Restoring the Bank Lending Channel of Monetary Transmission

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1. Introduction

This paper reports on a 'round table' panel discussion that that took place at the 30th International Symposium on Money, Banking and Finance, at the University of Nantes, 27-8 June 2013. The conference was organised[1] by the European Research Group GdRE (Groupement de Récherche European) on Money, Banking and Finance which is part of the CNRS (Centre Nationale de la Récherche Scientific) in France. As part of the conference, the UK's ESRC (European and Social Research Council) and Bank of England sponsored MMFRG (Money, Macro, Finance Research Group) organised a 'Round Table' panel discussion on 27 June (17:45-19:00) with the same title as this paper. It has now become a tradition for the MMFRG to organise an event at the GdRE's annual international conference, and *vice versa*.

The panel was chaired by Andy Mullineux (Accounting, Finance and Economics Department, Bournemouth University Business School) on behalf of the MMFRG and consisted of: Leonardo Gambacorta (MED, Bank for International Settlements); Paul Mizen (Centre for Finance, Credit and Macroeconomics, University of Nottingham); Clas Wihlborg (Chapman University); and Richard Werner (Centre for Banking, Finance and Sustainable Development, University of Southampton).

A review of the discussion follows an overview of the background to the 'Credit Crunch' that originated with the 'North Atlantic Liquidity Squeeze' (NALS) in August/September 2007 (Mullineux, 2008)

2. Background to the 'Credit Crunch'

In the run up to late summer 2007, bank credit supply was booming on the back of: an increase in the leveraging by banks of their capital, though issuance of short term asset backed commercial paper (ABCP) and secured and unsecured bonds and asset price inflation, particularly in housing, property markets and stock markets; which was raising the value of collateral underpinning lending and ABCP issuance. Additionally, securitisation, particularly of home loans and commercial mortgages through the issuance of mortgage backed securities (MBS), was facilitating an

[1] Particular thanks are due to Christian Aubin of CRIEF (Centre de Récherche sur L'Integration Economique et Financière) who led the conference organising committee along with Raphaelle Bellando and Jean-Bernard Chatelain.

‘Originate to Distribute’ (OtD) model; allowing banks effectively to ‘pass the parcel’ of loans originated. Regulatory bodies and Finance Ministries were widely persuaded, with the Bank for International Settlements (BIS) a notable exception, that the OtD model was facilitating the dispersion of risk across the financial sector, particularly to insurers, as well as the rapidly emerging shadow banking sector, so that risk was being beneficially and efficiently shared. The development in the derivatives markets of Collateralised Debt Obligations (CDOs) created the perception that the credit risks were being insured and added an ‘accelerator’ to the process (Tett, 2009).

In reality, it transpired that prior to the NALS, and the subsequent Global Finance Crisis (GFC) sparked by the collapse of Lehman Brothers in September 2008, there had been ‘over lending’ and ‘over leveraging’ and risks had not been insured as efficiently, or indeed moved off the banks’ balance sheets, as believed. Pre-crisis bank lending was thus abnormal and the practices underlying it should not be ‘restored’, as such.

Further, the tax system contains a strong bias (IMF, 2010) towards debt financing because interest paid by businesses can be ‘expensed’, whilst the payments of dividends, out of after tax profits cannot. This bias gave banks, at the fulcrum of credit creation, an incentive to leverage their equity capital as far as possible in order to increase their returns on equity to record post war levels and, in so doing, boost share prices and the value of ‘share options’ paid to bank management as part of their remuneration packages. This major distortion has yet to be rectified. The continuing dependence of small and medium sized enterprises (SMEs) on debt finance, particularly from banks, makes it politically difficult to remove tax deductibility entirely.

The NALS involved the freezing of the wholesale, and particularly the interbank money markets, which most banks, other than local retail banks, had become heavily dependent upon for funding. Central banks had to step in as ‘lenders of last resort’, on increasingly liberal terms, overturning the long established ‘Bagehot doctrine’ (Goodhart, 2008) and to remained engaged in providing liquidity to banks six years, and counting, after the onset of the NALS.

