFIEC's National Information Center provides the relationship table between BHC and bank subsidiaries. I only include institutions where the average loan-to-asset ratio is above 25%.

**Interest Rate Shocks.** My measure of interest rate shock is the series of Jarociński and Karadi (2020) due to their decomposition between information and monetary shock.

### B.2. Variable Definitions

**Bank Leverage.** I define leverage as the ratio between total liabilities (**UBPR2948**) and total assets (**UBPR2170**).

**Markup.** I define the markup as follows

$$\text{markup}_{j,t} = \frac{1 + \text{Int. Rate Loan}/400}{1 + \text{Int. Rate Expense}/400} - 1$$

where I transform interest rate expense (**UBPRE666**) and loan interest rate (**UBPRE686**) in per quarter rates.

**Deposits.** Deposits are defined as Demand, NOW, ATS, and MMDA and Deposits Below Insurance Limit (**UBPRK431**) minus Deposits Below Insurance Limit (**UBPRK426**) plus Federal Funds Purchased & Resales (**UBPRF858**).

**Long-term Liabilities.** I define long-term liabilities as time deposits plus other borrowed money. To compute the long-term liabilities I use non-core liabilities (**UBPRK445**) plus small non-brokered deposits (**UBPRK426** minus **UBPR2366**) minus Federal Funds

Purchased & Resales (**UBPRF858**).

**Long-term share.** I define the long-term share of liabilities as long-term liabilities divided by total liabilities (**UBPR2948**).

**Short term investments over total assets.** To proxy for liquidity of the assets, I use the variable short term investments over total assets (**UBPRE589**).

**Return on assets.** To proxy for return on assets I use the net income over total assets (**UBPRE013**).

**Gross Loan Losses.** To capture banks' credit risk, I use the gross loan losses (**UBPRE390**).

**Non-performing Loans.** I use the UBPR constructed non-performing loans (**UBPR7414**).

**Interest Expense on Long-term Liabilities.** I construct the interest expense on Long-term liabilities by summing the expenses on time deposits (**UBPRHR59**) and Other Borrowed Money (**UBPRD479**).

**Quarterly average of Long-term Liabilities.** To compute the borrowing rates on non-reservable liabilities, I need to calculate their quarterly average stocks, analogous to the approach on the UBPR. For this, I sum the quarterly average of time deposits (**UBPRHR65**) and Other Borrowed Money (**UBPRD443**).

**Interest Expense on Deposits.** I construct the interest expense on deposits by summing the expenses savings accounts (**UBPRD372**) and transaction accounts (**UBPRD513**).

**Quarterly average of Deposit Liabilities.** To compute the borrowing rates on deposits, I need to calculate their quarterly average stocks, analogous to the approach on the UBPR. For this, I sum the quarterly average of savings accounts (**RCONB563**), Federal Funds Purchased & Repos (**UBPR3353**), and transaction accounts (**RCON3485**).

**Interest Rate on Liabilities.** Interest rate on any type of liability is measured as the interest rate expense, divided by the quarterly average stock.

### B.3. Empirical Robustness

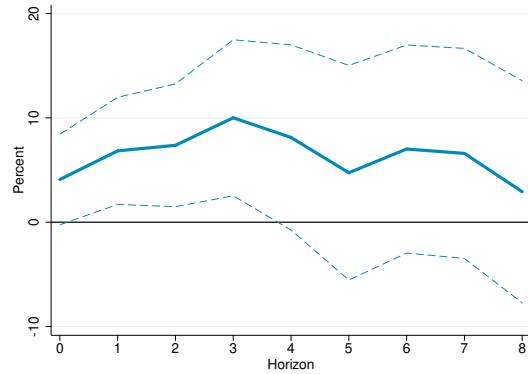
As a robustness to my baseline specification, I re-estimate the Jordà (2005) under the following specification:

$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h M_{j,t-1} \varepsilon_t^m + \gamma^j \varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (\text{A.1})$$

where  $\gamma^j$  is the bank-specific permanent heterogeneous response to monetary policy, the rest is the same as the benchmark specification.

Figure B.1 shows the result of estimating the specification of Equation A.1. Similar to the benchmark, my results are significant at the 10% significance level for the same interval. Because maturity is not normalized, the point estimates are different.

Figure B.1: Heterogeneous Lending Response to Monetary Shock Alternative 1



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

To understand how the estimation of the within-bank variation and the permanent heterogeneous response ( $\gamma^j$ ) are related, I re-estimate the projections under the following specification:

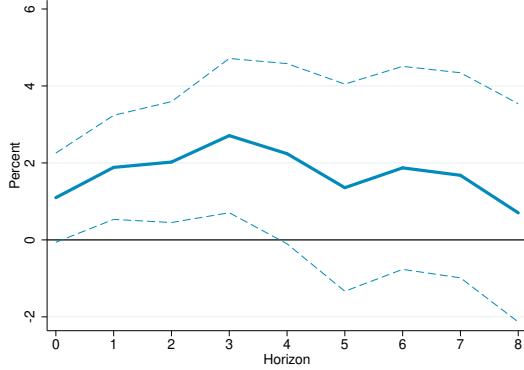
$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h (M_{j,t-1} - \bar{M}_j) \varepsilon_t^m + \gamma^j \varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (\text{A.2})$$

all the variables are the same as specified before.

