Bank regulation, credit ratings and systematic risk
by
Giuliano Iannota and George Pennacchi

João Santos
Federal Reserve Bank of New York
and
Nova School of Business and Economics

Summary

- Theory:
  - The use of credit ratings in regulation can be a source of moral hazard
  - If ratings reflect only expected default losses, this will give banks an incentive to select securities with larger systematic risk.
- Empirical evidence:
  - Bond spreads in the primary market do reflect bonds' systematic risk
  - In contrast bond credit ratings do not fully reflect bonds' systematic risk
- Paper's key insight: If regulations are based on credit ratings banks can increase shareholder value by choosing securities with grater systematic risk

Comment 1: Theory

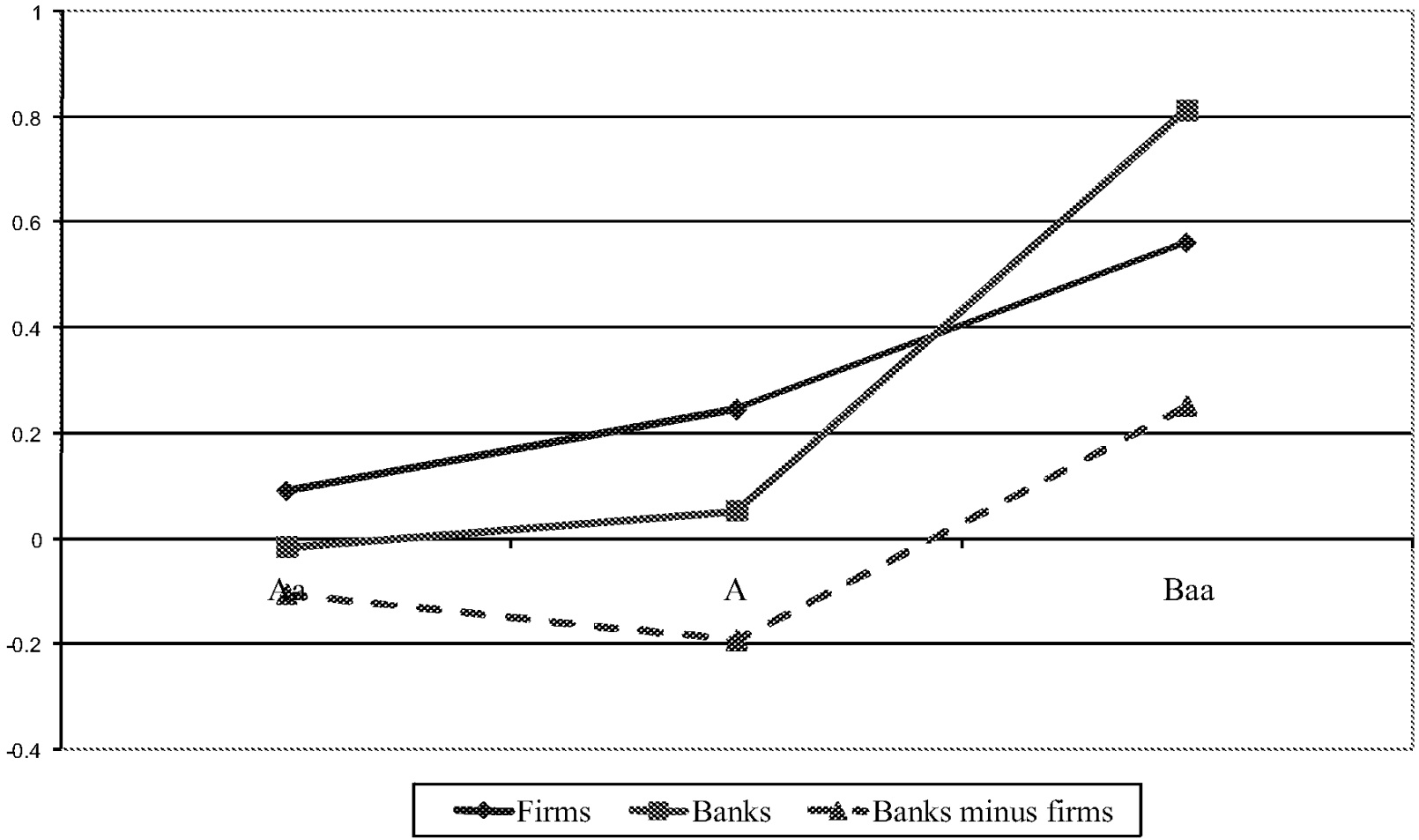
- Pennacchi (2006): if insurance premiums are set to a bank's expected losses and fail to include a systematic risk premium, banks that make investments with higher systematic risk enjoy a greater financing subsidy.
- Acharya, Santos and Yorulmazer (2010): actuarially fair deposit insurance premium—the premium that exactly covers the expected cost to the deposit insurance provider—should not only increase in relation to individual bank failure risk but also in relation to the bank's contribution to systemic risk.

