Financial Advisory Roundtable (FAR)
November 22, 2013

Duration Risk Taking and Financial Stability

1. What types of institutions have the largest incentives for duration risk taking in the low interest rate environment?
    a. Banks: duration risk versus net interest margin
    b. Dealers: Volker rule exemption for Treasuries and agencies
    c. Insurance companies: asset-liability management
    d. Buyside: bond mutual funds, REITs, hedge funds, pension funds
    e. Off-balance sheet exposures
    f. Leveraged lending
    g. Emerging market interest rate exposure

2. What are the amplification mechanisms in a rates selloff?
    a. Duration risk appetite
    b. Duration hedging
    c. Fire sale externalities
    d. Run risk

3. What are policy actions that can be taken to mitigate interest rate risk?
    a. What are policy actions for specific institutions?
    b. What are policy actions for specific amplification mechanisms?

4. How should stress test scenario design incorporate interest rate risk taking?
    a. Can capital stress test effectively capture interest rate risks exposure?
    b. How would the current stress test framework have to be expanded to capture rate risk?
    c. What are reasonable magnitudes of interest rate moves?
    d. What are capital versus liquidity implications?
    e. What are interactions with other macroeconomic factors used in the scenarios?

5. The bond market experienced a selloff since May 3 with the 10-year Treasury yield rising from 1.63 percent to 2.74 percent between May 2 and July 5. To date, the cumulative loss of holding a 10-year Treasury since May 3 amounts to 14%. Since 1961, the selloff ranks as the 10th worst.
    a. Is the magnitude of the selloff surprising?
    b. To what extent does the selloff reflect changes in the financial system?
    c. To what extent does the selloff reflect macroeconomic developments?