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Options on Interbank Rates and Implied Disaster Risk

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Abstract

The identification of disaster risk has remained a significant challenge due to the rarity of macroeconomic disasters. We show that the interbank market can help characterize the time variation in disaster risk. We propose a risk-based model in which macroeconomic disasters are likely to coincide with interbank market failure. Using interbank rates and their options, we estimate our model via maximum likelihood estimation (MLE) and filter the short-run and long-run components of disaster risk. Our estimation results are independent of the stock market and serve as an external validity test of rare disaster models, which are typically calibrated to match stock moments.

I. Introduction

Severe macroeconomic contractions are often accompanied by widespread financial sector distress. Historical events such as the Great Depression illustrate how disruptions in the banking system can trigger or amplify economic collapse (Bernanke (1983)). More recent empirical work supports this view, showing that defaults in the financial sector, unlike those in nonfinancial sectors, are closely tied to macroeconomic downturns (Allen, Bali, and Tang (2012), Giesecke, Longstaff, Schaefer, and Strebulaev (2014)). The association between macroeconomic and financial crises is particularly strong for extreme episodes: As noted by Reinhart and Rogoff (2013), virtually all consumption disasters documented by Barro and Ursúa (2008) were coupled with systemic banking crises.

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In this article, we exploit this empirical regularity to propose a new method for estimating the risk of rare economic disasters. Macro-finance models featuring disaster risk have become a popular framework for capturing macroeconomic tail risk and explaining prominent asset pricing puzzles.[1] Yet, the rare disaster literature faces a major empirical challenge. Disasters are often referred to as "dark matter" because of their rarity and the obscurity of their source. This criticism points to the fact that it is difficult to reliably estimate the parameters associated with disasters based on the historical consumption time series.[2] Estimating time-varying disaster risk is even more difficult; Cochrane (2017) describes time-varying disaster probabilities as "dark energy," unless they can be independently anchored to external data.

We address these limitations by using interbank rates and their options. Our key assumption is that macroeconomic disasters are likely to coincide with interbank market failure – a view supported by historical data. This assumption provides a direct link between disaster risk and observed prices in the interbank market. We show that interbank rates and their options allow us to characterize the time-series evolution of disaster risk, with the aid of a model.

For our analysis, we adopt a risk-based model where the nominal pricing kernel is affine and is comprised of Brownian and Poisson shocks to five state variables of the economy: real consumption growth, mean consumption growth, expected inflation, short-run disaster risk, and long-run disaster risk. This framework allows us to derive the expressions for three distinct interest rates: i) interbank rate (LIBOR), ii) risk-free rate (proxied by the OIS rate), and iii) government bill rate (Treasury rate).

Within our model, risk-free lending always pays back the promised amount at the end of its maturity, whereas interbank lending is potentially subject to partial defaults in the event of a disaster. Consequently, their interest rate difference, the so-called LIBOR-OIS spread, is highly informative about disaster risk, directly reflecting the two disaster-related state variables. We also show that the spread between the interbank rate and the Treasury rate, commonly referred to as the TED spread, can serve as a useful indicator of disaster risk. However, its signal may be noisier than the LIBOR-OIS spread due to the complexity arising from the Treasury convenience yield. Following recent studies on safe/liquid assets, we assume that government bills may carry a convenience yield in our model, causing the Treasury rate to be, on average, lower than the risk-free rate.

In addition to the two interest rate spreads, we take advantage of interest rate caps and swaptions. We approach these financial instruments from a new angle. Prior studies simply consider them as option contracts on future benchmark interest rates, often overlooking the aspect that the underlying rates are not default-free. In contrast, we view them as options on future interbank rates: A cap consists of a series of caplets, each of which is a call option on the LIBOR; a swaption provides

[1] In order to describe an extreme and rare economic downturn, the literature defines macroeconomic disasters as a severe drop in real consumption per capita (e.g., Barro (2006), Barro and Ursúa (2008), Gabaix (2012), and Wachter (2013)) or as a significant reduction in total factor productivity (e.g., Gourio (2012)).

[2] In line with this, Chen, Dou, and Kogan (2024) raise concerns about overfitting in-sample data: If a model overfits, its implications become highly sensitive to small perturbations in disaster parameters.

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its holder the right to enter into an interest rate swap that exchanges fixed coupons with floating coupons based on the LIBOR. Naturally, these instruments reflect the possibility of interbank market failure and, hence that of economic disasters. We believe that this is an important distinction because, as witnessed during the 2008 financial crisis, interbank rates can significantly deviate from default-free interest rates.

We estimate the model parameters via maximum likelihood estimation (MLE) using the data from February 2002 to December 2019. As a result, we obtain parameter estimates whose signs and magnitudes are economically sensible. The model-implied time series for interest rates, caps, and swaptions mimic their data counterparts reasonably well. Our results provide additional guidelines that can help discipline the calibration of rare disaster models.

An important advantage of our estimation is that it is possible to extract the short-run and long-run components of latent disaster risk through a filtering approach. Specifically, we adopt the unscented Kalman filter because caps and swaption prices are nonlinear functions of the latent and observable state variables.[3] From a sensitivity analysis, we discover that the short-run component of disaster risk is mainly identified by the LIBOR-OIS spread with a short maturity. In contrast, the long-run component of disaster risk is primarily filtered through caps and swaptions whose payoffs are contingent on future interbank rates over a long horizon. Importantly, the forward-looking information from interest rate options plays a crucial role in estimating the whole dynamics of disaster risk.

Additionally, based on the filtered time series of the short-run and long-run components of disaster risk, we verify the testable implications that disaster risk is associated with conditional moments and returns in the equity market. We find that higher disaster risk is generally linked to lower stock market valuations, in terms of the price-dividend and price-earnings ratios. Intuitively, the short-run component of disaster risk significantly explains implied variance, expected realized variance, and the variance risk premium over the next month, as well as short-maturity out-of-the-money put option prices. The long-run component, however, becomes more relevant for longer-horizon moments. Shocks to disaster risk are also negatively associated with prominent equity return factors, such as market, size, and liquidity, and have stronger negative effects on returns for cyclical industries.

Overall, our results demonstrate that the interbank market can potentially be useful for overcoming the criticisms of rare disaster models, which are typically calibrated to match stock data. Our estimation is independent of equity market moments and, thus, serves as an external/out-of-sample validity test of the models. The estimation results suggest that disaster risk is significant in magnitude and in variation, strongly supporting macro-finance models with the rare disaster mechanism.

Our article relates to several strands of the literature.[4] We contribute to the rare disaster literature by estimating the time-varying risk of economic disasters.

[3]The unscented Kalman filter has been widely used in filtering latent variables from nonlinear financial asset prices. See, for instance, Filipović and Trolle (2013), Christoffersen, Dorion, Jacobs, and Karoui (2014), Park (2016), Doshi, Elkamhi, and Ornthanalai (2018), and Bakshi, Crosby, Gao, and Hansen (2023).

[4]In the Supplementary Material, we provide detailed comparisons with related papers in table format, highlighting our modeling innovations and empirical contributions.

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Granted, we are not the first to attempt to quantify the time-series variation in disaster risk. For example, Berkman, Jacobsen, and Lee (2011) proxy the perceived disaster probability by a crisis severity index, constructed based on the number of international political crises. Manela and Moreira (2017) create a text-based disaster concern measure, called news implied volatility (NVIX), using the words in front-page articles of the *Wall Street Journal*.[5] Rather than proposing another index that potentially correlates with disaster risk, our goal is to directly estimate the risk of consumption disasters under the assumption that consumption disasters are likely to coincide with interbank market failure. A key advantage of our framework is that it is possible to exploit the information contained in interbank rates and their options, which allows us to separately extract the short-run and long-run components of disaster risk.

Our estimation relies on the pricing data on interest rate caps and swaptions. Prior studies, including Longstaff, Santa-Clara, and Schwartz (2001), Han (2007), and Trolle and Schwartz (2009), mainly concentrate on the relative pricing of caps and swaptions. However, the literature has paid little attention to what these financial instruments imply about the aggregate economy or other financial markets. We explore the economic content of caps and swaptions by focusing on the fact that their payoffs are contingent on future interbank rates. We confirm that interbank rate options indeed contain valuable information about the risk of economic disasters.

The findings of this article also potentially relate to the growing literature on the role of financial intermediaries in asset pricing. He and Krishnamurthy (2013) and Brunnermeier and Sannikov (2014) argue that intermediaries, rather than households, act as marginal investors and, therefore, their financial constraints serve as key drivers of market risk premia. Adrian, Etula, and Muir (2014) and He, Kelly, and Manela (2017) empirically support this theory by showing that intermediary-induced factors outperform traditional risk factors in explaining asset returns in various markets. Although our analysis mainly concerns economic disasters, the pricing kernel we adopt has properties that are isomorphic to those of an intermediary-based pricing kernel: When the interbank market is hit by a shock (which is modeled as a shock to disaster risk in our framework), the pricing kernel responds and amplifies risk premia. Our results hint that the disaster-based explanation and the intermediary-based explanation of asset markets might share common microfoundations.

The rest of this article proceeds as follows: Section II describes the model. Section III describes the data as well as explains how we estimate the model and extract time-varying disaster risk. Section IV reports the estimation results and discusses their implications. Section V concludes the article.

[5]Related, Bollerslev and Todorov (2011a), (2011b), (2014) and Andersen, Fusari, and Todorov (2015) estimate and study the risk of rare events in the equity market using an essentially model-free approach based on high-frequency index time series and/or short maturity out-of-the-money index options. Bakshi, Gao, and Xue (2023) define a disaster as an event in which the equity market declines over a certain threshold and estimate its probability using S&P 500 options.

II. Model

A. Risk of Disasters and Interbank Rates

How can we characterize the time-varying risk of economic disasters? In this section, we illustrate how interbank rates can help. Let C_t denote aggregate real consumption, which follows an affine jump diffusion process:

$$\frac{dC_t}{C_{t^-}} = \mu_t dt + \sigma_C dB_{C,t} + \left(e^{Z_{C,t}} - 1\right) dN_t,$$

where $B_{C,t}$ is a standard Brownian motion. The occurrence of consumption disasters is specified by a Poisson process N_t with a negative jump size random variable $Z_{C,t}$: When a consumption disaster occurs ($dN_t = 1$), consumption falls from C_{t^-} to $C_{t^-} e^{Z_{C,t}}$. Given this setup, our main objective is to properly estimate the time series of the intensity process for N_t. We assume that N_t has stochastic intensity λ_t whose dynamics are described by

$$d\lambda_t = \kappa_\lambda(\xi_t - \lambda_t)dt + \sigma_\lambda \sqrt{\lambda_t} dB_{\lambda,t},$$
$$d\xi_t = \kappa_\xi\left(\overline{\xi} - \xi_t\right)dt + \sigma_\xi \sqrt{\xi_t} dB_{\xi,t},$$

where ξ_t is the time-varying mean of λ_t. Simply put, λ_t and ξ_t represent the short-run and long-run components of disaster risk. In the absence of a disaster ($dN_t = 0$), the consumption dynamics simply reduce to a Geometric Brownian motion with time-varying mean μ_t and constant volatility σ_C, where

$$d\mu_t = \kappa_\mu(\overline{\mu} - \mu_t)dt + \sigma_\mu dB_{\mu,t}.$$

That is, the mean consumption growth in normal-times μ_t reverts to its long-run mean $\overline{\mu}$ at the rate of κ_μ, while experiencing random Brownian shocks $dB_{\mu,t}$ with volatility coefficient σ_μ.

We study the time-series evolution of λ_t and ξ_t by linking consumption disasters to the banking sector. As evident in the example of the Great Depression, the collapse of the banking sector is closely related to severe economic downturns. In fact, Reinhart and Rogoff (2013) point out that virtually all consumption disasters documented by Barro and Ursúa (2008) were accompanied by severe systemic banking crises. Motivated by this insight, we assume that consumption disasters are likely to coincide with extremely rare events where the interbank market fails and market participants suffer significant losses.

More formally, let L_t denote the time-t face value of interbank lending. We assume that in the event of a consumption disaster, the interbank market fails with probability $\overline{p}$, which results in a loss to the lenders:

$$L_t = \begin{cases} L_{t^-} e^{Z_{L,t}} & \text{with probability } \bar{p} \text{ if a disaster occurs at time } t, \\ L_{t^-} & \text{otherwise.} \end{cases}$$

That is, the face value, or the expected principal payment from interbank lending, reduces from L_{t^-} to $L_{t^-} e^{Z_{L,t}}$ if the interbank market fails.[6] By defining I_t as a

[6]The reduced-form way in which we model risky interbank lending is reminiscent of fractional-loss-at-default models in the spirit of Duffie and Singleton (1999) and Duffie (2005).

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Bernoulli random variable with success probability $\overline{p}$, we can express the dynamics of L_t as

$$\frac{dL_t}{L_{t^-}} = \left(e^{Z_{L,t}I_t} - 1\right)dN_t. \tag{1}$$

Here, we do not model the behaviors of banks nor the structure of the interbank market, which can potentially generate consumption disasters and interbank market failure in an endogenous fashion. Moreover, we are agnostic about any causal link: whether interbank market failure leads to consumption disasters or vice versa, and through which mechanism they are related. Since our focus is on empirically characterizing time-varying disaster risk, it suffices that these two types of extreme events are likely to coincide with each other.

