Long Rates, Life Insurers, and Credit Spreads

Ziang Li

Discussion by Kristy Jansen

Marshall School of Business
University of Southern California

Fixed Income Research and Implications for Monetary Policy 2025

Paper in a nutshell

Paper in a nutshell

- Main finding: Credit spreads tend to narrow when long-term interest rates rise.
  - Especially strong for bonds held by life insurers.

Paper in a nutshell

- Main finding: Credit spreads tend to narrow when long-term interest rates rise.
  - Especially strong for bonds held by life insurers.

- Mechanism:
  - Life insurers have a negative duration mismatch:

  $\Rightarrow$ $D^A < D^L$ or $D^A - D^L < 0$
  - When long-term rates rise:
    - Net worth of insurers increases.
    - Their risk-bearing capacity rises.
    - They buy more risky bonds $\Rightarrow$ spreads fall.

Paper in a nutshell

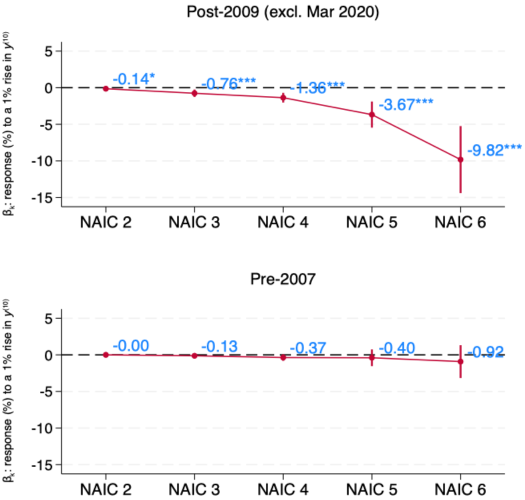
- Main finding: Credit spreads tend to narrow when long-term interest rates rise.
  - Especially strong for bonds held by life insurers.

- Mechanism:
  - Life insurers have a negative duration mismatch:

  $\Rightarrow$ $D^A < D^L$ or $D^A - D^L < 0$
  - When long-term rates rise:
    - Net worth of insurers increases.
    - Their risk-bearing capacity rises.
    - They buy more risky bonds $\Rightarrow$ spreads fall.

- Main contribution: shows why duration mismatch matters for bond pricing.
  - Bulk of intermediary asset pricing literature focuses on banks, broker dealers, and hedge funds $\rightarrow$ we need more on insurers and pension funds!

Paper in a nutshell cont'd



Summary

- Neat contribution to the intermediary asset pricing literature!
- Well executed and clear main take-aways.
- My discussion focuses on future directions and policy implications.

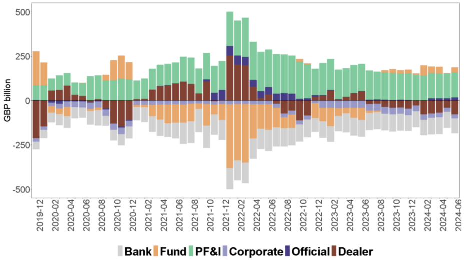
What happened during the interest rate hike period in 2022-2023?

- In 2022-2023, interest rates rose sharply. Hence, risk-bearing capacity of life insurers rises $\Rightarrow$ buy more risky bonds $\Rightarrow$ credit spreads fall.

What happened during the interest rate hike period in 2022-2023?

- In 2022-2023, interest rates rose sharply. Hence, risk-bearing capacity of life insurers rises ⇒ buy more risky bonds ⇒ credit spreads fall.
- However, UK pension crisis 2022 revealed another risk: margin calls on interest rate derivative positions (swaps, repos etc.).

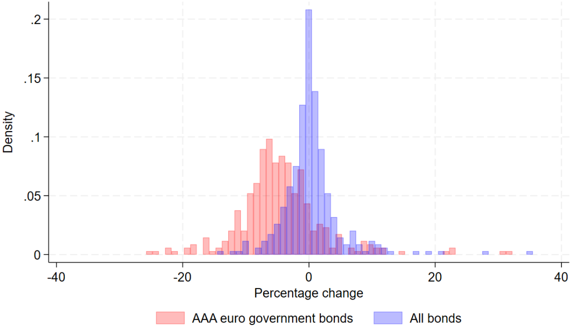
Figure 1: Net Outstanding Positions



Source: Khetan, Li, Neamtu, Sen (2024)

What happened during the interest rate hike period in 2022-2023?

- Evidence of forced sales of (safe) assets during periods of interest rate hikes (Pinter 2023; Jansen, Klingler, Ranaldo, and Duijm 2023; Alfaro, Bahaj, Czech, Hazell, and Neamtu 2024).



Source: Jansen, Klingler, Ranaldo, and Duijm 2023

What happened during the interest rate hike period in 2022-2023?

- Hence, while a rise in interest rates is good news for the solvency or net worth of insurers, it may induce liquidity risk.
- As such, instead of buying additional risky bonds, insurers may need the additional resources to fulfill (costly) margin calls.

What happened during the interest rate hike period in 2022-2023?

- Hence, while a rise in interest rates is good news for the solvency or net worth of insurers, it may induce liquidity risk.
- As such, instead of buying additional risky bonds, insurers may need the additional resources to fulfill (costly) margin calls.
- Which mechanism carried a higher weight during this episode? Do we observe differences in the relationship between Treasury yields and credit spreads during moderate versus sharp rises in interest rates?

Implications for monetary policy

- Standard view: higher interest rates $\Rightarrow$ tighter financial conditions.
- This paper: long-rate increases can ease credit by compressing spreads.
- Indeed, positive long-rate shocks induce more bond issuance by risky firms.
- Key question: what does it imply for monetary policy effectiveness if higher 10-year yields lower financing costs for riskier firms?

Conclusion

- Clean identification of the impact of the duration mismatch on credit spreads!
- It would be super interesting to explore the various mechanisms at play and its effect on credit spreads during 2022-2023.
- Other interesting avenues: what is the relationship between long-term rates and credit spreads in other jurisdictions, like Europe or Japan?
- A must read for colleagues working in intermediary asset pricing!