This has led to the realisation that the risk weighted capital adequacy rules devised by the Basel Committee on Banking Standards (BCBS) needed to be completed by liquidity rules that require deposit taking banks to hold sufficient liquid reserves to weather a liquidity freeze of up to a month (the Liquidity Coverage Ratio) and to reduce their reliance on wholesale, relative to retail, deposit funding (the Net Stable Funding Ratio) (www.bis.org).

The onset of the GFC, following the collapse of the Lehman Brothers investment bank in September 2008 led to an even stronger contraction of bank lending, or ‘Credit Crunch’, because it was realised that banks needed to ‘deleverage’ by increasing the capital to asset ratios through a combination of asset reduction and new capital raising. Banks that had been ‘bailed-out’ by governments using taxpayers’ money were required to halt dividend pay outs and retain profits to build capital; although seemingly excessive remuneration of employees, including large bonuses, continued to be paid. With access to bank credit declining and a recession ensuing, it was also necessary for households to 'deleverage' by reducing their indebtedness; which in turn curbed consumption and potential output growth. Further, falling house prices in some countries, e.g. the US, Ireland and Spain, reduced household wealth, as did falling stock prices. This in turn reduced the value of housing collateral underpinning outstanding loans and available to post against new borrowing.

Larger non-banking firms seemed to weather the storm well, but hoarded 'cash', rather than invest in the uncertain environment. Given their dependency on banks for finance (Bernanke and Gertler, 1999), SMEs, in contrast, faced a difficult economic environment and uncertain access to credit. The 'credit rationing of SMEs is to be expected under 'information asymmetry' (Stiglitz and Weiss, 1981), but the post crisis Credit Crunch introduced acute credit rationing. Mechanisms for dealing with credit rationing include government sponsored loan guarantees and subsidised financing via development banks and agencies. In some countries, including the UK, these were ramped up (see discussion of Paul Mizen's Panel presentation below). The guarantees can however prove expensive when default rates are high (Cowling, 2010).

The monetary authorities responded to the Credit Crunch by cutting interest rates to close to zero and holding them there for an unprecedented period. In order to maintain margins to cover lending risks, the banks did not pass on the interest rate cuts in full to SMEs. Hence, although borrowing rates for SMEs fell relative to pre-crisis rates, they still remained well above zero. However, with UK inflation persistently and significantly positive, the rates offered in real terms were low. Nevertheless, opinion surveys showed that SMEs felt that they were facing credit rationing and that credit was expensive. Whilst the supply of credit to SMEs is seemingly constrained, there is also evidence of declining demand for credit because economic growth remains low. Many SMEs have in fact chosen to repay debt to deleverage themselves.

In such conditions, Keynes (1936) described monetary policy as like 'pushing and string' and introduced the concept of a 'liquidity trap'. The central banks have tried to increase the pace of the economic recovery using unconventional monetary policy, dubbed 'Quantitative Easing' (purchases of government financial securities), or 'QE', and 'Credit Easing' (purchases of private sector financial assets, particularly MBS in the US). This has been combined with attempts in the US to manipulate the 'yield curve' through 'Operation Twist', which entails varying issuance and purchases of government (Treasury) bonds of various maturities. The overall aim has been to hold long term, as well as short term, interest rates down, since the longer rates have more influence on the cost of mortgages and debt financing for investment. The concomitant rise in bond and other financial asset prices, however, increases the risk of capital losses by bondholders including commercial banks and insurance and pension funds.

Keynes' (1936) 'liquidity trap' describes a situation where interest rates are so low and (bond prices so high), that (almost) everyone expects them to rise, and thus to make capital losses on bond holdings. Better then to hoard 'cash', or liquidity.

