Risk Taking and Interest Rates: Evidence from Decades in the Global Syndicated Loan Market

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The views expressed are those of the authors and do not reflect those of the FRB and IMF.
Introduction

• How interest rates in the United States and other factors affect risk taking in the market for cross-border corporate loans? Is there evidence on the global lending and risk-taking channels?

• Before the Global Financial Crisis, banks made ex-ante riskier loans to non-U.S. borrowers in response to a decline in U.S. short-term interest rates, and, after it, both banks and nonbanks made such loans in response to a decline in U.S. longer-term interest rates.

• Economic uncertainty, risk appetite, and the U.S. dollar exchange rate play a limited role in explaining ex-ante credit risk.

• To the extent that actions of the Federal Reserve affect U.S. interest rates, evidence of cross-border spillover effects of U.S. monetary policy.

• Highlight the potential policy challenges faced by central banks in affecting credit risk cycles in their own jurisdictions.
Literature and Contribution

• Cross-border bank lending as a potential channel through which monetary conditions in one country affect capital flows and credit growth in the global financial system.
  • Focus on the direction and magnitude of cross-border flows; little has been done to study the riskiness of these flows.
  • Quantitative measures of risky assets may not be sufficient to detect financial vulnerability as risk taking in the financial sector involves quality rather than the quantity of assets—see Kalemli-Ozcan, Sorensen, and Yesiltas (2012).

• Risk taking channel of monetary policy—numerous theoretical and empirical contributions.
  • Focus on banks’ risk taking in home markets in response to short-term interest rates.
  • Here: Using market-based measures of credit risk, examine how changes in short- and long-term U.S. interest rates and other factors affect risk taking by banks and nonbanks in the global syndicated term loan market.
Issuance of bonds and originations of loans

- A syndicated term loan is made for a duration of 5-7 years by a group of lenders to a nonfinancial borrower at an interest rate that is indexed to a short-term benchmark interest rate.
- Focus on syndicated term loans that are denominated in U.S. dollars, indexed to the U.S. dollar LIBOR, and originated in the global market.
- Originations of syndicated term loans ($2 trillion in 2013) are comparable in size to issuance of nonfinancial corporate bonds ($1.6 trillion).
- It is a market for risky assets: IG-rated borrowers account for just a small fraction of term loan originations.
- Risk taking representative of the global financial system’s: Lenders and borrowers from around the world—both from AFEs and EMEs.
Ownership of syndicated term loans at origination and over time

- Based on syndicated term loans made in the United States in the past several years.
  - Similar data for the global market are believed not to exist.
- A sequence of box plots for bank ownership shares at different time intervals since loan originations.
- Risk taking representative of the broader financial system’s: Banks originate and quickly sell off stakes in loans to shadow banks (funds, structured products, and others).
- In this market, attributing risk taking solely to banks may be highly misleading.
Loan spreads and probabilities of borrower default

- Based on syndicated term loans made in the United States in the past several years that are captured by U.S. supervisory data.
- A loan spread over the index interest rate: Good proxy for a loan’s ex-ante credit risk and other risk characteristics.
  - Loan spreads that are fixed at origination for the duration of loans are highly positively correlated with through-the-cycle probabilities of borrower default over a one year horizon.

Note: Based on merged SNC and Dealscan data
Loan spreads and probabilities of borrower default

\[
\log(\text{spread}_{j,l,b,t}) = \alpha_l + \delta_{PD}\log(\text{PD}_{j,b,t}) + Q_{j,t}\delta_Q + \beta_T R^T_t + X_t\gamma + \theta_{l,y} + \theta_{b,i,y} + \varepsilon_{j,l,b,t}
\]