Figure B.2 shows the result of estimating the specification of Equation A.2. Similar to the

previous specification, my results do not change. This is expected because the estimation of  $\gamma^j$  captures the bank-specific ex-ante heterogeneity. The different point estimates arise from the standardization of the within-bank maturity differences.

Figure B.2: Heterogeneous Lending Response to Monetary Shock Alternative 2



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

Now, I check if my results are robust to the fed funds shock of Jarociński and Karadi (2020) without the "purging" of the information shock. I re-estimate the projections under the following speciation:

$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h(M_{j,t-1} - \bar{M}_j)\varepsilon_t^{\text{fed}} + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (\text{A.3})$$

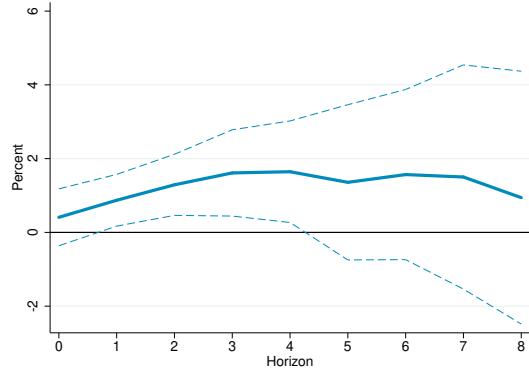
where  $\varepsilon_t^{\text{fed}}$  is the fed fund shock.

Figure B.3 shows the result of estimating the specification of Equation A.3. Similar to the benchmark specification, the alternative of the interest rate shock behaves similarly to the monetary shock, as identified by Jarociński and Karadi (2020).

I also check if the responses are the same if I use the variations of the fed funds rate instead. Under this alternative, I re-estimate the projections under the following speciation:

$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h(M_{j,t-1} - \bar{M}_j)\Delta_t^{\text{fed}} + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (\text{A.4})$$

Figure B.3: Heterogeneous Lending Response to Monetary Shock Alternative 3

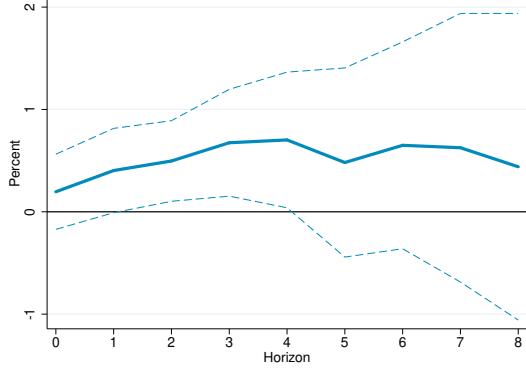


*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

where  $\Delta_t^{\text{fed}}$  is the variation of the fed funds rate. I instrumentalize the variation using the monetary policy shocks.

Figure B.4 shows the result of estimating the specification of Equation A.4. Although with smaller values, my results are significant at the 5% significance level for the same interval.

Figure B.4: Heterogeneous Lending Response to Monetary Shock Alternative 4



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

Now, I turn my attention to the maturity gap. The rationale for this is to check if interest rate risk affects banks' lending heterogeneously. The construction for the variables follows English et al. (2018). For these, I conduct two estimations with the maturity gap. First, I estimate the model without a bank-specific response to monetary policy:

$$y_{j,t+1+h} - y_t = \alpha_{j,h} + \alpha_{t,h} + \beta_h M_{j,t-1}^{\text{gap}} \varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h} \quad (\text{A.5})$$

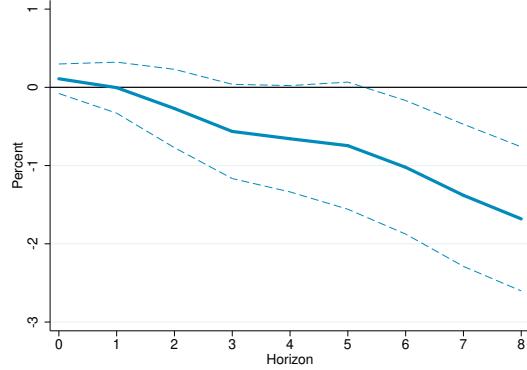
Figure ?? presents the local projections for the heterogeneous lending responses with respect to the maturity gap. As expected, banks with a larger maturity gap reduce their lending by a greater extent. However, since this specification does not control for bank-specific variation in the maturity gap, the estimated effects may be biased by bank-level responses.