The central banks' policy of providing an elastic supply of liquidity may thus increasingly become like 'pushing on a string'. To bring about a significant stimulus to the economy, banks must start lending the idle cash and firms hoarding cash must start investing it. Improved 'animal spirits' (Keynes, 1936) will eventually, it is hoped, bring this about, and then the central banks will face the problem of extracting excess liquidity before asset bubbles and price inflation accelerate. The persistently low long term interest rates may well already have stimulated 'yield seeking' asset price inflation in commodity and stock markets, and house prices inflation returned to the US in 2012 and the UK in 2013.

The 'bank lending channel' of monetary policy (Bernanke and Gertler, 1999), however, remains impaired in the UK; and even more so in the 'peripheral', particularly the Southern, Eurozone member countries, due to the 'fragmentation' of the 'money markets' discussed by Clas Wihlborg in his Panel presentation. Even in the US, bank lending to SMEs remains subdued.

The observation that, despite the best efforts of the national central banks (including the European Central Bank, ECB) to hold down interest rates and pump liquidity into their economies, bank lending remains restrained, prompted the choice of the title for Panel discussion.

Essentially, the question was: "under what conditions will the banking system resume 'normal' lending, particularly to SMEs?"

The new 'normal' will of course be different from the pre-crisis over lending 'normal' based on over leveraging. It is probably also true that SMEs face not only a 'credit (funding) gap', but also an 'equity gap'. Indeed, for the more entrepreneurially innovative 'growth' firms, equity funding is more appropriate, but the supply of equity funding from the venture capital industry also contracted in the wake of the GFC.

It should be noted that banks face relatively high 'fixed costs' of lending and thus prefer to make a smaller number of larger loans, to a large number of small loans. For smaller borrowers, low transaction cost, credit provision, and also invoice discounting ('factoring' or 'asset based lending') over the internet, may be more appropriate. For marginal borrowers, particularly those 'financially excluded' by credit scoring based bank and internet lenders; mutual financial institutions, such as credit unions and community development finance institutions (CDFIs), may be appropriate lenders. The banking system as a whole is thus adapting to fill credit gaps left by the traditional commercial banks; which are also loosing businesses to the capital markets as smaller firms gain increasingly cheaper access to direct debt finance from the bond markets. A process of disintermediation is underway, with the 'shadow banking' and wider financial system filling some of the gaps left by mainstream banks.

This is most advanced in the US, but also evident in Japan and Europe. Consequently, the 'Credit Crunch' may not be as severe as it seems.

The bank regulatory authorities have been encouraging deleveraging by increasing the Basel risk weighted capital adequacy requirements, and most recently, particularly in the US, UK, and Switzerland, increasing or introducing non-risk weighted 'leverage ratios'; particularly on larger banks (Mullineux, 2013c), Banks have lobbied against these capital increases, arguing that they will raise the cost of capital and force them to cut back on lending, particularly to SMEs. Consequently, government policy is self-defeating. It will prolong the recession and reduce the ability of banks to build capital from retained profits. It will also make it difficult for banks to restore the very high returns on equity they achieved prior to the crisis.

An alternative view is that it should not matter whether banks are funded by debt of equity (Modigliani and Miller, 1958), and indeed banks historically operated with much lower leverage ratios (Capie and Woods, 1991). Further, to the extent that they are able to absorb more losses (by reducing dividend payments), banks will be safer and equity and bond financing will in fact become cheaper. To render banks safe, Admati and Hellwig (2013) advocate substantial further increases in minimum (equity) capital. The real cost to the banks, of course, is the loss of the subsidy to shareholders and bondholders provided by the implicit government insurance of banks that are considered to be 'too big to (be allowed) to fail'. Raising capital requirements need not lead to a fall in bank lending, and may even make it cheaper, if it reduces the cost to banks of funds. Less leveraging will also reduce 'risk shifting' by shareholders to bondholders, and so encouraging shareholders to become more active stewards of bank risk management.