Under this simple setup, it is intuitive that the spread between the interbank rate and the risk-free rate contains important information about disaster risk. The pricing relation implies that the τ-maturity zero-coupon interbank rate can be derived as

$$y_{i,t}^{(\tau)} = -\frac{1}{\tau}\log \mathbb{E}_t\left[\frac{M_{t+\tau}}{M_t}\cdot\frac{L_{t+\tau}}{L_t}\right], \tag{2}$$

where $\frac{M_{t+\tau}}{M_t}$ represents the nominal pricing kernel whose existence is guaranteed under no arbitrage. While interbank lending contracts are potentially subject to partial defaults, risk-free lending always pays back the promised amount at the end of its maturity. The τ-maturity zero-coupon risk-free rate is calculated as

$$y_{f,t}^{(\tau)} = -\frac{1}{\tau}\log \mathbb{E}_t\left[\frac{M_{t+\tau}}{M_t}\cdot 1\right]. \tag{3}$$

Comparing equations (2) and (3) suggests that changes in disaster risk have a direct effect on the interest rate spread $y_{i,t}^{(\tau)} - y_{f,t}^{(\tau)}$. When disaster risk rises, the expectation of the future payoff $L_{t+\tau}/L_t$ decreases, which pushes the interbank rate upward. However, this effect is missing for the risk-free rate as the future payoff from a default-free bond is, by definition, always 1. As a result, the spread between the two interest rates widens when disaster risk increases.

These equations also suggest that fluctuations in disaster risk or in other potential risk factors can have indirect effects on the interbank rate and the risk-free rate through the pricing kernel. However, if risk factors only impact the pricing kernel but not the future payoff $L_{t+\tau}/L_t$, they will move the interbank rate with the same degree as the risk-free rate, leaving the spread between the two unchanged. As is clear in equation (1), the distribution $L_{t+\tau}/L_t$ only depends on instantaneous disaster risk λ_t and its time-varying mean ξ_t, and this suggests that risk factors that are orthogonal to λ_t and ξ_t will have no impact on the interest rate spread $y_{i,t}^{(\tau)} - y_{f,t}^{(\tau)}$. In Section II.C, we show that this spread indeed depends only on λ_t and ξ_t in our fairly flexible setup, confirming this intuition.

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B. Nominal Pricing Kernel

Equations (2) and (3) make it clear that we need a nominal pricing kernel $M_{t+\tau}/M_t$ to derive the expressions for zero-coupon yields. Rather than deriving it from investors' preferences as in typical equilibrium models, we take a reduced-form approach and directly specify the nominal pricing kernel. To this end, we first establish the state variables in the economy. In addition to real consumption (C_t), mean consumption growth (μ_t), and the short-run/long-run components of disaster risk (λ_t, ξ_t), we take one more variable that is typically used to capture the state of the nominal economy: expected inflation. This is particularly relevant, as we examine the term structure of nominal interest rates. In our model, the expected inflation process q_t solves the following stochastic differential equation:

$$dq_t = \kappa_q(\overline{q} - q_t)dt + \sigma_q dB_{q,t} + Z_{q,t}dN_t,$$

where $B_{q,t}$ is another standard Brownian motion. Motivated by Tsai (2015), we assume that q_t is also subject to the same Poisson process N_t and that the jump size random variable $Z_{q,t}$ is, on average, positive.[7]

We specify our pricing kernel in a general form so that it can be directly estimated using data. We assume that Brownian shocks ($dB_{C,t}$, $dB_{\mu,t}$, $dB_{\lambda,t}$, $dB_{\xi,t}$, $dB_{q,t}$) are independent of one another and of a Poisson shock (dN_t). These six independent shocks to the five state variables (C_t, μ_t, λ_t, ξ_t, q_t) are priced and hence constitute the nominal pricing kernel:

$$\begin{aligned}(4)\qquad \frac{dM_t}{M_{t^-}} = &-r_t dt - \theta_C dB_{C,t} - \theta_\mu dB_{\mu,t} - \theta_\lambda\sqrt{\lambda_t}dB_{\lambda,t} - \theta_\xi\sqrt{\xi_t}dB_{\xi,t} - \theta_q dB_{q,t}\\ &+\left(e^{\theta_N Z_{C,t}} - 1\right)dN_t - \lambda_t\mathbb{E}\left[e^{\theta_N Z_{C,t}} - 1\right]dt,\end{aligned}$$

where $\left(\theta_C, \theta_\mu, \theta_\lambda, \theta_\xi, \theta_q, \theta_N\right)$ indicate the market prices of risk and r_t represents the instantaneous nominal risk-free rate.[8] To preserve the affine structure of our setup, we represent the short rate r_t as a linear function of the state variables, similar to Ang and Piazzesi (2003) and Joslin, Le, and Singleton (2013):

$$(5)\qquad r_t = \delta_0 + \delta_\lambda\lambda_t + \delta_\xi\xi_t + \delta_\mu\mu_t + \delta_q q_t.$$

The pricing kernel fully characterizes the risk-neutral measure, as the Radon–Nikodym derivative process of the risk-neutral measure with respect to the physical

[7]Since jumps in consumption and expected inflation always occur together through N_t, our model cannot generate inflation spikes that are not accompanied by disasters. In fact, Tsai (2015) adopts an additional Poisson process to capture such independent inflation spikes. Given our focus on studying disaster risk, we choose a more parsimonious setup and abstract away from this additional feature.

[8]The jump term $\left(e^{\theta_N Z_{C,t}} - 1\right)dN_t$ in the pricing kernel captures the idea that there is a very high marginal utility state, which we call a disaster. A common econometric challenge in the disaster literature is that it is very difficult to separately identify the market price of risk θ_N and the size distribution of disasters $Z_{C,t}$, as we do not observe any disaster realizations in the post-war sample. In our estimation, we set $Z_{C,t}$ to the empirical distribution of real consumption disasters compiled by Barro and Ursúa (2008). This not only helps identify θ_N but also allows us to interpret the estimated intensity of the Poisson process N_t as the probability/frequency of consumption disasters.

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measure equals $M_t \int_0^t r_s ds$. In Appendix A.1, we derive the risk-neutral dynamics of the underlying processes using Girsanov's theorem.

Based on the pricing kernel specified in equation (4), we finally calculate the expressions for $y_{i,t}^{(\tau)}$ and $y_{f,t}^{(\tau)}$ in equations (2) and (3). We show that both interbank rates and Treasury rates are linear in state variables λ_t, ξ_t, μ_t, and q_t:

$$y_{i,t}^{(\tau)} = -\frac{1}{\tau}\left[a_i(\tau) + b_{i,\lambda}(\tau)\lambda_t + b_{i,\xi}(\tau)\xi_t + b_\mu(\tau)\mu_t + b_q(\tau)q_t\right], \tag{6}$$

$$y_{f,t}^{(\tau)} = -\frac{1}{\tau}\left[a_f(\tau) + b_{f,\lambda}(\tau)\lambda_t + b_{f,\xi}(\tau)\xi_t + b_\mu(\tau)\mu_t + b_q(\tau)q_t\right], \tag{7}$$

where deterministic functions a_i, a_f, $b_{i,\lambda}$, $b_{f,\lambda}$, $b_{i,\xi}$, $b_{f,\xi}$, b_μ and b_q solve the ordinary differential equations in Appendix A.2.

C. Interest Rate Spreads

One important aspect when comparing equations (6) and (7) is that the loadings on mean consumption growth μ_t and expected inflation q_t are identical for both types of interest rates. Therefore, for a given maturity τ, the difference between $y_{i,t}^{(\tau)}$ and $y_{f,t}^{(\tau)}$ becomes a function of disaster risk (λ_t, ξ_t) alone, consistent with the intuition developed in Section II.A. In our analysis, the data counterparts of the interbank rate and the risk-free rate are the London interbank offered rate (LIBOR) and the overnight index swap (OIS) rate, respectively, after being adjusted for compounding frequencies.[9] Thus, we can see that the spread between the (continuously compounded) LIBOR and OIS rate, the so-called LIBOR-OIS spread, can be expressed by

$$\mathrm{LOIS}_t^{(\tau)} = -\frac{1}{\tau}\left[\left(a_i(\tau) - a_f(\tau)\right) + \left(b_{i,\lambda}(\tau) - b_{f,\lambda}(\tau)\right)\lambda_t + \left(b_{i,\xi}(\tau) - b_{f,\xi}(\tau)\right)\xi_t\right].$$

Our view that the LIBOR-OIS spread directly reflects disaster risk is novel, but not inconsistent with the existing view on the source of interbank risk. Prior studies typically decompose interbank risk (and hence the LIBOR-OIS spread) into a liquidity component and a pure credit component.[10] We do not make such a distinction; we study the possibility of extreme tail events implied by the total risk of the interbank market, regardless of where it originates from. Modeling these

[9] Rigorously speaking, the OIS rates are not risk free, as they are derived from overnight index swaps based on the effective federal funds rate. Given that this is the rate at which banks borrow/lend their reserves on an uncollateralized basis, the OIS rates can essentially be seen as a "continually-refreshed" overnight interbank rate (Hull and White (2015)). Despite this, the OIS rates are widely used as a primary proxy for risk-free interest rates, especially in derivative markets. While the federal funds seller faces overnight credit risk, this is often considered very small, though not negligible, given the short maturity (and the fact that the buyer is another bank). Another contributing factor is that the effective federal funds rate is directly influenced by the Federal Reserve and has not deviated significantly from the target range since the 2000s.

[10] See, for example, Michaud and Upper (2008), Taylor and Williams (2009), Acharya and Skeie (2011), Filipović and Trolle (2013), and McAndrews, Sarkar, and Wang (2017).

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market phenomena separately is beyond the scope of our article. Instead, we simply capture the risk of such an economic downturn using disaster risk.

We also note that the fluctuations in the LIBOR-OIS spread are purely systematic in our framework, as they are driven by the risk of economic disasters. One might argue that this spread can also be influenced by bank-specific shocks. Granted, the LIBOR is calculated empirically using input data from only about a dozen contributing banks. However, they are large and systemically important banks; significant shocks to these banks cannot be purely idiosyncratic, considering their critical roles in the intricately intertwined banking system.

It is worth highlighting that we do not assume the yield on Treasury securities (simply, Treasury rate) to be our benchmark interest rate for riskless discounting; we choose the OIS rate instead, which is a conventional market proxy for the risk-free interest rate. The recent literature has documented that Treasury securities carry a convenience yield, derived from their special role as safe/liquid assets (e.g., Krishnamurthy and Vissing-Jorgensen (2012)). This implies that the Treasury rate can go even below the true risk-free rate. Consistently, we define the τ-maturity Treasury rate $y_{g,t}^{(\tau)}$ as

$$y_{g,t}^{(\tau)} = y_{f,t}^{(\tau)} - y_{x,t}^{(\tau)},$$

where $y_{x,t}^{(\tau)}$ represents the Treasury convenience yield, typically proxied by the OIS-Treasury spread.

In fact, the OIS-Treasury spread is on average positive in the data, supporting the presence of a convenience yield from holding Treasury securities. Nevertheless, the data reveal that this spread occasionally turns negative, most notably during the COVID-19 crisis (e.g., He, Nagel, and Song (2022)). To capture these properties in reduced form, we assume that the Treasury convenience yield is driven by an instantaneous convenience rate x_t, which follows a mean-reverting Gaussian process:

$$dx_t = \kappa_x(\bar{x} - x_t)dt + \sigma_x dB_{x,t}.$$

The standard Brownian motion $B_{x,t}$ is assumed to be independent of other Brownian and Poisson shocks. Under this setup, the τ-maturity convenience yield $y_{x,t}^{(\tau)}$ is derived as

$$y_{x,t}^{(\tau)} = \frac{1}{\tau}\log \mathbb{E}_t\left[e^{\int_t^{t+\tau} x_u du}\right] = -\frac{1}{\tau}[a_x(\tau) + b_x(\tau)x_t], \tag{8}$$

where the expressions for the deterministic functions a_x and b_x are provided in Appendix A.2.

With the Treasury convenience, the spread between the LIBOR and the Treasury rate, the so-called TED spread, becomes a function of (λ_t, ξ_t) as well as x_t:

$$\begin{aligned}\text{TED}_t^{(\tau)} = -\frac{1}{\tau}\Big[&\big(a_i(\tau) - a_f(\tau) + a_x(\tau)\big) + \big(b_{i,\lambda}(\tau) - b_{f,\lambda}(\tau)\big)\lambda_t \\ &+ \big(b_{i,\xi}(\tau) - b_{f,\xi}(\tau)\big)\xi_t + b_x(\tau)x_t\Big].\end{aligned}$$

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This suggests that while the TED spread is still a meaningful indicator of disaster risk, its signal is relatively less clear than the LIBOR-OIS spread due to the added complexity introduced by the convenience factor x_t.

D. Options on Interbank Rates

In this section, we introduce derivative contracts called caps and swaptions whose payoffs depend on future interbank rates. When discussing their payoffs and pricing, it is convenient to introduce the following notation:

$$P_i(t,t+\tau)=\exp\left[-\tau\cdot y_{i,t}^{(\tau)}\right].$$

In other words, $P_i(t,t+\tau)$ represents the time-t value of \$1 zero-coupon interbank lending maturing at time $t+\tau$. Additionally, we need the expression for the LIBOR in the model. Recall that the LIBOR is a simple interest rate and, therefore, is not exactly the same as the continuously compounded rate $y_{i,t}^{(\tau)}$. We can convert between the two interest rates using the following relation:

$$y_{i,t}^{(\tau)}=\frac{1}{\tau}\log\left[1+\tau\text{LIBOR}_t^{(\tau)}\right],\text{or equivalently, LIBOR}_t^{(\tau)}=\frac{1}{\tau}\left[\exp\left(\tau\cdot y_{i,t}^{(\tau)}\right)-1\right].$$

An interest rate cap consists of a series of caplets that mature every 6 months.[11] Specifically, the first caplet matures 6 months from today, and the last caplet matures 6 months prior to the cap maturity date. Let T denote the time to maturity of a cap from today (time t), and K denote its strike interest rate. For notational convenience, we define $\Delta=0.5$ and $t_j=t+\Delta j$.

