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What Interbank Rates Tell Us About Time-Varying 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 argue 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 MLE and filter out 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.

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1 Introduction

As an explanation for puzzles in macro-finance, the rare disaster literature has received ample attention (for a comprehensive review, see Tsai and Wachter, 2015). The fundamental notion behind rare disasters is to put more weight on events that are extremely bad, albeit unlikely. Rietz (1988) and Barro (2006) introduce and formalize the rare disaster mechanism to explain the equity premium puzzle. More recently, Gabaix (2012), Gourio (2012), and Wachter (2013) incorporate variable disaster risk to account for puzzles related to volatility and return predictability.

However, rare disaster models have also received their fair share of criticism. For example, rare disasters are often referred to as "dark matter" because of the rarity of their observations and the obscurity of their source.[1] These criticisms point to the fact that it is difficult to reliably estimate the parameters associated with disasters. In line with this, Chen, Dou, and Kogan (2021) raise concerns with regard to overfitting in-sample data: if a disaster model excessively overfits in-sample data, then the model implication would be sensitive to small perturbations of disaster parameters. Estimating time-varying disaster risk is even more challenging. Cochrane (2017) considers time-varying probabilities of disasters as "dark energy" unless there is a way to independently anchor them to an external data source.

In this paper, we address these issues by estimating the time variation in disaster risk using interbank rates and their options. The key assumption we make is that macroeconomic disasters are likely to coincide with interbank market failure. The connection between the two types of extreme events has been empirically supported; according to Reinhart and Rogoff (2013), virtually all consumption disasters documented by Barro and Ursúa (2008) were accompanied

[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; Wachter, 2013) or as a significant reduction in total factor productivity (e.g., Gourio, 2012).

by severe systemic banking crises.[2] Intuitively, this assumption provides a direct link between disaster risk and 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 the four state variables of the economy: real consumption growth, expected inflation, short-run disaster risk, and long-run disaster risk. Under our framework, we derive the model expressions for the interbank rate and the Treasury rate for each maturity. In our model, nominal government bonds always pay back the promised amount at the end of their maturity, but interbank lending contracts are potentially subject to partial defaults if a disaster occurs. Therefore, their yield gap, the so-called TED spread, is highly informative about disaster risk, directly reflecting the two disaster-related state variables.

In addition to the TED spread, we take advantage of interest rate caps and swaptions. We approach these financial instruments from a different 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 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 using the data from

[2]The general idea of linking macroeconomic crises and banking crises has been well established in the literature. Bernanke (1983) argues that the failure of a substantial fraction of U.S. banks was the primary reason behind the Great Depression. Moreover, Allen, Bali, and Tang (2012) and Giesecke, Longstaff, Schaefer, and Strebulaev (2014) empirically compare the risk of financial sector defaults with that of non-financial corporate defaults and find that the former influences macroeconomic downturns, whereas the latter does not.

January 1997 to December 2019.[3] 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 extended Kalman filter because caps and swaption prices are nonlinear functions of the latent and observable state variables. From a sensitivity analysis, we discover that the short-run component of disaster risk is mainly identified by the TED spread with a short maturity. In contrast, the long-run component of disaster risk is primarily filtered out 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 dynamics of disaster risk.

Overall, our results emphasize 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 parameter estimates suggest that disaster risk is significant in magnitude and in variation, strongly supporting macro-finance models with the rare disaster mechanism. In addition, 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 should be associated with various conditional moments and returns in the equity market. All in all, our findings corroborate the disaster-based explanation of various asset pricing puzzles.

We contribute to the rare disaster literature by estimating the time-varying risk of economic disasters. Granted, we are not the first to attempt to quantify the time series variation in

[3]In Section 4.5, we extend the data to December 2020 and examine how disaster risk evolved during the COVID-19 pandemic crisis.

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.[4] 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 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 paper 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 are key drivers of market risk premia. Adrian, Etula, and Muir (2014) and He, Kelly, and Manela (2017) empirically support the theory by showing that intermediary-induced factors outperform traditional risk factors in explaining asset returns

[4]Related, Bollerslev and Todorov (2011a), Bollerslev and Todorov (2011b), Bollerslev and Todorov (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.

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 generates 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 paper proceeds as follows. Section 2 describes the model. Section 3 describes the data as well as explains how we estimate the model and extract time-varying disaster risk. Section 4 reports the estimation results and discusses their implications. Section 5 concludes.

2 Model

2.1 The Risk of Disasters and Interbank Rates

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

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

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 (i.e., $dN_t = 1$), consumption falls from C_{t^-} to $C_{t^-}e^{Z_{C,t}}$. Given this setup, the core question at hand 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

$$\begin{aligned} d\lambda_t &= \kappa_\lambda(\xi_t - \lambda_t)dt + \sigma_\lambda\sqrt{\lambda_t}dB_{\lambda,t}, \\ d\xi_t &= \kappa_\xi(\bar{\xi} - \xi_t)dt + \sigma_\xi\sqrt{\xi_t}dB_{\xi,t}, \end{aligned}$$

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.

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 extreme 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 $\bar{p}$, 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. By defining I_t as a Bernoulli random variable with success probability $\bar{p}$, we can express the dynamics of L_t as

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

Note that 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 difference between the 3-month interbank rate and the 3-month Treasury rate, the so-called TED spread, contains important information about disaster risk. To illustrate, we compare the expressions for interbank rates and Treasury rates. 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, nominal government bonds always pay back the promised amount at the end of their maturity. The τ-maturity zero-coupon government bond yield (or simply, Treasury rate) is calculated as:

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

Comparing equations (2) and (3) suggests that changes in disaster risk have a direct effect on the TED spread, defined as $\left[y_{i,t}^{(0.25)} - y_{g,t}^{(0.25)} \right]$. When disaster risk rises, the expectation of the future payoff $\frac{L_{t+\tau}}{L_t}$ decreases, which pushes interbank rates upward. However, this effect is missing for Treasury rates as the future payoff from default-free government bonds is always 1. As a result, the TED spread 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 interbank rates and Treasury rates through the pricing kernel. However, if risk factors only impact the pricing kernel but not the future payoff $\frac{L_{t+\tau}}{L_t}$, they will move interbank rates with the same degree as Treasury rates, leaving the TED spread unchanged. Since the distribution $\frac{L_{t+\tau}}{L_t}$ only depends on instantaneous disaster risk λ_t and its time-varying mean ξ_t (as clear in equation (1)), this suggests that risk factors that are orthogonal to λ_t and ξ_t will have no impact on the TED spread. In Section 2.2, we show that the TED spread indeed depends only on λ_t and ξ_t in our fairly flexible setup, confirming this intuition.

Our view that the TED 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 TED spread) into a liquidity component and a pure credit component.[5] 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. For instance, during a severe economic downturn, it is possible that interbank market liquidity dries up (systemic liquidity shock) and investors hoard Treasury bills (flight to safety), extending the TED spread. Modeling these market phenomena separately is beyond the scope of our paper. Instead, we simply capture the risk of such an economic downturn using disaster risk, which we view as the ultimate origin of various market phenomena.

Lastly, we note that the fluctuations in the TED spread are purely systematic in our framework, as they are driven by disaster risk. One might argue that the TED spread can also be influenced by bank-specific shocks. Granted, the 3-month interbank rate (i.e., 3-month LIBOR), which the TED spread is built on, is calculated empirically using input data from only about a dozen contributor banks. However, they are large and systemically important banks. Significant shocks to these banks cannot be purely idiosyncratic, considering their critical roles

[5]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).

in the intricately intertwined banking system.

2.2 Term Structure of Interest Rates

Equations (2) and (3) make it clear that we need a nominal pricing kernel $\frac{M_{t+\tau}}{M_t}$ to derive the expressions for zero-coupon yields on interbank lending and on government bonds. Before specifying the pricing kernel, we first establish the state variables in the economy. In addition to real consumption (C_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 interest rates. In our model, the expected inflation process q_t solves the following stochastic differential equation:

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

where $B_{q,t}$ is a standard Brownian motion. As highlighted in Tsai (2015), it is necessary for macroeconomic disasters to coincide with positive jumps in expected inflation in order to generate an upward-sloping term structure of nominal interest rates. For parsimony, we capture this commonality by assuming 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.

We specify our pricing kernel in a general form so that it can be directly estimated using data. We assume that Brownian shocks ($dB_{C,t}$, $dB_{\lambda,t}$, $dB_{\xi,t}$, $dB_{q,t}$) are independent of one another and of a Poisson shock (dN_t). These five independent shocks to the four state variables

$(C_t,\, \lambda_t,\, \xi_t,\, q_t)$ are priced and hence constitute the nominal pricing kernel:

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

where r_t represents the instantaneous nominal risk-free rate. To preserve the affine structure of our setup, we represent r_t as a linear function of the state variables, similar to Ang and Piazzesi (2003) and Joslin, Le, and Singleton (2013):

$$r_t \;=\; \delta_0 + \delta_\lambda \lambda_t + \delta_\xi \xi_t + \delta_q q_t. \quad (5)$$

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 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 $y_{g,t}^{(\tau)}$ in equations (2) and (3). We show that both interbank rates and Treasury rates are linear in state variables λ_t, ξ_t, and q_t:

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

$$y_{g,t}^{(\tau)} \;=\; -\frac{1}{\tau}\left[a_g(\tau) + b_{g,\lambda}(\tau)\lambda_t + b_{g,\xi}(\tau)\xi_t + b_q(\tau) q_t\right], \quad (7)$$

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

One notable aspect when comparing equations (6) and (7) is that the loadings on expected inflation q_t are identical for both types of interest rates. Therefore, for each maturity τ, the

difference between the interbank rate and the Treasury rate becomes a function of disaster risk (λ_t, ξ_t) alone, consistent with the intuition developed in Section 2.1. Although the TED spread typically refers to the gap in the 3-month yields, we expand its definition for an arbitrary τ and refer to it as the τ-maturity TED spread hereafter:

$$\text{TED}_t^{(\tau)} = -\frac{1}{\tau}\Big[\big(a_i(\tau) - a_g(\tau)\big) + \big(b_{i,\lambda}(\tau) - b_{g,\lambda}(\tau)\big)\,\lambda_t + \big(b_{i,\xi}(\tau) - b_{g,\xi}(\tau)\big)\,\xi_t\Big]. \tag{8}$$

2.3 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:

$$P_i(t, t+\tau) = \exp\left(-\tau \cdot y_{i,t}^{(\tau)}\right). \tag{9}$$

In other words, $P_i(t, t+\tau)$ represents the time-t value of \$1 zero-coupon interbank lending maturing at time $t+\tau$.

