

The Heterogeneous Bank Lending Channel of Monetary Policy

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Does bank interest rate risk exposure matter for monetary policy transmission?

- Euro area heterogeneous loan pricing: fixed-rate (FR, DE) vs variable-rate (ES, IT).

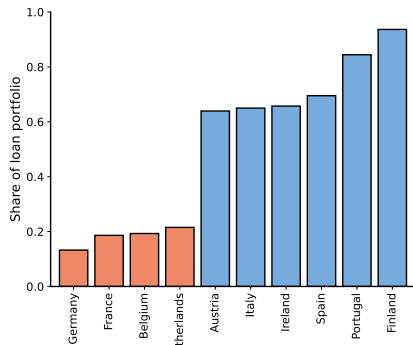


Figure 1: Share of variable rate loans across euro area countries

Does bank interest rate risk exposure matter for monetary policy transmission?

- Euro area heterogeneous loan pricing: fixed-rate (FR, DE) vs variable-rate (ES, IT).
- Transmission depends on bank characteristics (Kashyap and Stein, 2000)
- Transmission is amplified by leverage
(Jimenez et al., 2012; Dell'Ariccia et al., 2017; Altavilla et al., 2020)
- U.S. banks with higher IRR exposure exhibit stronger transmission
(Gomez et al., 2021, Altunok et al., 2023)

This paper

- A structural model is essential to go beyond cross-sectional estimates.
- **Quantitative heterogeneous-banks macro model**
 - Ex-ante heterogeneity in loan-rate fixation (fixed vs. variable rates)
 - Ex-post heterogeneity in capital ratios (driven by idiosyncratic credit risk)
- **Theoretical benchmark (Modigliani-Miller logic)**
 - Absent insolvency risk, the FR/VR heterogeneity is irrelevant for monetary transmission
 - Whether FR/VR distinction matters depends on the empirical distribution of bank leverage and proximity to regulatory constraints (quantitative question)

Preview of the results

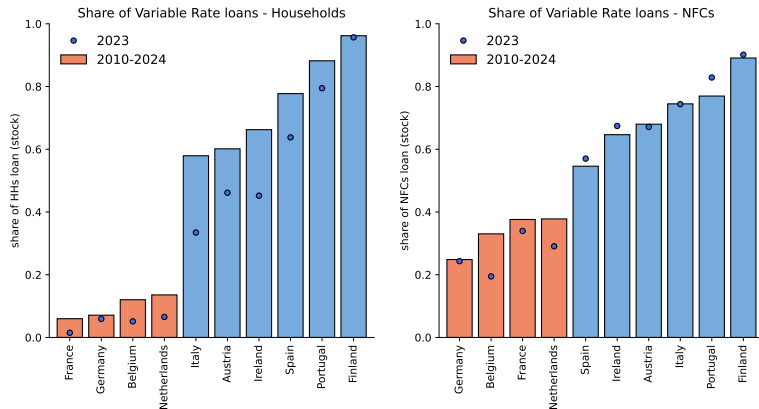
1. Model consistent with long-run distributional features of euro area banks
 - Cross-sectional distribution of assets and capital ratios
2. In a monetary tightening **lending contracts more strongly** for banks with...
 - Fixed-rate loans
⇒ through an equity accumulation channel
 - High leverage (key margin of transmission)
⇒ data informs the magnitude of amplification
3. **Key insight: sources of heterogeneity interact**
 - Without heterogeneity in leverage, heterogeneity in loan pricing becomes irrelevant.
4. Implications for financial stability and conduct of monetary & macropru policy

Outline

1. Data: Bank heterogeneity in the euro area
2. The Model: Mechanism + Theory
3. Quantitative results
 - Long-term features
 - Dynamic response to MP
 - Policy implications

Data. Euroarea

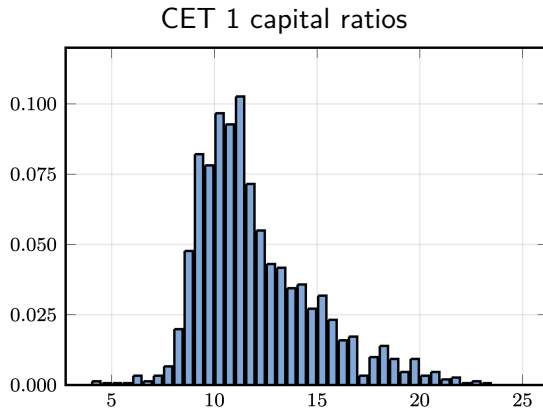
Heterogeneity in loan-rate fixation



Data sources: ECB Statistical Data Warehouse. Lending to households includes mortgage loans, consumer loans, and other loans.