The jth caplet provides the holder of the cap with the right, not the obligation, to borrow a dollar at the rate of K between times t_j and t_{j+1}. If the future 6-month LIBOR at time t_j is higher than the strike K, this caplet is exercised, and the holder borrows a dollar at the lower-than-the-fair interest rate. That is, the payoff from exercising the caplet is $\Delta\times\left(\text{LIBOR}_{t_j}^{(0.5)}-K\right)$. This payoff occurs at time t_{j+1} because the interest payment is made at the end of the borrowing period.

Since the cap is a collection of a $m_T=\left(\frac{T}{\Delta}-1\right)$ number of caplets, the time-t cap value is calculated as

$$V_{\text{cap}}^{(T)}(t,K)=\sum_{j=1}^{m_T}\mathbb{E}_t^Q\left[\exp\left(-\int_t^{t_{j+1}}r_s ds\right)\left[\Delta\times\left(\text{LIBOR}_{t_j}^{(0.5)}-K\right)\right]^+\right], \tag{9}$$

where Q represents the risk-neutral measure (see Appendix A.1). In Appendix A.3, we demonstrate that equation (9) can be computed using the transform analysis of Duffie, Pan, and Singleton (2000).

An interest rate swaption grants the holder the right to enter into an interest rate swap (IRS). There are two types of swaptions. When exercised, a payer swaption

[11]More precisely, a conventional cap contract traded in the market is a collection of caplets that mature every 3 months. As documented by Longstaff et al. (2001), assuming semi-annually spaced caplets for computational convenience is innocuous, generating a negligible difference when it comes to Black-implied volatilities.

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delivers an IRS where the holder pays the fixed leg and receives the LIBOR-based floating leg (a payer IRS); a receiver swaption delivers an IRS where the holder receives the fixed leg and pays the LIBOR-based floating leg (a receiver IRS). We now define T as the time to maturity of payer and receiver swaptions. Let K denote their strike interest rate. The tenor of the IRS at the maturity of the swaptions is denoted as $\overline{T}$. Under this notation, our swaptions of interest are often referred to as T-into-$\overline{T}$ swaptions.

The payer swaption is exercised if the future $\overline{T}$-maturity swap rate at time $t+T$ is larger than the strike K. In this case, the holder enters into a payer IRS contract and makes a profit by exchanging the fixed rate K (which is lower than the fair swap rate) for the floating rate. The pricing relation implies that the time-t payer swaption value is calculated by

$$(10)\quad V_{\text{payer}}^{(T,\overline{T})}(t,K)=\mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[V_{\text{floating}}^{(\overline{T})}(t+T,K)-V_{\text{fixed}}^{(\overline{T})}(t+T,K)\right]^+\right],$$

where the value of the payer IRS delivered at option expiry, if exercised, is simply the difference between its floating leg $V_{\text{floating}}^{(\overline{T})}(t+T,K)$ and its fixed leg $V_{\text{fixed}}^{(\overline{T})}(t+T,K)$. Similarly, the receiver swaption is exercised if the future $\overline{T}$-maturity swap rate at time $t+T$ is smaller than the strike K. The time-t receiver swaption value is expressed as

$$(11)\quad V_{\text{receiver}}^{(T,\overline{T})}(t,K)=\mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[V_{\text{fixed}}^{(\overline{T})}(t+T,K)-V_{\text{floating}}^{(\overline{T})}(t+T,K)\right]^+\right].$$

Traditionally, the industry norm was to calculate both the floating and fixed legs of an IRS based on LIBOR-swap discounting. However, the global financial crisis cast doubt on the validity of LIBOR-swap discounting. Going through the Lehman failure and the subsequent credit crunch that led to a sharp rise in LIBOR, the market migrated to OIS discounting, which is now the new norm for derivative pricing (Hull and White (2015)). While our sample period includes both pre-crisis and post-crisis periods, we believe that OIS discounting is theoretically more suitable, especially given that most derivative trades require margins and are heavily collateralized.

However, when it comes to tractability, there is a significant benefit of using LIBOR-swap discounting: It always puts the floating leg at par because the floating coupons and their discount rates are both based on future LIBOR rates. As a result, the IRS pricing reduces to computing the fixed leg $V_{\text{fixed}}^{(\overline{T})}(t+T,K)$, which is equivalent to the value of a coupon bond with the (annualized) coupon rate of K:

$$(12)\quad V_{\text{fixed}}^{(\overline{T})}(t+T,K)=\Delta\left[K\sum_{j=1}^{\overline{T}/\Delta}P_i(t+T,t+T+j\Delta)\right]+P_i\left(t+T,t+T+\overline{T}\right).$$

For analytical tractability, we opt for the simplifying assumption that the future IRS contract, delivered at option expiry, is valued using LIBOR-swap

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discounting.[12] Then, equation (12) suggests that interest rate swaptions can essentially be viewed as options on a coupon bond. Due to coupon payments, the expression for the coupon bond price contains multiple terms, which makes it impossible to calculate the expectations in equations (10) and (11) using the semi-analytic approach of Duffie et al. (2000). We adopt the stochastic duration method implemented by Trolle and Schwartz (2009), which enables us to accurately approximate the price of a coupon bond option by a constant multiplication of the price of a zero-coupon bond option (see, e.g., Wei (1997), Munk (1999)). We provide a detailed description of the swaption pricing procedure in Appendix A.3.

III. Estimation

A. Data

Our data sample consist of the following variables: interbank rates, OIS rates, Treasury rates, Black-implied volatilities for caps and swaptions, expected inflation, and real consumption per capita. All variables are sampled at the monthly frequency at the end of each month, from February 2002 to December 2019.

Interbank rates consist of 3-, 6-, and 12-month LIBOR rates as well as 2-, 3-, and 5-year swap rates, all of which are downloaded from Bloomberg.[13] We also collect OIS rates from Bloomberg and Treasury rates from FRED for the same maturities. To make the data comparable with the model-implied interest rates, we need to convert the three types of interest rate term structures into continuously compounded zero curves. To do so, we use linear interpolation to construct par curves with maturities ranging from 6 months to 5 years with 6-month intervals. From these interpolated par curves, we extract smooth forward rate curves and, in turn, zero-coupon yield curves via the Nelson and Siegel (1987) parameterization. Summary statistics for these interest rates are reported in Panels A, B, and C of Table 1.

Note that our analysis relies on interest rates with maturities of up to 5 years, despite their availability of up to 30 years. This is our intentional choice, as long-term interest rates are potentially subject to some frictions that are beyond our model. In particular, since the 2008 financial crisis, the 30-year swap rate has maintained a lower level than the 30-year Treasury rate, which poses a puzzle. This phenomenon is not just seen in the 30-year maturity: We frequently observe a negative swap spread for any long-term maturity between 5 years and 30 years. Klingler and Sundaresan (2019) argue that negative swap spreads reflect underfunded pension plans' increased demand for duration hedging with long-term swaps. Even without such explicit demand effects, Jermann (2020) shows that negative swap spreads can be justified via limits to arbitrage associated with frictions for

[12]Under OIS discounting, the floating leg of a LIBOR-based IRS is no longer at par and is worth more than 1. Consequently, $V^{(\overline{\tau})}_{\text{floating}}(t+T,K)$ remains in the swaption pricing formula. This term makes it virtually impossible to obtain a semi-analytical solution. Handling the fixed leg $V^{(\overline{\tau})}_{\text{fixed}}(t+T,K)$ alone already requires an approximation called the stochastic duration method due to numerous coupon terms; adding floating coupons further complicates the pricing formula to an extreme level.

[13]On Mar. 5, 2021, the ICE Benchmark Administration Limited announced the complete discontinuation of the publication of USD LIBOR effective Jun. 30, 2023. The crucial role of USD LIBOR as a benchmark interest rate will be largely taken over by the secured overnight financing rate (SOFR). See Jermann (2019), (2024) and Klingler and Syrstad (2021) for further discussion about the transition from USD LIBOR to SOFR.

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TABLE 1

Summary Statistics

Table 1 reports the mean, standard deviation, minimum, median, maximum, and first-order autoregressive coefficient (AR1) of continuously compounded zero-coupon Treasury rates (Panel A), OIS rates (Panel B), and interbank rates (Panel C), as well as cap and swaption implied volatilities (Panels D and E). All values are expressed in percentage terms, except for the AR1, which is unitless.

	Mean	Std. Dev	Min	Median	Max	AR1
Panel A. Treasury Rate						
3M	1.32	1.51	0.00	0.95	5.13	0.993
6M	1.43	1.53	0.03	1.01	5.17	0.994
1Y	1.55	1.48	0.11	1.23	5.14	0.993
2Y	1.74	1.40	0.15	1.37	5.09	0.988
3Y	2.00	1.31	0.32	1.61	5.06	0.984
5Y	2.44	1.20	0.57	2.21	5.03	0.976
Panel B. OIS Rate						
3M	1.45	1.59	0.08	1.00	5.35	0.995
6M	1.48	1.59	0.08	1.04	5.41	0.995
1Y	1.59	1.58	0.10	1.17	5.50	0.993
2Y	1.80	1.53	0.12	1.35	5.45	0.989
3Y	2.07	1.47	0.23	1.61	5.44	0.986
5Y	2.49	1.40	0.48	2.17	5.47	0.981
Panel C. Interbank Rate						
3M	1.71	1.60	0.22	1.18	5.58	0.992
6M	1.85	1.54	0.32	1.34	5.51	0.993
1Y	2.07	1.42	0.54	1.64	5.56	0.991
2Y	2.10	1.46	0.39	1.66	5.55	0.988
3Y	2.31	1.44	0.44	1.89	5.55	0.985
5Y	2.76	1.34	0.75	2.56	5.56	0.979
Panel D. Cap IV						
2Y	49.65	25.10	12.18	50.52	102.70	0.969
3Y	46.41	21.56	13.43	46.30	93.22	0.964
4Y	43.43	18.63	13.99	43.03	82.59	0.958
5Y	40.26	15.97	14.26	39.80	77.47	0.954
Panel E. Swaption IV						
1-into-4	36.57	12.88	13.20	37.20	75.22	0.924
2-into-3	34.88	12.01	14.10	34.09	70.75	0.932
3-into-2	33.47	11.67	14.55	32.28	67.86	0.936
4-into-1	32.16	11.35	14.60	30.50	69.33	0.931

holding long-term Treasuries. Rather than incorporating extra frictions into our model, we keep our model simple and focus on short- and mid-term interest rates.

We download the pricing data on caps and swaptions from Bloomberg.[14] Caps and swaptions are typically quoted in terms of Black-implied volatilities. For each market price, the corresponding Black-implied volatility is found by backsolving the volatility term in the Black (1976) model. Caps and swaptions in our sample are at-the-money forward (ATMF), meaning that the strike price of each option is equal to the current forward price of the underlying. Specifically, the strike price of a T-maturity ATMF cap is the T-maturity swap rate. The strike price of a T-into-$\overline{T}$ ATMF swaption is the forward swap rate between the option expiry (T years from today) and the underlying swap expiry ($T + \overline{T}$ years from today). Panels D and E of Table 1 present summary statistics for cap and swaption implied volatilities.

The data on expected inflation are from the Blue Chip Economic Indicators survey. This data set provides the forecasts of inflation for the current calendar year and the next calendar year. For each month, we calculate a proxy for the

[14]There are multiple sources for caps and swaptions data on Bloomberg. We mainly use the sources "CMPN" for caps and "BBIR" for swaptions, which provide the Black-implied volatilities calculated based on LIBOR-swap discounting.

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1-year-ahead expected inflation by calculating the weighted average between the two forecasts. Lastly, the monthly time series of real consumption per capita is downloaded from FRED.

B. Unscented Kalman Filter and Maximum Likelihood Estimation

From the data described in Section III.A, we filter the time series of the latent processes $(\lambda_t, \xi_t, \mu_t, x_t)$ using the unscented Kalman filter and estimate the model parameters via maximum likelihood estimation (MLE). In this section, we detail our model estimation procedure.

Estimating our model is computationally challenging. In each iteration of the MLE procedure, we need to evaluate the log-likelihood function. Due to cap/swaption pricing, this requires numerically solving the system of complex-valued ordinary differential equations of Duffie et al. (2000) several times. Furthermore, we have a large number of parameters to be estimated. Evidently, estimating all of these parameters all at once in a single MLE is highly time-consuming.

To alleviate the computational burden, we first separately estimate the parameters κ_q, $\overline{q}$, and σ_q, which govern the normal-time dynamics of expected inflation. This is possible because a consumption disaster is absent during our sample period, implying that the observed time series of expected inflation was completely driven by these three parameters. Specifically, κ_q, $\overline{q}$, and σ_q are estimated by maximizing the log-likelihood of the expected inflation time series, conditional on no disasters. We also set $\overline{\mu}$ to be 1.05%, which is the average real consumption growth during our sample period.

We further reduce the dimension of our parameter space by putting a restriction on the value of δ_0. Taking expectations on both sides of equation (5) results in

$$\mathbb{E}[r] = \delta_0 + \delta_\lambda \mathbb{E}[\lambda] + \delta_\xi \mathbb{E}[\xi] + \delta_\mu \mathbb{E}[\mu] + \delta_q \mathbb{E}[q].$$

Here, we proxy the unconditional mean of the short rate ($\mathbb{E}[r]$) by the average 1-week OIS rate ($\widehat{\mathbb{E}}[r]$) from Bloomberg. Then, the value of δ_0 is given by

$$\delta_0 = \widehat{\mathbb{E}}[r] - \delta_\lambda \overline{\xi} - \delta_\xi \overline{\xi} - \delta_\mu \overline{\mu} - \delta_q \widehat{\mathbb{E}}[q],$$

where $\widehat{\mathbb{E}}[q]$ is the average expected inflation during our sample period.

