Discussion of "Short-Term Interest Rates and Bank Lending Terms" (Dell'Ariccia, Laeven, and Suárez)

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1 Summary

- Very interesting paper.
- Broad question: Role of banks in the transmission of monetary policy
- More specifically, is there a risk-taking channel?
- Important policy implication: is risk poorly priced by banks?

- Other papers are focused on "quantities", this paper is focused on "prices".

- "Quantities": within a given risk bucket, financial intermediaries invest more in relatively higher yields when the FF rate is low. Becker and Ivashina (JF 2015)

- "Prices": within a given risk bucket, banks offer lower spreads when the FF rate is low.

- Effect on prices can be a consequence of reaching-for-yield portfolio reallocations.

- Results consistent with a risk-taking channel: when rates are low, and conditional on loan risk,...
  - Loan spreads are lower
  - Fewer secured loans
  - Longer maturity

- Keys to the identification strategy:

1. Compare loans with the same risk during periods of high and low rates.

2. Movements in the FF rate are truly shocks, i.e., not endogenous to economic activity.

2 Comments

1. Time variation in default probabilities and/or risk premium

2. Borrower quality

3. Incentives or mistakes?

2.1 Time variation in spreads conditional on risk

- The paper uses 5 risk buckets. Average risk is 3.3 $\approx$ "moderate"

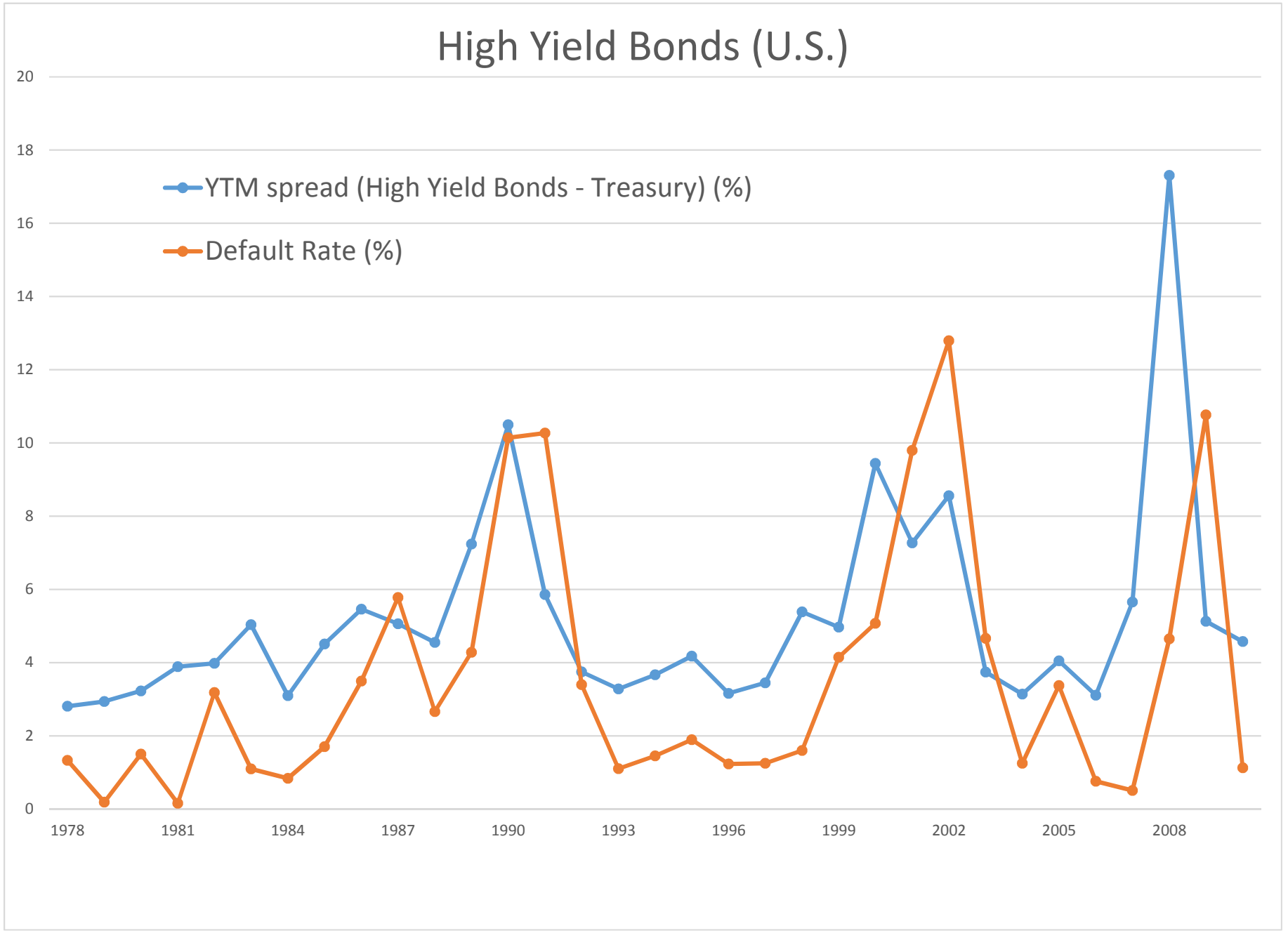
- Should "moderate" risk always have the same spread attached across the business cycle?