The stark contrast between the pre-crisis credit boom and the post crisis Credit Crunch illustrates clearly that the bank credit creation 'multiplier' is not a constant, but instead varies with economic and financial conditions (Tobin and Brainard, 1963). Whilst it is true that the bulk of 'broad money' is created through bank lending, or credit creation, rather than by central bank printing presses, the amount that banks can create depends on there being a demand for credit at the interest rates charged. Broad money in the UK (e.g. M3 and M4) growth has been markedly slower after the crisis, than before it. This reflects a tightening of lending standards and a decline in the demand for credit; in part due to households reducing their 'debt overhang', and firms paying down debts. 'Restoring' the 'bank lending channel' thus requires finding a way of increasing the bank credit 'multiplier' from its current low levels. This involves increasing both the demand for and the supply of, credit, or bank lending.

3. <u>The Panel Discussion</u>

Leonardo Gambacorta illustrated that the bank lending channel had changed a great deal over the last 20 or 30 years (see also: Gambacorta and Marques, 2011) and also emphasised how the crisis had reminded us of the importance of liquidity, a theme picked up by Douglas Diamond in his keynote lecture at the conference commemorating 30 years since the publication of the famous Diamond and Dybvig (1983) paper.

Leonardo highlighted the major differences between cycles with and without financial crises and illustrated how monetary policy is less effective in a financial crisis (see also: Bech, Gambacorta and Kharroubi, 2012). This explains the deployment of unconventional monetary policies, such as 'Quantitative Easing' (QE), in response to the GFC.

Whilst deleveraging in a ‘normal’ downturn is of little importance, a financial crisis is preceded by over-leveraging, and thus substantial deleveraging is required after the crisis (Bech, Gambacorta and Kharroubi, 2012). In this situation over indebted economic agents may not consume more in response to lower interest payments, but rather seek to repay debt. Moreover a struggling banking system may be not to pass on lower rates to the rest of the economy because of the need to restore appropriate risk margins and recapitalise from earnings retained from interest margins. Leonardo argued that deleveraging achieved during a downturn following a financial crisis is ultimately beneficial for the subsequent recovery. Whilst in normal business cycles, in which debt levels are not excessive, any increase in leverage would help to finance profitable investment projects and consumption; during a financial crisis, in contrast, such benefits are more than offset by the costs of failing to repair balance sheets. In this case, he postulates, sectorial credit policies that aim to reallocate resources towards sectors that are most productive, and have not been drugged by the crisis, could be very helpful.

Leonardo observed that, both as a legacy of the pre-crisis financial boom, and as a result of accommodative monetary policies in response to the crisis, the level of private non-financial sector debt is historically high globally (BIS, 2013). Despite some progress in reducing private sector debt, particularly in advanced economies that experienced a significant accumulation of debt during the boom, balance sheet repair remains incomplete and is acting as a drag on economic growth. Meanwhile, increased leverage in other advanced economies and in emerging market economies (EMEs), suggests the potential build-up of vulnerabilities in some regions. Debt levels in ‘Emerging Asia’ are, for example, trending toward the peak reached before the Asian financial crisis of the late 1990s. Moreover, while debt levels are serviceable at current very low interest rates, what will happen when interest rates rise to positive real rates? To service the debt at such levels, Leonardo concluded, faster GDP growth are required to reduce debt to GDP ratios.

The ‘Growth Imperative’ that arguably led to, or at least significantly contributed to, the GFC (Rajan, 2010) is thus still with us. An alternative solution, given the current high levels of national debt aggravated by the operation of ‘automatic stabilisers’ to combat the ‘Great Recession’ brought on by the GFC, and the Keynesian counter cyclical fiscal policy interventions and bank bail-outs deployed to prevent a second ‘Great Depression’, is to allow inflation to erode the real value of debt, as many governments have done in the past (Calomiris and Haber, 2014).

Next, Paul Mizen illustrated the rationing of this supply of bank lending and the rise in the cost of bank lending in the UK. Because banks had increased their ‘risk spreads’ following the crisis, lending rates to SMEs remained significantly above zero. Supply and demand factors were at work and it was difficult to disentangle them. SMEs are the most ‘bank dependent’ (Bernanke and Gertler, 1999), firms in the UK and pose the highest credit risk for lenders as they have little equity to absorb losses and the value of their collateral (often the family home) has become less reliable.