Moreover, we set $\overline{\xi}$ to be 2.86%, which is the average probability of consumption disasters across OECD countries, according to Barro and Ursúa (2008). We also construct the empirical distributions of $Z_{C,t}$ and $Z_{q,t}$ by compiling consumption declines and inflation rates during historical consumption disasters from the Barro-Ursúa data set.[15] Lastly, we assume $Z_{L,t} = Z_{C,t}$: The more severe the interbank market failure, the more severe the consumption disaster.[16]

[15] The Barro-Ursua data set contains a few extreme hyperinflation events, such as the hyperinflation of Weimar Germany in the 1920s, when the inflation rate exceeded 3,000%. Given that the number of historical consumption disasters is only 89, such extreme outliers completely dominate the moment-generating function of $Z_{q,t}$. Thus, we exclude the observations that fall more than 3 times the interquartile range above the third quartile. No observations fall more than 3 times the interquartile range below the first quartile.

[16] We can relax this assumption by setting $Z_{L,t} = kZ_{C,t}$ and estimating k directly. However, in this case, the coefficient k is not well identified separately from $\overline{p}$; an increase (decrease) in k can be compensated by a decrease (increase) in $\overline{p}$ or vice versa.

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As a result, we are left with 20 parameters to be estimated within the main MLE procedure:

$$\Theta = \left[\kappa_\mu, \sigma_\mu, \sigma_C, \kappa_\xi, \sigma_\xi, \kappa_\lambda, \sigma_\lambda, \kappa_x, \sigma_x, \overline{x}, \overline{p}, \delta_\lambda, \delta_\xi, \delta_\mu, \delta_q, \theta_\lambda, \theta_\xi, \theta_\mu, \theta_q, \theta_N\right],$$

besides three extra parameters concerning measurement errors (described below). We derive the likelihood function $\mathcal{L}$ under the assumption that we observe the following: i) LIBOR-OIS spreads and TED spreads with 3-, 6-, 12-month maturities, ii) interbank rates, OIS rates, and Treasury rates with 3-, 6-, 12-month, 2-, 3-, 5-year maturities, iii) 2-, 3-, 4-, 5-year cap implied volatilities, iv) 1-into-4, 2-into-3, 3-into-2, 4-into-1 swaption implied volatilities, and v) real consumption growth. For notational simplicity, we let Y_t denote the vector of all these observations at time t.

To construct the likelihood function $\mathcal{L}$, it suffices to derive the transition density of Y_t. Specifically, we define $\mathcal{L}_t$ as the likelihood of observing Y_t conditional on $Y_{t-\Delta t}$:

$$\mathcal{L}_t = \mathbb{P}(Y_t | Y_{t-\Delta t}; \Theta),$$

where $\Delta t = 1/12$ represents monthly time intervals between observations. Not only does this transition density depend on the observable state variable q_t, but it also relies on the four latent variables λ_t, ξ_t, μ_t, and x_t.

In order to solve this filtering problem, we specify the state equation and the measurement equation in the state-space representation of our model. The state equation describes the dynamics of a latent state vector $S_t = [\lambda_t, \xi_t, \mu_t, x_t]^\top$. There are two ways to map the continuous-time dynamics of S_t into the discrete-time state equation. The first approach applies the Euler discretization to λ_t, ξ_t, μ_t, and x_t and then finds the discrete-time relation between S_t and $S_{t-\Delta t}$. In contrast, the second approach finds the exact relation between S_t and $S_{t-\Delta t}$ without any approximation and then discretizes the resulting relation. We adopt the latter approach following Chen and Scott (2003), as it better captures the square-root diffusions of the first two latent processes. Consequently, we arrive at the following linear state equation:

$$S_t = \eta + \Psi S_{t-\Delta t} + \varepsilon_t, \quad \text{where } \mathbb{E}_{t-\Delta t}\left[\varepsilon_t \varepsilon_t^\top\right] = \Omega_{t-\Delta t}. \tag{13}$$

We provide the expressions for a four-dimensional vector η, 4×4 matrix Ψ, and 4×4 time-varying covariance matrix Ω in the Supplementary Material. Since ε_t is non-normal, we approximate it by a normal distribution with the same covariance matrix. Prior studies document that this approximation is innocuous.[17]

Now, we turn to the measurement equation. We assume that Y_t is observed with a vector of measurement errors e_t:

$$Y_t = h(S_t, q_t) + e_t, \quad \text{where } \mathbb{E}_{t-\Delta t}\left[e_t e_t^\top\right] = Q.$$

Note that h is a vector-valued function of the state variables, which generates the model counterparts of the data. The mean-zero random vector e_t is normally

[17] See, for example, Duan and Simonato (1999), Duffee (1999), Chen and Scott (2003), Trolle and Schwartz (2009), and Filipović and Trolle (2013).

distributed with covariance matrix Q. For parsimony, all measurement errors are assumed to be independent of one another, making the off-diagonal entries of Q zero. As for the diagonal entries, we assume that the standard deviations of the measurement errors are identical for the interest rate spreads (σ_{SP}), for the interest rates (σ_{ITR}), and for the Black-implied volatilities (σ_{OPT}). The measurement equation clearly suggests that the linear Kalman filter cannot be used in our estimation. This is because h is not a linear function: Cap/swaption prices as well as their Black-implied volatilities are nonlinear in the state variables. Therefore, we apply the unscented Kalman filter, proposed by Wan and Van Der Merwe (2000). The Supplementary Material provides a detailed description of how the unscented Kalman filter is implemented under our setup.

In each iteration of the MLE procedure, we obtain not only the time series of the estimated latent variables $\left\{\widehat{\lambda}_t, \widehat{\xi}_t, \widehat{\mu}_t, \widehat{x}_t\right\}$ but also the time series of the transition densities $\{\mathcal{L}_t\}$. Let $\{t_k\}_{k=1}^n$ denote monthly-spaced points in time when the data time series are observed. Then, the log-likelihood function for the entire observations can finally be expressed as

$$\log \mathcal{L} = \sum_{k=1}^{n} \log \mathcal{L}_{t_k}.$$

We determine the parameter estimates by maximizing this log-likelihood function.

IV. Estimation Results and Implications

A. Parameter Estimates

Table 2 reports the values of our parameter estimates, along with their robust standard errors in parentheses. First of all, the estimated dynamics of consumption growth and expected inflation are economically sensible. During normal periods without disasters, consumption growth has a long-run mean ($\overline{\mu}$) of 1.05% and a standard deviation (σ_C) of 0.81%, broadly consistent with the first two moments of the observed consumption time series in our sample. The process of mean consumption growth μ_t is not only persistent with $\kappa_\mu = 0.7343$ but also quite volatile with $\sigma_\mu = 0.37\%$. The parameter values for expected inflation are also in line with its data time series: The long-run mean ($\overline{q}$) is 2.12%, the conditional volatility (σ_q) is 0.65%, and the monthly autocorrelation ($e^{-\kappa_q \Delta t}$) is 0.96.[18]

Our main focus is on the model parameters that are associated with the dynamics of disaster risk. In our model, disaster risk has a two-factor structure with λ_t and ξ_t. While both processes are estimated to be highly persistent with low mean reversion speed ($\kappa_\lambda = 0.4373$ and $\kappa_\xi = 0.0446$), λ_t is relatively less persistent than ξ_t. This is intuitive because λ_t captures the short-run component of disaster risk, whereas ξ_t captures the long-run component. Consistent with this interpretation, λ_t

[18]While expected inflation plays a crucial role in capturing the level of interest rates in our model, its omission is not impossible given that our model is reduced-form. In the Supplementary Material, we consider a nested case of our model without expected inflation and show that it is rejected based on a likelihood ratio test.

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TABLE 2

Parameter Estimates

Table 2 reports the values of the model parameters estimated through the unscented Kalman filter/MLE procedure. The model consists of the following five state variables: real consumption (C_t), mean consumption growth (μ_t), expected inflation (q_t), instantaneous disaster intensity (λ_t), and the long-run mean of disaster intensity (ξ_t). We also report the dynamics of the instantaneous Treasury convenience rate (x_t), the factor loadings on the short rate, the market prices of risk, and the standard deviations of measurement errors. Reported together in parentheses are robust standard errors.

Consumption growth		κ_μ	σ_μ	σ_C	$\overline{\mu}$	
	Est.	0.7343	0.0037	0.0081	0.0105	
	(SE)	(0.0152)	(0.0002)	(0.0005)		
Expected inflation		κ_q	σ_q	$\overline{q}$		
	Est.	0.5239	0.0065	0.0212		
	(SE)	(0.3153)	(0.0011)	(0.0028)		
Disaster risk		κ_ξ	σ_ξ	$\overline{\xi}$		
	Est.	0.0446	0.0204	0.0286		
	(SE)	(0.0071)	(0.0002)			
		κ_λ	σ_λ	$\overline{p}$		
	Est.	0.4373	0.1560	0.9035		
	(SE)	(0.0130)	(0.0039)	(0.0295)		
Convenience yield		κ_X	σ_X	$\overline{x}$		
	Est.	0.8162	0.0017	0.0021		
	(SE)	(0.1915)	(0.0003)	(0.0004)		
Short rate		δ_λ	δ_ξ	δ_q	δ_μ	δ_0
	Est.	−0.1443	−2.1572	0.4594	2.1835	0.0476
	(SE)	(0.0026)	(0.1160)	(0.0251)	(0.0356)	
Market price of risk		θ_λ	θ_ξ	θ_q	θ_μ	θ_N
	Est.	−0.1355	−0.6377	−3.6234	0.2696	−0.1075
	(SE)	(0.0031)	(0.0589)	(0.0870)	(0.0139)	(0.0061)
Measurement errors		σ_{SP}	σ_{ITR}	σ_{OPT}		
	Est.	0.0014	0.0020	0.0742		
	(SE)	(0.0001)	(0.0001)	(0.0032)		

exhibits a higher conditional volatility than ξ_t (i.e., $\sigma_\lambda > \sigma_\xi$). In Section IV.C, we further characterize the time variation in disaster risk by examining the filtered time series of λ_t and ξ_t. The conditional probability of interbank market failure given the occurrence of a disaster ($\overline{p}$) is estimated as 0.9035, suggesting that the two types of extreme events are indeed likely to coincide.

We also report the estimated dynamics of the instantaneous convenience rate x_t. Relative to λ_t and ξ_t, the process for x_t is much less persistent with $\kappa_x = 0.8162$, which corresponds to a monthly autocorrelation of 0.93. The long-run mean ($\overline{x}$) is 0.21%, and the conditional volatility (σ_x) is 0.17%. Given that the average 3-month Treasury rate is only about 1.32% over our sample period, the relative magnitude of the Treasury convenience yield is not small.

The estimated coefficients δ_λ, δ_ξ, δ_q, and δ_μ in Table 2 show how the four state variables λ_t, ξ_t, q_t, and μ_t affect the nominal short rate in our estimated model. We first observe that the factor loading on expected inflation is positive. This conforms to the economic intuition that expected inflation rises with nominal interest rates. While expected inflation is an important factor, empirical evidence suggests that a significant portion of the variation in the nominal short rate is still attributable to the variation in the real short rate (Haubrich, Pennacchi, and Ritchken (2012)). The table reports that the factor loading is positive for μ_t but negative for λ_t and ξ_t. This is in accordance with the precautionary savings motive. Investors are inclined to save more to secure against future uncertainty when mean consumption growth declines or disaster risk rises, driving down real interest rates.

Additionally reported are the market prices of risk. The coefficients θ_λ, θ_ξ, and θ_q are negative, as investors dislike both horizons of disaster risk and inflation risk:

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Investors' marginal utility, or equivalently, the pricing kernel in equation (4), rises when positive realizations of $dB_{\lambda,t}$, $dB_{\xi,t}$, and $dB_{q,t}$ raise λ_t, ξ_t, and q_t, respectively. Similarly, Poisson shocks are also priced negatively with $\theta_N < 0$. Since $e^{\theta_N Z_{C,t}}$ is larger than 1, the pricing kernel jumps up when a disaster occurs ($dN_t = 1$). In contrast, the coefficient θ_μ is positive, as $dB_{\mu,t}$ is a good economic shock that increases consumption growth. All in all, we conclude that the signs and magnitudes of the model parameters from our estimation align well with general economic intuition.

B. Model Fit to Interest Rates, Caps, and Swaptions

We now investigate whether our estimated model is capable of producing a reasonable fit to the market data on interest rates, caps, and swaptions. Figure 1 first examines short-term interest rates by plotting the time series of the 3-month Treasury rate (Graph A), OIS rate (Graph B), interbank rate (Graph C), LIBOR-OIS spread (Graph D), TED spread (Graph E), and Treasury convenience yield (Graph F) in the data (solid blue lines) and in the model (dashed red lines).

Graph A of Figure 1 shows that at the beginning of our data sample, the Treasury rate entered a steady downward trend until 2004. During this time, the Federal Reserve lowered the federal funds rate from 6% to 1%, as investors faced high economic and financial uncertainty stemming from the 2001 recession, the Sept. 11 attacks, and the Afghanistan War. This period of expansionary monetary policy was followed by a 3-year period of contractionary monetary policy due to a housing market bubble and high inflation, causing the Treasury rate to gradually increase. From 2007, the Treasury rate began to rapidly decline again when the economy was hit by the subprime mortgage crisis and eventually reached a level close to zero. Since then, the Treasury rate has maintained a very low level until the Federal Reserve started raising interest rates in 2015.

