Discussion of
“Intermediary Balance Sheet Constraints, Bond Mutual Funds' Strategies, and Bond Returns”

by Giannetti, Jotikasthira, Rapp, Waibel

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The views expressed are solely own.

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Main research question

Do liquidity-supplying mutual funds take over market-making activity from dealer banks because dealers are subject to the leverage ratio (LR) regulation?

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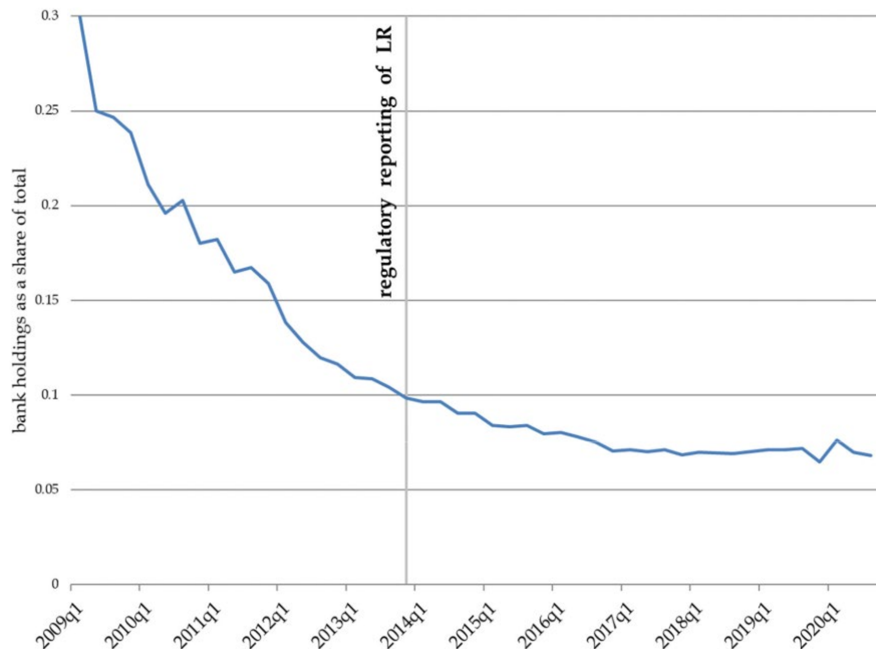
Why is this important?



Dealer banks' corporate bond holdings declined substantially over the past 15 years

Decline from ~30% in 2009 to ~6% in 2017 and onwards

Source: "Bank Balance Sheet Constraints and Mutual Fund Fragility", 2020, Breckenfelder and Ivashina, R&R RFS.

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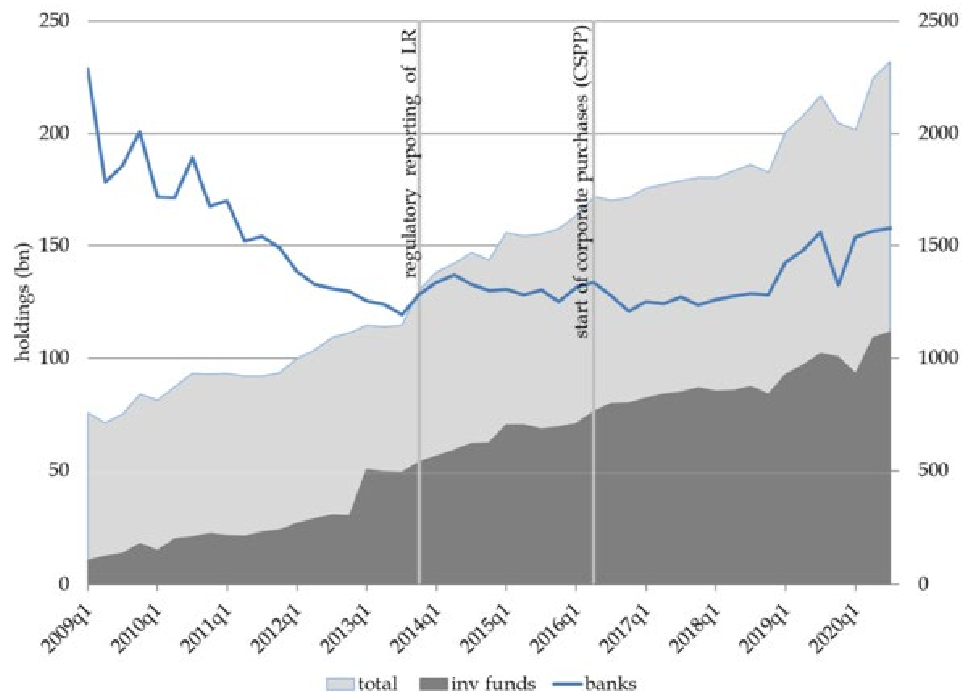

Source: “Bank Balance Sheet Constraints and Mutual Fund Fragility”, 2020, Breckenfelder and Ivashina, R&R RFS.