As regards 'restoring' bank lending, Paul asked, 'to what?'; noting that banks over lent before the crisis. Relaxation of 'credit standards' had led them to 'under-price' credit risks. Nevertheless, there was an acute need to reduce the currently excessive credit rationing in the UK.

The UK government responded to the Credit Crunch by reviewing its Small Finance Loan Guarantee Scheme (Cowling, 2010) and replacing it with the Enterprise Guarantee Scheme[2]. HM Treasury and the Bank of England also tried to stimulate bank lending to SMEs, first through 'Project Merlin' (Mullineux, 2011 and 2012) and subsequently via its current 'Funding for Lending Scheme' (FFLS); which provides cheap funding for banks engaging in mortgage and SME lending. The banks have shown much more interest in using the funding to advance mortgages, than SME loans.

Clas Wihlborg, the third speaker, emphasised that the Credit Crunch was particularly prevalent in the 'periphery countries' of the Eurozone as a result of the 'Doom Loop' linking the sovereign debt crises to the banking crises; which was the topic of the Panel session at the 2012 conference in Nantes (Mullineux, 2013a and b).

The pre-crisis single Eurozone credit market had 'fragmented', so that German SMEs could borrow much more cheaply than Spanish SMEs. To get banks to lend more with lower risk premiums, it was first necessary to restore the health of banks. The long term solution might be a Banking Union, although Clas Wihlborg's view, shared in particular by one of last year's panellists, Jean-Paul Pollin (University of Orleans), was that the Banking Union project was too grandiose and required progress towards fiscal and political unions that would take decades, rather than a few years, to achieve.

In the short term, the problem of the 'Zombie banks', that are technically insolvent, but propped up by governments, needed to be resolved; even if common bank regulation and supervision under the ECB can be operationalized. Loss recognition was essential and bad debt problems had to be resolved; echoing Charles Calomiris' (Columbia University) comments at last year's Panel (Mullineux, 2013a and b). Bank losses should be written down whilst establishing 'depositor preference'; assuring depositors have seniority as creditors. This must be agreed internationally.

Once the debts of bank creditors are written down in proportion to their seniority and residual bank losses have been realised, the banks would need to be recapitalised. Unfortunately, the banks most in need of recapitalisation often have the highest levels of their national government debt. Forced transfers between Eurozone creditor and debtor countries, and their banks, seem inevitable (after the September 2013 German elections!). Charles Calomiris also made this point last year (Mullineux, 2013a and b).

The sources of recapitalisation funding were identified to be: domestic government/taxpayer; the European Stabilisation Mechanism (ESM) and/or an enhanced European bank resolution fund (involving fiscal transfers between states);

[2] Fn on the SFLGS & the EGS

and selling assets (deleveraging) in non-‘fire sale’ conditions, after the loss allocations.

Clas Wihlborg had some additional observations regarding the proposed Banking Union. Separate supervision of large and small banks might be sensible, but banking market competition distorting national supervisory favouritism and regulatory capture should be avoided. Regulatory capture of the ECB by big banks should also be guarded against.

Harmonising regulatory procedures might prove to be easier than supervisory practices and both needed to be embedded in legal systems. The UK and Denmark had made a good start on this. International bankruptcy procedures, especially regarding government debt, are rudimentary and revolve around ‘collective action clauses’ that have been subject to a successful legal challenge in Argentina (Wall Street Journal, 2013)

The logic of the EU’s Liikanen Report (EC, date) and the UK’s Independent Commission on Banking report (ICB, date) and recent US policy initiatives for the restructuring of banks into separately capitalised subsidiaries, at home and abroad, is that separately capitalised subsidiaries can be allowed to fail in a banking resolution process. Separation of deposit taking from investment banking and trading activity (the ‘Volcker Rule’ in the US and the ICB ‘ring-fencing’ and Liikanen proposals) helps safeguard deposit protection schemes, which even if funded and underpinned by depositor preference, are ultimately underwritten by taxpayers (Mullineux, 2013c).

