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Comments of "The Spillovers, Interactions, and (Un) Intended Consequences of Monetary and Regulatory Policies"

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The Spillovers, Interaction, and (Unintended) Consequences of Monetary and Regulatory Policies

by Forbes, Reinhardt, and Wieladek

discussion by Enrica Detragiache

ARC -- November 6, 2015

Quick summary of the paper

- **Facts:**
  - Big decline in cross-border lending by UK banks post-crisis
  - The biggest drop is immediately post-Lehmann, but a further decline started in early 2012
  - Domestic lending declined by much less
  - The deleveraging was concentrated in interbank lending

Quick summary of the paper

- **Main finding:**
  - A major contributor to the cross-border interbank deleveraging of UK banks was the Funding-for-Lending Scheme (FLS)
  - Specifically, 30 percent of the deleveraging is attributable to the FLS.

Quick summary of the paper

Why the FLS?

- UK banks were facing intense capital pressure from supervisors
- With a binding capital constraint, the 'subsidy' from the FLS caused banks to expand domestic lending at the expense of cross-border lending

What I like about the paper

- **Understanding the interaction between regulatory/supervisory policies and monetary policy is a most pressing issue**
  - A lot of talk about the ZLB. But the ZCB (zero excess capital bound) may be as important to monetary policy effectiveness
- **The theory underlying the effect highlighted in the paper is straightforward and convincing**

What the regressions show us

- UK banks facing larger capital demands from supervisors contracted their cross-border lending the most
- The sensitivity of cross-border lending to capital demands was higher in Q3 2012-Q1 2015 then in Q1 1997-Q2 2012, i.e. after the FSL was introduced (QE did not make any difference)
- This 'extra sensitivity' was especially large for banks with a large FLS-eligible loan portfolio (the more domestically-oriented banks)

What the regressions show us

- This is a before/after exercise, comparing the 10 quarters of post-FSL with 56 quarters of pre-FLS
- Of these, some 40 quarters were pre-crisis quarters
- Could it be that the sensitivity to capital was higher in later years for reasons other than the FLS?

Alternative explanations to rule out

- Post-GFC it was more difficult/costly for banks to raise capital relative to pre-GFC
- Post-Basel III banks facing supervisory capital demands also had to face even stronger capital pressures from the markets
- Post-Basel III interbank lending was being penalized (see debate on the liquidity coverage ratio)

What the regressions show us

- **Possible alternatives:**
  - Cross-border lending had become generally riskier than domestic lending (possibly because of the euro area sovereign crisis)
  - These forces might have been stronger for domestically-oriented banks. The UK banking sector was emerging from a deep crisis and was under profound restructuring
  - The less FLS-sensitive banks may be mainly foreign bank affiliates, for which the factors listed above may have played out differently

Easy things to add to the paper

- Discuss the euro crisis and regulatory reforms, their potential role in explaining cross-border deleveraging, and to what extent evidence in the paper is or is not consistent with those effects

Easy things to add to the paper

- **Add a new set of regressions to show that UK banks *domestic lending* sensitivity to capital *declined* in the post-FSL period**
  - This would help rule out some of the alternative explanations
- **Distinguish between foreign subs and UK banks**

Easy things to add to the paper

- **Alter the definition of the FLS dummy to show that it is not a pre-crisis/post crisis dummy:**
  - For instance, have the dummy switch in mid-2008 to include the whole post-GFC period and show that the interaction loses significance
  - Or introduce a separate dummy and its interactions for the pre-crisis period. Show that the post-FLS interactions remain significant
- **Show that the results are robust to the exclusion of euro area countries/banks**

Endogeneity/reverse causality

- Supervisory capital add-ons endogenous
- Could it be that supervisors were pushing less capitalized, domestically-focused banks to both increase capital and reduce cross-border exposure (ex. German Landesbanken)?

Endogeneity/reverse causality

- More generally: Capital add-ons may be correlated with omitted variables that also help explain why banks deleverage cross-border
- Approach in the paper: regress the capital add-ons on bank observables. Use the residual as "exogenous" measure of capital add-ons

Endogeneity/reverse causality

- Better approach: If observables might explain deleveraging, put them as explanatory variables in the main regression
- This gives a "cleaner" coefficient on the capital add-on (but there is still the problem of unobservables…)

Final point: Should we worry about bank de-globalization?

- The authors do not say
- UK bank cross-border lending almost tripled between 2002 and 2008, from 2 trillion to 6 trillion US$
- Domestic lending grew only by some 70 percent
- Maybe it was a bubble deflating…

Thank you