Comment 2: Empirics: Investigation of credit spreads

- "Our calculations of a bond issuer's delta and residual volatility do not use information on the new bond issue itself, but instead rely on the issuer's stock market and balance sheet information prior to the bond issue."
- An average debt maturity of ten years seems long (average loan maturity is five years).
- Use separate ratings of each agency; not average ratings
  - S&P and Moodys' appear to account for systematic risk differently
  - Investors assign different weights to their ratings (Santos 2009)
- Combining bonds of financials and nonfinacials can be problematic because investors treat them differently
  - During recessions investors demand higher spreads, but the premium varies with the bond rating and whether the bond was issued by a bank or a nonfinancial (Santos 2009)

Comment 2: Empirics (cont.)

Figure 1. Cost of recessions to banks & firms by credit rating



Comment 3: Are bonds a good testing market?

- Investing in bonds is not a core business of banks
- How informative is the paper's exercise?
- A better test would be to look at banks' loan pricing policies and/or their loan retention choices

Interest rate risk and bank equity valuations
by
W. English, S. Van den Heuvel and E. Zakrajsek

Summary

- Objective:
  - Investigate how bank stock prices respond to unexpected interest rate changes induced by monetary policy announcements
- Results:
  - Stock prices decline following an unexpected increase in the level and slope of the yield curve.
  - The decline is less pronounced for banks with a large maturity gap; and it is bigger for banks with more “core deposits”.
  - An increase in interest rates and the yield slope leads to an improvement in banks’ interest margins but it also contributes to an outflow of core deposits.

Comment 1: Methodology

- In computing the repricing/maturity gap, the authors take the existing maturity in all existing bank positions/securities as given and independent of interest rate changes. However, it is likely that the maturity on many of these positions/securities will get renegotiated
- No attempt to control for off balance commitments; however we know that credit spreads on corporate credit lines vary positively with the slope of the yield curve (Paligorova and Santos 2012)
- There is a great deal of focus in the paper on “core deposits” (savings, transaction and demand deposits), but shouldn’t the focus be on interest paying vs. non interest paying deposits or more generally on interest elastic vs inelastic funding sources?

Comment 2: Approach used to explain stock price reaction

- In investigating the stock market reaction, the authors focus on unexpected changes in interest rates induced by monetary policy announcements
- In attempting to explain the stock market reaction, the authors focus on changes in the 3-month Treasury yield and the 10y/3m term spread.

Comment 3: Related literature

- Most of existing studies find that greater asset-liability mismatch is associated with a greater sensitivity of bank stock returns to interest rate changes
- This paper finds the opposite; it would be nice to have an explanation for the difference

Comment 4: Explaining the results

- More explanation of the results would be useful.
- For example, why is it that banks with liabilities that include a greater fraction of demand and transaction deposits exhibit a more negative reaction to interest rates increases?