- **FR countries:** Germany, France, Belgium, and Netherlands
- **VR countries:** Spain, Portugal, Italy, Austria, Finland, Ireland
- Loan-rate pricing patterns are highly persistent over time

Heterogeneity in bank leverage



Sources: S&P Global. The sample corresponds to 163 large and medium-sized European banks from 2013 to 2020.

- Large heterogeneity in CET 1 capital ratios
- Most European banks hold substantial capital buffers ➡

The model

The Model – Environment

Two institutional environments:

- FR economy: banks issue fixed-rate loans
- VR economy: banks issue variable-rate loans

Banking sector

- Continuum of perfectly competitive banks in the loans market

Non-financial sector

- Entrepreneurs: demand loans for funding investment projects
- Households: Save in deposits and gov. bonds, consume, own the banks
- Government: sets policy rate and runs a deposit insurance scheme

The model – Banking sector

- Assets: risk-free short-term reserves and risky long-term loans
 - idiosyncratic credit risk: loan default shocks
 - lending frictions: convex loan origination cost
- Liabilities: short-term deposits, and equity
 - deposit structure: retail and wholesale
 - equity accumulated only via retained earnings
- Capital Regulation:
 - *minimum capital requirement*: Failure to comply → bankruptcy

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Key Features:

1. Maturity transformation + deposit structure
+ loan pricing (FR vs VR) ⇒ Captures net interest margins (NIM) dynamics!

The model – Banking sector

- Assets: risk-free short-term reserves and risky long-term loans
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Key Features:

2. Slow moving leverage

+ idiosyncratic credit risk $\Rightarrow$ ex-post heterogeneity in leverage!

The model – Banking sector

- Assets: risk-free short-term reserves and risky long-term loans
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Key Features:

3. Heterogeneity in capital ratios

+ *minimum capital requirements* ⇒ *endogenous capital buffers*!

Key differences between FR and VR economies

FR economy

- Fixed interest rate on new loans.
- Gradual repricing of legacy portfolio when policy rate changes.
- Monetary tightening initially compresses net interest margins (NIM)
⇒ funding costs rise but loan income lags.

VR economy

- Interest rate on new loans: fixed spread over r_t^M .
- Quick repricing of legacy portfolio when policy rate changes.
- Monetary tightening can improve NIM initially
⇒ loan income rises with policy rate.

Mechanism: The speed of loan rate adjustment drives differences in profitability, capital ratios, and lending responses.

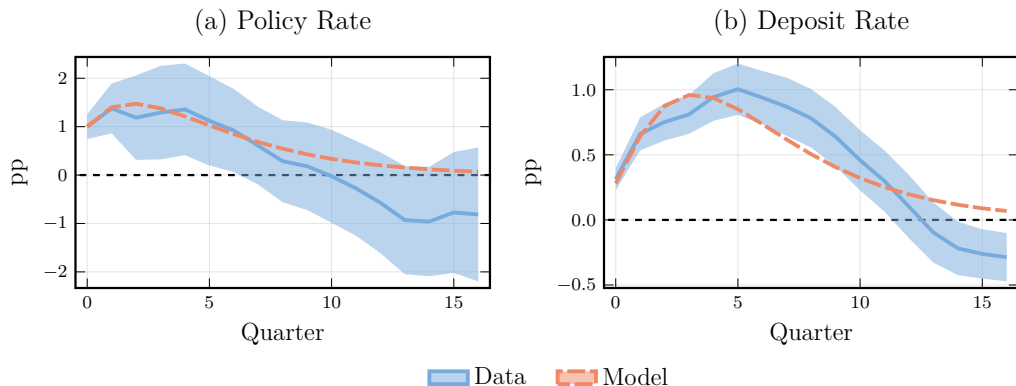
Quantitative Results

Dynamics. Model simulations

Perfect foresight: Responses to a monetary tightening $\Delta^+ r^M$ (100 bps)