In addition, we need the expression for the 6-month LIBOR in the model. Recall that the 6-month LIBOR is a simple interest rate and, therefore, is not exactly the same as the continuously compounded rate $y_{i,t}^{(0.5)}$. In fact, the 6-month LIBOR rate is expressed as:

$$\text{LIBOR}_t = 2\left[\exp\left(\tau \cdot y_{i,t}^{(\tau)}\right) - 1\right] = 2\left(\frac{1}{P_i(t, t+0.5)} - 1\right). \tag{10}$$

An interest rate cap consists of a series of caplets that mature every 6 months.[6] Specifically, the first caplet matures 6 months from today, and the last caplet matures 6 months prior to

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

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 j-th 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 $\Delta \times \big(\text{LIBOR}_{t_j} - K\big)$. 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:

$$V_{\text{cap}}^{(T)}(t, K) = \sum_{j=1}^{m_T} \mathbb{E}_t^Q \left[\exp\left(- \int_t^{t_{j+1}} r_s ds \right) \left[\Delta \times \left(\text{LIBOR}_{t_j} - K \right) \right]^+ \right], \tag{11}$$

where Q represents the risk-neutral measure (see Appendix A.1).[7] In Appendix A.3, we demonstrate that equation (11) can be computed using the transform analysis of Duffie, Pan, and Singleton (2000).

An interest rate swaption grants the holder the right, not the obligation, to enter into an interest rate swap (IRS). There are two types of swaptions. When exercised, a payer swaption delivers an IRS where the holder pays the fixed leg and receives the floating leg (a payer IRS); a receiver swaption delivers an IRS where the holder receives the fixed leg and pays the 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 $\bar{T}$. Under this notation, our swaptions of interest are often referred to as T-into-$\bar{T}$ swaptions.

[7] We can obtain the same result if we multiply the cap payoff by the pricing kernel and take the expectation under the physical measure. Following the convention in the literature on interest rate derivatives, we use the pricing relation under the risk-neutral measure.

The payer swaption is exercised if the future $\bar{T}$-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 profit, or the value of this payer IRS at time $t+T$, is simply the difference between its floating leg and its fixed leg. The floating leg is always 1 because it is equivalent to the value of a floating rate note whose coupons reset periodically. In contrast, the fixed leg is equivalent to the value of a dollar notional coupon bond with the (annualized) coupon rate of K:

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

Therefore, the time-t payer swaption value is expressed as:

$$V_{\text{pay}}^{(T,\bar{T})}(t,K) = \mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[1 - V_{\text{fixed}}^{(\bar{T})}(t+T,K)\right]^+\right]. \tag{13}$$

Similarly, the receiver swaption is exercised if the future $\bar{T}$-maturity swap rate at time $t+T$ is smaller than the strike K. The time-t receiver swaption value is expressed as:

$$V_{\text{rcv}}^{(T,\bar{T})}(t,K) = \mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[V_{\text{fixed}}^{(\bar{T})}(t+T,K) - 1\right]^+\right]. \tag{14}$$

These equations suggest 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 (13) and (14) using the semi-analytic approach of Duffie, Pan, and Singleton (2000). To make the computation tractable, we adopt the so-called stochastic duration method implemented by Trolle and Schwartz (2009). This method 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.

3 Estimation

3.1 Data

Our data sample consists of the following variables: interbank 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 January 1997 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.[8] We also collect the Treasury rates with the same maturities from the Federal Reserve Bank of St. Louis. To make the data comparable with the model-implied interest rates, we need to convert the two 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.

Note that our analysis relies on interest rates with maturities up to 5 years, despite their availability 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

[8]On March 5, 2021, the ICE Benchmark Administration Limited announced the complete discontinuation of the publication of USD LIBOR effective June 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), Jermann (2020a), and Klingler and Syrstad (2021) for further discussion about the transition from USD LIBOR to SOFR.

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 (2020b) shows that negative swap spreads can be justified via limits to arbitrage associated with frictions for 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.[9] 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-$\bar{T}$ ATMF swaption is the forward swap rate between the option expiry (T years from today) and the underlying swap expiry ($T + \bar{T}$ years from today).

The data on expected inflation is obtained from the Blue Chip Economic Indicators survey. This dataset provides the forecasts of inflation for the current calendar year and the next calendar year. For each month, we calculate a proxy for the 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 from the Federal Reserve Bank of St. Louis.

[9]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. Since the source "BBIR" provides the time series from April 2002, we complement it by adding the swaption data from the source "CMPN" for the period between January 1997 and March 2002.

3.2 Extended Kalman Filter and Maximum Likelihood Estimation

From the data described in Section 3.1, we filter out the time series of the latent processes (λ_t, ξ_t) using the extended 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, Pan, and Singleton (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 μ_C, σ_C, κ_q, $\bar{q}$, and σ_q, which govern the normal-time dynamics of real consumption and expected inflation. This is possible because a consumption disaster is absent during our sample period, implying that the observed time series of real consumption and expected inflation were completely driven by these five parameters. Specifically, μ_C and σ_C are estimated by maximizing the log-likelihood of the real consumption time series, conditional on no disasters. Similarly, κ_q, $\bar{q}$, and σ_q are estimated from the expected inflation time series via MLE.

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:

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

Here, we proxy the unconditional mean of the short rate ($\mathbb{E}[r]$) by the average 1-month risk-free rate ($\hat{\mathbb{E}}[r]$) from the CRSP dataset. Then, the value of δ_0 can be obtained as:

$$\delta_0 = \hat{\mathbb{E}}[r] - \delta_\lambda \bar{\xi} - \delta_\xi \bar{\xi} - \delta_q \hat{\mathbb{E}}[q],$$

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

Moreover, we set $\bar{\xi}$ 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-Ursua dataset.[10] Lastly, we assume $Z_{L,t} \equiv Z_{C,t}$: the more severe the interbank market failure, the more severe the consumption disaster.[11]

As a result, we are left with 15 parameters to be estimated within the main MLE procedure:

$$\Theta = [\kappa_\xi, \sigma_\xi, \kappa_\lambda, \sigma_\xi, \bar{p}, \delta_\lambda, \delta_\xi, \delta_q, \theta_\lambda, \theta_\xi, \theta_q, \theta_N, \sigma_{SP}, \sigma_{ITR}, \sigma_{OPT}],$$

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

To obtain 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 $Y_{t-\Delta t}$:

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

where $\Delta t = 1/12$ represents monthly time intervals between observations. Not only does this

[10] The Barro-Ursua dataset 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.

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

transition density depend on the observable state variable q_t, it also relies on the two latent variables λ_t and ξ_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 $S_t = [\lambda_t, \xi_t]^\top$. 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 and ξ_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 two latent processes. Consequently, we obtain the following linear state equation:

$$S_t = \eta + \Psi S_{t-\Delta t} + \epsilon_t, \quad \text{where } \mathbb{E}_{t-\Delta t}\left[\epsilon_t \epsilon_t^\top\right] = \Omega_{t-\Delta t}. \tag{15}$$

We provide the expressions for two-dimensional vector η, 2×2 matrix Ψ, and 2×2 time-varying covariance matrix Ω in Appendix B. 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.[12]

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

$$Y_t = h(S_t, q_t) + e_t, \quad \text{where } \mathbb{E}_{t-\Delta t}\left[e_t e_t^\top\right] = Q. \tag{16}$$

Note that $h(\cdot)$ 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 distributed with co-

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

variance matrix Q. For parsimony, we assume that Q is determined by the following three parameters: the standard deviation of the measurement errors for TED spreads (σ_{SP}), the one for interest rates (σ_{ITR}), and the one for Black-implied volatilities (σ_{OPT}). All measurement errors are iid and independent of one another.

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 extended Kalman filter, in which h is locally linearized at each set of predicted values of the state variables. In Appendix B, we provide a detailed description of how the extended 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 $\left\{\hat{\lambda}_t,\ \hat{\xi}_t\right\}$, 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:

$$\log \mathcal{L} = \sum_{k=1}^{n} \log \mathcal{L}_{t_k}. \tag{17}$$

We obtain our parameter estimates by maximizing this log-likelihood function.[13]

[13]For robustness, we also run the penalized MLE by adopting the fragility measure of Chen, Dou, and Kogan (2021) as a penalty function. The fragility measure captures how much our estimated model overfits in-sample data relative to the baseline case, in which the model is estimated only based on interest rates without interbank options. While the penalized MLE slightly changes the point estimates of the model parameters, we find that the overall implications of the model remain intact.

4 Estimation Results and Implications

4.1 Parameter Estimates

Table 1 reports the values of our parameter estimates, together with their robust standard errors in parentheses. First of all, we can observe that the parameter values for consumption growth and expected inflation are economically sensible. During normal periods without disasters, consumption growth has a mean (μ_C) of 1.41% and a standard deviation (σ_C) of 0.83%, consistent with the first two moments of the observed consumption time series in our sample. The parameter values for expected inflation are also in line with the corresponding data time series: the long-run mean ($\bar{q}$) is about 2%, the conditional volatility (σ_q) is 0.6%, and the monthly autocorrelation ($e^{-\kappa_q \Delta t}$) is approximately 0.96.

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 ($\kappa_\lambda = 0.2786$ and $\kappa_\xi = 0.0558$), 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 exhibits a higher conditional volatility than ξ_t (i.e., $\sigma_\lambda > \sigma_\xi$). Overall, our results reveal that the estimated dynamics of disaster risk are broadly consistent with the calibration of Seo and Wachter (2018), who adopt the same two-factor disaster risk structure. In Section 4.3, 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 ($\bar{p}$) is estimated as 0.96, suggesting that the two types of extreme events are indeed likely to coincide.

