Unconventional monetary policy and bank risk taking

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Central banks are ramping up efforts to limit the economic fallout of the pandemic. Credit: Public Domain Pictures from Pixabay

Unconventional monetary policy does not lead to greater risk-taking by banks, according to new research. This will be welcome news for central banks and policymakers as they ramp up efforts to limit the economic fallout of the pandemic.

"Slashing interest rates is the usual response to a recession, but with rates now at 0.25% the Reserve Bank of Australia (RBA) can't cut any further, so it has now resorted to "unconventional" means to free up funds," says University of Technology Sydney finance researcher Dr. Thomas Matthys.

"This means they are buying bonds to add cash to the balance sheets of Australian banks. The idea is that banks then channel this forward to the rest of the economy, providing loans at cheaper rates to individuals and firms, and allowing for extended mortgage holidays," he says.

While these unconventional policies should help to lift the economy, grow asset prices and stem panic on markets, there can also be negative impacts.

Savers will receive a lower deposit rate on their savings accounts, so self-funded retirees will find it harder to get by, and it will become more difficult for banks to get a return on their investments.

Previous research has suggested that when a central bank's policy interest rate goes lower (conventional monetary policy), banks start reaching for yield by investing in riskier loans. This can lead to bank failures and imperil the economy.

So researchers decided to examine whether unconventional monetary policy measures also lead to increased risk taking by the banking sector.

They looked at the syndicated loan market, which is the market for large corporate loans, and the impact of unconventional monetary policy in the US after the global financial crisis in 2008.

With a syndicated loan, two or more banks get together to grant a loan to one corporation—typically larger companies such as miners or retail chains.

What they found was that although, on average, loan interest rates go down following looser monetary policy, this was only the case for firms with sound financial performance.

The researchers found no additional interest rate reduction for riskier firms, which would have pointed to bank risk-taking behavior.

These results, published in the *Journal of International Money and Finance*, confirm that, at least in the syndicated loan market, unconventional monetary policy doesn't necessarily lead to increased risk-taking, which is good news for the Reserve Bank and policy-makers.

"While unconventional monetary policy supports the financial system in a crisis, it needs to be complemented by other prudential policies that ensure bank asset quality.

"The Australian Prudential Regulation Authority (APRA) will strike the balance between supporting the economy and ensuring bank risk-taking is kept in check using such instruments as loan to value ratios and capital and liquidity ratios," says Dr. Matthys.

Dr. Matthys also notes that there are other lessons to be learned from the US and European responses to the 2008 global financial crisis.

"In Europe, unconventional monetary policy did not seem to help businesses as much as it did in the US. This may be because the US was very quick to clean up toxic assets on banks' balance sheets in the midst of the crisis through TARP—the Troubled Asset Relief Program," says Dr. Matthys.

"Europe for a long time after the crisis had a legacy of high non-performing loans on bank balance sheets, which contributed to the ineffectiveness of unconventional monetary policy and very low rates. It leaves them with reduced firepower in the face of market instability," he says.

Many countries have a high debt burden, which means that if unemployment rises substantially, it will lead to home loan defaults, which negatively feed back to the stability of the financial system through lower bank income and additional write-offs.

"While the 2008 global financial crisis was a crisis of household debt burdens, companies today also on average have higher debt. This is where unconventional monetary policy may provide relief, as central banks supply liquidity," says Dr. Matthys.

More information: Thomas Matthys et al, Unconventional Monetary Policy and Bank Risk Taking, *Journal of International Money and Finance* (2020). DOI: 10.1016/j.jimonfin.2020.102233

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