The 3-month OIS rate in Graph B and the 3-month interbank rate in Graph C also exhibit similar time-series patterns compared to the 3-month Treasury rate, although their magnitudes are generally larger. However, a distinctive pattern is observed around September 2008 when Lehman Brothers filed for bankruptcy. In contrast to the other two rates, the interbank rate sharply increased, reflecting a serious risk of a potential systemic meltdown in financial markets. This event is more noticeable from the time series of the LIBOR-OIS spread in Graph D and that of the TED spread in Graph E. While the LIBOR-OIS spread stayed at a high level between 2007 and 2009 during the Great Recession period, an exceptionally high value of roughly 2.4% was seen in September 2008. Fluctuations in the TED spread are more magnified. As can be seen in Graph F, the 3-month Treasury convenience yield shot up to about 1% and remained high as investors hoarded Treasury securities (flight-to-safety/liquidity). As a result, the TED spread, which is the sum of the LIBOR-OIS spread and the Treasury convenience yield, sharply went up, even beyond 3%.

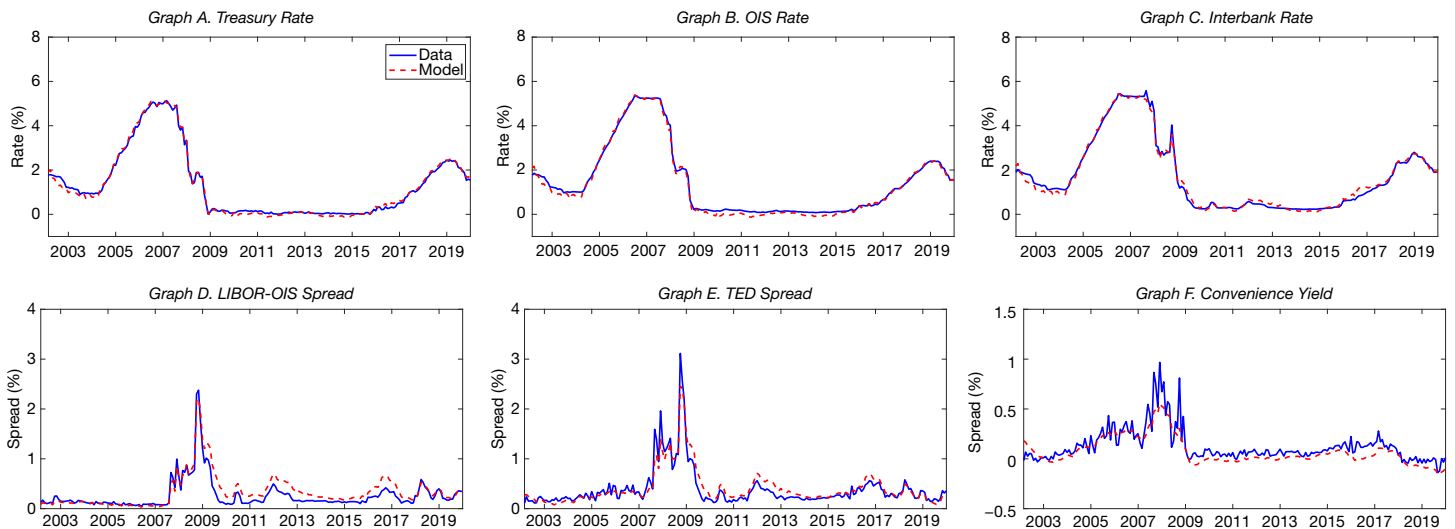
From the six graphs of Figure 1, we find that our model effectively accounts for the patterns of the three types of interest rates as well as their spreads. The dashed red lines that represent the model-implied time series closely resemble the solid blue lines that represent the data time series, peaking and dipping at similar points in time. This holds true for longer-maturity interest rates as well. In Figure 2, the

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FIGURE 1

Three-Month Interest Rates and Their Spreads in the Data and in the Model

Figure 1 plots the time series of the 3-month Treasury rate (Graph A), OIS rate (Graph B), interbank rate (Graph C), LIBOR-OIS spread (Graph D), TED spread (Graph E), and Treasury convenience yield (Graph F) in the data and in the model, from February 2002 to December 2019. The solid blue lines represent the data, and the dashed red lines represent the model. All interest rates are calculated using continuously compounded zero rates and are expressed in percentage terms.

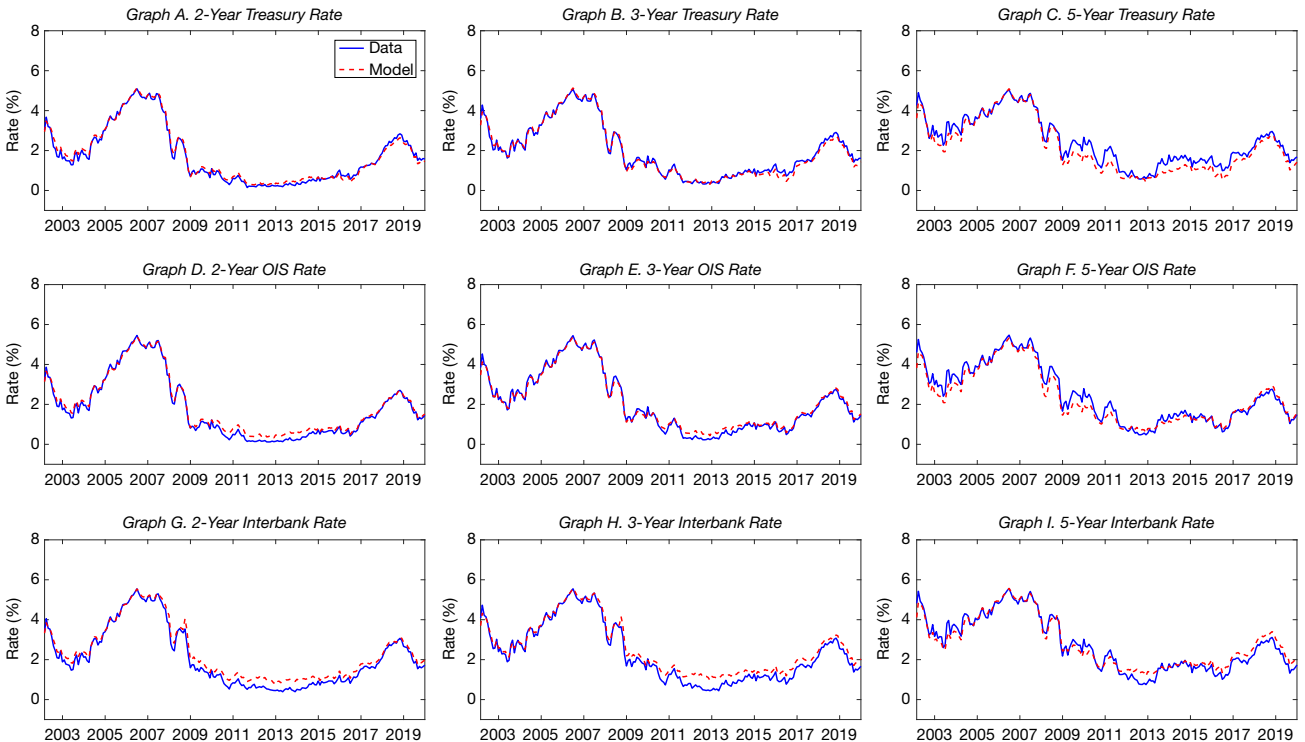


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FIGURE 2

Interest Rates in the Data and in the Model

Figure 2 depicts the time series of the Treasury rates (Graphs A, B, and C), OIS rates (Graphs D, E, and F), and interbank rates (Graphs G, H, and I) with 2-, 3-, and 5-year maturities in the data and in the model, from February 2002 to December 2019. The solid blue lines represent the data, and the dashed red lines represent the model. All values are expressed in percentage terms.



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TABLE 3

Pricing Errors

Table 3 evaluates the empirical performance of our model. Panel A reports three measures of mean pricing errors: ME, MAE, and MRE, averaged by security type (interest rates, cap implied volatilities, and swaption implied volatilities) and maturity. Panel B presents regressions of each data series on its corresponding model-implied series and reports the resulting slope coefficients and R^2 values. The *t*-statistics, shown in brackets, are computed using the Newey and West (1987) method with four lags.

Panel A. Mean Pricing Errors

		3M	6M	1Y	2Y	3Y	5Y
Interest rates	ME	0.0003	0.0002	−0.0001	−0.0014	−0.0009	0.0013
	MAE	0.0011	0.0005	0.0010	0.0017	0.0016	0.0025
	MRE	0.0190	0.0135	−0.0081	−0.0721	−0.0374	0.0532
		2Y	3Y	4Y	5Y		
Cap IVs	ME	−0.0369	0.0023	0.0146	0.0094		
	MAE	0.1293	0.0805	0.0532	0.0466		
	MRE	−0.0743	0.0049	0.0335	0.0234		
		1-into-4	2-into-3	3-into-2	4-into-1		
Swaption IVs	ME	0.0634	0.0553	0.0405	0.0184		
	MAE	0.0702	0.0593	0.0516	0.0489		
	MRE	0.1734	0.1585	0.1211	0.0573		

Panel B. Regressions of Data on Model-Implied Values

		3M	6M	1Y	2Y	3Y	5Y
Interest rates	Coef.	0.98	1.00	1.01	1.04	1.02	0.98
	t-stat	[193.74]	[455.85]	[230.11]	[143.57]	[111.10]	[74.76]
	R^2 (%)	99.34	99.80	99.35	98.92	98.05	95.42
		2Y	3Y	4Y	5Y		
Cap IVs	Coef.	0.74	0.84	0.87	0.83		
	t-stat	[13.91]	[19.22]	[28.95]	[30.36]		
	R^2 (%)	71.67	81.57	89.07	91.58		
		1-into-4	2-into-3	3-into-2	4-into-1		
Swaption IVs	Coef.	0.82	0.84	0.83	0.77		
	t-stat	[15.32]	[17.87]	[17.08]	[13.88]		
	R^2 (%)	79.73	87.74	87.86	84.83		

model-implied Treasury rates, OIS rates, and interbank rates with 2-, 3-, and 5-year maturities closely track their data counterparts. More formally, Panel A of Table 3 reports three measures of empirical performance: mean error (ME), mean absolute error (MAE), and mean relative error (MRE). The pricing errors for interest rates, while slightly increasing with maturity, are small across the board. For instance, the MAEs range from 0.05% (6 months) to 0.25% (5 years), confirming that the model captures the interest rate data fairly well.

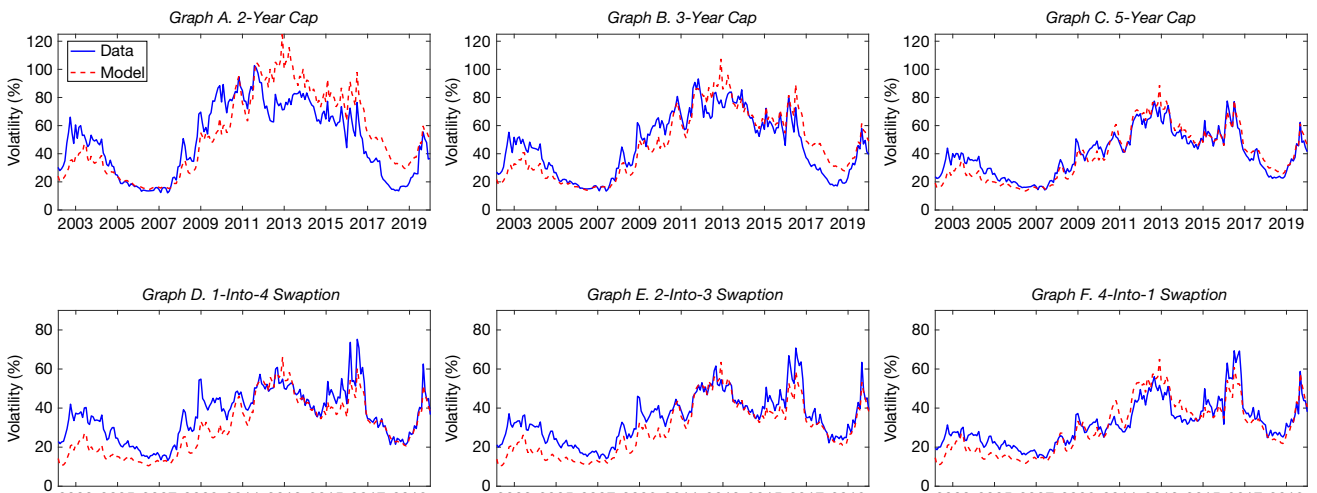
We now turn to caps and swaptions. Graphs A, B, and C of Figure 3 present the time series of the Black-implied volatilities for the 2-, 3-, and 5-year caps, while Graphs D, E, and F present those for the 1-into-4, 2-into-3, and 4-into-1 swaptions. In each graph, the solid blue line denotes the data, and the dashed red line denotes the model. The figure shows that our model's fit to the data is decent but not perfect. As reported in Panel A of Table 3, the MAEs of cap and swaption implied volatilities range between 5% and 8%, except for the 2-year cap, which has an MAE of 13%. It is not surprising that our model cannot accurately match every cap or swaption. Prior studies document that it is challenging to jointly account for the pricing of caps and swaptions in crisis periods, even with flexible statistical models featuring several latent processes (Longstaff et al. (2001), Han (2007), Trolle and

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FIGURE 3

Black-Implied Volatilities in the Data and in the Model

Figure 3 presents the time series of the Black-implied volatilities for the 2-, 3-, and 5-year caps (Graphs A, B, and C) and those for the 1-into-4, 2-into-3, and 4-into-1 swaptions (Graphs D, E, and F) in the data and in the model. The sample period is from February 2002 to December 2019. The solid blue lines represent the data, and the dashed red lines represent the model. All values are expressed in percentage terms.