1. Aggregate responses: Model vs data IRFs.
2. Cross-sectional responses.
3. Turning off heterogeneity.

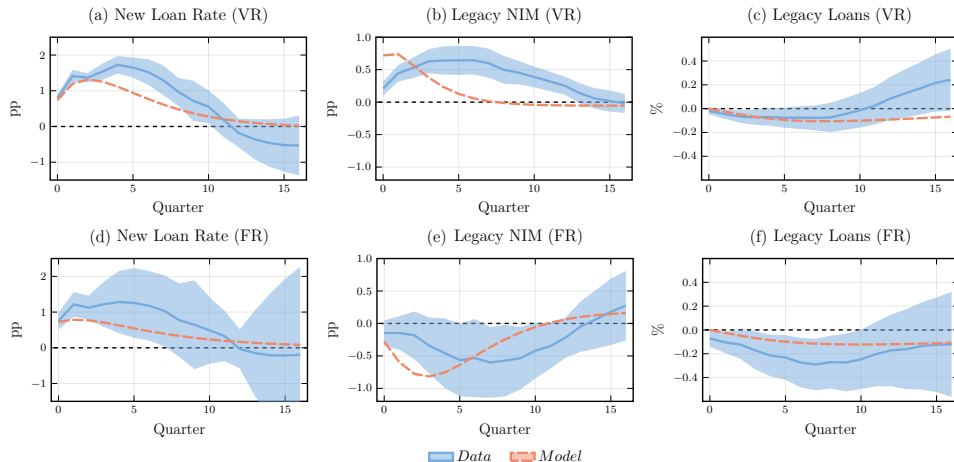
Targeted impulse responses



Blue lines: empirical impulse responses to a monetary policy surprise

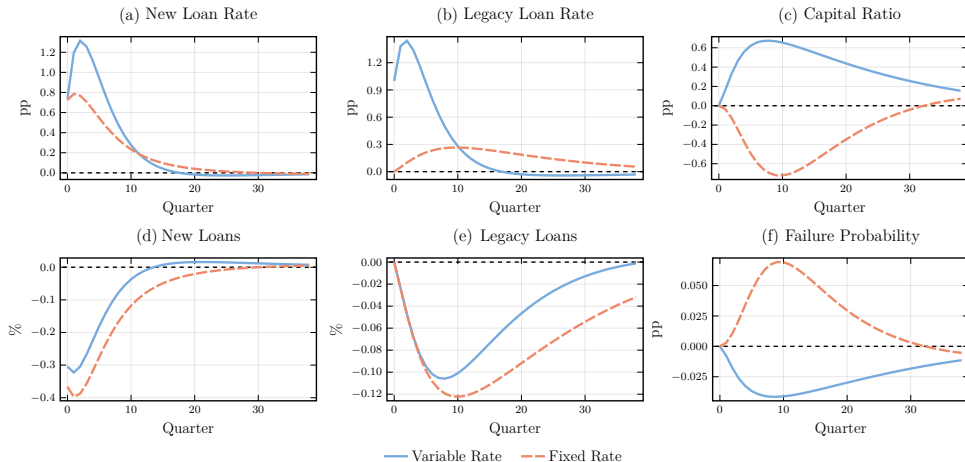
Red lines: sequences fed to the model

Model vs Data: untargeted responses to a monetary tightening



- Data responses: Panel Local Projections with country fixed effects ➡

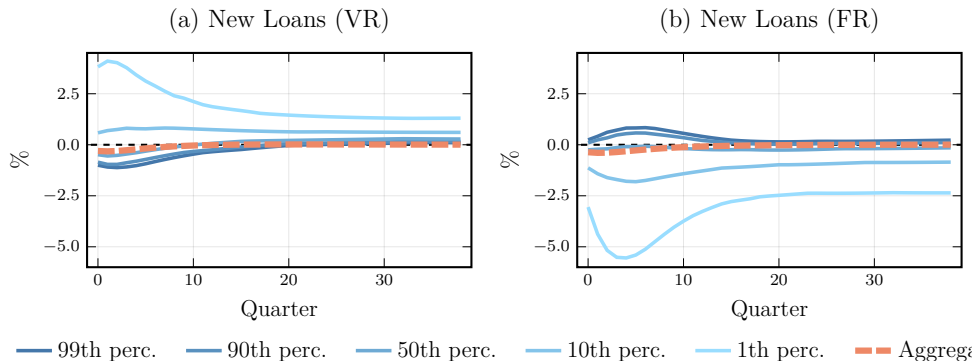
Fixed-rate vs Variable-rate: aggregate responses



Amplification (Panel d): Model predicts that new lending response is about 1/3 stronger in FR economies

The cross-sectional mechanism

- Why do VR and FR banks respond differently? Proximity to capital constraints!