Under the proposed European Banking Union, there would be a pooling of national deposit insurance schemes, leading German taxpayers potentially to pay out to depositors of banks in other countries; a *de facto* fiscal transfer union. Strong prudential bank regulation and supervision is thus remains essential to protect depositors and taxpayers from abuse by risk prone banks (and their shareholders).

Clas Wihlborg is an advocate of regulatory competition, believing it can lead to a ‘race to the top’ (Wihlborg, 2012), rather than a ‘race to the bottom’, as feared by Kane (date), if implicit taxpayer guarantees, especially of the larger (‘too big to fail’) banks, can be illiminated using credible resolution regimes incorporating ‘bail-ins’ of creditors and depositor preference (Mullineux, 2013c)

Richard Werner, the fourth and last panellist to speak, argued that a separately identifiable ‘bank lending channel’ of the monetary transmission mechanism, in response to a change in interest rates, as postulated by Bernanke and Gertler (1999)**,** was a misconception because monetary policy *always* works directly through the quantity of bank lending, there is no separate interest rate channel.

Banks are special because they create the vast bulk of the money supply (97%) by advancing loans and granting credit, which adds to the money supply. Hence regulatory liquidity requirements have an important role to play, as Leonardo Gambacorta had argued, and Bob Diamond had emphasised in his keynote speech. Richard also favoured the simpler and more direct ‘credit guidance’ procedures because they are, in his view, the only bank credit regulatory measures with a consistent track record of achieving the set objectives; such as avoiding asset price bubbles and financial crises.

As an aside, we should note that 100% reserve banking has had some prominent advocates and is a potential means of stabilising banks; although money market mutual funds also had to be underwritten by the US taxpayer during the GFC. To the extent that bank loans are permissible assets, with 100% reserves, they are fully funded by retail deposits and leveraging is curbed, which is why Irving Fisher (1933) was an advocate; and so too is bank money creation, and inflationary tendencies, which is why Milton Friedman (1969) was an advocate.

Richard's proposal for restoring bank lending is to clear non-performing loans from bank balance sheets, at zero cost to tax payers and society at large, through central bank purchases of impaired bank loans at face value. This would not amount to 'printing money', he argues, since through this book keeping exercise the central bank is not injecting any money into the economy (defined as the bulk of the economy that cannot create money (Werner, 2005). Major central banks have, in Japan for example, have successfully implemented this policy before (Werner, 2009). Banks should then be encouraged to lend their excess liquid reserves to the national government under an 'Enhanced Debt Management Scheme', whereby the government stops issuing bonds and instead covers its public sector borrowing requirements by entering into loan contracts with banks. This would increase bank credit creation and hence stimulate new economic transactions without crowding out others, adding to the money supply and boosting nominal growth, and hence employment. He believed that this was an attractive proposition for countries such as Spain and Ireland.

Richard's basic point is that bank lending is beneficial to growth as long as the borrowing is put to productive use; and as long as there are borrowers willing and able to do so, bank lending for GDP enhancing transactions should be maximised and the central banks should supply the necessary liquidity cheaply. Non-GDP enhancing 'speculative' lending in pursuit of non-productive capital gains, and purely financial transactions such as 'churning' portfolios, should be curbed, however.

In such a world, the demand for credit, or rather the supply of potentially productive investment opportunities is a potential constraint on the ability of banks to expand the credit supply productively. Nevertheless, there is a strong Keynesian case for the government acting as 'borrower of last resort' (Friedman, B.M. et al, 1991) when bank credit is contracting, as in many Eurozone countries currently. Richard's 'Quantity Theory of Credit' (Werner, 1997 and 2013), however, envisages an endless stream of potentially productive investments as he argues that human ingenuity has always delivered new productivity-enhancing technologies and innovations

The discussion following the panellists' presentations included responses by the presenters to the comments of the others and comments and questions from the audience.