The estimated coefficients δ_λ, δ_ξ, and δ_q in Table 1 show how the three state variables λ_t, ξ_t, and q_t affect the nominal risk-free rate in our estimated model. We observe that the

factor loadings on λ_t and ξ_t are negative. This is in accordance with the intuition behind the precautionary savings motive. When disaster risk rises, investors are inclined to save more to secure against future uncertainty, and this drives down the real risk-free rate in equilibrium. In contrast, the factor loading on expected inflation is positive. This can be explained by the so-called Fisher effect: the nominal risk-free rate is approximately the real risk-free rate plus the expected inflation rate. Indeed, the magnitude of δ_q is 0.80, implying that a 1% increase in expected inflation leads to a roughly 1% increase (a 0.8% increase, to be exact) in the nominal risk-free rate.

Additionally reported are the market prices of risk. We find that the signs of these four coefficients are reasonable. The market prices of diffusive risk (θ_λ, θ_ξ, and θ_q) are positive.[14] This suggests that the pricing kernel or investors' marginal utility rises when a positive Brownian shock ($dB_{\lambda,t}$, $dB_{\xi,t}$, or $dB_{q,t}$) is realized. In contrast, the market price of jump risk (θ_N) is negative. This indicates that $e^{\theta_N Z_{C,t}}$ is larger than 1, which subsequently implies that the pricing kernel goes up when a disaster occurs ($dN_t = 1$). All in all, we conclude that the signs and magnitudes of the model parameters from our estimation well comply with general economic intuition.

4.2 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. We first examine short-term interest rates by plotting the time series of the Treasury rate (Panel A), the interbank rate (Panel B), and the TED spread (Panel C) with a 3-month maturity in the data (solid blue line) and in the model (dashed red line). All interest rates are expressed as continuously compounded rates. As described in Section 2.2, the TED spread is calculated as the difference between the interbank

[14] In our estimation, θ_c is not identified because it is irrelevant for interest rates and interest rate options.

rate and the Treasury rate, both with continuous compounding.

Panel A of Figure 1 shows that at the beginning of our data sample from 1997 to 2001, the 3-month Treasury rate maintained a relatively stable level, fluctuating between 4% and 6%. Note that we can see a small dip toward the end of 1998, which corresponds to the Long-Term Capital Management (LTCM) crisis. Starting from 2001, the Treasury rate entered a steady downward trend up 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 due to the 2001 recession, the September 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 maintained a very low level until the Federal Reserve started raising interest rates in 2015.

The 3-month interbank rate in Panel B of Figure 1 also exhibits a similar time series pattern in general compared to the 3-month Treasury rate, although its magnitude is slightly larger. However, a distinctive pattern is observed around September 2008 when Lehman Brothers filed for bankruptcy. In contrast to the Treasury rate, 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 TED spread in Panel C of Figure 1. While the TED spread stayed at a high level between 2007 and 2009 during the Great Recession period, an exceptionally high value of over 3% was seen in September 2008. Also of note is the early part of the sample between 1997 and 2000. Not only was the TED spread relatively high, it significantly fluctuated with a cluster of small peaks due to the events surrounding the 1997 Asian financial crisis, the 1998 Russian moratorium, the LTCM crisis, and the dot-com bubble burst.

From the three panels of Figure 1, we find that our model is able to account for these patterns of the Treasury rates and interbank rates as well as their differences. 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 around the same points in time. This is the case for longer-maturity interest rates as well: in Figure 2, we find that the model-implied Treasury rates and interbank rates with 1-, 3-, and 5-year maturities mimic their data counterparts fairly well. Granted, the fit is not perfect. For instance, although our model matches the low-frequency trend of the 5-year Treasury rates and interbank rates relatively well, it does not capture some of their high-frequency short-run fluctuations, as can be seen in Panels C and F of Figure 2. Instead of adding more factors to improve the fit, we choose to keep our model simple and parsimonious, as our goal is to extract time-varying disaster risk, not to fit interest rates.

We now turn to caps and swaptions. Panels A, B, C, and D of Figure 3 present the time series of the Black-implied volatilities for the 2-, 3-, 4-, and 5-year caps, and Panels E, F, G, and H present those for the 1-into-4, 2-into-3, 3-into-2, and 4-into-1 swaptions. In each panel, the solid blue line denotes the data, and the dashed red line denotes the model.

Before discussing the model outcomes, we point out that interpreting the magnitude and the time series variation of Black-implied volatilities in the data is not straightforward. For example, the Black-implied volatilities for the 2-year cap are generally much higher than those for the 5-year cap. Why is this the case? Furthermore, in all of the panels in Figure 3, the Black-implied volatilities between 2010 and 2016 are exceptionally high even compared to the Great Recession period between 2007 and 2009.

Why do the time series and cross sectional patterns of Black-implied volatilities seem odd? The reason is that Black-implied volatilities for caps and swaptions, converted from their market prices through the Black formulas, represent yield volatilities, not bond price volatilities. Hence,

the level of Black-implied volatilities simply tends to be higher when the level of interest rates is lower. This explains why Black-implied volatilities in the data turn out to be so high in the post Great Recession period, despite relatively lower uncertainty in the market: a 1% expected movement in a yield corresponds to 20% yield volatility if the yield is currently at 5%, whereas it corresponds to 100% if the yield is at 1%. To facilitate interpretation, it is possible to convert each Black-implied volatility into its equivalent price volatility. Under the Black model, forward yield volatility σ_{yield} shares the following relation with forward-starting bond price volatility σ_{price}:

$$\sigma_{\text{price}} = \tau \times y \times \sigma_{\text{yield}},$$

where, with a slight abuse of notation, τ is the maturity of the bond and y is the given (forward) yield. Using this simple relation, Figure 4 converts the Black-implied volatilities in the data and in the model into their equivalent forward-starting bond price volatilities. The Black-implied volatility for the T-maturity cap is converted into the price volatility of a bond that corresponds to its last caplet: a 6-month zero-coupon bond starting after $(T-0.5)$ years and maturing after T years from today. The Black-implied volatility for the T-into-$\bar{T}$ swaption is converted to the price volatility of a $\bar{T}$-maturity zero-coupon bond starting T years from today.

Figure 4 shows that our model's fit to the data is decent but not perfect. While the fit to short-maturity caps and short-tenor swaptions (Panels A, B, G, and H) is reasonably good, the model slightly exaggerates the fluctuations of longer-maturity caps and longer-tenor swaptions compared to the data (Panels C, D, E, and F). It is not surprising that our model is not able to well 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 a flexible statistical model featuring several latent processes (Longstaff, Santa-Clara, and Schwartz, 2001; Han, 2007; Trolle and Schwartz, 2009). We want to reiterate that 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. For our purposes, we believe that our simple economic model does a reasonably good job in capturing the data overall.

4.3 Characterizing Time-Varying Disaster Risk

Our estimation procedure enables us to characterize the time variation in disaster risk via the extended Kalman filter. Figure 5 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 the figure, it is clear 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. At the beginning of our sample, we can observe a few spikes around the LTCM crisis and the dot-com bubble burst, at which λ_t rose beyond 3%. While the instantaneous disaster risk hovered around a low level of 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 jumped to a level above 6%. Specifically, 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, like in the European sovereign debt crisis.

While λ_t captures a fast-moving component of disaster risk, ξ_t captures a slow-moving component. The filtered time series in Figure 5 reveal that ξ_t is much less volatile than λ_t 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 was still high 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 6 shows how TED spreads (Panel A) and Black-implied volatilities for caps (Panel B) and swaptions (Panel C) change when we vary λ_t or ξ_t from the 10th percentile to the 90th percentile of its filtered values. In each panel, 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 is set at its median value in both cases. Lastly, the black dot in the middle of each bar graph represents the model value when λ_t and ξ_t are both at their median values.

Panel A of Figure 6 reveals that the short-run component of disaster risk λ_t is mainly identified by TED spreads. While TED spreads increase with both λ_t and ξ_t, they are much more sensitive to λ_t. For example, the 3-month TED spread moves substantially, ranging from 0.2% to 0.75%, when λ_t varies between the 10th and 90th percentiles. In contrast, the 3-month TED spreads barely change with respect to ξ_t, as can be seen in the panel.

These results are intuitive. The 3-month interbank rate is higher than the 3-month Treasury yield because it is further influenced by the risk of a disaster happening over a 3-month horizon. Therefore, their gap, the 3-month TED 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 panel, we find that the longest TED spread with a 12-month maturity is more responsive to changes in ξ_t, compared to the 3-month TED spread. However, the magnitude of 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 TED 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 TED spreads, it has

a large impact on interbank rate options. In Panels B and C of Figure 6, we discover completely opposite patterns. The Black-implied volatilities in both panels are highly sensitive to changes in ξ_t, whereas they are relatively less sensitive to changes in λ_t. Note that 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.

In sum, our analysis demonstrates that both the short-run and long-run components of disaster risk are well identified using the data on interbank rates and their options. As discussed in Section 2.1, TED spreads do not depend on any risk factors orthogonal to disaster risk and, thus, are highly informative about disaster risk, especially with respect to its short-run component. Furthermore, caps and swaptions are long-term option contracts on future interbank rates, which are pivotal in estimating the long-run component of disaster risk. It is worth noting 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.

4.4 Implications for the Equity Market

Rare disaster models are often criticized as a macro-finance model 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 its 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 stock market moments, such as the equity premium and the market volatility.

However, Chen, Dou, and Kogan (2021) 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 TED spreads as well as caps and swaptions. Since our estimation does not depend on equity market moments, our estimation results can serve as an external/out-of-sample validity test of disaster risk models for the equity market. The parameter estimates from Section 4.1 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; Gourio, 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 time series provide an extra basis for testing the implications of disaster risk for the equity market. First of all, Panel A of Table 2 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).[15] 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

[15]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.

state variables.

