Discussion
"The hunt for yield: not waving but drowning?" by Domanski, Shin, and Sushko

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European life insurance companies

- have large inventories of contracts that promise high minimum payments at remote future dates
- are subject/subject themselves to investment rules requiring that insurance premia be invested in assets whose payoffs must closely replicate the resulting liabilities

- Incompleteness of markets for long-lived, safe assets implies that insurers' demand for long-term bonds may decrease with long-term yields in some range

- This may amplify fluctuations in long-term yields induced by unconventional monetary policies (among other things)

4 questions

- Is this a problem?

If it is,

- Is the problem due to life insurance contracts?
- Is the problem due to life insurance regulation?
- Is the problem due to unconventional monetary policy?

My short answers

- Is this a problem? I don't know

If it is,

- Is the problem due to life insurance contracts? Probably
- Is the problem due to life insurance regulation? Maybe
- Is the problem due to unconventional monetary policy? I don't know

Is this a problem?

" If effective, the combination of the "low for long" policy for short term policy rates coupled with quantitative easing tends to depress yields... Fixed income investors with minimum nominal return needs then migrate to riskier instruments such as junk bonds, emerging market bonds, or commodity ETFs... [T]his reach for yield is precisely one of the intended consequences of unconventional monetary policy. The hope is that as the price of risk is reduced, corporations faced with a lower cost of capital will have greater incentive to make real investments, thereby creating jobs and enhancing growth."

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Is this a problem?

"There are two ways these calculations can go wrong. First, financial risk taking may stay just that, without translating into real investment. For instance, the price of junk debt or homes may be bid up unduly, increasing the risk of a crash, without new capital goods being bought or homes being built...
Second, and probably a lesser worry, accommodative policies may reduce the cost of capital for firms so much that they prefer labor-saving capital investment to hiring labor."

Rajan (23 June 2013, BIS)
"A step in the dark: unconventional monetary policy after the crisis"

Is this a problem?

- That monetary easing induces institutional investors to push down long-term yields is not a bad thing per se
- This is the goal! The extra kick due to the amplification mechanism discussed here may not be a bad thing
- The issue is more that life insurers' investments are too local and too safe: invest excessively in the sovereigns of their residence countries. It is the consequence of
  - Compartmentalized capital markets in the eurozone
  - The nature of life insurance contracts
  - Prudential rules

Life insurance contracts

- Transformation risk: Life insurers sells cash flows that they cannot purchase in capital markets
- So do banks, and this is why they are fragile, but
  - They can borrow these cash flows from the central bank in case of emergency - Public backstop
  - Deposits have an obvious social utility - Money

Life insurance contracts

- Does it make sense that life insurers offer long-term guarantees that governments and social security systems do not feel comfortable offering?
- How credible is the guarantee? There are many instances of restructuring of such guarantees: France, Japan in the 1990s
- Probably a strong case for re-thinking the supply/taxation/regulation of long-term stores of value in the eurozone

Prudential regulation

Solvency 2 has been accused of distorting insurers' investments away from some asset classes (equity, asset-backed securities,...). Certainly made it more costly, but 2 possibilities

- The assumptions of Solvency 2 regarding the long-term behavior of the market portfolio are wrong (overly pessimistic)
- These assumptions are a conservative but correct summary of our knowledge/beliefs but it shows that life insurance contracts offer guarantees that are not well suited to the long-term behavior of the market portfolio
- It is hard to separate the analysis of prudential regulation from that of optimal life insurance contracts

Monetary easing and financial instability

Big question looming: What are the respective contributions of unconventional policies to growth and employment and to financial instability?

- We have models of excessive financial transformation/inefficient financial booms and busts *(with reduced forms for monetary policy)*
- We have a relatively consensual analytical framework for the real impact of monetary policy *(with nearly perfect markets)*
- Academie has not yet produced a consensual analytical framework that features both
- Some recent attempts: Farhi Werning (2015), Farhi Tirole (2012), Plantin Shin (2015)