EUROPEAN CENTRAL BANK

EUROSYSTEM

Discussion of “Monetary Policy and the Run Risk of Loan Funds”

by Nicola Cetorelli, Gabriele La Spada, João Santos

ECB-New York Fed workshop
June 22, 2023

The views expressed are solely own.

Johannes Breckenfelder (ECB)

Motivation

Open-end mutual funds are key financial intermediaries:

- grew substantially over the past decade
- large holders of securities (Breckenfelder and Hoerova, 2023)
- concerns about fragility → run risk due to the illiquidity of their assets holdings

This paper focuses on Loan Funds:

- hold corporate loans (less liquid than corporate bonds)
- have experienced rapid growth over the past years (outpacing the growth of bond mutual funds)
- their loans are floating-rate and prone to renegotiation when economic conditions improve → exposed to monetary policy changes in nuanced ways

www.ecb.europa.eu ©

Key findings in a nutshell

1. Loan funds more vulnerable to run risk than other debt mutual funds

2. The performance of loan funds is tied to policy rate and LIBOR movements:

   - a rise in policy rates leads to inflows, and a decrease leads to outflows
   - the relation is asymmetric: weaker for policy rate increases (and vice versa)
   - the effect of monetary policy shocks on loan fund flows depends on the level of market short-term rates

→ A novel channel of monetary policy transmission to the credit sector, via non-banks

www.ecb.europa.eu ©

My comments

www.ecb.europa.eu ©

1. How does monetary policy affect fund flows?

This paper focuses on the “interest rate channel”:

- loan funds' income stream should worsen when LIBOR decreases (and vice versa)
- policy rate decreases → net *out*flows from loan funds (and vice versa)

An alternative transmission channel: “risk-taking channel”

- policy rate decreases are associated with increases in investor risk appetite (Bekaert, Hoerova and Lo Duca, JME 2013)
- evidence that looser US monetary policy leads to net *in*flows to investment funds globally (Kaufmann, JEEA 2022)
- “amount of risk” versus “price of risk” (~ risk appetite) of loan fund investors and how they react to monetary policy

www.ecb.europa.eu ©

2. Loan funds and the control group

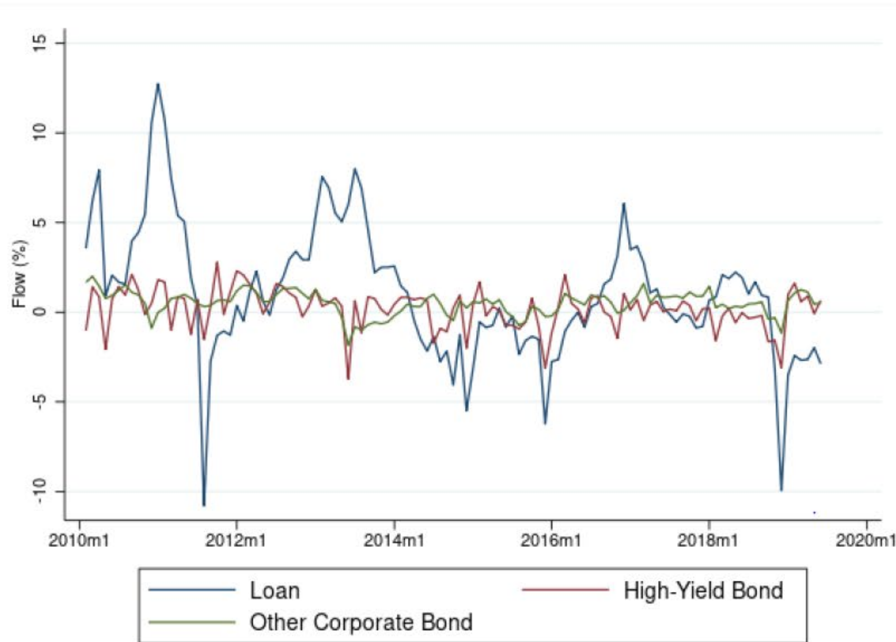
High-yield bond funds a good control group?