Hence, we regress the five conditional equity market moments 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 0.39 standard deviation drop in the log price-dividend ratio. A one standard deviation increase in ξ_t leads to a 0.75 standard deviation drop in the log price-dividend ratio. These negative relations are statistically significant with high Newey and West (1987) t-statistics.[16] 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 expected realized variance measure the risk-neutral and physical expectations of future 1-month stock market variance, respectively. The variance risk premium, 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 2 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

[16]Since the sample size is 276, we choose the number of lags to be $0.75\sqrt[3]{276} \simeq 5$, following Newey and West (1994).

index price.[17] 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 regressing 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 3 reports the results from regressing the market, size, value, momentum, and liquidity factors on changes in λ_t and ξ_t.[18] 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. We do not discover any significant results for the value and momentum factors.

[17] We download options data from OptionMetrics. Since we do not observe options with fixed moneyness nor a constant maturity everyday, 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.

[18] 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.

Lastly, Panel B of Table 3 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, utilities, energy, and healthcare, are likely to be less exposed to disaster risk. This intuition is confirmed in Panel B: the relations between changes in disaster risk and industry returns show relatively small t-statistics for industries including consumer non-durables, energy, healthcare, and utilities (columns (6)-(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 highly significant negative relations.

4.5 COVID-19 Pandemic Crisis

In 2020, the global economy and financial markets were severely impacted by the COVID-19 pandemic crisis. What do interbank rates and their options imply about this crisis through our model framework?

We extend our data sample and examine how the implied short-run and long-run components of disaster risk progressed over the pandemic period. Based on the parameter estimates in Table 1, we apply the extended Kalman filter constructed in Section 3.2 to the data from January 2020 to December 2020. Figure 7 plots the resulting time series of filtered λ_t (solid blue line) and ξ_t (dashed red line).

The figure reveals that the long-run component ξ_t showed a relatively stable pattern, while it steadily increased at a modest rate throughout 2020 (3.50% in January and 3.96% in December). In contrast, the short-run component λ_t exhibited more drastic changes over the period. Until February, λ_t remained at a low level below 1%, but it jumped up to about 4% in March and rose as high as 6% in April. This was followed by an abrupt decline in May, pushing λ_t quickly back to its pre-pandemic level.

Overall, Figure 7 suggests that, at least through our model framework, the COVID-19 pandemic resulted in a very short-lived economic/financial crisis, despite the fact that the pandemic and its impact are very much in play even in 2021. This interpretation is in line with the view of the Business Cycle Dating Committee of the NBER; the committee recently determined that the pandemic-originated recession only lasted for two months (March and April), making it the shortest U.S. recession ever documented.

5 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 paper 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 TED spreads and prices on interbank rate options 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 time-varying disaster probabilities but also their dynamics.

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 also confirm that the implications of these models for equity moments and equity returns are consistent with the empirical evidence. Put together, we conclude that disaster risk has important implications for the equity market.

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:

$$\begin{aligned} dB^Q_{C,t} &= dB_{C,t} - \theta_C dt, \\ dB^Q_{\lambda,t} &= dB_{\lambda,t} - \theta_\lambda \sqrt{\lambda_t} dt, \\ dB^Q_{\xi,t} &= dB_{\xi,t} - \theta_\xi \sqrt{\xi_t} dt, \\ dB^Q_{q,t} &= dB_{q,t} - \theta_q dt, \end{aligned}$$

where θ_C, θ_λ, θ_ξ, and θ_q indicate the market prices of risk. Moreover, under the risk-neutral measure, the disaster intensity and the moment generating function (MGF) of the jump size distributions are represented as:

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

where $\Phi_Z(u_1, u_2, u_3) = \mathbb{E}\left[e^{u_1 Z_C + u_2 Z_L + u_3 Z_q}\right]$ 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,

$$\begin{aligned}
\frac{dC_t}{C_t} &= \mu_C^Q dt + \sigma_C dB_{C,t}^Q + \left(e^{Z_{C,t}} - 1\right) dN_t, \\
d\lambda_t &= \kappa_\lambda^Q(\nu\xi_t - \lambda_t)dt + \sigma_\lambda\sqrt{\lambda_t}dB_{\lambda,t}^Q, \\
d\xi_t &= \kappa_\xi^Q(\bar{\xi}^Q - \xi_t)dt + \sigma_\xi\sqrt{\xi_t}dB_{\xi,t}^Q, \\
dq_t &= \kappa_q^Q(\bar{q}^Q - q_t)dt + \sigma_q dB_{q,t}^Q + Z_{q,t}dN_t,
\end{aligned}$$

where $\mu_C^Q = \mu_C + \theta_C\sigma_C,\ \kappa_\lambda^Q = \kappa_\lambda - \sigma_\lambda\theta_\lambda,\ \nu = \frac{\kappa_\lambda}{\kappa_\lambda^Q},\ \kappa_\xi^Q = \kappa_\xi - \sigma_\xi\theta_\xi,\ \bar{\xi}^Q = \frac{\kappa_\xi\bar{\xi}}{\kappa_\xi^Q},\ \kappa_q^Q = \kappa_q$, and $\bar{q}^Q = \frac{\kappa_q\bar{q}+\theta_q\sigma_q}{\kappa_q^Q}$.

A.2 Zero-Coupon Rates on Interbank Lending and Government Bonds

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:

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

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, $b_{i,\lambda}$, $b_{i,\xi}$, $b_{i,q}$ as follows:

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

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

Similarly, the price of a government bond is given as:

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

and we conjecture the price has the form of

$$P_g(t, t+\tau) = \exp(a_g(\tau) + b_{g,\lambda}(\tau)\lambda_t + b_{g,\xi}(\tau)\xi_t + b_{g,q}(\tau)q_t).$$

Since $\left(e^{-\int_0^t r_u du}P_{g,t}(\tau)\right)$ 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_g, $b_{g,\lambda}$, $b_{g,\xi}$ and $b_{g,q}$:

$$\begin{aligned}
a_g'(\tau) &= -\delta_0 b_{g,\xi}(\tau)\kappa_\xi^Q\bar{\xi}^Q + b_{g,q}(\tau)\kappa_q^Q\bar{q}^Q + \frac{1}{2}b_{g,q}(\tau)^2\sigma_q^2, \\
b_{g,\lambda}'(\tau) &= -\delta_\lambda - b_{g,\lambda}(\tau)\kappa_\lambda^Q + \frac{1}{2}b_{g,\lambda}(\tau)^2\sigma_\lambda^2 + \Phi_Z(\theta_N, 0, b_{g,q}(\tau)) - \Phi_Z(\theta_N, 0, 0), \\
b_{g,\xi}'(\tau) &= -\delta_\xi + b_{g,\lambda}(\tau)\kappa_\lambda^Q\nu - b_{g,\xi}(\tau)\kappa_\xi^Q + \frac{1}{2}b_{g,\xi}(\tau)^2\sigma_\xi^2, \\
b_{g,q}'(\tau) &= -\delta_q - b_{g,q}(\tau)\kappa_q^Q,
\end{aligned}$$

with the initial conditions: $a_g(0) = b_{g,\lambda}(0) = b_{g,\xi}(0) = b_{g,q}(0) = 0$.

Note that $b_{i,q}(\tau)$ and $b_{g,q}(\tau)$ are identical, as their ODEs are identical with the same initial condition. Therefore, we simply denote them as $b_q(\tau)$.

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, Pan, and Singleton (2000), Collin-Dufresne and Goldstein (2003), and Trolle and Schwartz (2009), we compute the put option price by using the transform analysis:

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

where

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

Note that $\psi(\cdot)$ solves the complex-valued ODEs of Duffie, Pan, and Singleton (2000), and $\mathrm{Im}(\cdot)$ represents the imaginary part of a complex number.

The time-t cap price is given by equation (11). 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:

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

As discussed in Section 2.3, 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 (13) results in:

$$\begin{aligned} V_{\text{pay}}^{(T,\bar{T})}(t,K) &= \mathbb{E}_t^Q\left[\exp\left(-\int_t^{t+T} r_s ds\right)\left[1-V_{\text{fixed}}^{(\bar{T})}(t+T,K)\right]^+\right] \\ &\approx \zeta\mathcal{P}(t,T,t+\mathcal{D}(t,T,\bar{T}),\zeta^{-1}), \end{aligned} \tag{A.2}$$

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

$$\begin{aligned} & b_{i,\lambda}(\mathcal{D}(t))^2\sigma_\lambda^2\lambda_t + b_{i,\xi}(\mathcal{D}(t))^2\sigma_\xi^2\xi_t + b_q(\mathcal{D}(t))^2\sigma_q^2 \\ &\qquad + \left[\Phi(\theta_N,0,2b_q(\mathcal{D}(t))) - 2\Phi(\theta_N,0,b_q(\mathcal{D}(t))) + \Phi(\theta_N,0,0)\right]\lambda_t \\ &= \left[\sum_{j=1}^{\bar{T}/\Delta} w_j b_{i,\lambda}(T+j\Delta)\right]^2\sigma_\lambda^2\lambda_t + \left[\sum_{j=1}^{\bar{T}/\Delta} w_j b_{i,\xi}(T+j\Delta)\right]^2\sigma_\xi^2\xi_t + \left[\sum_{j=1}^{\bar{T}/\Delta} w_j b_q(T+j\Delta)\right]^2\sigma_q^2 \\ &\qquad + \left[\sum_{j=1}^{\bar{T}/\Delta}\left[w_j^2\Phi(\theta_N,0,2b_q(T+j\Delta)) - 2w_j\Phi(\theta_N,0,b_q(T+j\Delta))\right.\right. \\ &\qquad\qquad \left.\left. + \sum_{k>j} 2w_j w_k\Phi(\theta_N,0,b_q(T+j\Delta)+b_q(T+k\Delta))\right] + \Phi(\theta_N,0,0)\right]\lambda_t, \end{aligned} \tag{A.3}$$