To assess whether the response to the maturity gap reflects an ex-ante source of heterogeneity rather than an ex-post adjustment, I re-estimate the previous regression by including each bank's specific response to monetary policy shocks:

$$y_{j,t+1+h} - y_{j,t} = \alpha_{j,h} + \alpha_{t,h} + \beta_h M_{j,t-1}^{\text{gap}} \varepsilon_t^m + \gamma^j \varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h}. \quad (\text{A.6})$$

This specification isolates the effect of the maturity gap from the banks' own heterogeneous

Figure B.5: Heterogeneous Lending Response to Monetary Shock Maturity Gap



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

sensitivities to monetary policy, allowing us to determine whether the maturity gap captures structural differences in funding exposure or simply reflects differential policy transmission at the bank level.

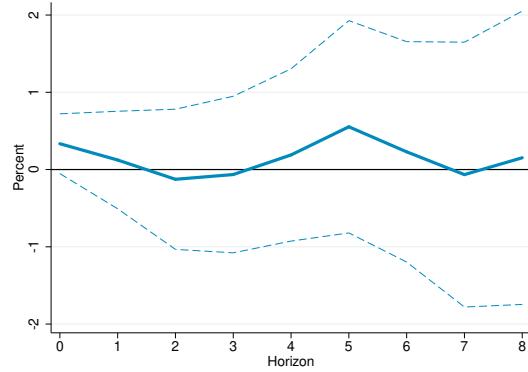
Figure ?? presents the local projections for the heterogeneous lending responses with respect to the maturity gap, controlling for bank-specific responses to monetary policy. Unlike the previous specification, the estimated effects are no longer statistically significant. This result suggests that the maturity gap may represent an ex-ante, bank-specific source of heterogeneity, rather than an ex-post adjustment—a mechanism that lies outside the scope of the model.

Lastly, I examine the heterogeneous response with respect to the maturity of banks' assets. Following the previous specification, I include both the bank-specific responses to monetary policy and the interaction between monetary shocks and asset maturity:

$$y_{j,t+1+h} - y_{j,t} = \alpha_{j,h} + \alpha_{t,h} + \beta_h M_{j,t-1}^{\text{assets}} \varepsilon_t^m + \gamma^j \varepsilon_t^m + \Gamma_1 X_{j,t-1} + e_{j,t+h}. \quad (\text{A.7})$$

This specification allows me to assess whether differences in the maturity structure of banks' assets contribute to the heterogeneity in lending responses beyond what is explained by their overall sensitivity to monetary policy.

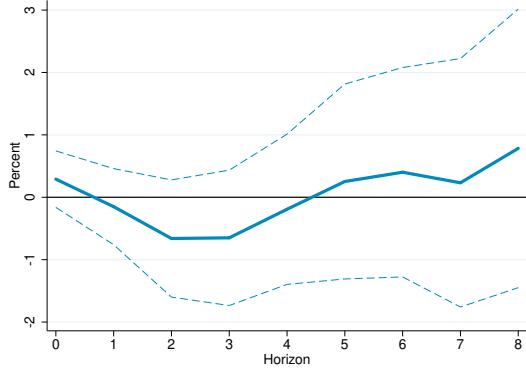
Figure B.6: Heterogeneous Lending Response to Monetary Shock Maturity Gap



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

Figure ?? presents the local projections for the heterogeneous lending responses with respect to the maturity of the assets, controlling for bank-specific responses to monetary policy. Like the previous specification, the estimated effects are not statistically significant. This result suggests that the maturity of the assets may represent an ex-ante, bank-specific source of heterogeneity.

Figure B.7: Heterogeneous Lending Response to Monetary Shock Maturity of Assets



*Notes:* The figure presents the impulse response of a 1% monetary shock, constructed by Jarociński and Karadi (2020), based on the local projection approach. The data is from the U.S. Call Reports covering 2002 to 2023 at the quarterly frequency. Maturity is constructed by using time-to-maturity brackets. The cumulative growth of loan growth is plotted with a 90 percent confidence interval shown using standard errors clustered at the bank and time level.

## C. Quantitative Appendix

### C.1. Algorithm for Steady State

The bank problem is solved using value function iteration (VFI) due to the existence of two defaultable liabilities, which might cause indeterminacy. In the benchmark setup, I have 101, 111, and 81 grids for the endogenous choice variables,  $R_\ell$ ,  $d'$ , and  $b'$ , respectively. Additionally, I use 7 grid points for  $p$ , 100 for  $n$ , and 21 for  $\omega$ . After each iteration, I update both liability prices to speed up the computational time. I stop the process if the distance between iterations is below a tolerance of  $10^{-6}$ . Then, I store the policies for each grid point of  $(p, n, b)$ .

The algorithm to solve the steady-state mass of banks according to their variables  $(p, n, b)$  follows Young (2010). Since the number of grid points for the endogenous variables for the cash-on-hand ( $n$ ) is significantly smaller than the number of grid points for  $R_\ell$ ,  $d'$ , it generates a faster convergence speed than if I were to have  $(p, a, d, b, \omega)$  as state variables. Therefore, my vector for the steady state distribution is given by  $(p, n, b)$ , which has more than 80 thousand grid points. Finally, I compute a transition matrix for  $(p, n, b)$ , iterating with an initial guess for  $\mu$  until the distribution converges.