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>log(PD, pct)</td>
<td>0.231***</td>
<td>0.206***</td>
<td>0.190***</td>
<td>0.189***</td>
</tr>
<tr>
<td>Other loan characteristics</td>
<td>Signif.</td>
<td>Signif.</td>
<td>Signif.</td>
<td>Signif.</td>
</tr>
<tr>
<td>Reporting bank-year fixed effects</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Borrower industry-year fixed effects</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Num. of observations</td>
<td>709</td>
<td>709</td>
<td>709</td>
<td>709</td>
</tr>
<tr>
<td>R-sq. adj.</td>
<td>0.40</td>
<td>0.50</td>
<td>0.56</td>
<td>0.57</td>
</tr>
<tr>
<td>RMSE</td>
<td>0.37</td>
<td>0.34</td>
<td>0.32</td>
<td>0.31</td>
</tr>
</tbody>
</table>

*Statistics in parentheses. *p < .1, **p < .05, ***p < .01.

Note. Based on DealScan loans matched with the Shared National Program data. Dependent variable is log(loan spread, pct) of loan j reported by agent bank l in quarter t.

- Note: j, l, b, t stand for loan, lender, borrower, and time; Q for loan characteristics; R^T and X for U.S. long-term interest rates and other macro factors.
- Macro variables—including risk appetite—explain little when we control for probabilities of default (PDs).
- Loan spreads are more comprehensive proxies of risk that PDs.
Syndicate regressions

- What factors affect risk taking in the market for cross-border corporate loans?
- DealScan data that captures loan information at origination.
- Sample on an “ultimate” lender/borrower basis at a quarterly frequency excludes U.S. borrowers and in many instances U.S. lenders to help with identification.

\[
\log(\text{spread}_{j,l,b,t}) = \alpha_t + \alpha_b + \beta_F R^F_t + \beta_T R^T_t + X_t \gamma \\
+ \theta_{l,c,y} + \theta_{l,i,y} + \theta_{b,c,y} + \theta_{b,i,y} + \phi_{j,t} + \varepsilon_{j,l,b,t}
\]

- Note: j, l, b, t stand for loan, lender, borrower, and time as before and c, i, and y for region, industry, and year.
- Focus on macro push factors: \( R^F \) is the U.S. federal funds rate, \( R^T \) the 10-year U.S. Treasury rate, and X are macro factors which include the U.S. dollar exchange rate.
- Include lower-frequency (annual) fixed effects to capture lenders’ types and regions.
- Pull factors are captured by lower-frequency (annual) fixed effects for borrowers’ industries and regions.
Syndicate regressions: Loans made by all lenders to non-U.S. borrowers

<table>
<thead>
<tr>
<th></th>
<th>(1) Pre-crisis</th>
<th>(2) Post-crisis</th>
<th>(3) Full</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed. funds rate, pct</td>
<td>-0.062**</td>
<td>-0.150***</td>
<td>-0.075***</td>
</tr>
<tr>
<td>10-year Treas. rate, pct</td>
<td>0.037</td>
<td>-0.108***</td>
<td>-0.010</td>
</tr>
<tr>
<td>Variance risk premium, pct sq.</td>
<td>0.002</td>
<td>-0.005</td>
<td>0.000</td>
</tr>
<tr>
<td>European sovereign spread, pct</td>
<td>0.014</td>
<td>-0.241***</td>
<td>0.003</td>
</tr>
<tr>
<td>Expected inflation, pct</td>
<td>-0.036</td>
<td>0.241***</td>
<td>0.043*</td>
</tr>
<tr>
<td>Low-grade bond spread, pct</td>
<td>0.099**</td>
<td>0.127***</td>
<td>0.041***</td>
</tr>
<tr>
<td>News-based uncertainty index</td>
<td>-0.003***</td>
<td>-0.000</td>
<td>-0.001***</td>
</tr>
<tr>
<td>U.S. dollar exch. rate (broad)</td>
<td>0.004</td>
<td>0.044***</td>
<td>0.009**</td>
</tr>
<tr>
<td>Post-2008 × 10-year Treas. rate, pct</td>
<td>-0.011</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-2008</td>
<td></td>
<td>0.498**</td>
<td></td>
</tr>
</tbody>
</table>

Num. of observ. | 61507 | 18687 | 89655
Num. of clusters | 50 | 18 | 76
R-sq. within | 0.34 | 0.31 | 0.42
RMSE | 0.31 | 0.32 | 0.32

* p < .1, ** p < .05, *** p < .01.