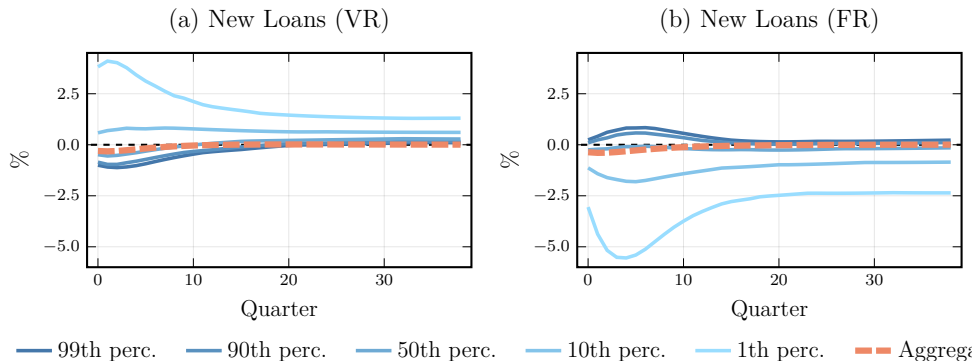


(a) VR banks: Rate hikes expand margins and build equity.

⇒ **Constrained banks (light blue)** move away from CR constraint and expand lending

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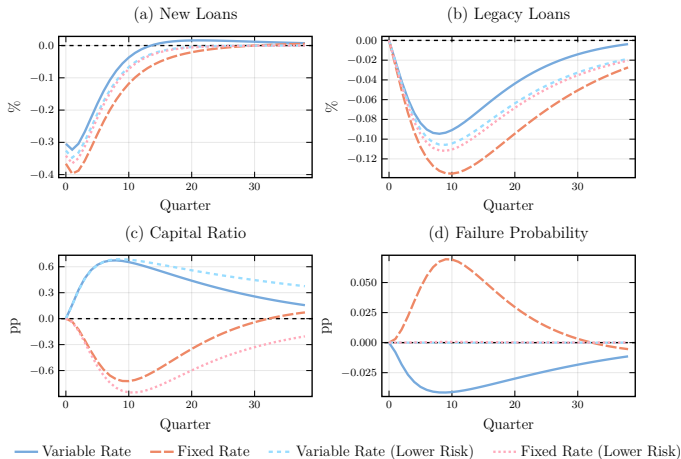


(b) FR banks: Rate hikes compress margins and erode equity.

⇒ Banks already near the constraint (light blue) must strongly cut lending to survive

Ex-ante vs. ex-post heterogeneity: role of idiosyncratic risk

- Model with lower idiosyncratic credit risk $\Rightarrow$ no heterogeneity in capital ratios



$\Rightarrow$ FR/VR amplifies responses because some banks operate close to regulatory constraints

Policy implications and robustness

- **Macroprudential policy interactions** Appendix
 - Releasing Countercyclical Capital Buffers (CCyB) during tightening relieves constrained banks, narrowing the FR/VR credit contraction gap
- **Monetary policy gradualism** Appendix
 - More gradual implementation of policy rate hikes allows for more gradual deleveraging, substantially reducing bank failure rates in FR economies
- **Robustness: Endogenous borrower credit risk** Appendix
 - Extending the model to allow borrower default to rise in VR economies when rates hike does not overturn the main results for moderate shocks

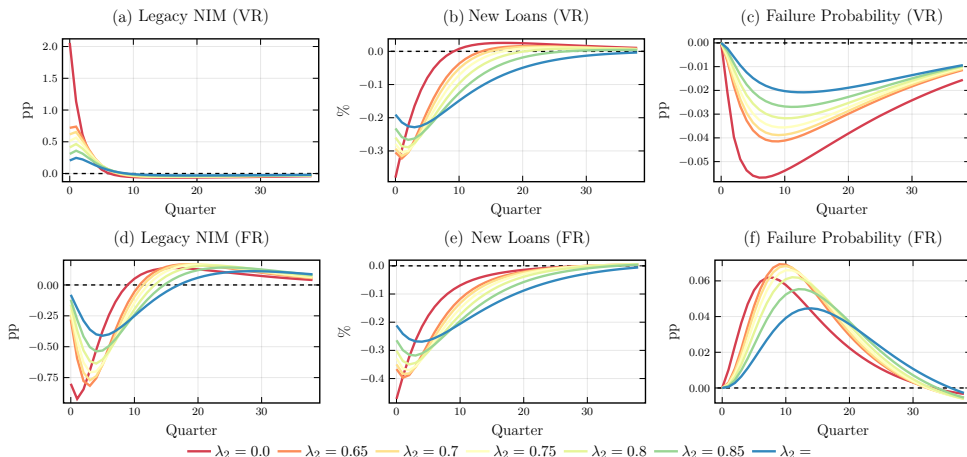
Takeways

1. Develop a **heterogeneous-banks quantitative macro model** with
 - Ex-ante heterogeneity in loan-rate fixation: fixed vs. variable rates
 - Ex-post heterogeneity in capital ratios (leverage)
2. Study aggregate and individual responses to monetary policy
 - **stronger contraction in lending for banks with FR loans**
3. **Sources of heterogeneity interact...**
without heterogeneity in leverage, heterogeneity in loan pricing becomes irrelevant
4. Timing of monetary and macropru policy is key for reducing differences in lending.