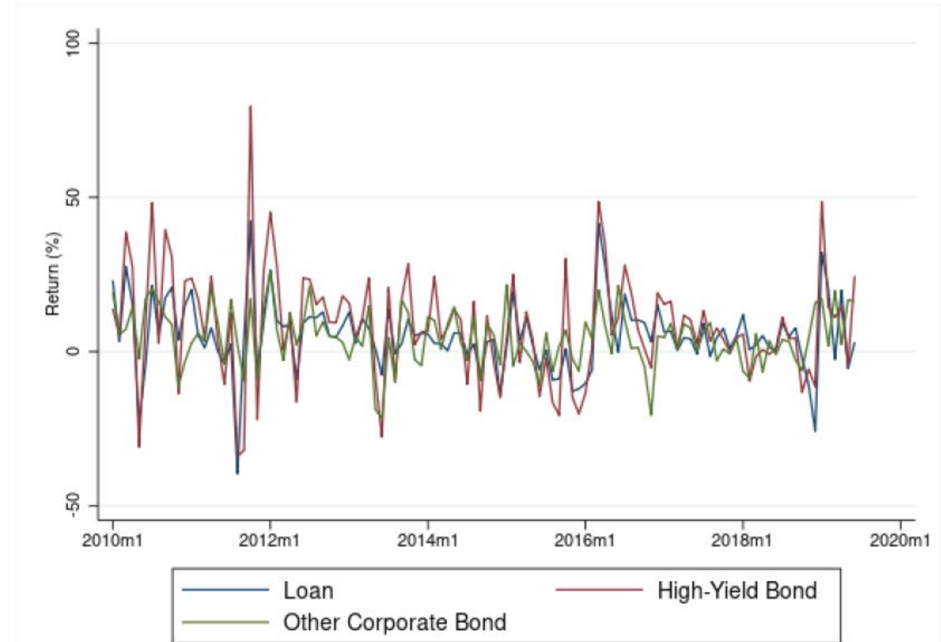
69 unique loan funds and 1467 (high-yield) bond funds

- effects for control goes in same direction as for loan funds; for loan funds the estimate is larger
- could loan funds be more elastic to shocks? – riskier, structurally different → differential estimates

www.ecb.europa.eu ©

2. Loan funds and the control group





LHS: Aggregate flows, large changes; RHS: Average returns, smaller

www.ecb.europa.eu ©

2. Loan funds and the control group:

Potential avenues:

→ a plot of control and treatment group around MP shocks –any differences or trends before the shocks?

→ rethink the control group:

- loan funds also invest in bonds (presumably high-yield)
- bond funds also invest in loans

Can there be an ex ante more equal set of funds?

- differential impact of MPs might come from geographic variation of the fund portfolio

www.ecb.europa.eu ©

3. Alternative measures of policy shocks

This paper exploits the “renegotiation” channel: borrowers want better terms when economic conditions improve

– “policy rates typically increase in response to improving macro conditions”

→ monetary policy tightening may be associated with a *decrease* of the income of loan fund due to borrowers negotiating better terms → asymmetric impact

A suggestion: employ central bank “information” shocks

– based on Jarocinski and Karadi (AEJ Macro, 2020), also available for the US

– a decomposition of central bank announcements into pure monetary policy shocks and information shocks that convey information about economic outlook

→ the latter could be more closely linked to the renegotiation channel

www.ecb.europa.eu ©

In sum…

This is a very interesting paper – I highly recommend you read it!

The paper:

- adds to the literature on fund fragility and monetary policy effects on non-bank financial intermediaries (Breckenfelder and Schepens, 2023)
- points out significant run risk in loan funds
- highlights a nuanced relationship between monetary policy and loan fund flows

www.ecb.europa.eu ©

THANK YOU!

johannes.breckenfelder@ecb.europa.eu

www.ecb.europa.eu ©