

# Monetary Policy and the Run Risk of Loan Funds

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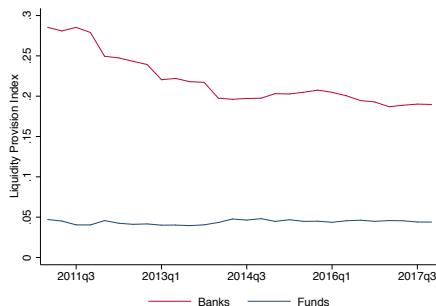
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# The Rise of Corporate Loan Mutual Funds

- 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 sector

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



Ma, Xiao, and Zeng (2020)

# 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

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- 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

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- 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 → 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

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- 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/renegeability 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

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- 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?

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- It would be good to clarify
  - pure interest rate effect  $\leftarrow$  monetary policy surprise per se
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- Side question: shouldn't renegotiation also happen in bad times when companies violate covenants?

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