Over the same time period, mutual fund holdings increased significantly

The corporate bond market has more than doubled in size → additional volumes purchased by funds

Regulation is a key driver of the shift from banks to funds/other investors

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Ingredients employed to study the question

1. Leverage Ratio-constrained banks and a source of exogenous variation
   - regulatory window-dressing as one such source (e.g., Du, Tepper, Verdelhan, JF 2018; Ranaldo, Schaffner, Vasios, JFE 2021…)

2. Matching the leverage constrained dealer bank to individual bonds
   - e.g., Adrian, Boyarchenko, Shachar (JME 2017)

3. Link: Leverage Ratio of banks → bonds → mutual funds
   - Breckenfelder and Ivashina (2020, R&R RFS) focus on how this link impacts fund fragility

4. Classification of liquidity-supplying funds and their trading activity
   - Anand, Jotikasthira, Venkataraman (RFS 2021)

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Key findings in a nutshell

Introduction of leverage ratio led to increased liquidity provision by bond mutual funds in the IG corporate bond market

Mutual funds with liquidity-supplying strategies have benefited in terms of performance

Profits associated with liquidity provision transferred from bank-affiliated dealers to mutual funds

IG liquidity-supplying (LS) funds outperform non-LS funds, particularly after the leverage ratio quarter-end reporting period

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My wish list

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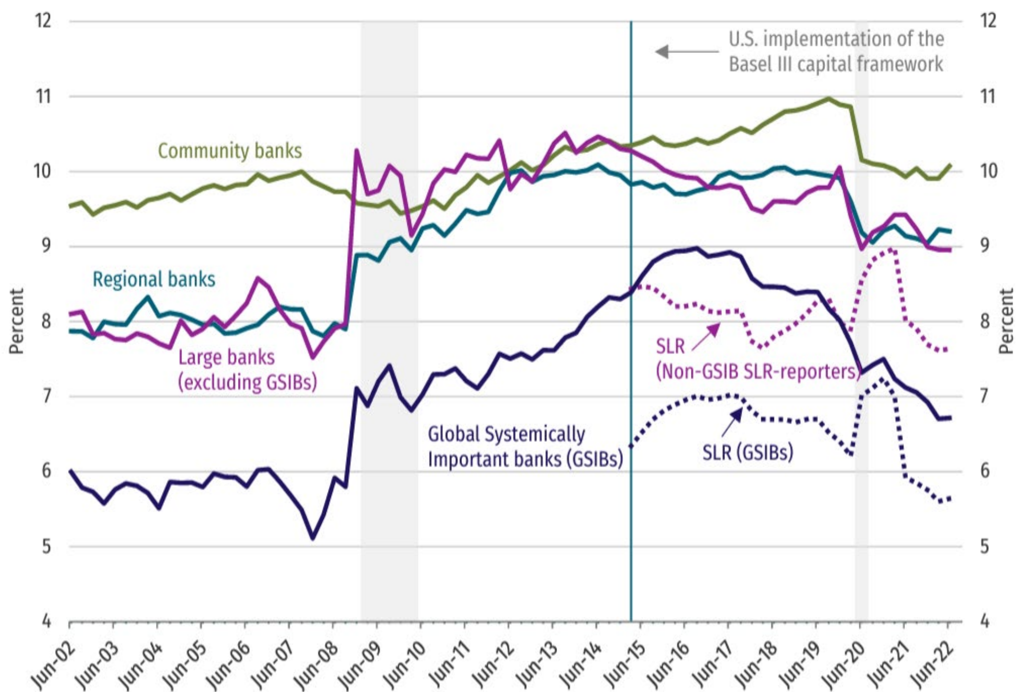
1. Leverage Ratio constraint



Source: Bank Capital Analysis Semiannual Update, 2022, Pellering, Kansas City Fed.

Leverage Ratio not binding for US banks

US banks' leverage ratios are well above the 5% minimum requirement

Suggestion: The paper could consider “relatively more” vs “relatively less” constrained dealers

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2. Leverage Ratio: variation

Alternative source of variation:

- The paper does not distinguish between US GSIBs and International GSIBs
- International GSIBs were more impacted by LR due to the lack of an initial LR
- Reporting differences: Euro area banks report only quarter-end ratios while US banks report both quarter-end ratios and the daily average over a quarter (Munyan, 2017)

Suggestion: Exploit differences in window-dressing incentives across banks

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3. Methodology

Before and After Analysis:

- Significant changes occurred in the bond market, making it tricky to take an average effect on the before and after periods:
  - Different regulations, QT, market stress periods

- There is some disagreement over the timing of the SLR requirement affecting dealer banks
  - Allahrakha, Cetina, Munyan (JFI 2018) suggest 2012

Suggestion: Use time-varying coefficients in the analysis to account for year-by-year or quarter-by-quarter changes around regulation.

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4. Liquidity Provision

Liquidity provision implies both buying and selling; in this paper, only buying is considered.

The paper shows that liquidity-supplying funds have larger inflows and that they buy more constrained bonds at quarter-ends.

I would like to learn more: Funds tend to rebalance their positions at month ends/quarter ends. LS funds have larger inflows → could it be that LS funds buy bonds to invest instead of supplying liquidity?

Related: Do banks buy (back) bonds at the beginning of the next quarter?

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5. Additional Comments for the Authors

1. Run a pre/post regression to see the differential effect. As it stands, coefficients for both periods are positive, so the difference might be insignificant.

2. The paper also mentions 'fragility.' If this part is retained, it should link fragility in the bond market to market-making.

3. The paper needs to align its contribution better with existing literature.

4. Adding figures to the paper would enrich the exposition.

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In sum…

The paper:

- highlights the significant shift in market-making from bank-affiliated dealers to mutual funds
- offers insights into the regulatory impact on bond market dynamics and mutual fund performance

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

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THANK YOU!

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