Appendix

Monetary policy gradualism

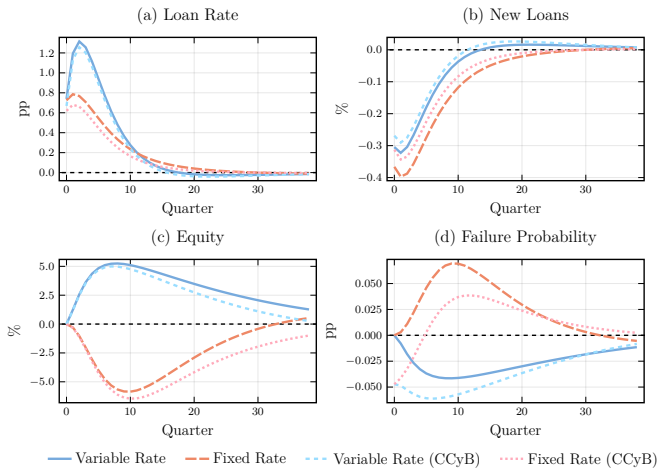
Figure 2: Effects of gradualism



Note: Panels a and b show the response of the legacy NIM; panels c and d show the response of new loans; panels e and (f) show failure probabilities. Left panels correspond to VR economies; right panels correspond to FR economies. Colors from red to blue correspond to increasing degrees of gradualism, captured by $\mu_2 \in \{0.0, 0.65, 0.7, 0.75, 0.85, 0.9\}$. Red corresponds to an AR(1) process ($\mu_2 = 0$); blue corresponds to the most gradual AR(2) process.

Macprudential policy interactions

Figure 3: Impulse response functions — Interest rate increase + CCyB release

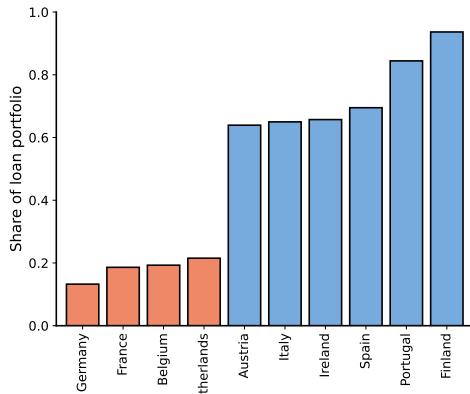


Robustness: Endogenous borrower default

- In VR economies, rate hikes pass directly to borrowers, potentially increasing their default risk and feeding back onto bank balance sheets
- In an extension, we allow the borrower's default probability to increase with the loan rate
 - Borrower default increases in the VR economy following a rate hike, dampening the positive effect on bank equity
 - However, for small to moderate monetary policy shocks, the direct effect of NIM expansion dominates
 - The result that VR economies experience a milder credit contraction than FR economies remains robust

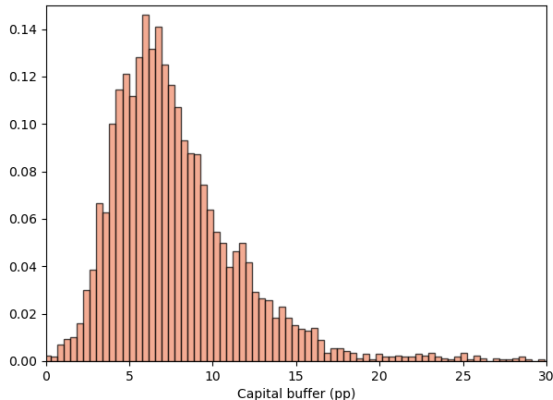
Heterogeneity in loan pricing

Figure 4: Share of variable rate loans across the euro area



Heterogeneity in bank leverage: capital buffers

CET1 capital buffer distribution across European banks



- Most European banks hold capital buffers around 6pp.
- 1/7 banks hold capital buffers greater than 10pp.