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

B The Extended Kalman Filter

As discussed in Section 3.2, we derive the discrete-time state equation based on the exact relation between $S_t = [\lambda_t, \xi_t]^\top$ and $S_{t-\Delta t} = [\lambda_{t-\Delta t}, \xi_{t-\Delta t}]^\top$. To do so, we first integrate both

sides of the stochastic differential equations for λ_t and ξ_t from time $t-\Delta t$ to time t:

$$\begin{aligned}
\lambda_t &= \lambda_{t-\Delta t} + \kappa_\lambda \int_{t-\Delta t}^{t} (\xi_u - \lambda_u) du + \sigma_\lambda \int_{t-\Delta t}^{t} \sqrt{\lambda_u} dB_{\lambda,u}, \\
\xi_t &= \xi_{t-\Delta t} + \kappa_\xi \int_{t-\Delta t}^{t} (\bar{\xi} - \xi_u) du + \sigma_\xi \int_{t-\Delta t}^{t} \sqrt{\xi_u} dB_{\xi,u}.
\end{aligned}$$

Note that an Ito integral is a martingale and, hence, its conditional mean is zero. By taking the conditional expectations $\mathbb{E}_{t-\Delta t}[\cdot]$ on both sides of the equations, we simply obtain $\mathbb{E}_{t-\Delta t}[S_t] = \eta + \Psi S_{t-\Delta t}$, where

$$\begin{aligned}
\eta &= \begin{bmatrix} -\frac{\kappa_\lambda \bar{\xi}}{\kappa_\lambda - \kappa_\xi} \left(e^{-\kappa_\xi \Delta t} - e^{-\kappa_\lambda \Delta t}\right) + \bar{\xi}\left(1 - e^{-\kappa_\lambda \Delta t}\right) \\ \bar{\xi}\left(1 - e^{-\kappa_\xi \Delta t}\right) \end{bmatrix}, \\
\Psi &= \begin{bmatrix} e^{-\kappa_\lambda \Delta t} & \frac{\kappa_\lambda}{\kappa_\lambda - \kappa_\xi}\left(e^{-\kappa_\xi \Delta t} - e^{-\kappa_\lambda \Delta t}\right) \\ 0 & e^{-\kappa_\xi \Delta t} \end{bmatrix}.
\end{aligned}$$

This relation allows us to express S_t as in equation (15):

$$S_t = \mathbb{E}_{t-\Delta t}[S_t] + \epsilon_t, \quad \text{where } \mathbb{E}_{t-\Delta t}[\epsilon_t] = 0 \text{ and } \mathrm{Var}_{t-\Delta t}[\epsilon_t] = \Omega_{t-\Delta t},$$

where the 2×2 covariance matrix $\Omega_{t-\Delta t}$ is given by

$$\Omega_{t-\Delta t} = \begin{bmatrix} \Omega_{\lambda\lambda,t-\Delta t} & \Omega_{\lambda\xi,t-\Delta t} \\ \Omega_{\lambda\xi,t-\Delta t} & \Omega_{\xi\xi,t-\Delta t} \end{bmatrix}.$$

Clearly, ϵ_t is non-normal. However, in order to use a conventional filtering approach, we approximate it by a mean-zero normal random variable with the same covariance matrix $\Omega_{t-\Delta t}$.[19]

[19] As discussed in Section 3.2, it is well known that the effect of this approximation is minimal.

We find each element of $\Omega_{t-\Delta t}$ by considering the marginal and joint dynamics of λ_t and ξ_t:

$$
\begin{aligned}
\Omega_{\lambda\lambda,t-\Delta t} &= \frac{\kappa_\lambda^2\sigma_\xi^2\xi_{t-\Delta t}}{(\kappa_\lambda-\kappa_\xi)^2\kappa_\xi}\left(e^{-\kappa_\xi\Delta t}-e^{-2\kappa_\xi\Delta t}\right)+\frac{\kappa_\lambda^2\bar{\xi}\sigma_\xi^2}{2(\kappa_\lambda-\kappa_\xi)^2\kappa_\xi}\left(1-e^{-\kappa_\xi\Delta t}\right)^2 \\
&\quad-\frac{2\kappa_\lambda\sigma_\xi^2(\xi_{t-\Delta t}-\bar{\xi})}{(\kappa_\lambda-\kappa_\xi)^2}\left(e^{-\kappa_\xi\Delta t}-e^{-(\kappa_\lambda+\kappa_\xi)\Delta t}\right)-\frac{2\kappa_\lambda^2\sigma_\xi^2\bar{\xi}}{(\kappa_\lambda-\kappa_\xi)^2(\kappa_\xi+\kappa_\lambda)}\left(1-e^{-(\kappa_\lambda+\kappa_\xi)\Delta t}\right) \\
&\quad+\frac{\kappa_\lambda^2\sigma_\xi^2(\xi_{t-\Delta t}-\bar{\xi})}{(\kappa_\lambda-\kappa_\xi)^2(2\kappa_\lambda-\kappa_\xi)}\left(e^{-\kappa_\xi\Delta t}-e^{-2\kappa_\lambda\Delta t}\right)+\frac{\kappa_\lambda\sigma_\xi^2\bar{\xi}}{2(\kappa_\lambda-\kappa_\xi)^2}\left(1-e^{-2\kappa_\lambda\Delta t}\right) \\
&\quad+\frac{(\lambda_{t-\Delta t}-\bar{\xi})\sigma_\lambda^2}{\kappa_\lambda}\left(e^{-\kappa_\lambda\Delta t}-e^{-2\kappa_\lambda\Delta t}\right)+\frac{\kappa_\lambda(\xi_{t-\Delta t}-\bar{\xi})\sigma_\lambda^2}{(\kappa_\lambda-\kappa_\xi)(2\kappa_\lambda-\kappa_\xi)}\left(e^{-\kappa_\xi\Delta t}-e^{-2\kappa_\lambda\Delta t}\right) \\
&\quad-\frac{(\xi_{t-\Delta t}-\bar{\xi})\sigma_\lambda^2}{\kappa_\lambda-\kappa_\xi}\left(e^{-\kappa_\lambda\Delta t}-e^{-2\kappa_\lambda\Delta t}\right)+\frac{\bar{\xi}\sigma_\lambda^2}{2\kappa_\lambda}\left(1-e^{-2\kappa_\lambda\Delta t}\right), \\
\Omega_{\xi\xi,t-\Delta t} &= \frac{\sigma_\xi^2\xi_{t-\Delta t}}{\kappa_\xi}\left(e^{-\kappa_\xi\Delta t}-e^{-2\kappa_\xi\Delta t}\right)+\frac{\sigma_\xi^2\bar{\xi}}{2\kappa_\xi}\left(1-e^{-\kappa_\xi\Delta t}\right)^2, \\
\Omega_{\lambda\xi,t-\Delta t} &= \frac{\kappa_\lambda}{\kappa_\lambda-\kappa_\xi}\Omega_{\xi\xi,t-\Delta t} \\
&\quad-\frac{\sigma_\xi^2\left(\xi_{t-\Delta t}-\bar{\xi}\right)}{\kappa_\lambda-\kappa_\xi}\left(e^{-\kappa_\xi\Delta t}-e^{-(\kappa_\lambda+\kappa_\xi)\Delta t}\right)-\frac{\kappa_\lambda\sigma_\xi^2\bar{\xi}}{(\kappa_\lambda-\kappa_\xi)(\kappa_\lambda+\kappa_\xi)}\left(1-e^{-(\kappa_\xi+\kappa_\lambda)\Delta t}\right).
\end{aligned}
$$

Since our measurement equation is not linear in the state variables, we adopt the extended Kalman filter. Specifically, we locally linearize the function $h(S,q)$ in equation (16) as follows:

$$h(S_t,q_t)\approx h\left(\hat{S}_{t|t-\Delta t},q_t\right)+H_t\times\left(S_t-\hat{S}_{t|t-\Delta t}\right),$$

where $\hat{S}_{t|t-\Delta t}$ is the predicted time-t state vector given the information at time $t-\Delta t$, and $H_t=\frac{\partial h}{\partial S}\left(\hat{S}_{t|t-\Delta t},q_t\right)$ is the partial derivative of $h(S,q)$ with respect to S, evaluated at the point $(\hat{S}_{t|t-\Delta t},\,q_t)$.

Then, according to the Kalman filter recursion, we obtain the filtered state vector at time

t (i.e., $\hat{S}_t$) from the filtered state vector at time $t - \Delta t$ (i.e., $\hat{S}_{t-\Delta t}$) as follows:

$$\begin{aligned}
\hat{S}_{t|t-\Delta t} &= \eta + \Psi \hat{S}_{t-\Delta t}, \\
P_{t|t-\Delta t} &= \Psi P_{t-\Delta t} \Psi' + \Omega_{t-\Delta t}, \\
\hat{S}_t &= \hat{S}_{t|t-\Delta t} + K_t \hat{e}_t, \\
P_t &= P_{t|t-\Delta t} - K_t H_t P_{t|t-\Delta t},
\end{aligned}$$

where

$$\begin{aligned}
K_t &= P_{t|t-\Delta t} H_t' F_t^{-1}, \\
F_t &= H_t P_{t|t-\Delta t} H_t' + Q, \\
\hat{e}_t &= Y_t - h\left(\hat{S}_{t|t-\Delta t}, q_t\right).
\end{aligned}$$

For the initial month, the values of $\hat{S}_{t-\Delta t}$ and $P_{t-\Delta t}$ are set to be the unconditional mean and variance of S_t. The Kalman filter recursion also enables us to calculate the likelihood of observing Y_t conditional on $Y_{t-\Delta t}$:

$$\log \mathcal{L}_t = -\frac{l}{2} \log(2\pi) - \frac{1}{2} \log |F_t| - \frac{1}{2} \hat{e}_t' F_t^{-1} \hat{e}_t,$$

where l is the size of the vector Y_t.

