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Discussion of

Bank Balance Sheet Constraints and Mutual Fund Fragility

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The views presented here are those of the author and do not represent views of the Fund management.

Key contributions

- The role of dealer banks' balance sheet constraints for financial fragility

- Three (closely related) contributions
  - Frictions in dealer markets: i) home bias and ii) fact that underwriter are also key secondary market dealers
  - Dealers' balance sheet constraints as an alternative measure of bond-illiquidity
  - Fixed-income funds that were exposed to dealer balance-sheet constraints in their portfolio faced more selling pressure during 2020 market sell off.

- Carefully executed but could focus further on one (or more) of the three key contributions

Two Measures Frictions in Dealer Markets

- **Home bias**
  - Fragility of bonds is measured as the within-country weighted averages of dealer distances to the 3% leverage ratio regulatory requirement.
  - How exactly does this home-bias play out? Do the least constraint dealers step in? Does a countries' bond market-microstructure matter (e.g. number of dealer banks, their substitutability)?

  ➔Matters for the construction of the fragility measure
- Should we expect any **nonlinearities** in the impact of the distance to the leverage requirement? ➔ Matters for the construction of the fragility measure
- **Underwriter ties**
  - Underwriters are active dealers in bonds' secondary markets and underwriter-issuer relationships tend to be "sticky"
  - Some evidence that underwriter-issuer relationship tends to be stable. Is that also true when underwriters face balance sheet constraints? Provision of secondary market liquidity is an important element of issuer-underwriter relationship.

Leverage ratio and bond liquidity (1)

- After December 31, 2013 (when banks started reporting regulatory leverage ratios) **bid-ask spreads of bonds tied to constraint dealer-banks increased.**
  - What are the **mechanisms** behind the reduction in bond liquidity after 2013? Did dealers reduce their balance sheets after December 2013? Did their trading activity decline?
  - Why not (also) look at dates when the leverage ratio became binding? Add non-EU countries for staggered approach?
  - What happened in the medium to long run? Did **other market participants** step in to benefit from widened bid-ask spreads?

Leverage ratio and bond liquidity (2)

- Authors suggest dealer constraints as alternative measurement of bond liquidity but how does it **compare to existing liquidity measures**?
  - Constraint should matter more in periods of stress. Are dealer constraints **a leading indicator** of illiquidity (as measured by other indicators)? Do they predict illiquidity in times of stress?
  - **Bid-ask spreads** can be an unreliable measure of liquidity in corporate bond markets (prices can become stale, quotes are non-binding, …). How do dealer constraints compare to other liquidity measures such as roundtrip costs or price impact?

Bond liquidity and 2020 mutual fund outflows

- Funds exposed to banks with lower balance sheet capacity performed worse in 2020
  - Similar approach to Falato, Goldstein, and Hortaçsu (2021). How important are dealers' balance sheet constraints relative to other sources of illiquidity?

- Funds' reaction
  - Do funds anticipate dealers' constraints?
  - **In normal times**, do funds load up on bonds affected by dealer balance sheet constraints to collect the liquidity premium?
  - Are funds with access to better **liquidity management tools** (e.g. swing pricing) less affected?

  ➔ Matters for policy conclusions.

Thank you!