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Discussion: How (in)effective was bank supervision during the 2022 monetary tightening?

by Yadav Gopalan and João Granja

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Huyen Nguyen, IWH and FSU Jena

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Research questions and main findings

The paper studies the decisions of bank supervisors and their effectiveness. Using the period around the monetary tightening of 2022, the authors ask:

- Do supervisors downgrade banks with large exposures to interest rate risk?
Yes, but only for Liquidity and Sensitivity Grades.
- If so, when? **Only after the Fed raised interest rates in 2022.**
- Do they downgrade banks that rely on unstable funding sources? **No**
- **Available for Sales** vs Hold to Maturity Portfolios, which one do bank supervisors pay more attention to?
- Do these actions mitigate risks at downgraded banks? **Partially Yes**

The paper in a nutshell

To study the downgrading decisions of bank supervisors, the authors:

- Use the monetary tightening in 2022 as a natural experiment – a shock **that changes the belief** of supervisors and banks related to the importance of interest rate risk.
- Exploit rich data sources: universe of commercial banks' CAMELS ratings between 2020Q4 and 2023Q1 combined with Call Reports.
- Continuous treatment: interest rate risk exposures, unstable deposits, and unrealized losses in AFS and HTM portfolios

Link supervisory actions to banks' risk taking:

- After being downgraded, these banks hold more cash, hold less long-term securities.
- But they do not engage more in interest rate risk hedging.

Assessment

The paper contains all elements for a top publication:

- **Timely and important topic:** link directly to the failures of several US banks in 2023 after the FED tightens their monetary policies.
- **Big Contribution:** One of very few papers that look at bank supervision in big journals. My search from top three finance journals: **7 papers** in the last 15 years on the broader theme of supervision.
- **Great idea combined with unique data** on on-site examinations of bank supervisors and the decisions on CAMELS Ratings.

My comments

- Interpretation of the results
- Mechanism
- Identification strategy
- Further Results: Implications for banks and their borrowers

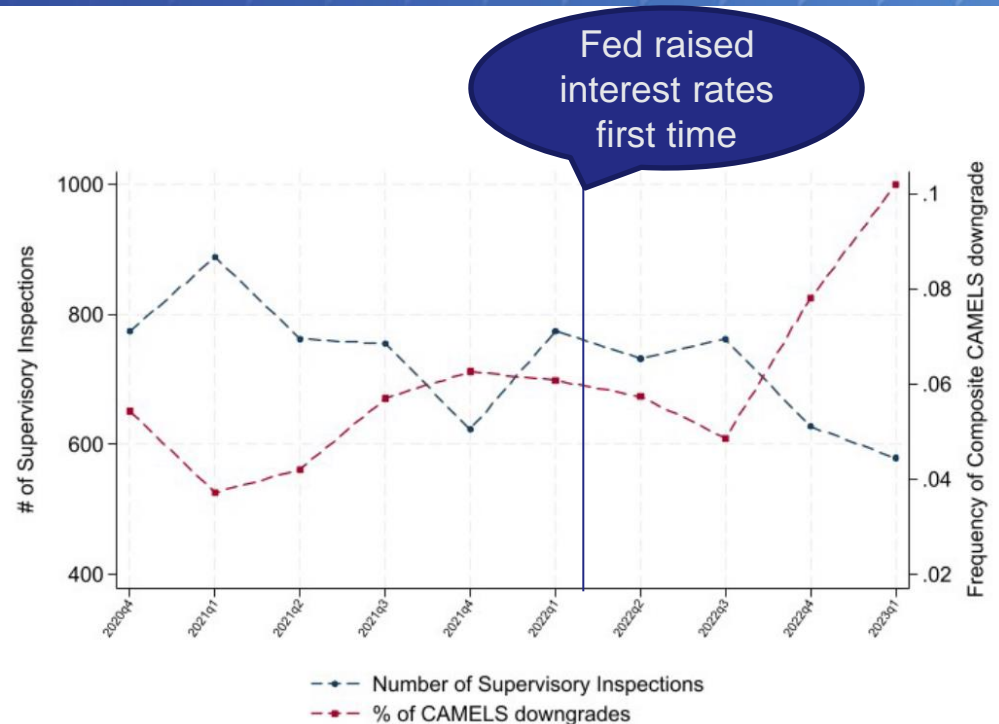
Comment #1: How much do bank supervisors know?

