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Interest rate risk and the creation of the Monetary Policy Committee: Evidence from banks' and life insurance companies' stocks in the UK



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ABSTRACT

This paper investigates the effect that the creation of the Monetary Policy Committee (MPC) has had on the interest rate risk which banks and life insurance companies face in the UK. By means of GARCH-M methodology, the stock returns are modelled on the CAPM and the Fama-French asset-pricing models, augmented with interest rate risk factors and referring to short- and long-term rates. Our results indicate that in the period before the Bank of England (BoE) was granted operational independence, changes in the level and volatility of interest rates significantly affected the stock returns of these companies. These effects have diminished since the MPC's creation in May 1997. In parallel, since the MPC's creation, macroeconomic uncertainty, as proxied by the MPC dis-sents, coexisted with significant effects on the short-term interest rate risk which banks and life insurance companies face. These results should be of interest to both analysts and policy-makers with respect to financial stability.

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1. Introduction

Interest rate risk is one of the most significant risks which banks and life insurance companies face, largely because of (1) a duration mismatch between their assets and liabilities and (2) the significant

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volatility of interest rates. Consequently, the inadequate risk management practices of banks and life insurance institutions can often lead to the structural vulnerability of the entire financial system and thus to financial crises.

There is a large body of literature that provides empirical evidence of a strong negative relation between stock returns of financial firms and interest rates (e.g., Carson, Elyasiani, & Mansur, 2008; Elyasiani & Mansur, 2003; Flannery, Hameed, & Harjes, 1997; Flannery & James, 1984; Lloyd & Shick, 1977; Santomero & Babel, 1997; Viale, Kolari, & Fraser, 2009). Choi, Elyasiani, and Saunders (1996), Allen and Jagtiani (1997), Hirtle (1997), and Benink and Wolff (2000) conclude, however, that interest rate sensitivity decreased in the late 1980s and early 1990s because of the availability of interest rate derivatives contracts that can be used for hedging purposes. Additionally, some authors argue that the interest rate dependence of financial stocks is time-variant and depends on economic conditions and monetary policy regimes (e.g., Booth, Officer, & Henderson, 1985; Brewer, Carson, Elyasiani, Mansur, & Scott, 2007; Choi, Elyasiani, & Kopecky, 1992; Elyasiani & Mansur, 1998; Ferrer, González, & Soto, 2010; Kane & Unal, 1988; Korkeamäki, 2011; Yourougou, 1990).

An important point that should be taken into account, however, when we investigate the effect of interest rate risk on banks and life insurance companies is the way in which monetary policy is conducted. In recent years, this conduct may have had a significant effect on interest rate risk exposures of banks and life insurance companies, to the extent that monetary policy implementation has changed significantly, along with the banking industry.

In most developed countries, central banks conduct their monetary policy either by targeting a short-term interest rate or by setting an official interest rate for their open market operations. These policy rates anchor the entire term structure of interest rates. Nowadays, it is widely accepted that the ability of a central bank to affect the economy depends critically on its ability to influence market expectations about the future path of overnight interest rates and not merely their current level. The reason is simple. Few, if any, economic decisions hinge on the overnight bank rate cost and availability of bank reserves. Consequently and in order to significantly affect expectations of future policy rate changes, central banks follow institutional reforms for greater transparency in monetary policy implementation framework to reinforce their credibility (see the empirical evidence in Eijffinger & Geraats, 2006).

More specifically, central bank independence (CBI) through its effect on central bank transparency (CBT; Geraats, 2002) and credibility (CBC; Rogoff, 1985) increases market operators' acceptance of monetary policy and the ability of the central bank to fulfil its objectives. The Bank of England adopted inflation targeting in December of 1992 and was granted operational independence with the creation of Monetary Policy Committee (MPC) in May 1997. Therefore, a crucial question arises: 'How did the creation of the Monetary Policy Committee (MPC) and its members' dissents regarding policy rate affect the interest rate risk which financial services companies faced?' Inflation expectations reflected in long-term rates are anchored, under high level of CBT. Therefore changes in the level of long-term rates and/or in the volatility of short-term rates (implying term structure movements) are not expected to affect investors' and financial firms' behaviour. According to our knowledge there has been no empirical evidence in this regard, a gap this paper attempts to fill.

The literature on the effects of the creation of the BoE's MPC is still limited. For an excellent review of the effect of the MPC's creation on the macroeconomic performance of the UK see King (2002, 2007). Chadha and Nolan (2001) use data before and after MPC's creation to assess whether a change to a more transparent monetary policy caused an increase in the volatility of interest rates in financial markets, but find no evidence in support of this hypothesis. In the same vein, Clare and Courtenay (2001) found that the independence of the BoE has influenced the reaction speed of exchange rates and futures contracts to macroeconomic news. Tuysuz (2011) argued that even if agents have been able to forecast policy rates decisions more accurately since May 1997, there is no clear impact of BoE independence on the reaction of interest rate levels to macroeconomic and monetary news.

Studying a number of central banks, Cihak (2006), Klomp and de Haan (2009) argue for a positive relation between CBI and financial stability, but no attention has been paid to an asset-pricing framework. Additionally, according to Alesina and Summers (1993), the variability of interest rates also reduces with higher CBI. Empirical evidence for the effect of CBI on interest rate risk facing financial services companies remains under investigation.

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