- Not necessarily, both default probabilities and the risk premium can be time varying.

loan spread=risk neutral default spread + risk premium

- Even if risk is the same, the loan spread can (should) change across the cycle.

- Just like the expected return of a stock with $\beta = 0.80$ moves across the cycle.


High Yield Bonds (U.S.)
YTM spread (High Yield Bonds - Treasury) (%)
Default Rate (%)
20
18
16
14
12
10
8
6
4
2
0
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008

- Caveat: the authors also look at "exogenous" FF rate movements (Tables 5-6), in principle unrelated to market dynamics, but the effects are very similar to previous tables with raw FF rates.
  - Should they be?
  - What if monetary policy is the source of market risk? (Lucca and Moench, JF 2015)

2.2 Borrower quality

- Even within a risk bucket, risk can vary across the cycle.

- Worsening credit quality of borrowers during credit booms. Greenwood and Hanson (RFS 2013)

- Changes in the use of collateral is a sign of changing quality of borrowers. Benmelech and Bergman (JFE 2009)

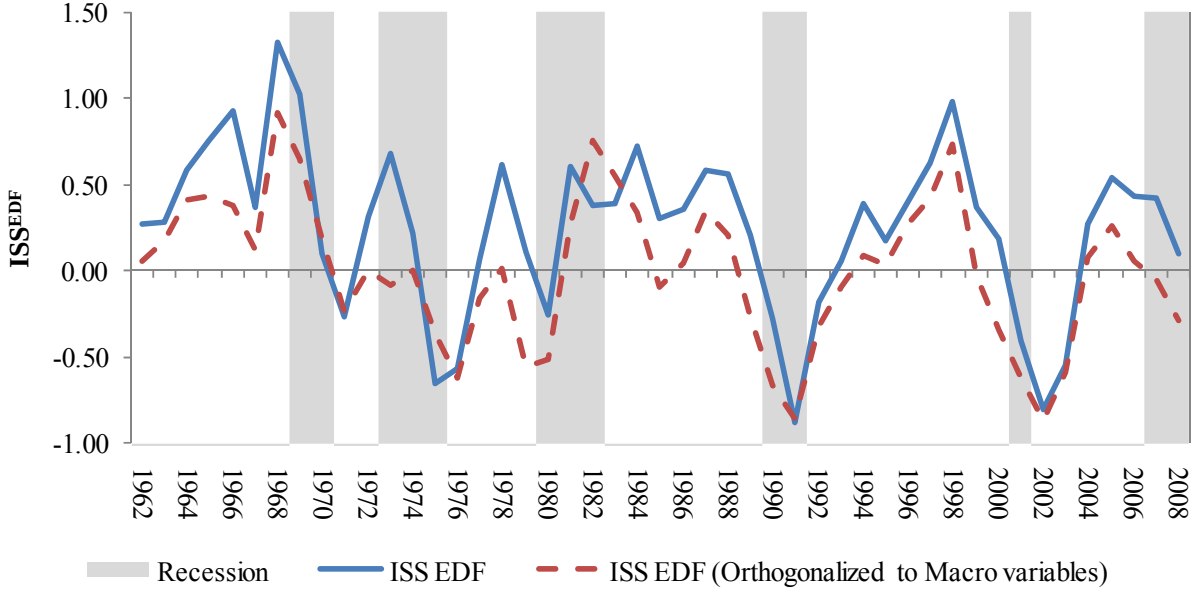