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Table 1: Parameter Estimates

Consumption growth	μ_C	σ_C		
	0.0141	0.0083		
	(0.0017)	(0.0005)		
Expected inflation	κ_q	σ_q	$\bar{q}$	
	0.5101	0.0060	0.0207	
	(0.2753)	(0.0009)	(0.0025)	
Disaster risk	κ_ξ	σ_ξ	$\bar{\xi}$	
	0.0558	0.0209	0.0286	
	(0.0011)	(0.0001)		
	κ_λ	σ_λ	$\bar{p}$	
	0.2786	0.1570	0.9646	
	(0.0014)	(0.0159)	(0.0141)	
Risk-free rate	δ_λ	δ_ξ	δ_q	δ_0
	-0.1641	-2.2303	0.7977	0.0712
	(0.0019)	(0.0671)	(0.0245)	
Market price of risk	θ_λ	θ_ξ	θ_q	θ_N
	0.1260	0.6437	1.9166	-0.1351
	(0.0049)	(0.0078)	(0.0640)	(0.0041)
Measurement errors	σ_{SP}	σ_{ITR}	σ_{OPT}	
	0.0010	0.0036	0.0691	
	(0.0001)	(0.0000)	(0.0004)	

Notes: This table reports the values of the model parameters estimated through the extended Kalman filter/MLE procedure. The model consists of the following four state variables: real consumption (c_t), expected inflation (q_t), instantaneous disaster intensity (λ_t), and the long-run mean of disaster intensity (ξ_t). We also report the risk-free rate factor loadings, the market prices of risk, and the conditional probability of interbank market failure given the occurrence of a disaster ($\bar{p}$). Lastly reported are the standard deviations of measurement errors, where subscripts SP, ITR, and OPT indicate TED spreads, interest rates, and Black-implied volatilities, respectively.

Table 2: Disaster Risk and Conditional Equity Moments

Panel A: Valuation ratios and variance-related variables					
	(1)	(2)	(3)	(4)	(5)
	log P/D	log P/E	IV	ERV	VRP
λ_t	-0.39	-0.30	0.60	0.57	0.27
	[-3.70]	[-3.03]	[3.25]	[2.77]	[2.07]
ξ_t	-0.75	-0.76	0.05	0.12	-0.06
	[-6.88]	[-7.55]	[0.61]	[1.58]	[-0.96]
Adj R^2 (%)	56.48	55.41	34.11	29.87	8.39
Panel B: Out-of-the-money put option prices					
	(1)	(2)	(3)	(4)	(5)
	1 month	3 months	6 months	9 months	12 months
λ_t	0.57	0.58	0.58	0.50	0.30
	[3.14]	[3.90]	[4.13]	[3.66]	[2.57]
ξ_t	0.09	0.13	0.21	0.28	0.25
	[1.01]	[1.42]	[2.26]	[2.82]	[2.37]
Adj R^2 (%)	30.49	31.34	31.97	25.48	11.06

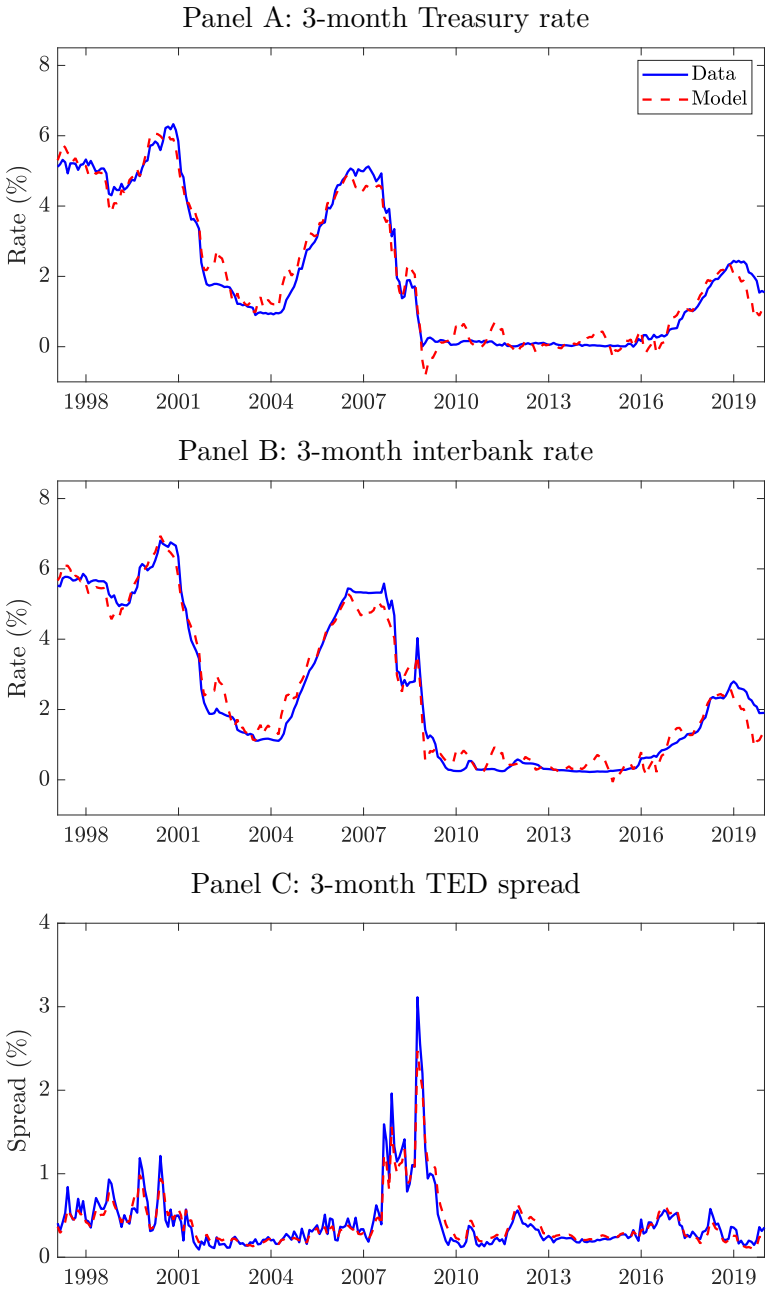
Notes: This table reports the results of contemporaneous time series regressions that examine the relation between the filtered disaster risk variables (λ_t and ξ_t) and conditional equity market moments. In both panels, we standardize the independent and dependent variables. In Panel A, the dependent variables are the log price-dividend ratio (log P/D), log price-earnings ratio (log P/E), implied variance (IV), expected realized variance (ERV), and the variance risk premium (VRP). In Panel B, the dependent variables are the normalized put prices of 90% moneyness put options with 1-, 3-, 6-, 9- and 12-month maturities. The t-statistics are reported in brackets and are computed based on the Newey and West (1987) method with five lags.

Table 3: Shocks to Disaster Risk and Equity Returns

Panel A: Factor portfolios					
	(1)	(2)	(3)	(4)	(5)
	MktRf	SMB	HML	MOM	LIQ
$\Delta\lambda_t$	-0.14	-0.10	0.12	-0.01	-0.18
	[-2.66]	[-2.07]	[1.66]	[-0.09]	[-2.25]
$\Delta\xi_t$	-0.20	-0.11	-0.02	0.07	-0.13
	[-2.91]	[-2.41]	[-0.26]	[0.84]	[-1.43]
Adj R^2 (%)	5.21	1.82	1.06	0.10	4.32
Panel B: Fama-French 10 industry portfolios					
	(1)	(2)	(3)	(4)	(5)
	Durbl	Manuf	HiTec	Telcm	Shops
$\Delta\lambda_t$	-0.11	-0.14	-0.14	-0.14	-0.08
	[-2.32]	[-2.33]	[-2.87]	[-2.86]	[-2.11]
$\Delta\xi_t$	-0.18	-0.18	-0.21	-0.17	-0.17
	[-2.79]	[-2.81]	[-2.93]	[-2.19]	[-2.59]
Adj R^2 (%)	3.76	4.40	5.46	4.12	3.04
	(6)	(7)	(8)	(9)	(10)
	NoDur	Enrgy	Hlth	Utils	Other
$\Delta\lambda_t$	-0.04	-0.09	-0.07	-0.11	-0.07
	[-0.74]	[-1.69]	[-1.20]	[-1.53]	[-1.47]
$\Delta\xi_t$	-0.04	-0.11	-0.11	-0.01	-0.19
	[-0.70]	[-1.84]	[-1.65]	[-0.15]	[-2.81]
Adj R^2 (%)	-0.05	1.54	1.20	0.79	3.50