Findings: Bank supervisors are aware of interest rate risks and downgraded high IR risk banks as early as 2022Q2.

But:

As of 2022Q2, markets already know about FED decisions.

Banks with high exposure to interest rate risks already experience decline in profit.

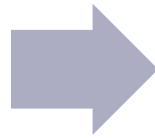


Food for thoughts: Would one see this action from bank supervisors as timely or as too late?

,Double penalty' issues with high IR risk banks: decline in profitability due to interest rates rising, and additional scrutiny from supervisors at the same time.

Comment #2: Mechanism analysis

Monetary tightening



Bank supervisors downgraded (L and S ratings) for banks with high IR risk exposure, unstable deposit sources, and high share of AFS holdings

What is the nature of the shock: change in beliefs about the role of interest rate risks? **Or something else?**

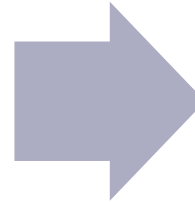
2022 coincides with many things: The end of forbearance policies after the pandemic; supply chain disruptions, geopolitical tensions.

Suggestions: Robustness checks: Interact with FED rates/ surprise element of monetary policies instead of POST.

Evidence on the communication of supervisors: Do they mention interest rate risks more after 2022Q2?

Comment #2: Mechanism analysis (cont.)

Bank supervisors downgraded (L and S ratings) for banks with high IR risk exposure, unstable deposit sources, and high share of AFS holdings



Downgraded banks take less risk

Why?

Because they are afraid of enforcement actions?

- because they obtain new information from banking supervision;
- because they simply respond to monetary policy shocks?

Suggestions: Discuss objective function of bank supervisors. Link to the information channel of banking supervision.

Comment #3: Bank supervision and the information channel

$$IR\ risk_{b,t} = F(Downgrade_i \times Post_t)$$

- Many downgrades happened during the tightening of monetary policies. The results may not be specific to the effect of bank supervision but simply because banks got hit by interest rate shock and, therefore, reduced exposure to IR risk.
- How to streamline the **uniqueness of bank supervision**?
 - Theory and evidence show that bank supervision enables the use of soft information in mitigating externalities of bank failures (Hirtle and Kovner, 2022). Berger, Davis and Flannery (2000), Gaul and Jones (2021), Eisenbach, Lucca and Townsend (2016).
 - Doing so helps explain why receiving downgrades from bank supervisors makes banks reduce risk and disentangle the effect of supervision from the effect of monetary policy.
- **Suggestion:**
 - Test if accounting information that banks reported after on-site examinations from supervisors changed,
 - Tests if stock prices of bank responded after on-site examinations.

Comment #4: Further thoughts on identification

$$\text{Downgrade}_{it} = \alpha_i + \gamma_t + \beta_0 \text{Int. Rate Risk}_{it} + \beta_1 \text{Int. Rate Risk}_{it} \times \text{Post}_t + \Gamma X_{it} + \epsilon_{it}$$

- In a normal DiD set-up, we hope for a **treatment status that does not change over time.**
- The use of $\text{Int. Rate Risk}_{it}$, allows observing the direct effect of exposure to interest rates on downgrade decisions, but at the same time, β_1 would also capture any changes in bank behavior that is not due to the shock (monetary policy tightening in this case).
- Suggestion: Use average pre-shock Int. Rate Risk_i that varies only at the bank level as robustness checks.
- **Fixed Effects:** Bank and Time FE: pretty neat but in regressions without bank FE, one can consider using Supervisor FE (or even Supervisor x Year FE) because not all 12 FEDs are equally strict, comparing within supervisor would control for differences in preferences and risk tolerance of different supervisors.
- **Clustering of SE:** Interest Rate Risk is specific to bank, and the decision to downgrade is from each supervisor, thus, clustering at the state where bank HQ located could be changed to clustering at either bank or supervisor level.

Comment #4: Further results and implications

- What are the implications of CAMELS downgrades for depositors and borrowers?
- How binding are these downgrades? Are downgrades for all components equally binding?
- Further heterogeneities: which banks are better prepared for the interest rate shocks?
 - Are banks that participate in stress tests before 2022Q2 better prepared for monetary policy tightening and less likely to be downgraded?
 - What about diversification in deposit sources and lending?