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Schwartz (2009)).[19] Our objective is not to fit the data perfectly. Rather, we attempt to characterize time-varying disaster risk by exploiting the information contained in interbank rates and their options. Instead of adding more factors to improve the fit, we choose to keep our model simple and parsimonious. For our purposes, we believe that our simple economic model does a reasonably good job of capturing the data overall.[20]

Panel B of Table 3 further assesses model fit by regressing each data series on its corresponding model-implied series (see, e.g., Bakshi et al. (2023)). The resulting slope coefficients are reported alongside the R^2 values. If the model accurately captures the time-series variation in the data, the estimated slope coefficients should be close to one, and the regression should yield a high R^2. The panel shows that slope coefficients for interest rates are indeed close to one, ranging from 0.98 to 1.04, and are statistically significant with extremely high R^2 values between 95.42% and 99.80%. For cap and swaption implied volatilities, the model yields somewhat lower but still substantial slope coefficients ranging from 0.74 to 0.87, with R^2 values between 71.67% and 91.58%. Taken together, these results demonstrate that our estimated model provides a good fit to the data.

C. Characterizing Time-Varying Disaster Risk

Our estimation procedure enables us to characterize the time variation in disaster risk via the unscented Kalman filter. Figure 4 presents the filtered time series of the short-run disaster risk component λ_t (solid blue line) and the long-run disaster risk component ξ_t (dashed red line), along with their summary statistics.[21]

The figure clearly shows that the instantaneous disaster risk λ_t is much more volatile than its time-varying mean ξ_t. Since λ_t is highly persistent, it sometimes significantly deviates from its mean value of 2.86% for extended periods of time. While λ_t hovered around a low level below 1% between 2002 and 2006, it abruptly increased to an extremely high level at the onset of the subprime mortgage crisis in 2007. During the subsequent 2-year period of severe economic downturns and financial market turmoil, λ_t persisted at levels above 4%. When Lehman Brothers declared bankruptcy in September 2008, λ_t reached its highest value, exceeding 11%. After the crisis, the level of λ_t came back to a normal level, but we still can see some small peaks that are associated with economic and financial uncertainty, such as in the European sovereign debt crisis.[22] The standard deviation of λ_t is 1.65% during our sample period.

While λ_t captures a fast-moving component of disaster risk, ξ_t captures a slow-moving component. The filtered time series in Figure 4 reveal that ξ_t is considerably

[19]Related, Bakshi et al. (2023) explain Treasury yields and option prices by adopting several latent variables, including both spanned and unspanned factors.

[20]Directly interpreting the magnitude and the time series variation of Black-implied volatilities for caps and swaptions may not be as intuitive because they represent yield volatilities, rather than bond price volatilities. In the Supplementary Material, we examine our model fit when Black-implied volatilities are converted into their equivalent bond price volatilities.

[21]The filtered time series and summary statistics of the other two latent variables x_t and μ_t are reported in the Supplementary Material.

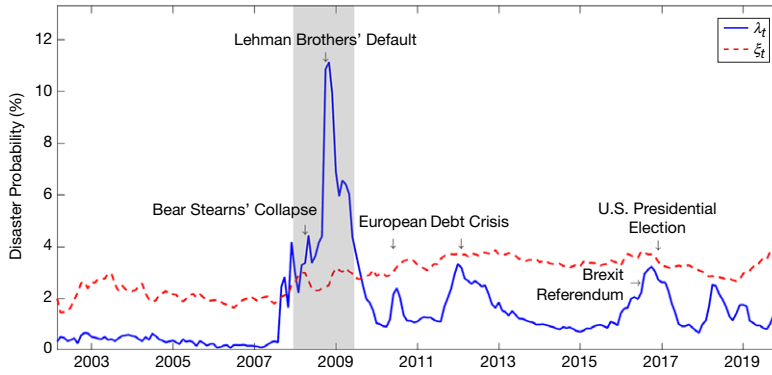
[22]The Supplementary Material extends the data to December 2020 and examines how disaster risk evolved during the COVID-19 pandemic crisis. It shows that the short-run component λ_t jumped up during the peak of the crisis, exceeding the long-run component ξ_t, and then abruptly declined in the following months.

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FIGURE 4

Implied Time-Varying Disaster Risk

Figure 4 displays the filtered time series of the short-run disaster risk component λ_t (solid blue line) and the long-run disaster risk component ξ_t (dashed red line) from February 2002 to December 2019. Reported together are the mean, standard deviation, minimum, 5th percentile, median, 95th percentile, and maximum values for each time series. All values are expressed in percentage terms.



	Mean	SD	Min	5th	50th	95th	Max
λ	1.56	1.65	0.10	0.19	1.07	4.32	11.13
ξ	2.91	0.64	1.46	1.89	3.05	3.73	3.88

less volatile than λ_t (with a standard deviation of 0.64% vs. 1.65%) and moves slowly without deviating too much from its mean value. Moreover, we observe that ξ_t is far more persistent than λ_t: Once it is hit by a large positive shock, it takes a long time for it to mean-revert back to its previous level. For instance, the level of ξ_t remained elevated during the post-Great Recession period. This is in sharp contrast with the behavior of λ_t, whose level quickly dropped even before the crisis was over.

Which aspect of the data makes it possible for us to characterize the time variation in λ_t and ξ_t, as discussed above? To understand how time-varying disaster risk is identified through our model, we conduct a sensitivity analysis. Figure 5 shows how the 3-, 6-, 12-month LIBOR-OIS spreads (Graph A) and the Black-implied volatilities for caps (Graph B) and swaptions (Graph C) change when we vary λ_t or ξ_t from the 5th percentile to the 95th percentile of its filtered values. In each graph, the solid blue lines describe the sensitivity with respect to λ_t while fixing ξ_t at the median, whereas the dashed red lines describe the sensitivity with respect to ξ_t while fixing λ_t at the median. Expected inflation q_t and mean consumption growth μ_t are set at their median values in both cases. Lastly, the black dot in the middle of each bar represents the model value when λ_t and ξ_t are both at their median values.

Graph A of Figure 5 reveals that the short-run component of disaster risk λ_t is mainly identified by the LIBOR-OIS spreads. While the LIBOR-OIS spreads increase with both λ_t and ξ_t, they are much more sensitive to λ_t. For example, the 3-month LIBOR-OIS spread moves substantially, ranging from 0.1% to 0.9%, when λ_t varies between the 5th and 95th percentiles. In contrast, the 3-month LIBOR-OIS spread barely changes with respect to ξ_t, as can be seen in the graph.

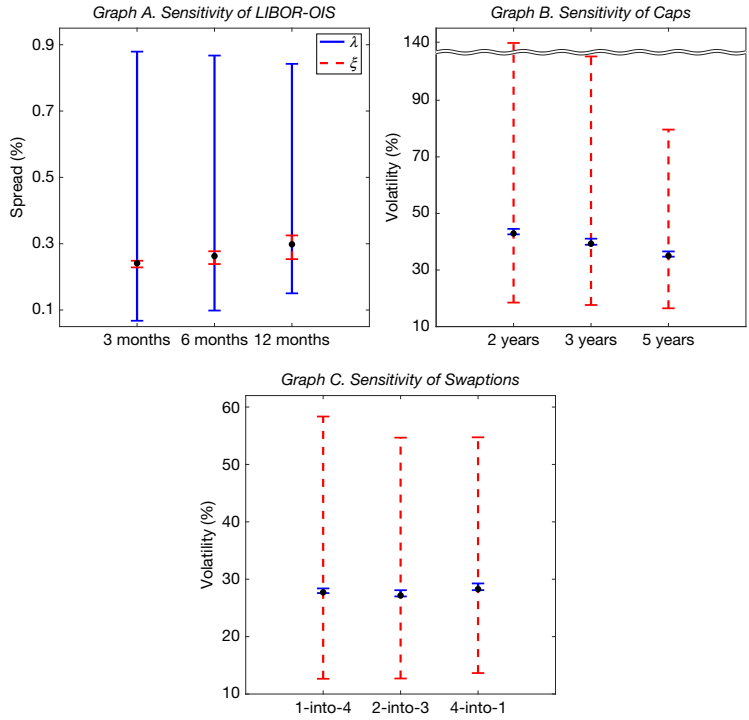
These results are intuitive. The 3-month interbank rate is higher than the 3-month OIS rate because it is further influenced by the risk of a disaster happening

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FIGURE 5

Comparative Statics

Figure 5 shows how the 3-, 6-, 12-month LIBOR-OIS spreads (Graph A) and the Black-implied volatilities for caps (Graph B) and swaptions (Graph C) change when λ_t or ξ_t varies from the 5th percentile to the 95th percentile of its filtered values. In each graph, the solid blue lines describe the sensitivity with respect to λ_t while fixing ξ_t at the median, whereas the dashed red lines describe the sensitivity with respect to ξ_t while fixing λ_t at the median. Expected inflation q_t and mean consumption growth μ_t are set at their median values in both cases. The black dot in the middle of each bar represents the model value when λ_t and ξ_t are both at their median values. All values are expressed in percentage terms.



over a 3-month horizon. Therefore, their gap, the 3-month LIBOR-OIS spread, is mostly sensitive to the short-run component of disaster risk. For the same reason, ξ_t plays a more noticeable role if a longer horizon is considered: From the graph, we find that the longest LIBOR-OIS spread with a 12-month maturity is more responsive to changes in ξ_t, compared to the 3-month LIBOR-OIS spread. However, the effect of ξ_t is still minuscule across all maturities, relative to the effect of λ_t. This confirms that the time series of the LIBOR-OIS spreads are the major channel through which the time variation of λ_t is identified.

Although the long-run component of disaster risk ξ_t has little impact on the LIBOR-OIS spreads, it has a large impact on interbank rate options. In Graphs B and C of Figure 5, we discover completely opposite patterns. The Black-implied volatilities in both graphs are highly sensitive to changes in ξ_t, whereas they are relatively less sensitive to changes in λ_t. The payoffs of caps and swaptions depend on future interbank rates over a long horizon ranging from 1 to 5 years. Hence, the pricing data on caps and swaptions play a critical role in characterizing the time variation of ξ_t.

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Note that these model exercises are predicated on the assumption that both λ_t and ξ_t are time-varying. In the Supplementary Material, we estimate two nested cases of our model: i) constant long-run mean of disaster risk (i.e., no variation in ξ_t) and ii) constant disaster risk (i.e., no variation in λ_t). Based on the likelihood ratio test, the two nested models are rejected, highlighting the significance of incorporating both time-varying λ_t and ξ_t.

In sum, our analysis demonstrates that both the short-run and long-run components of disaster risk are important model ingredients and are well identified using the data on interbank rates and their options.[23] It is worth emphasizing that the benefit of using interbank rate options is not limited to identifying the long-run component: The forward-looking information from caps and swaptions helps us accurately estimate the overall dynamics of disaster risk.

D. Implications for the Equity Market

Rare disaster models are often criticized as macro-finance models with "dark matter." In order to explain the high equity premium and volatility in the postwar period, these models need to rely on the possibility of extremely bad events and their substantial time variation. However, it is not possible to measure disaster risk directly from the data, nor statistically test it with meaningful power, due to the rare nature of such events.

This dark matter criticism raises some concerns about how disaster risk models are calibrated: In typical variable disaster risk models, the dynamics of disaster risk are calibrated to match some key equity market moments, such as the equity premium and the market volatility. However, Chen et al. (2024) point out that a model with economic dark matter is likely to be fragile due to the lack of internal refutability and poor out-of-sample performance. Addressing this criticism is challenging: As discussed by Cochrane (2017), it requires either independently anchoring time-varying disaster risk to some data or reconciling multiple asset classes under one consistent assumption about disaster risk.

Our analysis highlights that the interbank market can potentially be useful for addressing the dark matter criticism. We make a plausible assumption that consumption disasters are likely to coincide with interbank market failure. This identification assumption makes it possible to extract time-varying disaster risk that is manifested in LIBOR-OIS spreads as well as caps and swaptions. Since our estimation does not depend on equity market moments, our results can serve as an external/out-of-sample validity test of disaster risk models for the equity market. The parameter estimates from Section IV.A suggest that the estimated disaster dynamics are fairly close to those implied by Seo and Wachter (2018), whose calibration is primarily based on the equity market. Overall, our finding that disaster risk is significant in size and in variation strongly supports a disaster-based explanation of various asset pricing puzzles (Gabaix (2012), Wachter (2013)).

An additional advantage of our approach is that we obtain the past time series of the short-run and long-run components of disaster risk, namely λ_t and ξ_t. These

[23] In addition, the Supplementary Material provides a discussion of how the short-run and long-run components of disaster risk differently affect the instantaneous bond variance.

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TABLE 4

Disaster Risk and Conditional Equity Moments

Table 4 reports the results of contemporaneous time-series regressions that examine the relation between the filtered disaster risk variables (λ_t and ξ_t) and conditional equity market moments. Since λ_t and ξ_t are correlated, we take the orthogonal component of λ_t with respect to ξ_t. In both panels, we standardize the independent and dependent variables. In Panel A, the dependent variables are the log price-dividend ratio (log P/D), log price-earnings ratio (log P/E), implied variance (IV), ERV, and the VRP. In Panel B, the dependent variables are the prices of S&P 500 put options with 90% moneyness, normalized by the underlying index level. We consider options with maturities of 1, 3, 6, 9, and 12 months. The *t*-statistics, shown in brackets, are computed using the Newey and West (1987) method with four lags.