**t** statistics in parentheses.

Note: Based on U.S. dollar term loans made by all lenders to non-U.S. borrowers. Dependent variable is log(loan spread, pct) of loan \( j \) in quarter \( t \) made to borrower \( b \) from country \( b, c \) in industry \( b, l \) of type \( l, i \) from country \( l, c \). Included controls: Syndicate composition, lender type-year FE, lender country-year FE, borrower industry-year FE, borrower country-year FE, and dummy for crisis quarters.

- To the extent that the Federal Reserve controls U.S. interest rates, international risk taking spillovers from U.S. monetary policy.
- Riskier loans made to non-U.S. borrowers in response to decline in the funds rate before the crisis and in the 10-year U.S. Treasure rate after it. Other factors appear to play a more limited role.
- Post crisis “marginal effects”: Credit rating specific, small for IG-rated borrowers, material for others.
- The same results for loans made by:
  - U.S. lenders to non-U.S. borrowers—outward transmission of U.S. monetary policy.
  - Non-U.S. lenders to EME borrowers—strongest case for identification, indirect outward transmission of U.S. monetary policy.
Portfolio regressions

- Lenders tend to make risk taking decisions in terms of credit risk of loan portfolios not just individual loans.
- Focus on loan portfolios made by each lender to borrowers in AFEs and in EMEs.

\[
\log(p\text{spread}_{bc,t}) = \alpha_{bc} + \alpha_l + \beta_{FF} R_{lt}^F + \beta_{TT} R_{lt}^T + \gamma X_t \\
+ \theta_{1,c,y} + \theta_{1,i,y} + \theta_{bc,y} + \varepsilon_{l,b,t}
\]

- Note: bc stands for borrower region, other indexes as before.
- Pspread is the average loan spread for a portfolio of loans that a lender made to borrowers in a certain region at a certain time.
- By design, more limited options for pull factors.
Portfolio regressions: Loans made by all lenders to non-U.S. borrowers

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<th>(1) Pre-crisis</th>
<th>(2) Post-crisis</th>
<th>(3) Full</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed. funds rate, pct</td>
<td>-0.028*</td>
<td>-0.036***</td>
<td>-0.036***</td>
</tr>
<tr>
<td>10-year Treas. rate, pct</td>
<td>0.040*</td>
<td>-0.219**</td>
<td>0.036</td>
</tr>
<tr>
<td>Variance risk premium, pct</td>
<td>0.002</td>
<td>0.002</td>
<td>0.002*</td>
</tr>
<tr>
<td>European sovereign spread, pct</td>
<td>-0.015</td>
<td>-0.049</td>
<td>-0.037**</td>
</tr>
<tr>
<td>Expected inflation, pct</td>
<td>0.005</td>
<td>0.088</td>
<td>0.021</td>
</tr>
<tr>
<td>Low-grade bond spread, pct</td>
<td>0.019</td>
<td>0.032</td>
<td>0.037***</td>
</tr>
<tr>
<td>News-based uncertainty index</td>
<td>-0.002**</td>
<td>-0.002**</td>
<td>-0.002***</td>
</tr>
<tr>
<td>U.S. dollar exch. rate (broad)</td>
<td>0.002</td>
<td>0.016</td>
<td>-0.004</td>
</tr>
<tr>
<td>Post-2008 × 10-year Treas. rate, pct</td>
<td>-0.214***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-2008</td>
<td></td>
<td></td>
<td>1.327***</td>
</tr>
</tbody>
</table>

Num. of observ. 14675 4791 21591  
Num. of lenders 1690 675 1974  
Num. of clusters 50 18 76  
R-sq. within 0.15 0.12 0.32  
RMSE 0.49 0.38 0.48  

$t$ statistics in parentheses. * $p < .1$, ** $p < .05$, *** $p < .01$.
Note. Based on U.S. dollar term loans originated in the global market to non-U.S. borrowers. Dependent variable is log(average spread of loan portfolio, pct) of lender $l$ from country $c$ of type $t,i$ made to borrowers from country $b,c$ in quarter $t$. Included controls: Lender type-year FE$s$, lender country-year FE$s$, borrower country-year FE$s$, and dummy for crisis quarters.

