

Discussion of
“The Heterogeneous Bank Lending Channel of Monetary Policy”

by Abad, Bigio, Garcia-Villegas, Marbet & Nuño

Discussion by Wenhao Li

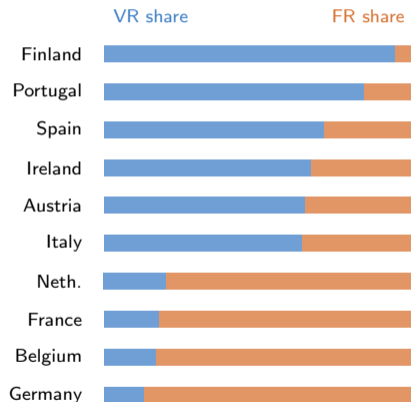
USC Marshall & NBER

WFA 2026 — Credit Cycles and Monetary Policy Session

Overview

- **Background:** Europe has a sharp divide between **VR** and **FR** credit systems.
- **Mechanism:** policy moves legacy-loan income differently in the two systems.
- **Capital channel:** income change → equity capital change → default risk and lending.
- **Quantitative result:** tightening reduces lending about 1/3 more in **FR**; default-risk responses **flip sign**.
- **What I like:** elegant model with deep microfoundations; transparent economics, rich quantitative results.

Composition across Europe



A two-period toy model: equity affects bank survival

Date 0: inherited legacy balance sheet (E, L, X, r_L^k) .

Date 1: choose new lending N ; equity and survival

$$E_1^k = \underbrace{E}_{\text{initial equity}} + \underbrace{(1 - \omega)r_L^k L - r_1^M X}_{\text{legacy income minus funding cost}} \\ + \underbrace{(1 - \omega)q_1^k N}_{\text{new-loan payoff}} - \underbrace{f(N)}_{\text{origination cost}}$$

failure if $E_1^k < \gamma(1 - \omega)(1 - \delta)(L + N)$

$$\bar{\omega}^k : E_1^k = \gamma(1 - \bar{\omega}^k)(1 - \delta)(L + N)$$

Lending choice

$$N^k = \arg \max_N \int_0^{\bar{\omega}^k(E_1^k, N)} [E_1^k + \beta Y_2^k] dF(\omega)$$

Mechanism

$$E_1^k \uparrow \Rightarrow \bar{\omega}^k \uparrow \Rightarrow \text{more states survive}$$

Monetary tightening first moves equity

Legacy pass-through X : net rate-sensitive funding exposure

$$\frac{\partial r_L^{\text{FR}}}{\partial r_1^M} = 0, \quad \frac{\partial r_L^{\text{VR}}}{\partial r_1^M} = 1.$$

FR: legacy rate fixed

$$\frac{\partial E_1^{\text{FR}}}{\partial r_1^M} = -X < 0$$

$$E_1^{\text{FR}} \downarrow$$

VR: legacy rate floats

$$\frac{\partial E_1^{\text{VR}}}{\partial r_1^M} = (1 - \omega)L - X$$

$$E_1^{\text{VR}} \uparrow \quad \text{if } X < (1 - \omega)L.$$

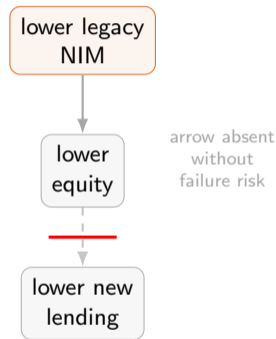
Same policy shock, opposite movement in bank equity, thus solvency risks.

When does equity affect new lending?

New bank lending:

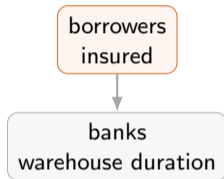
$$N^k = \arg \max_N \int_0^{\bar{\omega}^k(E_1^k, N)} [E_1^k + \beta Y_2^k] dF(\omega)$$

- In the irrelevance benchmark: $\bar{\omega}^k = 1$. Equity changes bank wealth, not the lending margin.
- With failure risk: lower E_1^k reduces the cutoff $\bar{\omega}^k(E_1^k, N)$, so future payoffs are collected in fewer states.



