Discussion: When Gambling For Resurrection Is Too Risky

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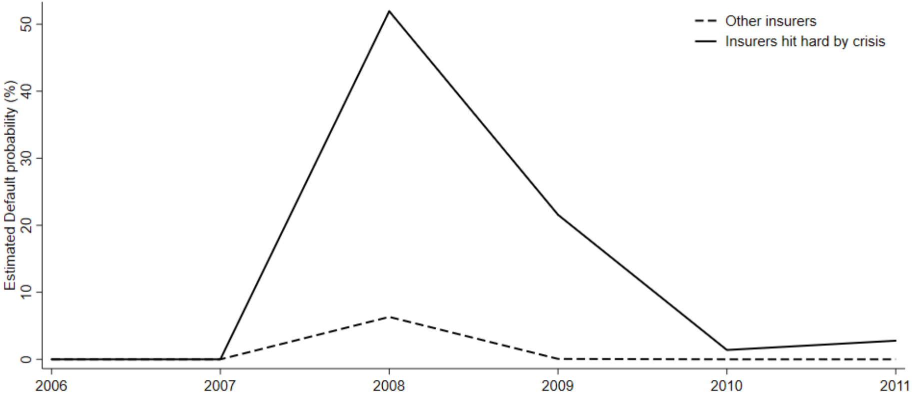
IMF Annual Macro-Financial Research Conference
April 11, 2018

Overview

1. Great paper!
2. Contradicts much academic and practitioner wisdom around financial risk taking.
3. Goes beyond earlier literature on financial risk to isolate decline in risk taking.
4. My comments:
    1. Review results.
    2. Interpretation.
    3. Implications.

KEY RESULT 1



- Underappreciated how much of insurance sector was nearly insolvent.
- CDS spreads give similar picture.

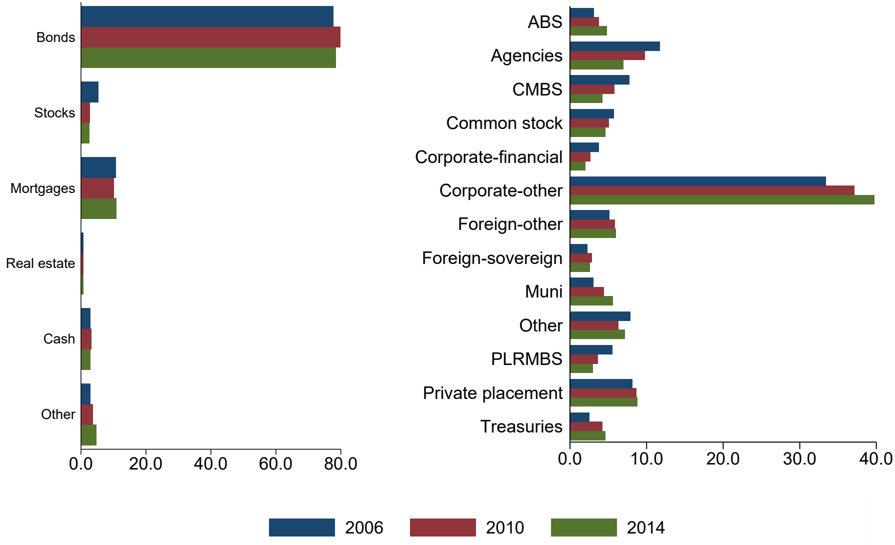
KEY RESULT 2

- "Hit hard" insurers start buying lower yield, safer bonds when the crisis starts.
- Regressions confirm result holds within rating category.

Interpretation

- Two main sources of profits for life insurers:
  1. Sales markup on policies.
  2. Asset insulation: target asset portfolio to illiquid assets and time purchases.
- Both sources create franchise value.
- Franchise value depends on insurer remaining solvent:
  1. Future sales require insurer to still be selling policies.
  2. Asset insulation disappears if insurer has to liquidate portfolio.
- Primacy of asset insulation view: if insurer cares most about maintaining solvency to take advantage of future sales, would invest portfolio in safe assets.

Asset allocation



Source: Chodorow-Reich, Ghent and Haddad.

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- Distressed insurers buy safer bonds during a crisis because:
  1. They do not benefit as much by holding a distressed bond because they value it at its market price.
  2. They want to reduce overall portfolio risk to tilt valuation of other assets toward long-run values.

Implications

- Paper focuses on rejecting risk-shifting view. I agree.
- Asset insulation view: want insurers to hold risky assets.
- Post-crisis risk environment:
  - Policy makers concerned about "reach-for-yield". Some argued it should limit monetary stimulus.
  - These insurers took less risk, not more.
  - Maybe system overall needed more, not less risk-taking by financial institutions in crisis aftermath.

Appendix slides