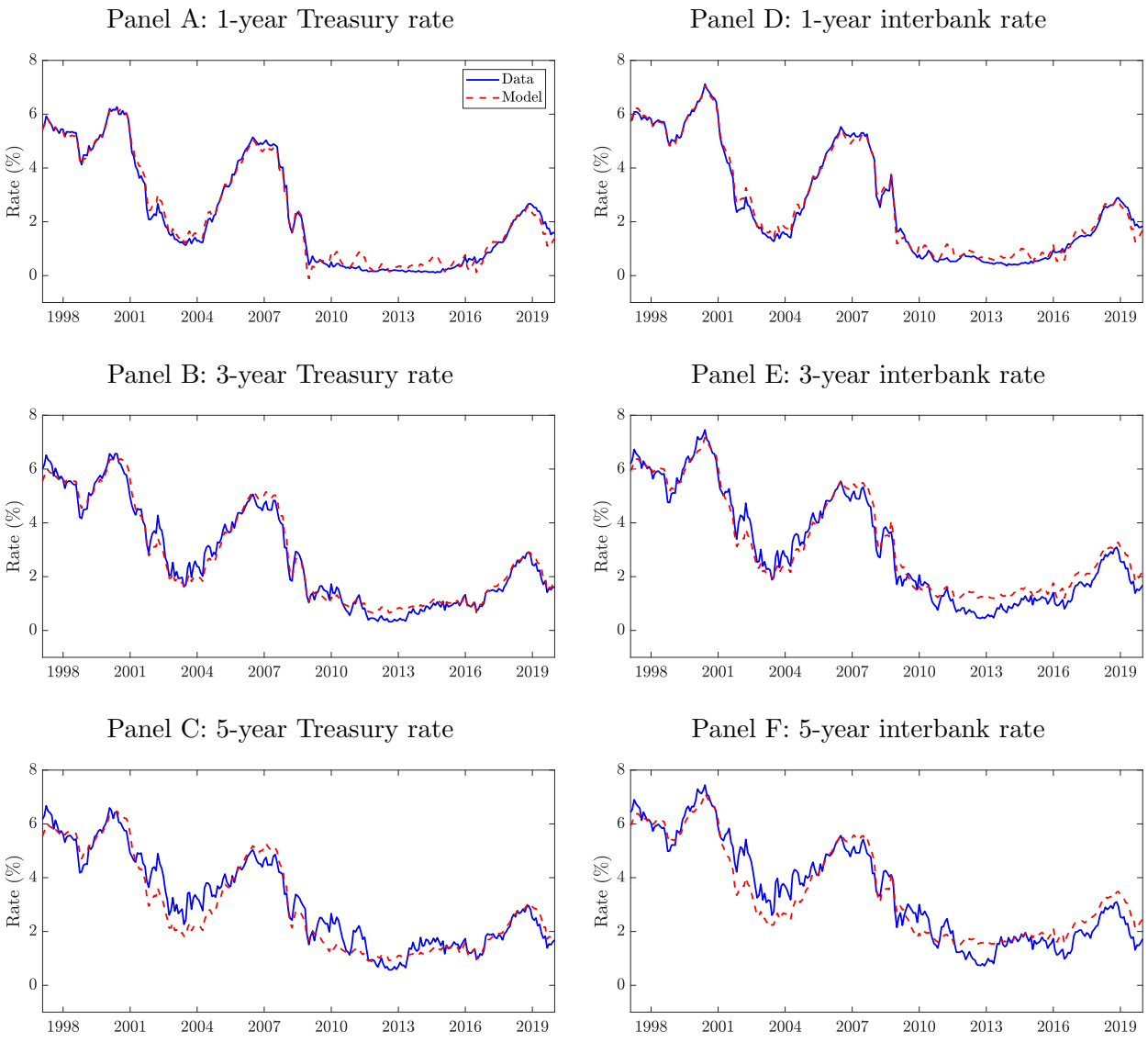
Notes: This table reports the results of contemporaneous time series regressions that examine the relation between changes in the filtered disaster risk variables (λ_t and ξ_t) and equity returns. In both panels, we standardize the independent and dependent variables. In Panel A, the dependent variables 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), consumer non-durables (NoDur), energy (Enrgy), healthcare (Hlth), utilities (Utils), and others (Other). The t-statistics are reported in brackets and are computed based on the Newey and West (1987) method with five lags.

Figure 1: Interest Rates and the TED Spread in the Data and in the Model



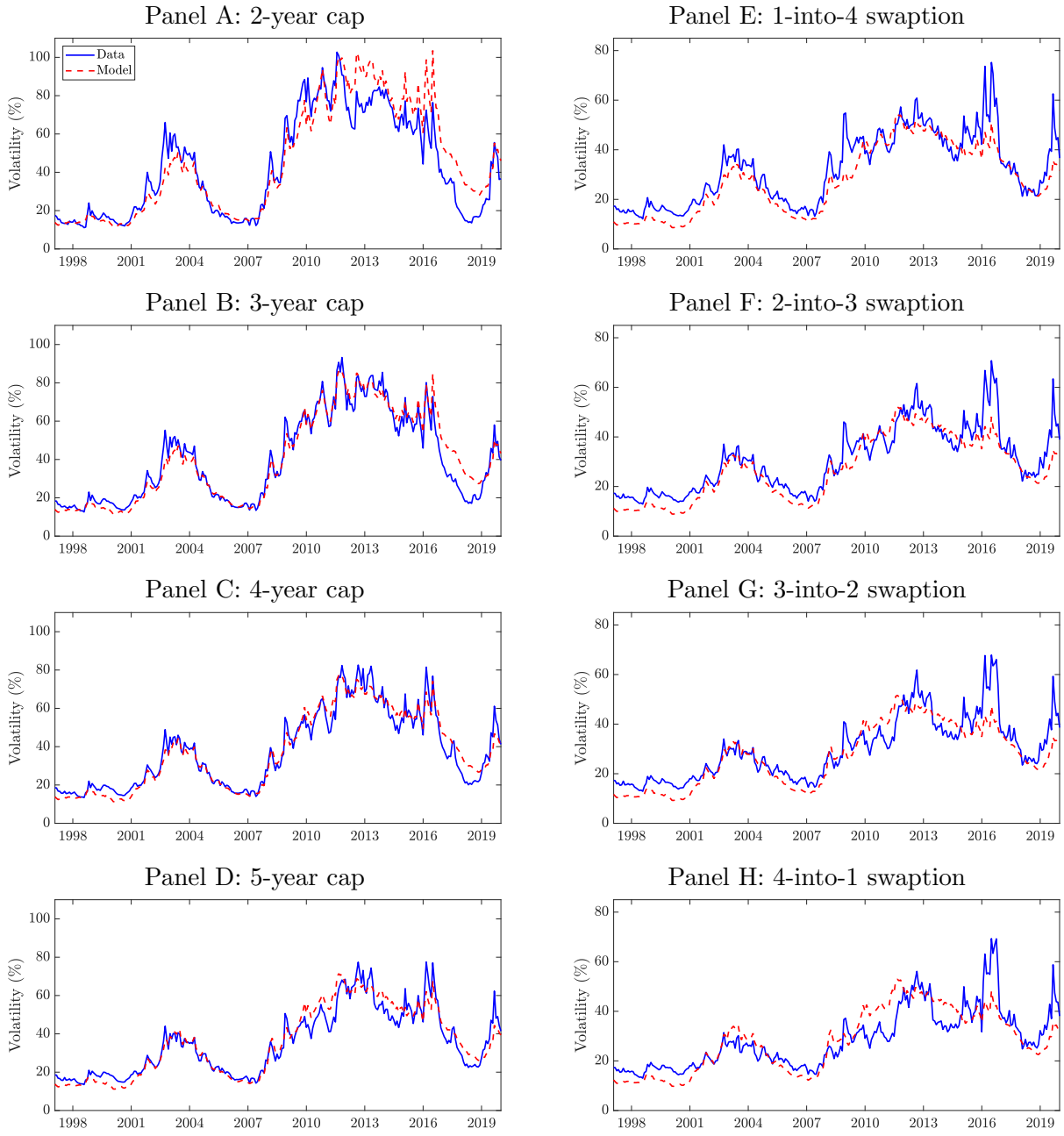
Notes: This figure plots the time series of the Treasury rate (Panel A), the interbank rate (Panel B), and the TED spread (Panel C) with a 3-month maturity in the data and in the model, from January 1997 to December 2019. The solid blue lines represent the data and the dashed red lines represent the model. All values are expressed in percentage terms.

Figure 2: Interest Rates in the Data and in the Model



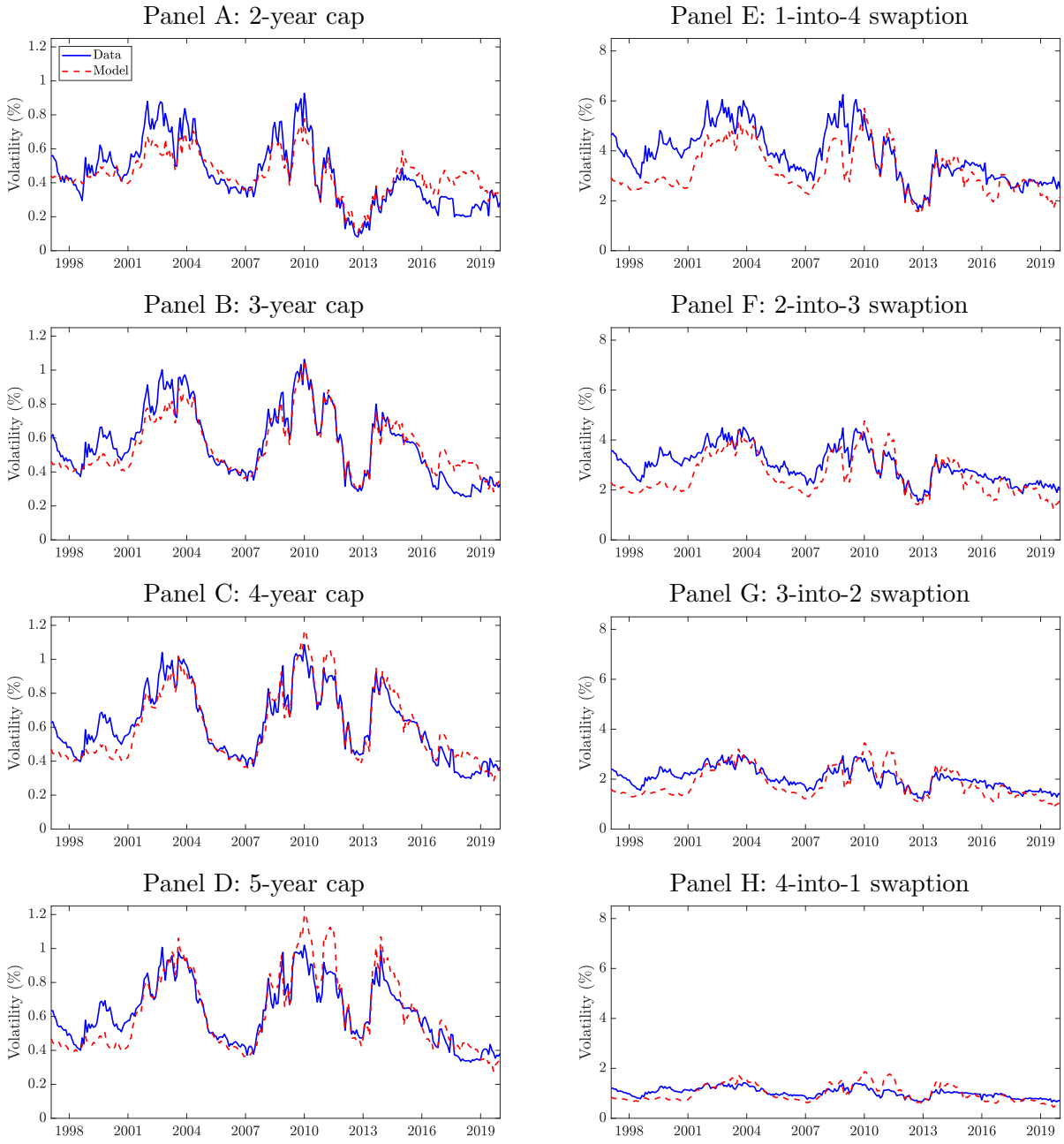
Notes: This figure depicts the time series of the Treasury rates (Panels A, B, and C) and the interbank rates (Panels D, E, and F) with 1-, 3-, and 5-year maturities in the data and in the model, from January 1997 to December 2019. The solid blue lines represent the data, and the dashed red lines represent the model. All values are expressed in percentage terms.