Bank liabilities

Retail deposits (D_{jt}): short-term insured liabilities

- Pay a deposit rate $r_t^D < r_t^M$
- Imperfect policy rate pass-through (sticky deposit rates/deposit beta < 1)
- Deposit base is linked to size of the overall portfolio: $D_{jt} \leq \alpha L_{jt}$
 - Deposit funding cannot be scaled up quickly
 - Deposit rates affect average funding cost, but not the marginal cost of new loans

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Wholesale debt (B_{jt}): short-term uninsured liabilities

- Perfect policy rate pass-through ($r_t^B = r_t^M$)
- r_t^B is the relevant marginal cost of new lending

Recursive Problem

The Recursive Problem of the Bank

$$V_t^B(L_{jt}, E_{jt}, x_{jt}^L) = \mathbf{1}_{\{E_{jt} \geq \gamma L_{jt}\}} \left[\max_{\{N_{jt}, M_{jt}, D_{jt}, B_{jt}\}} \beta \int_0^{\bar{\omega}_{jt+1}} [(1 - \chi) V_{t+1}^B(L_{jt+1}, E_{jt+1}, x_{jt+1}^L) + \chi E_{jt+1}] dF(\omega_{jt+1}) \right]$$

$$\text{s.t.} \quad B_{jt} = L_{jt} + N_{jt} + M_{jt} - D_{jt} - E_{jt},$$

(Balance sheet identity)

$$D_{jt} \leq \alpha L_{jt},$$

(Deposits constraint)

$$L_{jt+1} = (1 - \omega_{jt+1})(1 - \delta)(L_{jt} + N_{jt}),$$

(Loan LOM)

$$E_{jt+1} = E_{jt} + (1 - \tau)\Pi_{jt+1},$$

(Equity LOM)

$$E_{jt} \geq \gamma(L_{jt} + N_{jt}),$$

(Capital requirement)

$$M_{jt} \geq \theta(D_{jt} + B_{jt}),$$

(Reserve requirement)

◀ calibration

The theoretical benchmark: Irrelevance of rate exposure

Proposition 1. In the absence of idiosyncratic risk, the model features identical prices and allocations in the fixed- and variable-rate economies in steady state

- **Intuition:** If banks are unconstrained, they can smoothly adjust their balance sheets and absorb losses/gains via equity without cutting lending
 - No equity constraints $\rightarrow$ no effect of rate exposure
 - whether exposure matters depends on the empirical distribution of bank leverage:
 $\rightarrow$ mass of banks near the regulatory constraint

Calibration highlights

- Quarterly frequency, period 2013-2023.
- Matches euro area bank balance sheets (capital ratios, liquid assets, loan maturities)
- Key parameters... [what's important?](#)
 - Credit risk process
 - Loan adjustment costs
 - Entrepreneurs demand elasticities

recursive-problem

pre-set parameters

Steady-State. Long-term features

1. The model's steady-state **distribution of assets** follows a Power Law.
⇒ Common empirical feature in the banking (Janicki and Prescott, 2006; Bremus et al. 2018)
2. The model reproduces the left tail of the **capital ratio distribution**.
⇒ banks near the constraints are more sensitive to equity losses
3. The model is consistent with the euro area's **balance-sheet composition**.
⇒ replicates the observed mix of assets and liabilities

Jointly estimated parameters

	Jointly estimated	Value	Target	Data	Model
β	Subjective discount factor	0.933	Banks' return on equity (%)	6.4	6.4
ρ	Loan default correlation	0.51	Bank failure probability (%)	0.66	0.66
η	Loan origination cost	0.22	Voluntary capital buffer (%)	5.1	4.8
ζ_1	Ent. entry cost (level)	5.78	Avg. lending rates (%)	3.0	3.0
ζ_2	Ent. entry cost (power)	0.50	Response of new lending (%)	-0.38	-0.37
$\bar{\pi}$	Fixed operating cost	0.012	Non-interest expenses to assets (%)	0.34	0.22
χ	Bank's exit rate (pp)	2.00	Slope of log-log asset distribution	-1.56	-1.56

Credit risk process

- Vasicek credit risk model (Basel IRB foundation):

$$F_j(\omega) = \Phi \left(\frac{\sqrt{1-\rho} \Phi^{-1}(\omega) - \Phi^{-1}(\rho)}{\sqrt{\rho}} \right)$$

Default rate: $\rho = 2.65\%$;

loan correlation $\rho = 0.51$: targets dispersion in bank failure risk.

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- Loan origination costs

$$f\left(\frac{N_{jt}}{L_{jt}}\right) = \eta \left(\frac{N_{jt}}{L_{jt}}\right)^2 \quad \text{with } \eta > 0$$

η targets average voluntary capital buffer (target: 5.1%).

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- Entrepreneur entry cost: Rising and convex in credit volume

$$a(N_t) = \zeta_1 N_t^{\zeta_2} \quad \text{with } \zeta_1, \zeta_2 > 0$$

Level (ζ_1) targets average lending rates (3%).

Curvature ($\zeta_2 = 0.50$) governs responsiveness of lending to policy.

matches semi-elasticity of new lending: -0.38 for 100bp shock.