Panel A. Valuation Ratios and Variance-Related Variables

		log P/D	log P/E	IV	ERV	VRP
		1	2	3	4	5
λ_t	Coef.	−0.68	−0.53	0.72	0.64	0.37
	t-stat	[−5.13]	[−4.18]	[5.54]	[3.54]	[2.81]
ξ_t	Coef.	−0.48	−0.20	0.02	0.06	−0.05
	t-stat	[−7.25]	[−2.63]	[0.31]	[1.01]	[−0.80]
Adj R^2 (%)		68.69	31.87	52.30	41.29	13.83

Panel B. Out-of-the-Money Put Option Prices

		1 Month	3 Months	6 Months	9 Months	12 Months
		1	2	3	4	5
λ_t	Coef.	0.70	0.68	0.65	0.58	0.39
	t-stat	[5.38]	[5.78]	[5.34]	[5.18]	[4.62]
ξ_t	Coef.	0.04	0.11	0.21	0.31	0.31
	t-stat	[0.62]	[1.46]	[2.67]	[3.88]	[4.02]
Adj R^2 (%)		49.28	47.21	46.52	43.05	24.49

time series provide an extra basis for testing the implications of disaster risk for the equity market. First of all, Panel A of Table 4 considers the following conditional moments that are associated with the equity market: the price-dividend ratio (log P/D), price-earnings ratio (log P/E), implied variance (IV), expected realized variance (ERV), and variance risk premium (VRP).[24] Since these conditional moments are functions of disaster risk in variable disaster risk models, one testable implication is that their time-series variations should be explained by disaster-related state variables.

Hence, we run contemporaneous linear regressions of the five conditional equity market moments at time t on λ_t and ξ_t. We standardize both independent and dependent variables in our regressions to facilitate the interpretation of slope coefficients. In columns 1 and 2 of Panel A, we document that the valuation ratios fall when λ_t and ξ_t rise. For instance, a one-standard-deviation increase in λ_t leads to a 0.68 standard deviation drop in the log price-dividend ratio. A one-standard-deviation increase in ξ_t leads to a 0.48 standard deviation drop in the log price-dividend ratio. These negative relations are statistically significant with high *t*-statistics. These results are consistent with economic intuition as well as empirical evidence: Stock market valuations are low in bad economic times with high disaster risk.

In columns 3, 4, and 5, we examine the relation between disaster risk and each of the three variance-related variables. Note that the implied variance and the ERV measure the risk-neutral and physical expectations of future 1-month equity

[24]The price-dividend and price-earnings ratios are downloaded from Robert Shiller's website. The three variance-related variables are downloaded from Hao Zhou's website.

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market variance, respectively. The VRP, calculated as their difference, captures compensation for taking variance risk over a 1-month horizon. We expect positive relations from our regression because higher disaster risk results in higher variance risk as well as higher compensation for variance risk. In line with this, we find a strong positive relation between the short-run component of disaster risk λ_t and each variance-related variable. However, we find that the impact of the long-run component ξ_t is insignificant. This is not surprising, since the variance-related variables are based on a very short horizon, namely, a month.

Panel B of Table 4 considers out-of-the-money put option prices as additional conditional moments since they are particularly informative about tail events. At each point in time, we obtain the prices of S&P 500 put options with 90% moneyness, normalized by the underlying index price.[25] This normalization allows us to compare option prices at different points in time by removing the effect of the index level. Columns 1–5 report the results from contemporaneous linear regressions of the normalized prices of put options with 1-, 3-, 6-, 9-, and 12-month maturities on the time series of λ_t and ξ_t. Column 1 of Panel B demonstrates that λ_t significantly and positively explains the 1-month put option price while ξ_t has no statistically significant impact. This is consistent with the results for the 1-month-ahead implied variance in Panel A. Comparing the five columns in Panel B, we can see that λ_t is significant across all maturities. In the case of ξ_t, its economic magnitude and statistical significance gradually increase as option maturity increases. As a result, the effect of ξ_t becomes significant for maturities longer than or equal to 6 months. These results are sensible: The long-run component of disaster risk ξ_t better explains long-horizon equity moments, such as the price-dividend ratio, price-earnings ratio, and longer-term option prices.

So far, we have examined whether disaster risk can explain the variations in conditional equity market moments. Another testable implication of disaster risk for the equity market is that equity returns should be negatively associated with shocks to λ_t and ξ_t. Panel A of Table 5 reports the results from regressing the market, size, value, momentum, and liquidity factors on changes in λ_t and ξ_t.[26] We find that changes in both the short-run and long-run components of disaster risk are indeed negatively related to the market, size, and liquidity factors. This implies that λ_t and ξ_t capture more than just aggregate market risk.

Lastly, Panel B of Table 5 investigates how shocks to disaster risk affect contemporaneous excess returns on the Fama–French 10 industry portfolios. Intuitively, some industries are less sensitive to disaster risk than others. For example, industries that focus on consumer staples, such as food and utilities, are likely to be less exposed to disaster risk. This intuition is confirmed in Panel B: The relations

[25]We download options data from OptionMetrics. Since we do not observe options with fixed moneyness or a constant maturity every day, we use a regression-based interpolation of implied volatilities with respect to moneyness and maturity by adopting the methodology of Seo and Wachter (2019). The price of an option with a specific moneyness and a specific maturity is, then, calculated by plugging the interpolated implied volatility into the Black–Scholes formula.

[26]The market, size, and value factors follow Fama and French (1993), and the momentum factor follows Fama and French (2012). These time series are downloaded from Kenneth French's website. The liquidity risk factor follows Pastor and Stambaugh (2003) and is downloaded from Robert Stambaugh's website.

TABLE 5

Shocks to Disaster Risk and Equity Returns

Table 5 reports the results of contemporaneous time-series regressions that examine the relation between changes in the filtered disaster risk variables (λ_t and ξ_t) and equity returns. In both panels, we standardize the independent and dependent variables. In Panel A, the dependent variables are the excess market return (MktRf), size factor return (SMB), book-to-market factor return (HML), momentum factor return (MOM), and liquidity factor return (LIQ). In Panel B, the dependent variables are the excess returns on the 10 Fama–French industry portfolios. These industries include consumer durables (Durbl), manufacturing (Manuf), business equipment (HiTec), telecommunication (Telcm), retail (Shops), energy (Enrgy), healthcare (Hlth), consumer non-durables (NoDur), utilities (Utils), and others (Other). The *t*-statistics, shown in brackets, are computed using the Newey and West (1987) method with four lags.

Panel A. Factor Portfolios

		MktRf	SMB	HML	MOM	LIQ
		1	2	3	4	5
$\Delta\lambda_t$	Coef.	−0.22	−0.09	0.12	0.09	−0.14
	t-stat	[−4.98]	[−2.20]	[1.36]	[1.12]	[−1.27]
$\Delta\xi_t$	Coef.	−0.35	−0.27	−0.15	0.17	−0.30
	t-stat	[−5.33]	[−4.95]	[−1.80]	[2.04]	[−3.10]
Adj R^2 (%)		14.64	6.92	3.50	2.91	9.62

Panel B. Fama–French 10 Industry Portfolios

		Durbl	Manuf	HiTec	Telcm	Shops
		1	2	3	4	5
$\Delta\lambda_t$	Coef.	−0.15	−0.23	−0.21	−0.23	−0.16
	t-stat	[−4.62]	[−4.12]	[−5.89]	[−6.00]	[−4.99]
$\Delta\xi_t$	Coef.	−0.34	−0.33	−0.38	−0.28	−0.27
	t-stat	[−7.10]	[−6.09]	[−4.92]	[−3.75]	[−3.96]
Adj R^2 (%)		12.41	14.19	16.31	11.00	8.74
		Enrgy	Hlth	NoDur	Utils	Other
		6	7	8	9	10
$\Delta\lambda_t$	Coef.	−0.19	−0.18	−0.13	−0.25	−0.16
	t-stat	[−3.96]	[−3.06]	[−2.15]	[−3.92]	[−3.21]
$\Delta\xi_t$	Coef.	−0.29	−0.19	−0.15	−0.09	−0.33
	t-stat	[−5.13]	[−2.95]	[−2.05]	[−0.78]	[−5.10]
Adj R^2 (%)		9.99	5.65	3.14	5.91	11.67

between changes in disaster risk and industry returns show relatively smaller *t*-statistics for industries including consumer non-durables and utilities (columns 8–9). In contrast, for industries that are more business-cycle sensitive, such as consumer durables, manufacturing, business equipment, telecommunication, and retail (columns 1–5), we obtain more significant negative relations.

V. Conclusion

While prior studies on rare disasters calibrate time-varying disaster risk, accurately characterizing it from the data remains a considerable challenge. This is extremely difficult because disasters are nearly unobservable events in the post-war sample. In order to tackle this issue, our article ties time-varying probabilities of disasters to an independent source of data: interbank rates and their options.

Our approach relies on the assumption that macroeconomic disasters are likely to coincide with interbank market failure. This link allows us to derive the model-implied interest rate spreads and option prices on interbank rates as functions of the short-run and long-run components of disaster risk. We show that these data are particularly sensitive to disaster risk, which enables us to reliably infer not only the level of disaster probabilities but also their dynamics.

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The estimation results suggest that disaster risk is significant in size and in variation, strongly upholding the validity of macro-finance models with the rare disaster mechanism. Using the filtered time series of the short-run and long-run components of disaster risk, we confirm that the implications of these models for equity moments and equity returns are consistent with empirical evidence. Overall, our analysis highlights that interest rates and their options can be valuable tools for deepening our understanding of extreme economic tail risk.

Appendix

A Model Derivations

A.1. Risk-Neutral Dynamics

Given the assumption about the pricing kernel in equation (4), the Brownian shocks under the risk-neutral measure are written as follows:

$$\begin{aligned}
dB^{\mathcal{Q}}_{C,t} &= dB_{C,t} + \theta_C dt,\\
dB^{\mathcal{Q}}_{\mu,t} &= dB_{\mu,t} + \theta_\mu dt,\\
dB^{\mathcal{Q}}_{\lambda,t} &= dB_{\lambda,t} + \theta_\lambda \sqrt{\lambda_t} dt,\\
dB^{\mathcal{Q}}_{\xi,t} &= dB_{\xi,t} + \theta_\xi \sqrt{\xi_t} dt,\\
dB^{\mathcal{Q}}_{q,t} &= dB_{q,t} + \theta_q dt.
\end{aligned}$$

Moreover, under the risk-neutral measure, the disaster intensity and the moment generating function (MGF) of the jump size distributions are represented as

$$\begin{aligned}
\lambda^{\mathcal{Q}}_t &= \lambda_t \Phi_Z(\theta_N, 0, 0),\\
\mathbb{E}^{\mathcal{Q}}\left[e^{u_1 Z_C + u_2 Z_L + u_3 Z_q}\right] &= \frac{\Phi_Z(u_1 + \theta_N, u_2, u_3)}{\Phi_Z(\theta_N, 0, 0)},
\end{aligned}$$

where $\Phi_Z(u_1, u_2, u_3) = \mathbb{E}[e^{u_1 Z_C + u_2 Z_L + u_3 Z_q}]$ is the MGF of (Z_C, Z_L, Z_q) under the physical measure. This leads to the following risk-neutral dynamics of the underlying processes,

$$\begin{aligned}
\frac{dC_t}{C_t} &= \mu^{\mathcal{Q}}_C dt + \sigma_C dB^{\mathcal{Q}}_{C,t} + \left(e^{Z_{C,t}} - 1\right) dN_t,\\
d\mu_t &= \kappa^{\mathcal{Q}}_\mu \left(\bar{\mu}^{\mathcal{Q}} - q_t\right) dt + \sigma_\mu dB^{\mathcal{Q}}_{\mu,t}\\
d\lambda_t &= \kappa^{\mathcal{Q}}_\lambda (v\xi_t - \lambda_t) dt + \sigma_\lambda \sqrt{\lambda_t} dB^{\mathcal{Q}}_{\lambda,t},\\
d\xi_t &= \kappa^{\mathcal{Q}}_\xi \left(\bar{\xi}^{\mathcal{Q}} - \xi_t\right) dt + \sigma_\xi \sqrt{\xi_t} dB^{\mathcal{Q}}_{\xi,t},\\
dq_t &= \kappa^{\mathcal{Q}}_q \left(\bar{q}^{\mathcal{Q}} - q_t\right) dt + \sigma_q dB^{\mathcal{Q}}_{q,t} + Z_{q,t} dN_t,
\end{aligned}$$

where $\mu^{\mathcal{Q}}_C = \mu_C - \theta_C \sigma_C$, $\kappa^{\mathcal{Q}}_\mu = \kappa_\mu$, $\bar{\mu}^{\mathcal{Q}} = \frac{\kappa_\mu \bar{\mu} - \theta_\mu \sigma_\mu}{\kappa^{\mathcal{Q}}_\mu}$, $\kappa^{\mathcal{Q}}_\lambda = \kappa_\lambda + \sigma_\lambda \theta_\lambda$, $v = \frac{\kappa_\lambda}{\kappa^{\mathcal{Q}}_\lambda}$, $\kappa^{\mathcal{Q}}_\xi = \kappa_\xi + \sigma_\xi \theta_\xi$, $\bar{\xi}^{\mathcal{Q}} = \frac{\kappa_\xi \bar{\xi}}{\kappa^{\mathcal{Q}}_\xi}$, $\kappa^{\mathcal{Q}}_q = \kappa_q$, and $\bar{q}^{\mathcal{Q}} = \frac{\kappa_q \bar{q} - \theta_q \sigma_q}{\kappa^{\mathcal{Q}}_q}$.

