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# Discussion of “Asset Insulators” by Gabriel Chodorow-Reich, Andra Ghent and Valentin Haddad

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# Insulation



- CRGH point out that financial institutions insulate savers/investors from fluctuations in 'illiquid, risky' asset prices. Can be achieved by buy-and-hold strategy

- Model a financial asset which can be held directly or through a financial institution

- Inside the financial institution, asset is worth more. Wedge is stochastic, mean-reverting, positive mean.
  - If asset value is too negative, financial institution is liquidated (losing wedge)

- Implications
  - Insurer equity value is insensitive to asset market values in normal times
  - When asset values are low, firm equity gets depleted, and default risk rises: insulation disappears in a crisis… equity becomes sensitive to asset values

# Modeling strategy



- This framework is tractable, and should allow interesting extensions
- Financial industry dynamics are simplistic
  - I think there is no financial intermediation in long-run: sooner or later, the asset value will be low enough that the financial institution is liquidated
  - No entry
  - No new equity
- Allowing non-zero investment into financial intermediation could change crisis dynamics
  - Key frictions operate in the market for financial intermediation

# Empirical findings



- Estimate regressions of insurer equity returns on portfolio returns rescaled by insurer equity, in and out of crisis

$$\frac{\Delta MCAP}{MCAP} = \alpha + \beta \frac{\Delta Bond\ MV}{MCAP}$$

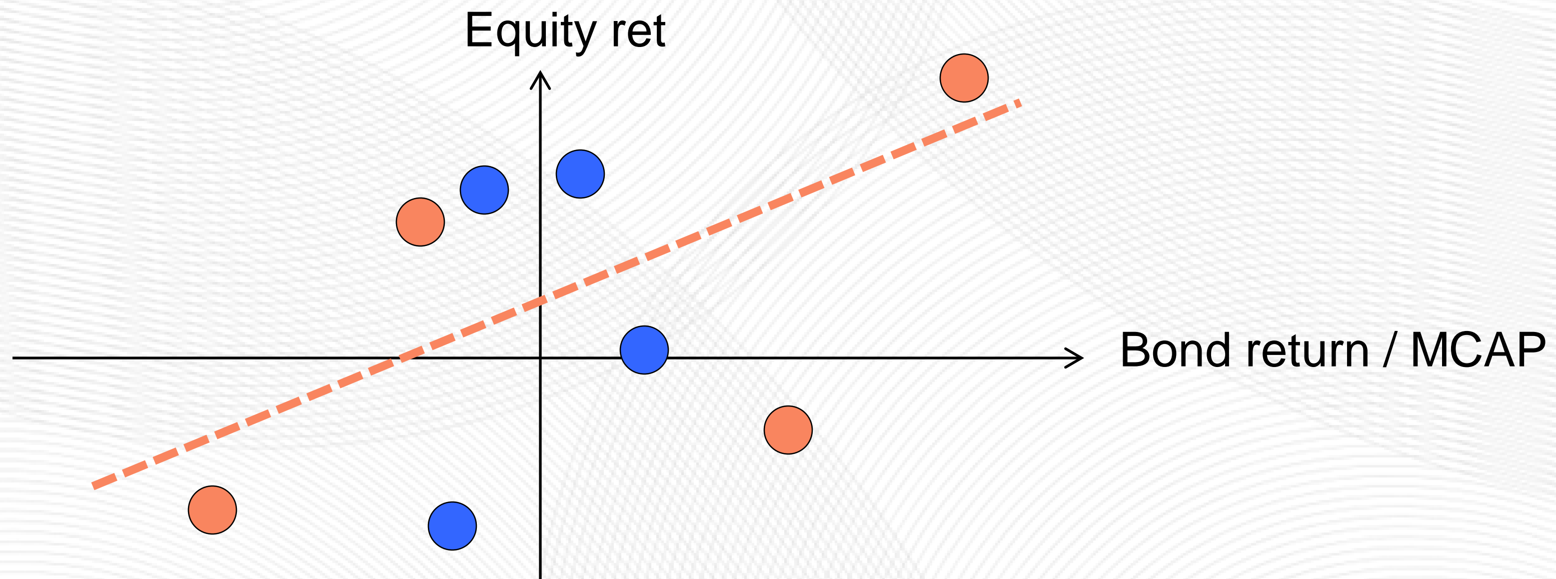
- Estimate on sample of daily absolute bond excess returns above 6%
  - In normal times, beta is 0.1
  - In crisis beta is 1

- Equity is more sensitive to bond portfolio performance in crisis

# Scaling



- Scaling impacts coefficient through weight on observations
  - MetLife $54B vs. FBL Financial $1.5B, American Equity Investment Life $2B




- Small insurers may have lower franchise value, more risk in crisis

# Who are the insulators?

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- Insurance is long-term, buy-and-hold, low cost, but have small advantage over direct ownership
  - Insurance
  - Index funds (no equity)
  - DB pension plans

- Other institutions are also patient (perhaps less), but have more obvious advantage as owners
  - PE
  - VC
  - Activist hedge funds

- When will the micro-foundations of why an institution is a good owner matter?
  - Existence of accurate, efficient market prices
  - Uniqueness of owner (firm-specific skill)
  - Controlling excessive trading tendencies (behavioral bias)
  - Regulatory advantage

# Dark side of insulators?

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- Insurance industry losses in 2008 made several firms shaky

- Massive drop in asset market values (bonds, stocks, MBS)
  - Distorted behavior in product markets (Koijen Yogo 2014)
  - Bailouts in TARP

- Some calls for more capital

- Industry regulator basically responded by removing capital requirements for RMBS (Becker Opp)

- Under insulator theory, regulatory forgiveness makes sense: we know prices will rebound, we know insurers should hold assets, so policy goal is to avoid liquidation
  - Cf. if risk of further losses, more equity might have been called for