Pre-set parameters

	Parameter	Value	Target/Source
p	Loan default rate, mean (%)	2.65	Mendicino et al. (2020)
λ	Loan loss-given-default	0.30	Mendicino et al. (2020)
δ	Loan maturity	0.20	Cortina et al. (2018)
τ	Corporate tax rate	0.20	Damodaran database.
γ	Min. capital requirement (%)	7.0	Basel III CET1 + Buffer requirement.
α	Deposits-to-loans ratio	0.78	Consolidated EA banks balance sheet.
θ	Liquidity requirement (%)	11.8	Liquid asset to total deposit ratio.
r^M	Steady-state policy rate (pp)	1.0	Avg. EA deposit facility rate, 1999-2019.
r^D	Steady-state deposit rate (pp)	0.5	Avg. EA overnight deposit rate, 2003-2023.

◀ calibration

Calibrated parameters

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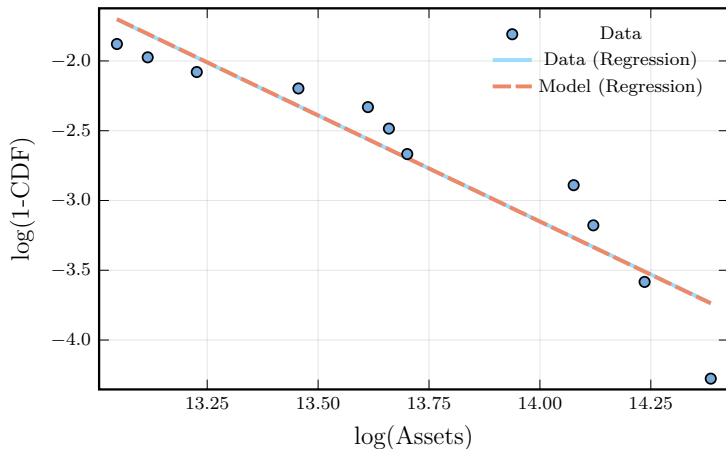
Balance sheet ratios

Table 1: Consolidated bank balance sheet: euro area 2013–2023 vs. model

Assets			Liabilities		
	Model	Data		Model	Data
Loans	88%	89%	Deposits	81%	78%
ST securities and reserves	12%	11%	Wholesale funding	9%	14%
			Equity capital	10%	8%

◀ calibration

Steady-state. Asset size distribution



- The model's steady-state distribution of assets follows a Power Law
⇒ Common empirical feature in the banking (Janicki and Prescott, 2006, Bremus et al. 2018)

Steady-state. Distribution of capital ratios

Table 2: Bank capital ratios: Data vs. Model

	All Banks	Large Banks	Model
1st Percentile	9.36	9.68	9.71
5th Percentile	11.22	10.91	11.10
10th Percentile	11.68	11.28	11.66
20th Percentile	12.31	11.67	12.18
30th Percentile	13.03	12.00	12.46
40th Percentile	13.54	12.41	12.65
Avg. Top 50%	18.71	14.73	13.13

- The model reproduces the left tail of the CR distribution well
⇒ banks near the constraints are more sensitive to equity losses

Heterogeneity in responses to monetary shocks

- Panel Local Projections with country fixed effects (Jordà, 2015)

$$y_{c,t+h}^{\ell} = \alpha_{c,h} + \beta_{1,h} \varepsilon_t^{MP} + \beta_{2,h} \left[\varepsilon_t^{MP} \times I_c^{FR} \right] + \Gamma_h X_{c,t}(L) + e_{c,t+h}$$

ε_t^{MP} : Δ ECB deposits facility rate instrumented (Jarocinski and Karadi, 2020)

I_c^{FR} : 1 if country c operates with fixed-rate pricing

$X_{c,t}$: GDP growth, inflation, BBB corporate yield, 1y DE bond yield.

- Recover responses across FR and VR economies

$$\begin{aligned} \{\beta_{1,h}\}_{h=0}^{16Q} &\Rightarrow \text{avg impact on variable-raters} \\ \{\beta_{1,h} + \beta_{2,h}\}_{h=0}^{16Q} &\Rightarrow \text{avg impact on fixed-raters} \end{aligned}$$

Model details

Bank – Balance Sheet

- Bank j starts with: legacy loans L_{jt} , accumulated equity E_{jt}
- Chooses: new loans N_{jt} , reserves M_{jt} ,
... (insured) deposits D_{jt} and wholesale debt (uninsured) B_{jt}
- Bank's balance sheet:

$$L_{jt} + N_{jt} + M_{jt} = D_{jt} + B_{jt} + E_{jt}$$

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- Differentiate between short (M_{jt}) and long-term assets ($L_{jt} + N_{jt}$)
 - maturity transformation is banks' core function
 - key distinction from classic banking literature:
Gertler&Kiyotaki (2010), Gertler&Karadi (2011), Mendicino et. al. (2021), Coimbra&Rey (2023)