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A.2. Zero-Coupon Yields

The time-t value of \$1 zero-coupon interbank lending maturing at time $t+\tau$ is written as

$$P_i(t,t+\tau)=\mathbb{E}_t^Q\left[e^{-\int_t^{t+\tau}r_u du}\frac{L_{t+\tau}}{L_t}\right].$$

By multiplying both sides of the above equation with $e^{-\int_0^t r_u du}L_t$, we obtain the following martingale:

$$e^{-\int_0^t r_u du}P_i(t,t+\tau)L_t=\mathbb{E}_t^Q\left[e^{-\int_0^{t+\tau}r_u du}L_{t+\tau}\right].$$

We conjecture that the price of a zero-coupon interbank lending is expressed as

$$P_i(t,t+\tau)=\exp\left(a_i(\tau)+b_{i,\lambda}(\tau)\lambda_t+b_{i,\xi}(\tau)\xi_t+b_{i,\mu}(\tau)\mu_t+b_{i,q}(\tau)q_t\right),$$

and its stochastic differential equation is given as

$$\begin{aligned}\frac{dP_{i,t}}{P_{i,t^-}}=&\left(b_{i,\lambda}(\tau)\kappa_\lambda^Q(v\xi_t-\lambda_t)+b_{i,\xi}(\tau)\kappa_\xi^Q\left(\overline{\xi}^Q-\xi_t\right)+b_{i,\mu}(\tau)\kappa_\mu^Q\left(\overline{\mu}^Q-\mu_t\right)+b_{i,q}(\tau)\kappa_q^Q\left(\overline{q}^Q-q_t\right)\right.\\&+\frac{1}{2}b_{i,\lambda}(\tau)^2\sigma_\lambda^2\lambda_t+\frac{1}{2}b_{i,\xi}(\tau)^2\sigma_\xi^2\xi_t+\frac{1}{2}b_{i,\mu}(\tau)^2\sigma_\mu^2+\frac{1}{2}b_{i,q}(\tau)^2\sigma_q^2\\&\left.-\left(a_i'(\tau)+b_{i,\lambda}'(\tau)\lambda_t+b_{i,\xi}'(\tau)\xi_t+b_{i,\mu}'(\tau)\mu_t+b_{i,q}'(\tau)q_t\right)\right)dt\\&+b_{i,\lambda}(\tau)\sigma_\lambda\sqrt{\lambda_t}dB_{\lambda,t}^Q+b_{i,\xi}(\tau)\sigma_\xi\sqrt{\xi_t}dB_{\xi,t}^Q+b_{i,\mu}(\tau)\sigma_\mu dB_{\mu,t}^Q+b_{i,q}(\tau)\sigma_q dB_{q,t}^Q\\&+\left(e^{b_{i,q}(\tau)Z_{q,t}}-1\right)dN_t.\end{aligned}$$

Since $\left(e^{-\int_0^t r_u du}P_{i,t}(\tau)L_t\right)$ is a martingale, the sum of the drift and the jump compensator should be zero. This martingale property provides the system of ordinary differential equations (ODEs) for a_i, $b_{i,\lambda}$, $b_{i,\xi}$, $b_{i,\mu}$, and $b_{i,q}$ as follows:

$$\begin{aligned}a_i'(\tau)=&-\delta_0+b_{i,\xi}(\tau)\kappa_\xi^Q\overline{\xi}^Q+b_{i,\mu}(\tau)\kappa_\mu^Q\overline{\mu}^Q+b_{i,q}(\tau)\kappa_q^Q\overline{q}^Q+\frac{1}{2}b_{i,\mu}(\tau)^2\sigma_\mu^2+\frac{1}{2}b_{i,q}(\tau)^2\sigma_q^2,\\b_{i,\lambda}'(\tau)=&-\delta_\lambda-b_{i,\lambda}(\tau)\kappa_\lambda^Q+\frac{1}{2}b_{i,\lambda}(\tau)^2\sigma_\lambda^2\\&+\overline{p}\Phi_Z\left(\theta_N,1,b_{i,q}(\tau)\right)+(1-\overline{p})\Phi_Z\left(\theta_N,0,b_{i,q}(\tau)\right)-\Phi_Z(\theta_N,0,0),\\b_{i,\xi}'(\tau)=&-\delta_\xi+b_{i,\lambda}(\tau)\kappa_\lambda^Q v-b_{i,\xi}(\tau)\kappa_\xi^Q+\frac{1}{2}b_{i,\xi}(\tau)^2\sigma_\xi^2,\\b_{i,\mu}'(\tau)=&-\delta_\mu-b_{i,\mu}(\tau)\kappa_\mu^Q,\\b_{i,q}'(\tau)=&-\delta_q-b_{i,q}(\tau)\kappa_q^Q,\end{aligned}$$

with the initial condition: $a_i(0)=b_{i,\lambda}(0)=b_{i,\xi}(0)=b_{i,\mu}(0)=b_{i,q}(0)=0$.

Similarly, the price of \$1 zero-coupon risk-free lending is given by

$$P_f(t,t+\tau)=\mathbb{E}_t^Q\left[e^{-\int_t^{t+\tau}r_u du}\cdot 1\right],$$

and we conjecture the price has the form of

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$$P_f(t,t+\tau)=\exp\left(a_f(\tau)+b_{f,\lambda}(\tau)\lambda_t+b_{f,\xi}(\tau)\xi_t+b_{f,\mu}(\tau)\mu_t+b_{f,q}(\tau)q_t\right).$$

Since $\left(e^{-\int_0^t r_u du}P_{f,t}(\tau)\right)$ is a martingale, the sum of the drift and the jump compensator should be zero. This martingale property provides the following system of ODEs for $a_f, b_{f,\lambda}, b_{f,\xi}, b_{f,\mu}$, and $b_{f,q}$:

$$\begin{aligned}
a_f'(\tau) &= -\delta_0+b_{f,\xi}(\tau)\kappa_\xi^Q\overline{\xi}^Q+b_{f,\mu}(\tau)\kappa_\mu^Q\overline{\mu}^Q+b_{f,q}(\tau)\kappa_q^Q\overline{q}^Q+\frac{1}{2}b_{f,\mu}(\tau)^2\sigma_\mu^2+\frac{1}{2}b_{f,q}(\tau)^2\sigma_q^2,\\
b_{f,\lambda}'(\tau) &= -\delta_\lambda-b_{f,\lambda}(\tau)\kappa_\lambda^Q+\frac{1}{2}b_{f,\lambda}(\tau)^2\sigma_\lambda^2+\Phi_Z\left(\theta_N,0,b_{f,q}(\tau)\right)-\Phi_Z(\theta_N,0,0),\\
b_{f,\xi}'(\tau) &= -\delta_\xi+b_{f,\lambda}(\tau)\kappa_\lambda^Q v-b_{f,\xi}(\tau)\kappa_\xi^Q+\frac{1}{2}b_{f,\xi}(\tau)^2\sigma_\xi^2,\\
b_{f,\mu}'(\tau) &= -\delta_\mu-b_{f,\mu}(\tau)\kappa_\mu^Q,\\
b_{f,q}'(\tau) &= -\delta_q-b_{f,q}(\tau)\kappa_q^Q,
\end{aligned}$$

with the initial conditions: $a_f(0)=b_{f,\lambda}(0)=b_{f,\xi}(0)=b_{f,\mu}(0)=b_{f,q}(0)=0$. Note that $b_{i,\mu}(\tau)$ and $b_{f,\mu}(\tau)$ are identical, and so are $b_{i,q}(\tau)$ and $b_{f,q}(\tau)$, as their ODEs are identical with the same initial conditions. Therefore, we simply denote them as $b_\mu(\tau)$ and $b_q(\tau)$, respectively.

Now we turn to the Treasury rate. The stochastic differential equation for x_t implies that for any $u \geq t$,

$$x_u=x_te^{-\kappa_x(u-t)}+\overline{x}\left(1-e^{-\kappa_x(u-t)}\right)+\int_0^{u-t}\sigma_x e^{-\kappa_x(u-t-s)}dB_{x,s}.$$

Clearly, x_u is Gaussian and so is $\left(\int_t^{t+\tau}x_u du\right)$. Hence, the expression for $\mathbb{E}_t\left[e^{\int_t^{t+\tau}x_u du}\right]$ in equation (8) can be derived using the MGF of a normal distribution. This leads us to the following deterministic functions a_x and b_x shown in equation (8):

$$\begin{aligned}
a_x(\tau) &= \left(\overline{x}+\frac{\sigma_x^2}{2\kappa_x^2}\right)\left[\frac{1-e^{-\kappa_x\tau}}{\kappa_x}-\tau\right]+\frac{\sigma_x^2}{4\kappa_x}\left[\frac{1-e^{-\kappa_x\tau}}{\kappa_x}\right]^2,\\
b_x(\tau) &= -\left(\frac{1-e^{-\kappa_x\tau}}{\kappa_x}\right).
\end{aligned}$$

Based on the identity $y_{g,t}^{(\tau)}=y_{f,t}^{(\tau)}-y_{x,t}^{(\tau)}$, the τ-maturity Treasury rate $y_{g,t}^{(\tau)}$ is obtained by

$$y_{g,t}^{(\tau)}=-\frac{1}{\tau}\left[a_f(\tau)-a_x(\tau)+b_{f,\lambda}(\tau)\lambda_t+b_{f,\xi}(\tau)\xi_t+b_\mu(\tau)\mu_t+b_q(\tau)q_t-b_x(\tau)x_t\right].$$

A.3. Cap and Swaption Pricing

Before deriving the expressions for the prices of caps and swaptions, we first find the pricing formula for a put option on $P_i(T_0,T_1)$ with a strike price K. Following Duffie et al. (2000), Collin-Dufresne and Goldstein (2003), and Trolle and Schwartz (2009), we compute the put option price by using the transform analysis:

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$$\mathcal{P}(t,T_0,T_1,K) = \mathbb{E}_t^Q\left[e^{-\int_t^{T_0} r_s ds}(K - P_i(T_0,T_1))\mathbb{1}_{\{P_i(T_0,T_1)<K\}}\right]$$
$$= KG_{0,1}(\log K) - G_{1,1}(\log K),$$

where

$$G_{a,b}(y) = \frac{\psi(a,t,T_0,T_1)}{2} - \frac{1}{\pi}\int_0^\infty \frac{\mathrm{Im}[\psi(a+iub,t,T_0,T_1)e^{-iuy}]}{u}du,$$
$$\psi(u,t,T_0,T_1) = \mathbb{E}_t^Q\left[\exp\left(-\int_t^{T_0} r_s ds\right)e^{u\log(P_i(T_0,T_1))}\right].$$

Note that the function ψ solves the complex-valued ODEs of Duffie et al. (2000), and the operator $\mathrm{Im}[\cdot]$ represents the imaginary part of a complex number.

The time-t cap price is given by equation (9). Under the approximation $e^{-\int_{t_j}^{t_{j+1}} r_s ds} \approx P_i(t_j,t_{j+1})$, we re-express the cap pricing formula as

$$V_{\text{cap}}^{(T)}(t,K) \approx \sum_{j=1}^{m_T}\mathbb{E}_t^Q\left[\exp\left(-\int_t^{t_j} r_s ds\right)P_i(t_j,t_{j+1})\left[\frac{1}{P_i(t_j,t_{j+1})} - 1 - \Delta\times K\right]^+\right]$$
$$= (1+\Delta\times K)\sum_{j=1}^{m_T}\mathcal{P}\left(t,t_j,t_{j+1},\frac{1}{1+\Delta\times K}\right).$$

As discussed in Section II.D, we price swaptions by adopting the stochastic duration method suggested by Wei (1997), Munk (1999), and Trolle and Schwartz (2009). Applying this method to equation (10) results in:

$$V_{\text{payer}}^{(T,\overline{T})}(t,K) = \mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[1 - V_{\text{fixed}}^{(\overline{T})}(t+T,K)\right]^+\right]$$
$$\approx \zeta\mathcal{P}\left(t,T,t+\mathcal{D}(t,T,\overline{T}),\zeta^{-1}\right),$$

where $\zeta = \frac{\sum_{l=1}^{\overline{T}/\Delta} Y_l P_i(t,t+T+l\Delta)}{P_i(t,t+\mathcal{D}(t,T,\overline{T}))}$. The stochastic duration $\mathcal{D}(t,T,\overline{T})$, or simply $\mathcal{D}(t)$, is defined as a quantity that satisfies:

$$b_{i,\lambda}(\mathcal{D}(t))^2\sigma_\lambda^2\lambda_t + b_{i,\xi}(\mathcal{D}(t))^2\sigma_\xi^2\xi_t + b_q(\mathcal{D}(t))^2\sigma_q^2 + b_\mu(\mathcal{D}(t))^2\sigma_\mu^2$$
$$+ [\Phi(\theta_N,0,2b_q(\mathcal{D}(t))) - 2\Phi(\theta_N,0,b_q(\mathcal{D}(t))) + \Phi(\theta_N,0,0)]\lambda_t$$
$$= \left[\sum_{j=1}^{\overline{T}/\Delta} w_j b_{i,\lambda}(T+j\Delta)\right]^2\sigma_\lambda^2\lambda_t + \left[\sum_{j=1}^{\overline{T}/\Delta} w_j b_{i,\xi}(T+j\Delta)\right]^2\sigma_\xi^2\xi_t + \left[\sum_{j=1}^{\overline{T}/\Delta} w_j b_q(T+j\Delta)\right]^2\sigma_q^2$$
$$+ \left[\sum_{j=1}^{\overline{T}/\Delta} w_j b_\mu(T+j\Delta)\right]^2\sigma_\mu^2 + \left[\sum_{j=1}^{\overline{T}/\Delta}\left[w_j^2\Phi(\theta_N,0,2b_q(T+j\Delta)) - 2w_j\Phi(\theta_N,0,b_q(T+j\Delta))\right.\right.$$
$$\left.\left. + \sum_{k>j} 2w_j w_k\Phi(\theta_N,0,b_q(T+j\Delta)+b_q(T+k\Delta))\right] + \Phi(\theta_N,0,0)\right]\lambda_t,$$

where $w_j = \frac{Y_j P_i(t,t+T+j\Delta)}{\sum_{l=1}^{\overline{T}/\Delta} Y_l P_i(t,t+T+l\Delta)}$, $Y_j = \Delta\times K$ for $j = 1,2,\cdots,\frac{\overline{T}}{\Delta} - 1$, and $Y_{\overline{T}/\Delta} = 1+\Delta\times K$.

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Supplementary Material

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