EUROPEAN CENTRAL BANK

EUROSYSTEM

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

by Giannetti, Jotikasthira, Rapp, Waibel

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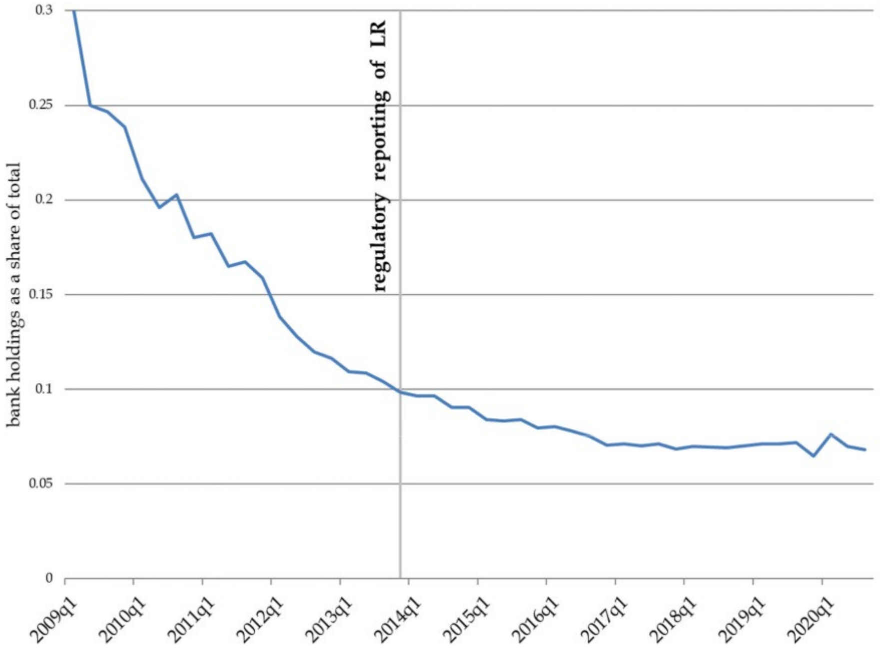
The views expressed are solely own.

Johannes Breckenfelder (ECB)

A novel 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?

Why is this important?

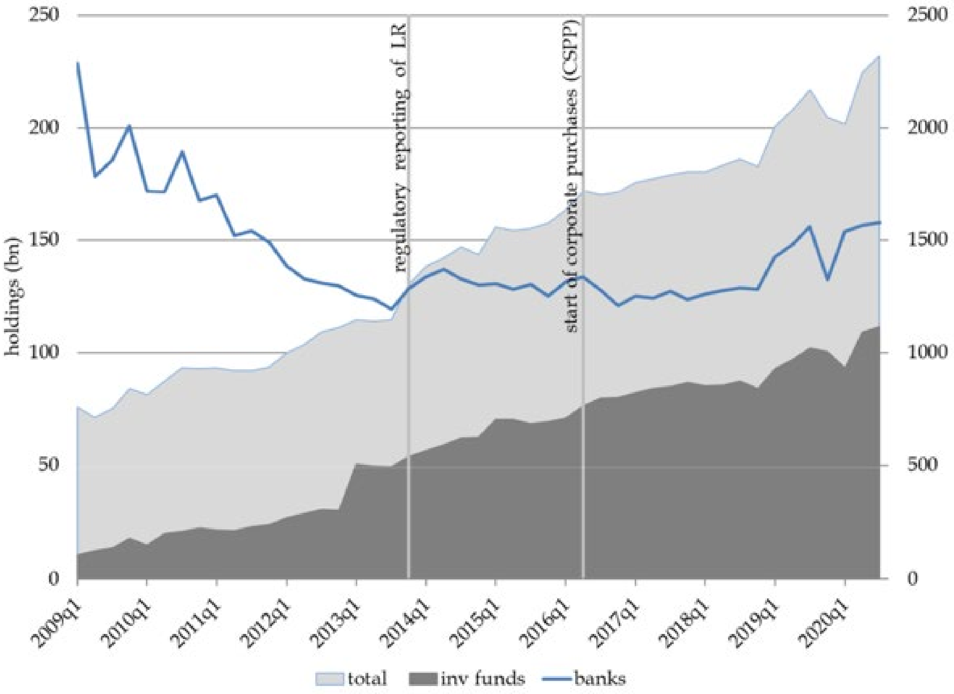


Source: "Bank Balance Sheet Constraints and Mutual Fund Fragility", 2020, Breckenfelder and Ivashina, R&R RFS.

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

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

Why is this important?



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

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)