Bank assets

Long-term loan portfolio (L_{jt}): continuum of risky loans

- Principal of 1 and avg. effective **lending rate** r_{jt}^L
- Law of motion:

$$L_{jt+1} = (1 - \delta)(1 - \omega_{jt+1})(L_{jt} + N_{jt}).$$

- δ **fraction matures** with iid prob. (Leland and Toft, 1996)
- $\omega_{jt+1} \sim F(p, \rho)$ **stochastic default rate** correlated at the bank level (Vasicek, 2002)
- Loss given default: fraction $\lambda \in (0, 1)$ of the principal
- Technology: new loans N_{jt} incur a convex cost $f\left(\frac{N_{jt}}{L_{jt}}\right) L_{jt}$

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Short-term reserves (M_{jt}): safe assets remunerated at the **policy rate** r_t^M

Loan rate pricing: fixed vs. variable regimes

Fixed-rate (FR) economy:

- Loan rate r_t^N is fixed at origination and constant until maturity.
- Average rate on legacy loans:

$$\bar{r}_{jt+1}^L = \frac{r_{jt}^L L_{jt} + r_t^N N_{jt}}{L_{jt} + N_{jt}}$$

Variable-rate (VR) economy:

- Loan rate $r_t^N = r_t^M + s_t^N$ adjusts with policy rate.
- Average rate on legacy loans:

$$r_{jt+1}^L = r_t^M + s_{jt+1}^L, \text{ with } s_{jt+1}^L = \frac{s_{jt}^L L_{jt} + s_t^N N_{jt}}{L_{jt} + N_{jt}}$$

Key distinction: $\Rightarrow$ in VR, repricing is quick as rates track monetary policy directly;
 $\Rightarrow$ in FR, repricing is gradual as new loans replace old ones.

Bank equity and Capital Regulation

- Equity is accumulated through retained earnings:

$$E_{jt+1} = E_{jt} + (1 - \tau)\Pi_{jt+1},$$

- Profits:

$$\begin{aligned}\Pi_{jt+1} = & (1 - \omega_{jt+1} - \lambda\omega_{jt+1}) \left(r_{jt}^L L_{jt} + r_t^N N_{jt} \right) - r_t^D D_{jt} - r_t^B B_{jt} && \text{(net interest income)} \\ & + r_t^M M_{jt} && \text{(return of reserves)} \\ & - f(N_{jt}/L_{jt}) L_{jt} && \text{(origination costs)}\end{aligned}$$

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$$\begin{aligned}\Pi_{jt+1} = & (1 - \omega_{jt+1} - \lambda\omega_{jt+1}) \left(r_{jt}^L L_{jt} + r_t^N N_{jt} \right) - r_t^D D_{jt} - r_t^B B_{jt} && \text{(net interest income)} \\ & + r_t^M M_{jt} && \text{(return of reserves)} \\ & - f(N_{jt}/L_{jt}) L_{jt} && \text{(origination costs)}\end{aligned}$$

- Minimum capital requirement (γ):

$$E_{jt} \geq \gamma L_{jt}$$

- Failure to comply: bank resolution $\rightarrow$ endogenous failure

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3. + Capital regulation $\Rightarrow$ endogenous capital buffers!

Main Mechanism

Net Profits (simplified):

$$\text{Variable rate: } \Pi_{jt+1} = \underbrace{(r_t^N N_{jt} + r_{jt}^L L_{jt})(1 - \omega_{jt+1})}_{\text{Net Interest Margin (NIM)}} - \bar{r}_t^D D_{jt} + \bar{r}_t^M M_t$$

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- Policy tightening:

$$\uparrow\uparrow^+ r_t^M \rightarrow \uparrow\uparrow \bar{r}_t^D \rightarrow \begin{cases} \uparrow r_{jt}^L L_{jt} + \uparrow r_t^N N_{jt} - \bar{r}_t^D D_{jt}, & \uparrow\downarrow \text{ NIM variable rate} \\ \cancel{\uparrow \bar{r}_{jt}^L L_{jt}} + \uparrow r_t^N N_{jt} - \bar{r}_t^D D_{jt}, & \downarrow \text{ NIM fixed-rate} \end{cases}$$

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Implications:

- When banks face constraints:** the speed of loan rate adjustment drives differences in profitability, capital ratios, and lending responses.
- If banks are unconstrained:** they smoothly adjust their balance sheets and absorb losses/gains via equity without cutting lending $\Rightarrow$ **Irrelevance of interest rate risk**