Figure 3: Black-Implied Volatilities in the Data and in the Model



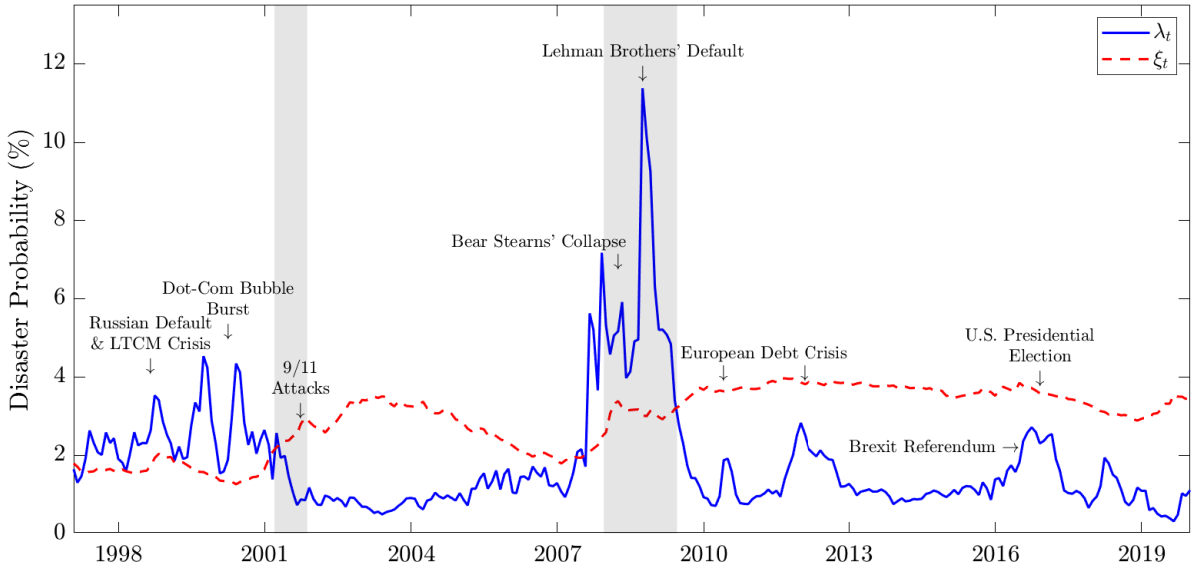
Notes: This figure presents the time series of the Black-implied volatilities for the 2-, 3-, 4-, and 5-year caps (Panels A, B, C, and D) and those for the 1-into-4, 2-into-3, 3-into-2, and 4-into-1 swaptions (Panels E, F, G, and H) in the data and in the model. The sample period is from January 1997 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.

Figure 4: Equivalent Bond Price Volatilities in the Data and in the Model



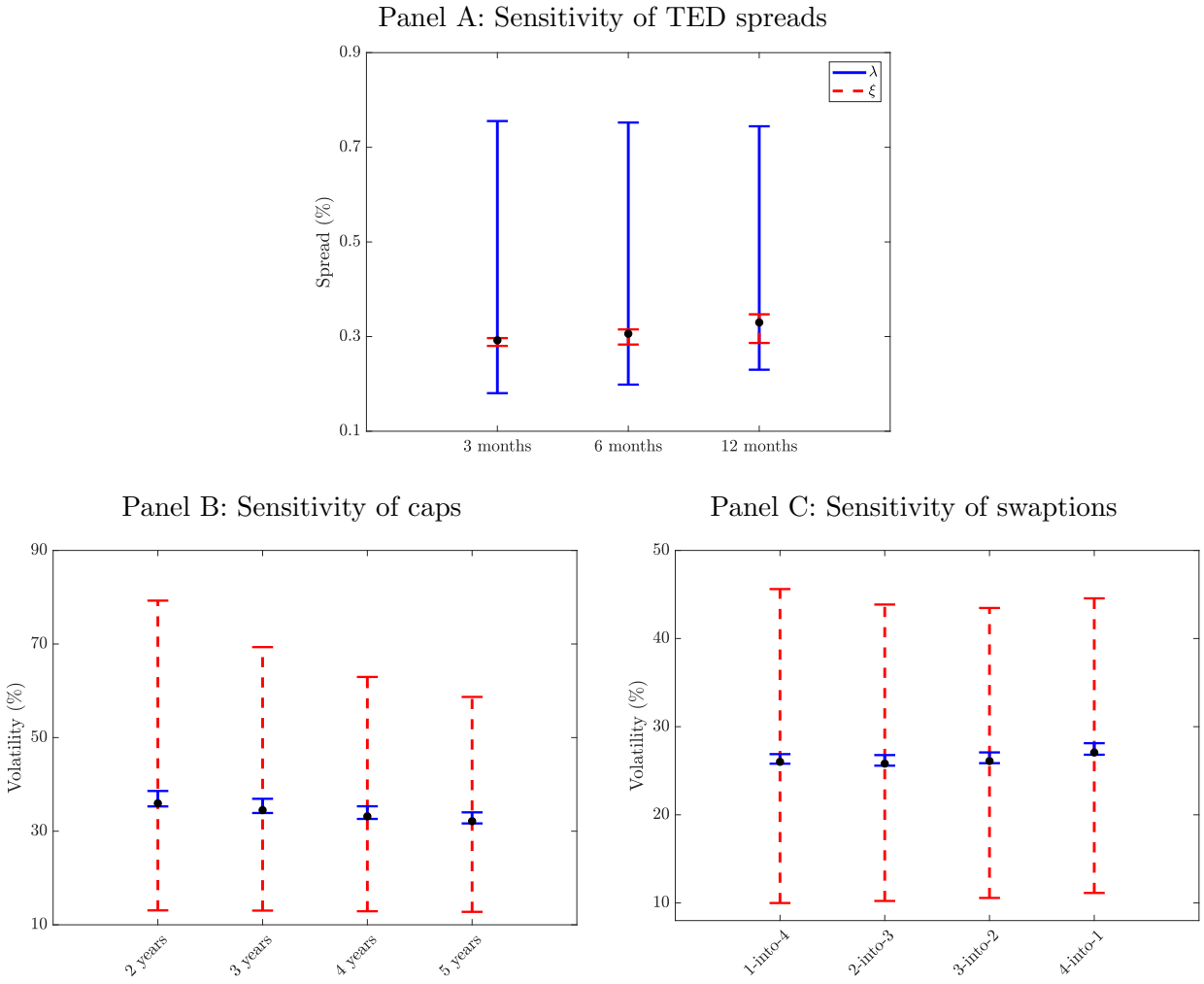
Notes: This figure plots the time series of the equivalent bond price volatilities for the 2-, 3-, 4-, and 5-year caps (Panels A, B, C, and D) and those for the 1-into-4, 2-into-3, 3-into-2, and 4-into-1 swaptions (Panels E, F, G, and H) in the data and in the model. The sample period is from January 1997 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.

Figure 5: Implied Time-Varying Disaster Risk



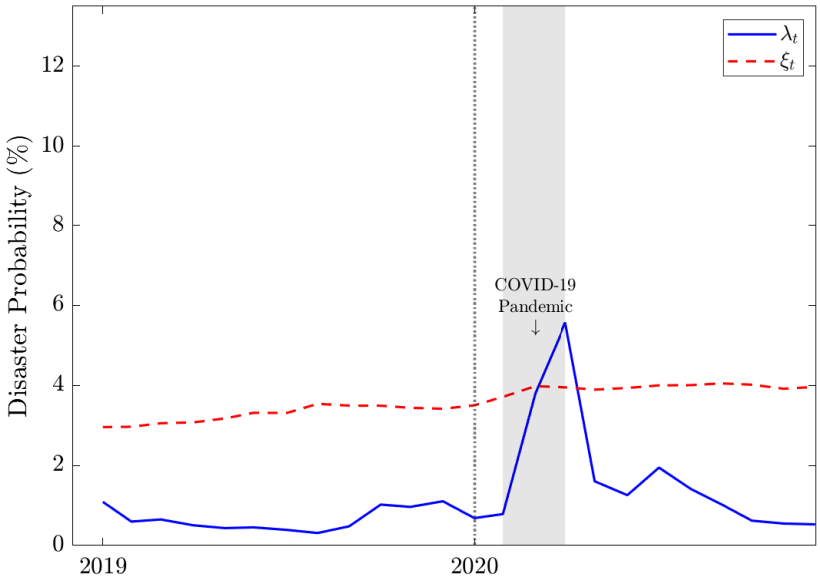
Notes: This figure displays the filtered time series of the short-run disaster risk component λ_t (solid blue line) and the long-run disaster risk component ξ_t (dashed red line), from January 1997 to December 2019. All values are expressed in percentage terms.

Figure 6: Disaster Risk, TED Spreads, and Interbank Rate Option-Implied Volatilities



Notes: This figure shows how TED spreads (Panel A) and Black-implied volatilities for caps (Panel B) and swaptions (Panel C) change when λ_t or ξ_t varies from the 10th percentile to the 90th percentile of its filtered values. In each panel, 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 is set at its median value in both cases. The black dot in the middle of each bar graph represents the model value when λ_t and ξ_t are both at their median values. All values are expressed in percentage terms.

Figure 7: Implied Disaster Risk During the COVID-19 Pandemic Crisis



Notes: This figure 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) during the COVID-19 pandemic crisis. The time series are from January 2019 to December 2020. All values are expressed in percentage terms.