Monetary Policy and the Run Risk of Loan Funds

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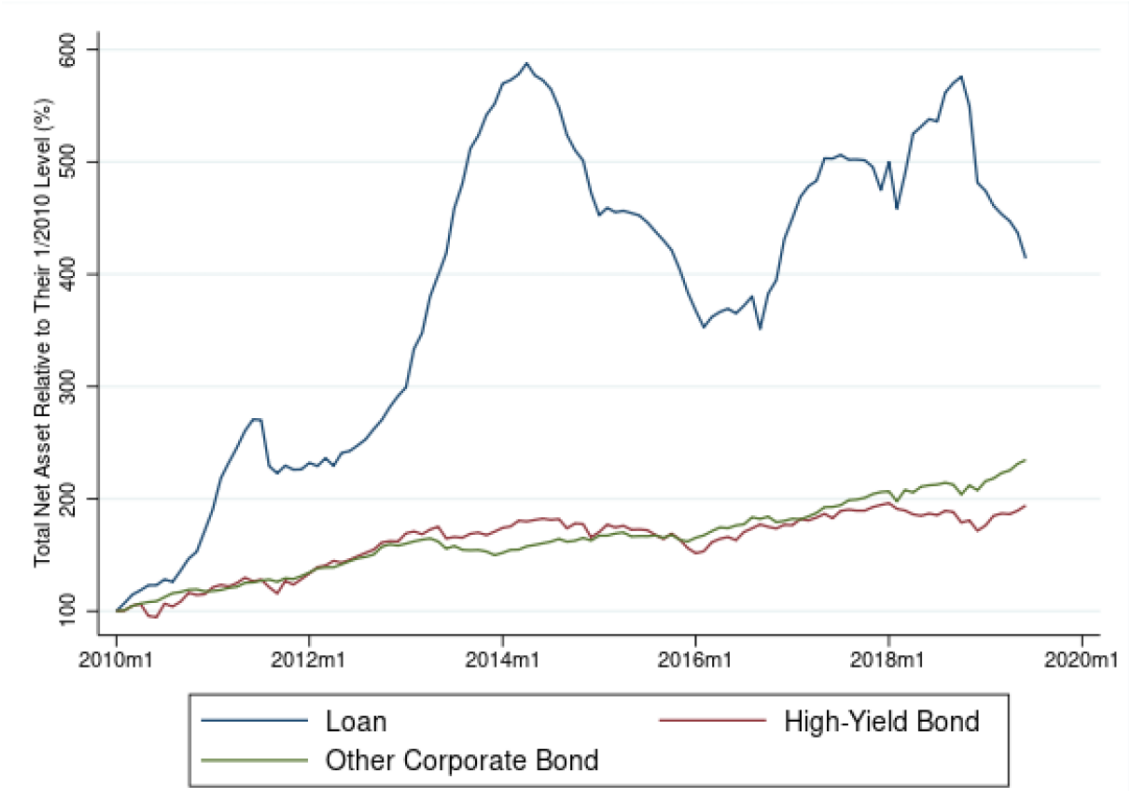
The Rise of Corporate Loan Mutual Funds

- Much work on corporate bond mutual funds but much less is known about loan mutual funds
  - Primarily invest in leveraged loans
  - Issue shares redeemable at short notice

Figure: The Growth of Loan Funds



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
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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 $\rightarrow$ 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

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- 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
- Runs also exist with commercial banks, but largely prevented by regulation, i.e., deposit insurance
- Mutual funds do not have deposit insurance and their liquidity mismatch can still lead to runs because of 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 discuss 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

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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 tends 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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  - 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?

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