Monetary Policy and the Run Risk of Loan Funds

Discussant: Yiming Ma

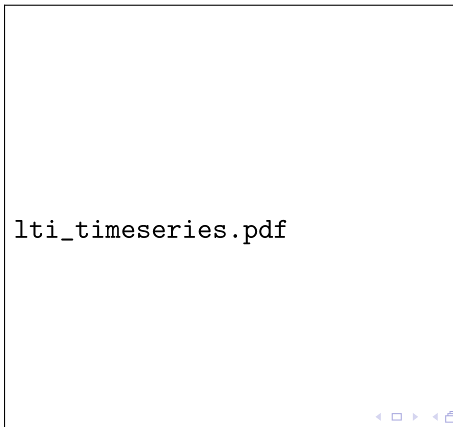
Columbia Business School

October 5, 2023

The Rise of Corporate Loan Mutual Funds

- Fixed-income open-end funds are important because of their liquidity transformation: invest in illiquid assets+ issue redeemable shares
- This is similar to the key role of the traditional banking seector

Figure: Liquidity Provision by Banks versus Fixed-Income Mutual Funds



The Rise of Corporate Loan Mutual Funds

- Little is known about loan mutual funds despite their growth

Figure: The Growth of Loan Funds

This is an Important Paper

This paper fills the gap by showing that...

1. Loan funds display higher run-risk than other fixed-income funds
    - Even compared to high-yield bond funds
    - Evidence: Investor flows more sensitive to bad past performance
    - Channel: $\uparrow$ opacity $\rightarrow \uparrow$ illiquidity $\rightarrow \uparrow$ fire-sale discounts born by remaining investors $\rightarrow \uparrow$ first-mover advantage

This is an Important Paper

This paper fills the gap by showing that...

1. Loan funds display higher run-risk than other fixed-income funds
   - Even compared to high-yield bond funds
   - Evidence: Investor flows more sensitive to bad past performance
   - Channel: $\uparrow$ opacity $\rightarrow \uparrow$ illiquidity $\rightarrow\uparrow$ fire-sale discounts born by remaining investors $\rightarrow \uparrow$ first-mover advantage
2. Negative monetary policy shocks lead to more outflows at loan funds
   - Channel: loans are floating-rate, $\downarrow$ policy shocks $\rightarrow \downarrow$ income stream to loan funds $\rightarrow \uparrow$ outflows

This is an Important Paper

This paper fills the gap by showing that...

1. Loan funds display higher run-risk than other fixed-income funds
   - Even compared to high-yield bond funds
   - Evidence: Investor flows more sensitive to bad past performance
   - Channel: $\uparrow$ opacity $\rightarrow\uparrow$ illiquidity $\rightarrow\uparrow$ fire-sale discounts born by remaining investors $\rightarrow\uparrow$ first-mover advantage

2. Negative monetary policy shocks lead to more outflows at loan funds
   - Channel: loans are floating-rate, $\downarrow$ policy shocks $\rightarrow\downarrow$ income stream to loan funds $\rightarrow\uparrow$ outflows

3. Positive monetary policy shocks do not lead to more inflows at loan funds
   - Channel in #2 is hampered because borrowers can renegotiate loan terms in good times, when there are positive policy shocks

Overall, this is a very nice paper!

It sheds light on the fragility of and the effect of monetary policy on loan funds $\rightarrow$ important contribution to the fixed-income mutual fund literature!

Just a few suggestions...

1. Broader pitch
   - Why compare to high-yield bond funds? What does it mean?
2. Credit risk control
   - Consider borrower-level and non-loan holdings as control
3. Interpretation of monetary policy effects
   - Policy effects versus macro-economic changes

1. Broader Pitch

- The current "comparison group" is bond funds/high-yield bond funds"
- Benefits:
  - Bonds funds are a relatively well-known benchmark in the literature
  - High-yield bond funds can help control for credit risk

1. Broader Pitch

- The current “comparison group” is bond funds/high-yield bond funds”
- Benefits:
  - Bonds funds are a relatively well-known benchmark in the literature
  - High-yield bond funds can help control for credit risk

- But what is the economic interpretation of this comparison?
  - Unlikely that bonds are converted into loans, vice versa.
- I think the key insight of this paper is not limited to loans funds versus bond funds!

1. Broader Pitch

The deeper insight lies in the interaction between redeemable shares (the liability side) + leveraged loans (the asset side)

- This is an innovation from loans being funded by demandable debt, i.e., deposits, at commercial banks
- Liquidity mismatch at mutual funds can still lead to runs because stale NAV, i.e., redeemable equity value behaves like debt!
- If demandable shares was truly equity-like and flexible , e.g., through swing-pricing, liquidity mismatch would not bear run-incentives

Suggest to elaborate more on liability-side interaction in the pitch, especially given the loans context. (No need to change execution)

2. Credit Risk Control

- Controlling for credit risk is important given the intended channels being illiquidity/opacity/renegotiability of loans
- High-yield bond funds and high-yield bond funds are helpful controls
- But one may still worry about...
  - Differences in time-varying borrower-level riskiness
  - Differences in time-varying liquid asset holdings, e.g., cash, money market instruments, Treasuries

2. Credit Risk Control

- Controlling for credit risk is important given the intended channels being illiquidity/opacity/renegotiability of loans
- High-yield bond funds and high-yield bond funds are helpful controls
- But one may still worry about...
  - Differences in time-varying borrower-level riskiness
  - Differences in time-varying liquid asset holdings, e.g., cash, money market instruments, Treasuries
- Suggest to
  - Control for proportion of cash and cash equivalents
  - Match borrower-level risk measures to calculate expected portfolio risk (if feasible)

3. Interpretation of Monetary Policy Effects

- Asymmetric response to policy surprise cuts and hikes explained by renegotiation of loans in good times, when there tend to be policy hikes
- But then, what is the effect of monetary policy surprises versus the effect of information signaled by monetary policy surprises?

3. Interpretation of Monetary Policy Effects

- Asymmetric response to policy surprise cuts and hikes explained by renegotiation of loans in good times, when there tend to be policy hikes
- But then, what is the effect of monetary policy surprises versus the effect of information signaled by monetary policy surprises?
- It would be good to clarify
  - pure interest rate effect ← monetary policy surprise per se
  - renegotiation channel ← signals about economic conditions, i.e., renegotiation likelihood, from monetary policy surprises

3. Interpretation of Monetary Policy Effects

- Asymmetric response to policy surprise cuts and hikes explained by renegotiation of loans in good times, when there tend to be policy hikes
- But then, what is the effect of monetary policy surprises versus the effect of information signaled by monetary policy surprises?
- It would be good to clarify
  - pure interest rate effect $\leftarrow$ monetary policy surprise per se
  - renegotiation channel $\leftarrow$ signals about economic conditions, i.e., renegotiation likelihood, from monetary policy surprises
- Side question: shouldn't renegotiation also happen in bad times when companies violate covenants?

Conclusion

This is a really nice paper filling an important gap about the fragility of loan funds and their response to monetary policy surprises!

Suggestions

1. Discuss the interaction with the liability side, i.e., redeemable shares that behave like deposits + link to deposit funding of loans at banks
2. More granular credit-risk controls
3. Clarify interpretation of effects following monetary policy shocks