Comments on “Interest Rate Risk and Bank Equity Valuations”

by

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General Comments

- Interesting and important topic
- Authors are careful about details, and the paper is well-done
- Improves our understanding of the transmission of monetary policy shocks through the banking system
  - Focus on banks as maturity transformers
  - Impact on the valuation of publicly traded BHCs
  - Evidence on reaction of banks and their customers to shocks to both the level and term structure slope of interest rates. Changes in accounting values can inform us about the mechanisms underlying how monetary policy is transmitted through the banking system.
- This paper goes well below the 6.5% unenlightment rate threshold (without anyone having to withdraw from the labor force).

But . . . . . .

- There are always some nits to pick.
- I will focus on:
  - Timing of the call report data
  - Bank subsidiary share of BHCs
  - Lack of information in derivatives position data
  - Quantity reactions to changes in interest rates
  - Possible asymmetric effects
- I also will mention some complications for extending the analysis to the current unconventional monetary policy period.

Timing of Call report Data

- “Each FOMC date is associated with the most recent, but strictly prior Call Report.”
- However, the call report data are not publicly available at the “as of” date.
- Thus, Call Report data are typically not publicly available until two or three months after the Call Report date.
- However, the less detailed 10-Q reports appear earlier.
- Recommendation: Check sensitivity of results to using Call Report dates at least three months prior to the FOMC date rather than simply prior to FOMC date.

Bank subsidiary Share of BHCs

- Because of the desire for maturity and repricing information at a more disaggregated level than is contained in the BHC Y-9C Call Reports, the Repricing/Maturity Gap measure is based on individual bank Call Report data.
- This can be problematic if the Repricing/Maturity Gap measure based on the summation of the individual bank subsidiaries is not representative of that for the consolidated BHC.
- This may occur for large BHCs with major nonbank subsidiaries.
- <u>Recommendation</u>: Aggregate the more granular individual bank data to construct measures that correspond to the quite limited interest sensitivity measures in the BHC Call Reports (HC-B Memoranda and HC-H). Compare these measures to determine the extent to which the summation of the individual bank measures are or are not representative of the consolidated BHC measures. Can also compare summation of total assets, total loans, etc., of bank subsidiaries to consolidated BHC values. If the bank subsidiary measures are not representative for certain BHC types, e.g., particularly large BHCs or BHCs with a large broker/dealer operation, then re-estimate equations omitting these types of BHCs to check sensitivity of results.

Lack of Information in Derivatives Position Data

- As the authors note, interest rate derivatives can be used to take on or to hedge interest rate risk. We can't know how they are being used at any given BHC.
- Notional values of derivatives do not tell us the nature of the positions, e.g., relative to the future direction of interest rates. Using fair values and even separating into trading and non-trading (hedging) purposes does not solve this problem.
- Thus, we do not know much, if anything, about the extent to which a BHC has hedged its interest rate risk, only if it is active in the interest rate derivatives market.
- A very few very large BHCs account for much of the volume of interest rate derivatives.
- <u>Recommendation</u>: Omit the set of very large BHCs that account for most of the volume of interest rate derivatives to check the sensitivity of the results for the key explanatory variables.

Quantity Reactions to changes in Interest Rates

- Table 9 contains several interesting results:
  - Even though a steepening of the term structure would tend to increase the return to maturity intermediation, bank loans decline.
  - An increase in the level of interest rates is associated with a reduction in core deposits.
- To what degree are these responses almost mechanical? The sample period ends in mid-2007, so it covers only a time period in which excess reserves were essentially zero. Thus, a tightening of MP, by removing reserves from the banking system, would force a reduction in reservable deposits (i.e., transactions accounts, which are included in the core deposits measure) and, to the extent that nonreservable deposits do not fully replace the lost reservable deposits, a shrinkage in assets to balance the shrinkage in liabilities.
- The correlations may be driven, in large part, by the business cycle; e.g., the decline in loans might be due primarily to a decline in loan demand.
- More generally, might there be asymmetrical responses, insofar as a tightening of MP imposes a binding constraint on bank reserves, while a loosening of MP eases a constraint ("pushing on a string")?
- <u>Recommendations</u>:
  - Investigate which core deposits decline
  - Allow the estimated coefficients to differ for positive and negative values for the level of interest rates and for the term structure slope.

Unconventional Monetary Policy

- The sample period ends in mid-2007 before we hit the zero lower bound (ZLB).
- As the authors note, using the post-2007 data is complicated by the government support programs for the financial system and possibly by perceived signaling about such support tied to FOMC announcements.
- Other important distinctions include:
  - Substantial excess reserves so that a MP tightening, when it comes, will not impose a binding constraint on bank reserves.
  - At the ZLB, can’t have a parallel shift down in interest rates.
  - With quantitative easing at the ZLB, an easing of monetary policy flattens the slope of the term structure in contrast to conventional MP policy in which an easing of MP policy tends to steepen the term structure slope.

Concluding Remarks

- This is a very good paper, well worth reading.
- And if the authors, unlike my teenaged daughter, take my recommendations seriously, it can become an even better paper that can easily fend off cheap shots from nitpickers.