Discussion:
Exorbitant Privilege? Quantitative Easing and the Bond Market Subsidy of Prospective Fallen Angels

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Motivation

- Large increase in the amount outstanding of BBB-rated bonds since 2009, with low offering spreads
  - From 17% of IG in 2001 to $> 50\%$ in 2019
- Massive downgrades during the COVID-19 shock
- What are the forces driving this unique pattern of BBB-rated bonds? What are the implications?

This Paper

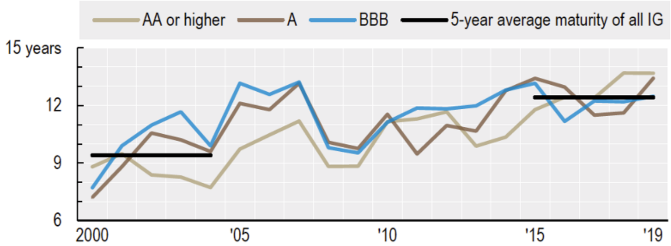
- Document subsidy for "prospective fallen angels" in the corporate bond market since 2009
  - Driven by investors exposed to Fed's QE program
- Real effect: more risk taking by the subsidized firms $\Rightarrow$ more materialized downgrades during COVID-19
  - Capital misallocation and risk build-up
  - Negative externalities on other firms
- Very important work on the consequences of unconventional monetary policy (QE)!
- Rich policy implications

Why Important?

- Different from the transmission of conventional MP, which mostly involves banks, the transmission of QE relies on heterogeneous NBFIs
  - Specific objectives and regulatory constraints
- Investor base for the U.S. corporate bond market
  - IG: 20% mutual funds, 60% life insurance companies
  - HY: 60% mutual funds, 20% life insurance companies
- Frictions in credit ratings + regulatory constraints based on ratings $\Rightarrow$ subsidy for risky BBB-rated firms
- Monetary policy does not seem to be market-neutral

Increased Maturity

Figure 1: Value-weighted Average Maturity of IG Bonds (Globally)



Source: Çelik, S., G. Demirtaş and M. Isaksson (2020)

- Valuation is more sensitive to interest rate movements and downgrades
- Long term impact: rollover risks in the future

The Origin of the Exorbitant Privilege

- The high demand for riskier bonds is usually rationalised by reaching-for-yield ("ignoring risk")
  - But here the yield is *lower* among the riskier bonds!
- Maybe it is other features of these bond that the investors value?
  - For example, the vulnerable bonds seem to have larger issuance size, which is correlated with liquidity

Policy Implications

- In 2021, the bond market had a record number of first time junk bond issuers...
- Overall lesson: where is the liquidity being directed given the investor base?
  - What are the objectives and constraints of these investors?
  - Macro-prudential: more emphasis on market-based measurements

Thank You!