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A Cost of Capital Approach
to Credit and Liquidity Spreads

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Abstract[2]
The market cost of capital approach has emerged as the standard for estimating risk margins for insurers' fair value balance sheets. This paper takes some of the ideas developed for valuing life insurance liabilities and applies them to the problem of valuing credit-risky bonds. The basic idea is that credit spreads should cover the cost a) best-estimate defaults plus the cost of holding capital for b) contagion risk (e.g., a credit crunch) and c) parameter risk, the risk that the best estimate is wrong and must be revised. We argue that the margins required for parameter risk can capture liquidity issues. In addition, the models developed here allow the cost of capital rate itself to be a random variable that allows credit spreads to open and close stochastically.

Finally, the paper argues that it is reasonable to include something like AA best-estimate default rates and liquidity spreads when valuing insurance liabilities. The main rationale for doing so is the idea that there are elements of the total credit risk issue which can be hedged between the assets and liabilities.