Incentive compatible solutions, ideally in the form of contractual obligations, were necessary to stop ‘risk shifting’. ‘Market capital’ in form of the hybrid debt/equity instruments and contingent convertible (‘co-co’) bonds was advocated.

There was discussion of the advisability of the structural separation of retail, trading and investment banking activities, given that, if there were significant economies of scale and scope, it might introduce inefficiencies. It was observed that after all, the subprime crisis was a commercial banking problem aggravated by securitisation and derivatives, not a problem with investment banks *per se*.

Basel II correctly supplements capital adequacy requirements with liquidity requirements, but the two sets of requirements must be made to interact and should not be seen as additively separable. 100% reserve banking would pass monopoly control over money creation to central banks, and potentially governments.

There was agreement with Andrew Haldane’s (2012 and 2013) view that Basel II and III relied on over complex risk weighting systems based on the big banks’ own models and that Basel III was already being ‘gamed’ by the banks. Leverage ratios are therefore needed as a backstop, as strongly argued in Blundell-Wignall and Roulet (2013).

Concern was expressed that the addition of supervisory powers to monetary policy responsibility at the ECB will give it too much power. Similar concerns have been raised about the accumulation of power at the Bank of England following the restructuring of the UK’s micro and macro prudential supervision of banks, and the wider financial system. Against this, the US Federal Reserve has considerable powers, and the GFC had made clear that macro prudential policy involves interaction between prudential regulation and supervision and monetary policy, as long emphasised by economists at the BIS (Borio and Zhu, 2008; Cecchetti and Kohler, 2012).

One member of the audience, Dominique Lacoue-Labarthe (University of Bordeaux IV), had managed to keep abreast of events in the real world and informed us that an EU agreement had been reached overnight on credit burden sharing using creditor ‘bail-ins’ in cases of insolvent banks; in light of the Cyprus experience and the preceding ‘bail-out’ (nationalisation) of the fourth largest Dutch bank, SNS Reaal, in February 2013, by the government of the Netherlands. Full implementation and confirmation of the details, was naturally postponed until the German elections in September!

Following on from Richard Werner’s proposals, it was suggested that the ECB might lend to the EIB in order to stimulate SME lending, much as the KfW, the development bank, does in Germany. The UK, as Paul noted is in the process of establishing a partially state funded Business (lending) Bank, which is due to become operational in September 2014. Further, the KfW opened a facility for SME lending in Spain in 2013.

In the parallel session, Laurent Weill (University of Strasbourg) discussed another structural issue, namely whether bank lending would be stimulated by entry of ‘challenger’ banks to increase competition, a policy the UK government has been pursuing without much success given the problems encountered by the Co-operative Bank in the UK in mid-2013. It is possible that, just as competition may increase banking instability by reducing lending margins and profitability (Revell, 1975; Chick and Dow, 1997; and Chick, 2008**),** so it may discourage risk taking and thus curb SME lending. It is notable that risk weighted asset based bank capital requirements potentially discourage relatively risky SME lending, whilst greater reliance on non-risk weighted leverage ratios might offset this.

The real challengers in the UK banking system are the credit scoring based internet ‘peer to peer’ lenders, invoice discounters, and ‘crowd funders’. ‘Relationship banking’ is still practised by regional banks in the US and Germany (Mullineux and Terberger, 2006), for example, but it is a dying art that should be fostered if SMEs, which are essentially local firms, are to find their funding needs properly met. Local banks remain the most important suppliers of SME loans in Germany, but are beginning to suffer, as are mutual banks generally, from regulation designed to protect taxpayers from excessive risk-taking by larger shareholder owned banks (see www.savings-banks.com). There is thus a strong case for the separate regulation of local retail based municipal and mutual banks, that encourages relationship banking as opposed to over reliance on credit scoring. The new EU supervisory arrangements provide for the ECB to take responsibility for large cross border banks and for domestic supervisors to take responsibility for local banks thus seems appropriate, though consistency across countries should somehow be assured.