Key findings in a nutshell

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

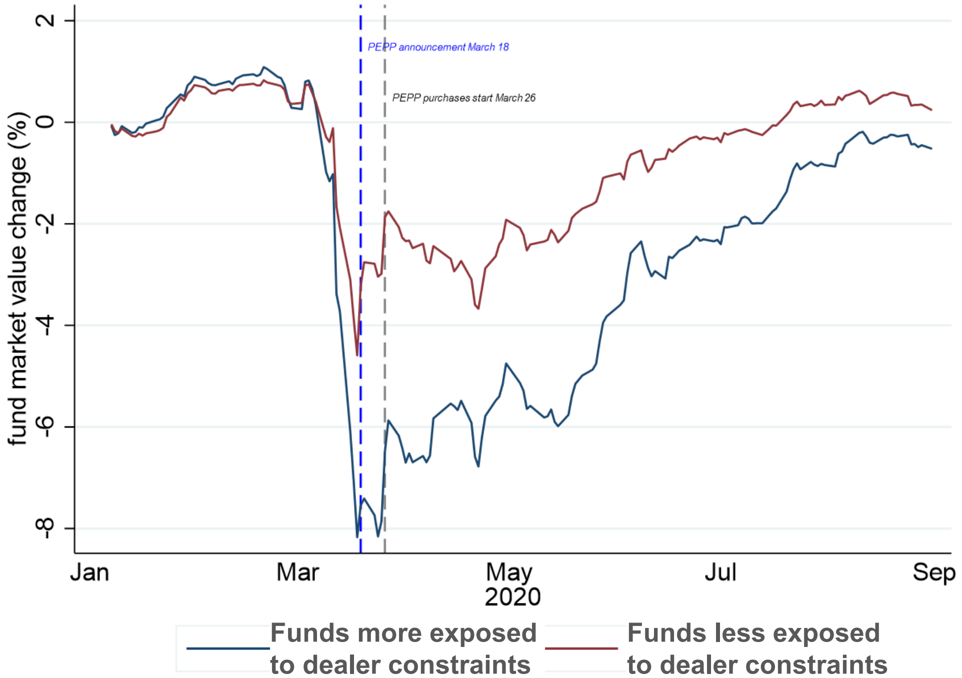
Mutual funds with liquidity-supplying strategies have benefited in terms of performance

Profits associated with liquidity provision are 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

My wish list

1. Contribution to the literature



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

What we **do** know:

Bonds linked to more **leverage-constrained dealers** are less liquid

→ **Mutual funds** holding such bonds are **more fragile** (worse performance and more outflows during the March 2020 turmoil)

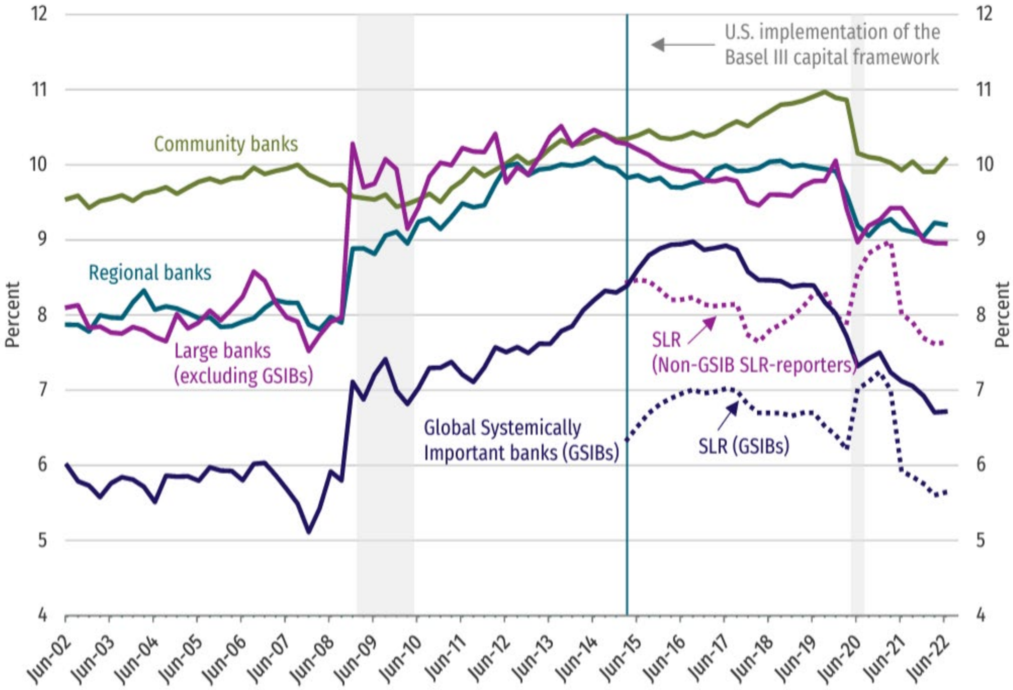
1. Contribution to the literature

What we **don’t** know:

Liquidity-supplying funds step in/buy when balance-sheet-constrained dealers want to sell assets at quarter ends due to the Leverage Ratio.

Suggestion: sharpen the contribution of the paper.

2. 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: Consider “relatively more” vs “relatively less” constrained dealers.

2. Leverage Ratio constraint: variation

Split between banks reporting LR at quarter-ends versus quarter-averaging:

– international GSIBs more impacted by LR due to 1) lack of initial LR and 2) quarter-end LR reporting vs US banks also report quarter-averages (Munyan, 2017)

Finding in the paper: liquidity-supplying funds buy somewhat more of bonds sold by banks reporting based on *quarter-averaging*

– the literature showed that banks reporting at *quarter-end* change their behavior more at quarter-ends (they window-dress more) → intuition for the finding?

Suggestion: Tighten the connection to the Leverage ratio regulation: e.g., can you show that dealers buy (back) bonds at the beginning of the next quarter?

3. Liquidity provision by funds

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 know 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?

3. Liquidity provision by funds

LS funds appear to have better performance in the first month after quarter-end

I would like to know more:

- is this due to the securities bought from banks before quarter-end?
- what do LS funds do with the securities acquired from banks before quarter-end? Do they sell them back to the banks after quarter-end?
- How do LS funds invest their inflows outside quarter ends?

In sum…

The paper:

- highlights the significant shift in market-making from bank-affiliated dealers to mutual funds
- offers insights on quarter-end effects in bond markets and impact on mutual fund performance

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

THANK YOU!

johannes.breckenfelder@ecb.europa.eu