Accepted Manuscript

Capital Requirements, Monetary Policy and Risk Shifting in the Mortgage Market

Arzu Uluc , Tomasz Wieladek

PII: S1042-9573(18)30046-9
DOI: 10.1016/j.jfi.2018.06.007
Reference: YJFIN 799

To appear in: *Journal of Financial Intermediation*

Received date: 29 August 2015
Revised date: 25 January 2018
Accepted date: 7 June 2018

Please cite this article as: Arzu Uluc , Tomasz Wieladek , Capital Requirements, Monetary Policy and Risk Shifting in the Mortgage Market, *Journal of Financial Intermediation* (2018), doi: 10.1016/j.jfi.2018.06.007

Capital Requirements, Monetary Policy and Risk Shifting in the Mortgage Market

Arzu Uluc [(1)] and Tomasz Wieladek[(2),*]

Abstract

We study the effect of changes to bank-specific capital requirements on mortgage loans with a new loan-level dataset containing all new mortgages issued in the UK between 2005Q2 and 2007Q2. We find that a rise of a 100 basis points in capital requirements leads to a 4% decline in individual mortgage loan size. Borrowers with an impaired credit history (verified income) are not (most) affected. This is consistent with origination of riskier loans to grow capital by raising retained earnings. We then examine the interaction of capital requirements and monetary policy. This suggests that a monetary policy tightening may mitigate the loan contraction associated with higher capital requirements, as maturity transformation allows the affected bank to profit from a steeper yield curve and raise capital through retained earnings. Overall, our findings in this paper that retained earnings are an important channel of adjustment to capital requirements.

Keywords: Capital requirements, loan-level data, mortgage market, monetary policy.

JEL **classification**: G21, G28.

(1) Bank of England. Email: arzu.uluc@bankofengland.co.uk

(2) Wieladek is Senior International Economist at Barclays and CEPR Research Affiliate. His contribution to this paper was completed while employed by the Bank of England and does not represent the views of Barclays. Email: tomaszwieladek@gmail.com

* We would like to thank Rohan Churm, Julia Giese, Richhild Moessner, Kostas Tsatsaronis, Vicky Saporta, Martin Weale and Matthew Willison, participants at the EUI conference on Macroeconomic Stability, Banking Supervision and Financial Regulation and the BIS workshop on Banking and regulation: The next frontier for helpful comments on an earlier draft. We are indebted to Belinda Tracey for substantial help at the beginning of this project. All remaining errors are ours. Any views expressed are solely those of the authors and so cannot be taken to represent those of the Bank of England or to state Bank of England policy. This paper was prepared under the Lamfalussy Fellowship Program sponsored by the ECB. Any views expressed are only those of the authors and do not necessarily represent the views of the ECB or the Eurosystem.

1. Introduction