Figure 1. Issuer Quality. ISS^{EDF}, is the difference between the average *EDF* decile between high and low debt issuers. *EDF* is the expected default frequency of Merton (1974). The figure also shows shading for NBER-designated recessions. The dotted line shows a version of ISS^{EDF} that has been orthogonalized with respect to the output gap (Hodrick-Prescott filtered real GDP).

2.3 Incentives or mistakes?

- Important distinction for policy intervention.

- Do incentives in banks induce risk-taking?

- Investors do not fully internalize the fall in credit quality during credit booms: they should demand even higher spreads! Greenwood and Hanson (RFS 2013)

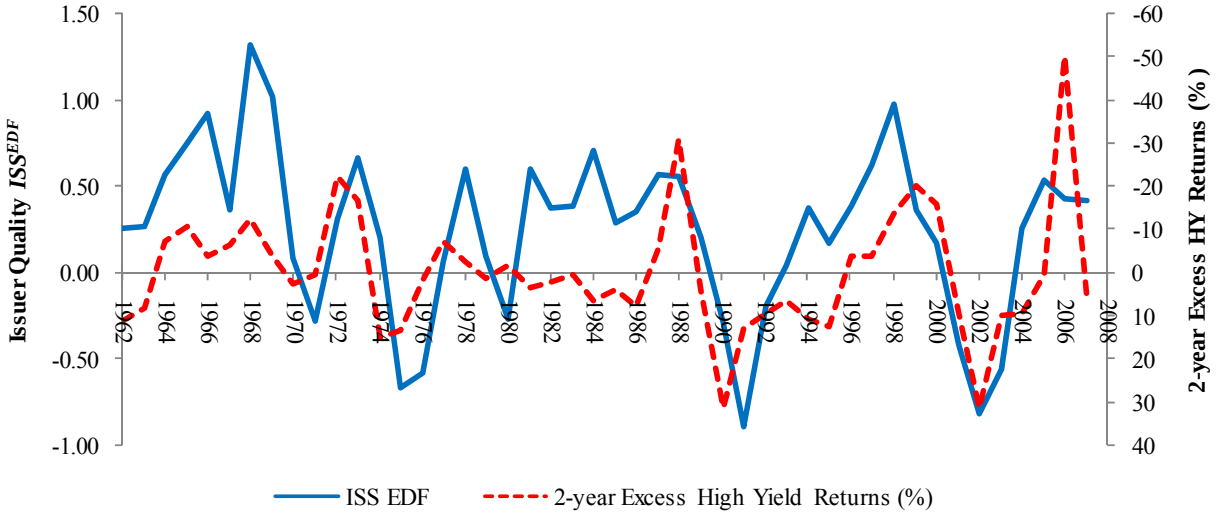


Figure 3. Issuer Quality and Subsequent High Yield Excess Returns. Issuer quality (left axis) plotted alongside cumulative excess high yield bond returns for the following two years (right axis). Returns are plotted in reverse scale, so the negative correlation appears positive visually. Issuer quality is measured with ISS^{EDF}, the difference between the average *EDF* decile of high and low debt issuers from 1962- 2008.

3 Conclusions

- Nice paper; I learned a lot.

- Unconventional evidence (about prices instead of quantities) in favor of risk-taking channel.

- Is risk poorly priced by banks? Do banks adjust spreads too much or too little in response to FF rates?