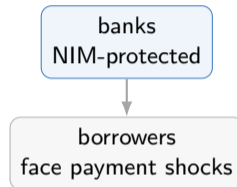
Point 1: **FR**/**VR** is an endogenous risk allocation

FR allocates rate risk to banks



Bank-side capacity: sticky deposits, hedges, long funding, covered bonds.

VR allocates rate risk to borrowers



Borrower-side capacity: payment buffers, default risk, renegotiation, demand.

FR vs. **VR** is an equilibrium outcome that depends on bank vs. borrower ability to absorb interest-rate risks.

What if **VR** vs. **FR** reflects borrower fragility?

The paper's **VR** sign comes from legacy loan income repricing.

Let κ be legacy-loan pass-through and let $\psi \equiv d\omega/dr^M \geq 0$ measure borrower default sensitivity after the payment shock.

$$\frac{dE^{\text{VR}}}{dr^M} = \underbrace{(1 - \tau) [\kappa(1 - \omega)L - X]}_{\text{VR legacy-NIM gain}} - \underbrace{D^{\text{VR}}\psi}_{\text{borrower-distress loss}}, \quad D^{\text{VR}} \equiv -E_{\omega}^{\text{VR}} > 0.$$

Paper's clean experiment

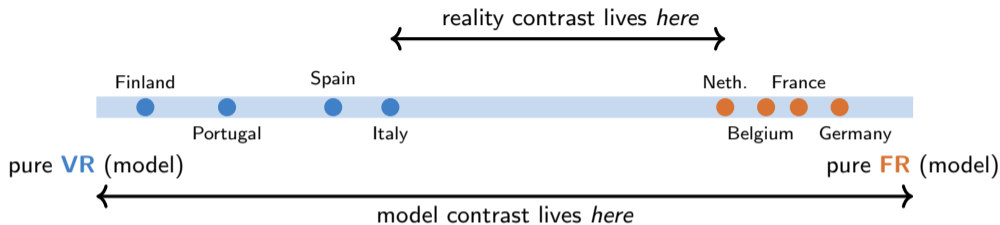
- Turn **FR** loans into **VR** loans.
- Keep borrower default process fixed.

Endogenous-contract concern

- **FR** may be chosen where borrowers need payment insurance.
- Then **VR** repricing can offset part of the equity gain.

How to address it: allow borrower fragility to vary across regimes.

What counterfactual should the quantitative model answer?



- The model compares pure endpoints; the data compare financial-system bundles.
- Feed each country its actual **VR** share, borrower default sensitivity, and effective funding/hedging exposure.
- Then ask: **how much of the $\frac{1}{3}$ survives as a contract effect?**

Point 2: directly test the equity mechanism

- The model's sharpest prediction is **not** lending; it is the **equity mechanism**: after tightening, equity buffers diverge by sign across **FR** and **VR** (their Fig. 5e).
- Current corroboration: surprise hikes produce more negative bank stock-price responses in **FR** countries.
- But this does not show **VR** stock prices rise, nor does it directly test the model's equity mechanism: retained earnings moving banks toward or away from the solvency threshold.

Direct test: after a tightening, do equity buffers of **FR**-country banks fall relative to **VR**-country banks — by the magnitude and persistence in Fig. 5e?

A direct empirical confrontation

$$\Delta h_{j,c,t+l} = \alpha_{j,l} + \alpha_{t,l} + \beta_l(MP_t \times FRShare_c) + \Gamma_l X_{j,c,t-1} + \varepsilon_{j,c,t+l},$$

$h \in \{\text{NIM, retained earnings/ROA, tier-1 capital ratio, new lending}\}$.

First-stage accounting

- NIM: does **FR** fall and **VR** rise?
- Retained earnings / ROA: does NIM cumulate into regulatory capital?
- Equity buffers: does the sign match Fig. 5e?

Then lending

- Interact with low-capital-bank indicator.
- The effect should concentrate near the solvency threshold.
- If equity does not move, the lending result is not this mechanism.

Summary

- **Excellent, transparent paper** that turns an important policy question into a disciplined quantitative exercise.
- **Point 1: Endogeneity of FR/VR.** The contract is a risk-allocation outcome. Borrower fragility and bank hedging/funding capacity may move with the contract.
- **Point 2: Equity mechanism.** The central test is not only lending or stock prices; it is whether equity buffers move as predicted.
- **Policy takeaway:** what matters is not simply FR vs. VR lending, but how policy shifts the distribution of bank equity near the solvency threshold.