

Trading interest rate risk in derivatives markets

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Abstract:

This paper studies banks' motives for trading in interest rate derivatives. It uses data from annual reports and regulatory filings to measure major market participants' derivatives portfolios, as well as their non-derivative exposure to interest rate risk. Risk exposures with and without derivatives are compared using a term structure model. While some banks use swaps to offset maturity mismatch on their balance sheet, others appear to increase their exposure to interest rate shocks by speculating in derivatives.