

Internal Models, Make Believe Prices, and Bond Market Cornering*

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Abstract

We show that U.S. life insurers used internal models to over-report the value of a large fraction of corporate bonds during the financial crisis. Reported credit spreads of bonds valued using internal models were substantially lower by 220 bps, as compared to bonds that are otherwise similar but valued using external sources. Misreporting is higher for bonds that are likely to be impaired and negatively affect regulatory ratios, for insurers that are constrained by regulatory capital, and for bond positions that are held by few insurers. Using novel data on U.S. state regulators, we document that misreporting is negatively correlated with the degree of supervision at the state level, but only for bonds held by multiple insurers. Supervision has limited impact on bonds held by fewer insurer due to the lack of reference prices available with state regulators. Consistent with these incentives, we show that insurers “corner the market” by holding a large fraction of a bond’s issue, as this allows them to bypass regulatory scrutiny and facilitates the use of internal models. Our findings have implications for the micro-structure of a segment of the corporate bond market and for properly assessing the fragility of financial institutions in bad times.

Keywords: Internal Models, Corporate Bonds, Capital Regulation, Bond Market Cornering, Life Insurers.

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