• Similar findings as for the syndicate regressions.
• Riskier loans made to non-U.S. borrowers in response to decline in the federal funds rate before the crisis and in the 10-year U.S. Treasury rate after it.
• News-based uncertainty appears to play a more consistent role across the periods.
• Caveats apply to all our regressions:
  • Lenders may hedge their syndicated loan risk exposures in other markets.
  • Because hedges are sold by other financial institutions, the broader financial system can be still strained to cope with additional credit risk.
  • Do not observe all assets of lenders in the sample.
Portfolio regressions: Loans made by banks and shadow banks

- Separate regression coefficients on U.S. interest rates for banks and nonbank financials estimated on portfolios of loans made to non-U.S. borrowers.

- Differences in the global risk taking channels before and after the Global financial crisis:
  - Before the crisis, banks’ risk taking was sensitive to the federal funds rate.
  - After the crisis, banks and nonbanks’ risk taking was driven by the 10-year U.S. Treasury rate.

- Robustness checks: Immediate lenders and borrowers; most active lenders; leveraged vs IG-grade loan portfolios.

<table>
<thead>
<tr>
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<th>(3)</th>
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<tbody>
<tr>
<td></td>
<td>Pre-crisis</td>
<td>Post-crisis</td>
<td>Full</td>
</tr>
<tr>
<td>Bank×Fed. funds rate, pct</td>
<td>-0.029**</td>
<td>-0.036***</td>
<td></td>
</tr>
<tr>
<td>Nonbank×Fed. funds rate, pct</td>
<td>0.000</td>
<td>-0.016</td>
<td></td>
</tr>
<tr>
<td>Bank×10-year Treas. rate, pct</td>
<td>0.044*</td>
<td>-0.224**</td>
<td>0.040*</td>
</tr>
<tr>
<td>Nonbank×10-year Treas. rate, pct</td>
<td>0.008</td>
<td>-0.207**</td>
<td>0.010</td>
</tr>
<tr>
<td>Bank×10-year Treas. rate, pct×Post-2008</td>
<td>-0.224***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonbank×10-year Treas. rate, pct×Post-2008</td>
<td>-0.147*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-2008</td>
<td></td>
<td></td>
<td>1.362***</td>
</tr>
<tr>
<td>Others not shown</td>
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<td>...</td>
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Num. of observ. 14098 4672 20844
Num. of groups. 1343 610 1563
Num. of clusters 50 18 76
R-sq. within 0.15 0.12 0.32
RMSE 0.49 0.38 0.48

$t$ statistics in parentheses. * $p < .1$, ** $p < .05$, *** $p < .01$.
Note. Based on U.S. dollar term loans originated in the global market to non-U.S. borrowers. Dependent variable is log(average spread of loan portfolio, pct) of lender $l$ from country $c$ of type $t$, $i$ made to borrowers from country $b$, $c$ in quarter $t$. Included controls: Lender type-year FE$s$, lender country-year FE$s$, borrower country-year FE$s$, and dummy for crisis quarters.
Conclusions

• Findings suggest the existence of the global risk-taking channel of U.S. monetary policy.
  • Lower interest rates in the United States encourage risk taking by U.S. and non-U.S. banks and shadow banks in other countries.

• Such spillovers highlight challenges faced by central banks, particularly those in EMEs, in affecting risk taking in lending and, more broadly, credit cycles in their respective jurisdictions.
  • The Federal Reserve’s monetary policy easing meant to boost “productive” risk taking in the United States, not necessarily risk taking in other countries.
  • View that spillovers may not be necessarily desirable, no matter the credit cycle in other jurisdictions.
  • Room for international policy coordination to ensure financial stability.