4. Conclusions

The question raised by the Panel was: ‘what does ‘restoring’ the bank lending channel mean?’ It was clear that the panellists did not envisage restoring bank lending to pre-crisis levels, because the run up to the crisis had entailed a relaxation of credit standards in pursuit of historically high returns on equity by banks, egged on by their shareholders. As the ‘credit cycle’ had reached its peak, leveraging had reached record levels and capital to asset ratios had declined. A tax system that allowed tax deductibility, or expensing, of interest payments on debt, especially by banks at the fulcrum of credit creation, had incentivised this.

The ‘new normal’, to which currently restrained lending should be raised, would be set in the context of risk based lending underpinned by adequate capital ratios. The debates about: how adequate is adequate, and what is the role of risk weighting based on banks own models are on-going. Banks should also make ‘forward looking’ provisions against bad and doubtful debts, accounting standards permitting. At the time of the conference in June 2013, the US banks were judged to be close to the ‘new normal’ following the US TARP (Troubled Asset Relief Programme) intervention launched on October 3, 2008 , than banks in the EU; were substantial bad and doubtful debts remain on the balance sheets and further recapitalisation and ‘provisioning’ against them is widely required.

It was further argued that this problem of ‘zombie banks’ must be tackled promptly, before the ‘new normal’ lending could be established. This in turn will require disentangling the Eurozone's 'Doom Loop', which was discussed in the MMFRG Panel session at last year's conference in Nantes. The view thus prevailed that putting banks on a sound footing would reduce their funding costs and thus reduce the cost of their lending and help resolve the Credit Crunch. The tax deductibility of interest on business, including bank, debt was a bigger issue to be tackled on another day, in another place.

It was also noted that loan guarantees are widely used to reduce credit rationing; particularly as regards SME lending; for which credit rationing is judged to be more acute due to greater information asymmetry, lack of collateral, and the fixed cost of lending problem. A number of countries, including the USA, Switzerland and the Netherlands allow income tax deductibility of mortgage interest payments, and the US has made extensive use of mortgage (home loan) guarantees in the post war period.

The KfW in Germany has been particularly successful in providing loan guarantees for SME lending (Mullineux, 1992 and 1994) and is to extend its operations to Spain in response to acute credit rationing there. The UK government revised its loan guarantee scheme in response to the Credit Crunch and has introduced a Funding for Lending scheme to provide banks with access to cheap funding for SME and mortgage lending. It has proved successful in stimulating mortgage lending, but not SME lending and so a state backed Business Bank is being created. The UK government also introduced a 'Help to Buy Scheme' to help first time buyers with small deposits to buy new homes, and, in mid-2013, it extended the scheme to provide US-style guarantees for mortgage lending to people seeking to buy older properties, but who can only afford small deposits. The IMF (2013) has warned that the UK government risks stoking up a new UK housing bubble by stimulating sub-prime lending!

Another possibility is for governments to encourage central banks to extend their 'unconventional' monetary stimulus; potentially compromising their monetary policy independence. It was proposed that the central banks should combine their money printing capacity with the retail and commercial bank's money (credit) creating capacity to provide an elastic supply of lending in response to demand by governments and enterprises for economically, and perhaps socially, productive project funding (Turner, 2012; Lyonnet and Werner, 2012). The supply of funding for non-productive, speculative, asset price inflating and bubble creating 'investments', and purlely financial trading, should however be curtailed; as part of macro-prudential policy, perhaps (Werner, 2012). Let's hope that a change in Keynesian 'animal spirits', combined with increased public sector led, perhaps via European Investment Bank, infrastructural project lending, can bring forth loans in response to a flow of good, productive, project proposals from SMEs.

The on-going process of disintermediation will lead larger firms increasingly to fund themselves 'directly' via the capital markets, as in the US. Smaller firms will increasingly find alternative sources of funding from the true new challengers in banking, over the internet.

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