EUROPEAN CENTRAL BANK
EUROSYSTEM

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

Opening remarks by Peter Praet, Member of the Executive Board of the ECB, Vienna, 26 January 2017

I am happy to be able to join this workshop as it addresses a number of topics that are of great importance for monetary policy and for the euro area banking system. First of all, the overall theme of the workshop – banking analysis for monetary policy purposes – is one that is particularly relevant in a predominantly bank based system such as the euro area. We remain in a challenging economic environment with unprecedented monetary policy measures, so it is vital that we have an active and enthusiastic network of central bankers, economists and researchers investigating these issues. For these reasons, I would like to say a few words about the overall themes that will be discussed today and briefly mention how they relate to the current environment, monetary policy and the different challenges we are facing in the euro area.

The topic of the first session is on **bank profitability**. Bank profitability is a concern for policy makers, because the smooth transmission of monetary policy requires a resilient and sustainable banking system. While many commentators stress the negative consequences of low interest rates on bank profitability even in the short-run, their misgivings are often based on a partial view of the effect of monetary policy on banks. There are a number of channels through which monetary policy affects banks' balance sheets – some direct and some indirect. Firstly, net interest income can be affected directly by the cost of excess liquidity holdings when the deposit facility rate is negative. Moreover, interest margins tend to decrease when yields compress and the yield curve flattens, as liabilities generally have shorter maturities than assets, and deposits in particular are less responsive to decreasing rates when interest rates are already low or negative. However, these effects are at least partly offset by the stimulative impact of monetary policy on macroeconomic activity leading to increased lending volumes and improvements in credit quality, and, in the short-term from the increase in the value of the securities held by banks owing to expansionary policy.

The papers presented in the first session today are extremely important as they shed light on these complex interactions between monetary policy and bank profitability from different perspectives. The first paper - Monetary policy and bank profitability in a low Interest rate environment - addresses the simultaneity and feedback between bank profitability and macroeconomic conditions, which is one of the main challenges in the literature. Moreover, it uses the structure of individual banks' balance sheets to simulate the differing impact of a term structure shock on the profitability of banks. Similarly, the second paper - From Low to Negative Rates: an Asymmetric Dilemma - uses very detailed information on Austrian banks to show that the effect of the interest rate environment on net interest margins can be heterogeneous across a diverse group of banks. These studies using more detailed micro bank level data help to elucidate many of the complex consequences of different monetary policy actions which are often not obvious when only looking at aggregate data and therefore are very welcome additions to the current research agenda.

The second session on **monetary policy transmission** is likewise of particular importance at this current juncture where we are navigating uncharted policy waters. The recent crisis included stress in both financial markets and the real economy and required an unprecedented conventional and unconventional policy response. The transmission of these policies was complicated by a number of factors which were particularly salient in the euro area. When the crisis struck there was no common framework for bank recovery and resolution and no adequate institutions to address the sovereign debt crisis. Moreover, private sector indebtedness and impairments on banks' balance sheets posed significant challenges to the transmission of policy. Policymakers had to adapt to these challenges and unconventional policy measures were designed to circumvent the significant obstacles to transmission.

In this environment, the papers in the second session are particularly relevant in understanding the effects of both conventional and unconventional policies and how they interact. The first paper - The bank lending channel of conventional and unconventional monetary policy – analyses how certain bank characteristics affect the transmission of the main refinancing rate and other unconventional policies to lending rates charged by banks. The second paper - The transmission mechanism of credit support policies in the euro area – likewise analyses how credit easing measures adopted by the ECB have affected loan supply and how the impact varies across different types of banks. Both these papers are essential in understanding the interactions between standard and non-standard policies and which types of banks will be most affected.

Much of the research presented at the workshop today, on the heterogeneous nature of monetary policy transmission and banking sector issues, would not be possible without micro level data. In this context, I look forward to the discussion on the analytical possibilities of using **bank lending survey (BLS) responses for individual banks**. Existing research using these data at the national level has led to an enhanced understanding of monetary policy transmission and a deeper insight into the supply and demand pressures that drive credit developments. For this reason, broadening and coordinating such research efforts across euro area countries would be an important advance for research into the effect of our policies.

We are also very fortunate today to be hearing from Professor Steven Ongena, whose research and expertise are consistently at the forefront of the academic and policy agenda on banking issues. Today, he will be talking to us about **the cost of equity and the supply of bank credit**. The topic of this keynote address reminds us that issues which impact the financial structure and funding costs of banks are not detached from the well being of firms and households in the euro area which rely on banks for credit to foster investment and expansion. The paper that will be presented by Professor Ongena implies that a decrease in the cost of equity leads banks to increase credit supply, which highlights how important equity is for the banking sector.

The session following this important keynote will expand further on the topic of **bank capital and the cost of equity**. This subject has been discussed recently several times in the Governing Council and is particularly relevant recently for two reasons. The first is that capital regulations have undergone many changes of late and these can have profound effects on banks' balance sheet decisions which can vary in the short and the long run. While many of these effects are intended it is vital to understand the impact horizon and to investigate possible unintended consequences. The second reason that this subject is important is due to the volatile equity market developments that we have seen in recent years, not least those experienced by euro area banks over the past year.

The session contains two papers that address this topic from two different perspectives. The first paper - Bank capital (requirements) and credit supply: evidence from pillar 2 decisions – uses time-varying individual bank capital requirements to show how they affect banks' balance sheets. The authors find that increases in required and actual bank capital ratios shrink banks' balance sheets, lending, securities holdings, deposit collecting but prompts interbank lending and borrowing. These assets tend to be costly in terms of capital charges indicating that equity capital costs for banks are not negligible. The second paper - Bank equity valuations and credit supply – investigates whether fluctuations of bank equity valuations which alter the cost of equity, are causally linked to credit supply changes. While a correlation between market values and credit growth has been documented, the causal link is quantified by controlling for confounding factors that may drive the co-movement of equity valuations and credit growth. The paper finds that the more costly bank equity is, the lower is, ceteris paribus, the incentive to expand credit supply. This effect comes from the fact that banks are bound by capital requirements meaning that on average credit growth is funded with the regulatory mix of debt and equity – plus a buffer of equity.

The final session of the day then makes the important link between the **banking sector and firms access to finance**. As central bankers in the euro area, our primary objective is maintaining price stability. Even though our policies are often bank centric, what we really care about is how they transmit to the real economy and specifically the extent to which they affect investment and employment activity, which drives changes in prices.

The three papers in the final session address the effects of monetary policies on firms and the general interactions between the banking system and firms' financing. The first paper - Do SMEs benefit from unconventional monetary policy and how? - finds that following the announcement of the outright monetary transactions (OMT), credit access improved for firms borrowing from banks with high balance sheet exposures to stressed sovereign debt. The second paper - Banks' foreign currency funding and exporters' performance – shows that US dollar funding shocks faced by French banks reduced the exports of the most exposed firms, implying important consequences for policies that seek to address frictions in currency markets. And the third paper in the session - Support is appreciated: on the effectiveness of the SME supporting factor – shows that changes in capital requirements that made loans to SMEs more attractive supported access to finance for medium sized firms in Europe.

So to sum up - I am very much looking forward to seeing the presentations today that cover such a rich range of topics and which are of vital importance, not just for researchers, but also for policymakers. I would encourage further collaboration among researchers across central banks and universities. Research using micro bank balance sheet data is crucial in understanding the problems we face in this new environment and in designing policies to overcome our challenges.

Thank you.