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What is the effect of unconventional monetary policy on bank performance?



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ABSTRACT

This paper examines the relationship between unconventional monetary policy and the US banking performance. Unconventional monetary policy is captured through the central bank's assets and excess reserves. Results show that unconventional monetary policy has a negative relationship with bank performance. Further analysis shows that the negative association between unconventional monetary policy and performance is mitigated for banks with a high level of asset diversification and low deposit funding. We also find that the negative relationship between unconventional monetary policy and performance subdues for deposit insured financial institutions. Finally, we use dynamic panel threshold analysis which reveals that the negative association between unconventional monetary policy and bank performance is particularly pronounced above the reported threshold value.

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1. Introduction

Responding to the financial meltdown in 2008, the Federal Reserve (Fed) in the US has been actively engaged in monetary expansion of immense proportions. Only as part of the Fed's large-scale asset purchases (LSAPs) programmes, trillions of the US long-term Treasury bonds and

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mortgage-backed securities (MBS) were purchased over the 2008–2013 period. It does not come as a surprise, therefore, that a lot of emphasis has been placed by academics and policy makers alike on understanding the impact of unconventional monetary policy (Joyce et al., 2012; Miles, 2014; Svensson, 2014). Along these lines, there has been a growing literature that examines the effect of interest rates on the risk-taking of banks (Altunbas et al., 2012; Buch et al., 2014; Delis et al., 2011; Fungacova et al., 2014; Ioannidou et al., 2015). This paper tries to bridge a gap in the existing literature by examining the underlying relationship between the unconventional monetary policies (UMPs), as measured by central bank's assets and excess reserves, and the performance of the US commercial and savings banks controlling for bank-specific and country-level variables.

Although there is a large volume of empirical literature regarding the broader economic impact of UMPs, there is rather limited evidence with regards to the relationship between UMPs and bank performance (Lambert and Ueda, 2014; Montecino and Epstein, 2014). Mostly, since the first round of the Fed's asset purchases in 2008, numerous studies offer explanations on the effectiveness of UMPs on asset prices, interest rates and a number of other macroeconomic variables (Bowman et al., 2015; Chen et al., 2012; D'Amico et al., 2012; Kapetanios et al., 2012; Krishnamurthy and Vissing-Jorgensen, 2011; Rogers et al., 2014; Swanson and Williams, 2014; Wright, 2012). Some studies employ high frequency data and look at the impact of the Fed policy announcements on long term interest rates (D'Amico et al., 2012; Krishnamurthy and Vissing-Jorgensen, 2011; Swanson and Williams, 2014; Wright, 2012) sovereign yields, stock prices and foreign exchange rates (Bowman et al., 2015; Rogers et al., 2014). Other studies look at the impact of UMPs on output and inflation (Chen et al., 2012; Kapetanios et al., 2012). Some other studies also investigate the association between UMPs and financial stability (Chodorow-Reich, 2014; Gilchrist and Zakrajsek, 2013). Gilchrist and Zakrajsek (2013) examine the effect of UMPs on corporate risk for commercial and investment banks over the 2008–2011 period. They conclude that UMPs increase corporate risk for the period under study. Similarly, Chodorow-Reich (2014) examines the effect of UMPs on risk-taking for a sample of insurers, and mutual funds from 2008 to 2013 period. The author finds some evidence of positive association between UMP and risk for the 2010–2013 period. The reported positive impact of UMP on bank risk-taking lends empirical support to the 'portfolio balance' channel that is introduced by Tobin (1963, 1969).¹

Turning now to the effect of UMPs on bank performance this could be explained through its impact on bank's interest margins which is an important source of bank profitability. Bank's interest margin reflects the net interest income that arises from the difference between the short term (deposit) rate and long term (lending) rate (Delis and Kouretas, 2011). When the Fed has initiated UMPs, the short term interest rate has already reached the zero lower bounds. Furthermore, expansionary monetary policies decrease long term interest rates, consistent with previous empirical studies (D'Amico et al., 2012; Krishnamurthy and Vissing-Jorgensen, 2011; Swanson and Williams, 2014; Wright, 2012). Therefore, a reduction in the long term interest rates due to UMPs would decrease the difference between these long term interest rates and the short term interest rates that would consequently suppress the interest margins. The extant literature points to two channels that UMPs, particularly LSAPs, could reduce long term interest rates. One is the 'portfolio balance' channel according to which the Fed's LSAPs could affect the long term interest rates through the reduction of the amount of long-term assets that the private sector holds (Gagnon et al., 2011; Joyce et al., 2012). The second is the 'signalling' channel through which LSAPs could signal to market participants that the Fed has changed its views on policy preferences. This in turn might change bond investors' expectations of the future short term interest rate resulting in lengthening the period of the near-zero federal fund rate. The 'signalling' channel would

¹ This theoretical framework is particularly relevant in the case of LSAPs, in which financial institutions are engaged particularly and thus 'portfolio balance' theory is a core mechanism that could explain the impact of UMP on bank risk (Steeley and Matyushkin, 2015). Tobin (1963, 1969) suggests that central banks could decrease the relative returns of financial institutions by shifting supplies of assets with different maturities and liquidity due to imperfect substitutability. In particular, when a central bank buys assets from banks, the amount of cash that financial institutions hold increases. Since cash is not a perfect substitute for assets, banks would put emphasis in rebalancing their portfolios by purchasing assets that are better substitutes and offer higher yield (Joyce et al., 2012; Kapetanios et al., 2012). These assets would comprise riskier assets than cash, such as stocks and bonds that in turn would increase the undertaken risk of banks (Fisher, 2010; Fratzscher et al., 2014).

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