Discussion of
"Interest Rate Risk, Deposit Rates, and Financial Stability"

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General comments and outline of this discussion

Great overall paper!

- Important question, for both academia and policy
- Excellent data and very interesting results
- Work in progress, so the paper can still improve

My discussion:

- Credit risk vs interest rate risk: comments & suggestions
- Other suggestions to improve the paper
  - Bank competition
  - Derivatives

One-page summary of the paper

Question:

- Analysis of interest rate risk, deposit rates, and financial stability

Data and shock:

- Supervisory, matched granular German loan & deposit data from the Bundesbank and the ECB
- Exploit the unexpected rise in euro area monetary rates over 2022-23

Key result:

- Banks with higher deposit ratios encountered greater interest rate risk, resulting in significant implicit losses within their asset portfolios
- Nevertheless, banks sustained stable profits by offering lower deposit rates, indicating a natural hedge through their deposit franchise

Interest rate risk vs credit risk

- **Interest rate risk** and **credit risk** are mostly **separated**
  - In **policy**: Pilar 1 vs 2 Basel regulation
  - But also in **academic** analyses
- But **even credit risk due to higher monetary rates**
  - A key exception is a theoretical paper by Martin Hellwig in 1993
- This is despite that **e.g. subprime borrowers** had variable loan interest rates in the **2000s boom**, but when the Fed increased MP rates from 1% to 5.25%, these borrowers (and others) defaulted → banking crisis

→ **I think an analysis of both risks associated to higher MP rates is crucial**

- Related, key question is what banks hedge: bank value *vs* cash flows?
- Or hedge profits? In this case, via current IFRS 9 provisions (or the US one), if ECL were calculated well, credit risk could be covered in profits
  - But many banks use a "standardized approach" to provisions (which does not vary much with MP rate changes). For the IRB model, moreover, it has been shown that bank manipulate IRB models

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Monetary policy rates on banking stability: credit vs interest rate risk

- This paper is about **understanding monetary policy & financial stability**

- We have a **very related paper, partly using Bank of Spain data**, that addresses both **credit risk and interest rate risk** and analyzes banking crises associated to higher monetary policy rates

  – "Monetary Policy, Inflation, and Crises: Evidence from History and Administrative Data," G. Jiménez, D. Kuvshinov, J.-L. Peydró, B. Richter *Journal of Finance*, forthcoming

  – Our paper is mostly country level, not bank level, except for one part, so both papers complement very well each other

- We show that **a U-shaped MP rate path increases banking crisis risk, via credit and asset price cycles, analyzing 17 countries over 150 years**

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Jiménez—Kuvshinov—Peydró—Richter (Journal of Finance, forthcoming)

- **Monetary rate (MP) hikes** (raw or instrumented using the international finance trilemma) materially **increase banking crisis risk**, but **only if preceded by prolonged monetary rate cuts**
  - These patterns are **unique to banking crises**, unlike non-financial-crisis (even deep) recessions
  - Stronger for deeper U-shapes, **over the systematic monetary policy component**

- For the **mechanism**:
  - Booms: **Prolonged MP rate cuts** raise the likelihood of "red zones" of **high credit and asset price** growth, consistent with higher **credit supply** and risk-taking
  - Bust: **Subsequent MP rate hikes** strongly reduce credit and asset prices, and substantially increase **banks' realized credit risk, rather than interest rate risk**
  - Only red zones combined with U-shaped rate paths strongly increase crisis risk

- Finally, we find consistent results in administrative, loan-level data from **Spain's post-1995 boom and crisis, notably credit supply & loan defaults**

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You want to isolate a "pure interest rate risk", BUT you have to deal with

Reach for longer maturity *vs* higher credit risk-taking in your paper:

- When MP rates are low for long, there is **both** higher risk-taking via longer maturities and also via higher borrower risk
  - Your paper mentions and tries to exploit one: maturity
  - But you treated banks during 2014-2021 took on both risks, so separate them may be very difficult
  - So it is better to use both of them, as higher MP rates affect both

Other suggestions to improve the paper

- **Bank competition**: The intro and motivation is about bank competition, but then not any regression analysis → exploit differential bank competition within Germany
  - Do you find stronger effects of the natural hedge and hence higher interest rate risk on the asset side (more duration risk) where bank competition is lower?

- **Balance sheet ("natural") *vs* derivative hedging**: As you can have access to the individual data on hedging via derivatives ☺ you could also analyze it:
  - Are balance sheet ("natural") hedging vs derivative hedging substitutes or complements (or independent)?