Run for Cash: 2020 Liquid Securities Squeeze & Mutual Funds Role in It

Discussion by Victoria Ivashina

"Anatomy of Liquidity Crisis: Corporate Bonds in the Covid-19 Crisis," Maureen O'Hara and Alex Zhou

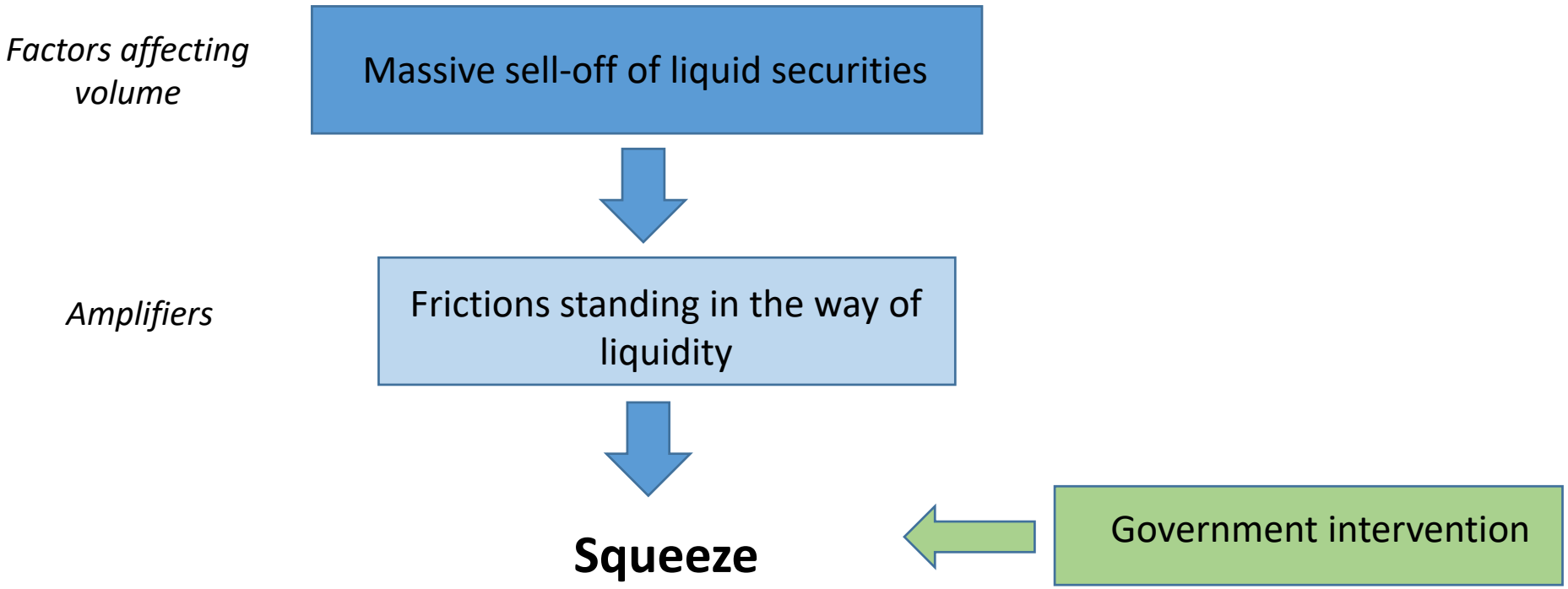
"Mutual Fund Liquidity Transformation and Reserve Flight to Liquidity," Yiming Ma, Kairong Xiao and Yao Zeng

November 20 ,2020

Financial Stability Conference: Stress, Contagion, and Transmission

How It All Fits Together:

- Both are essential papers to understand core elements of the 2020 liquid securities squeeze:



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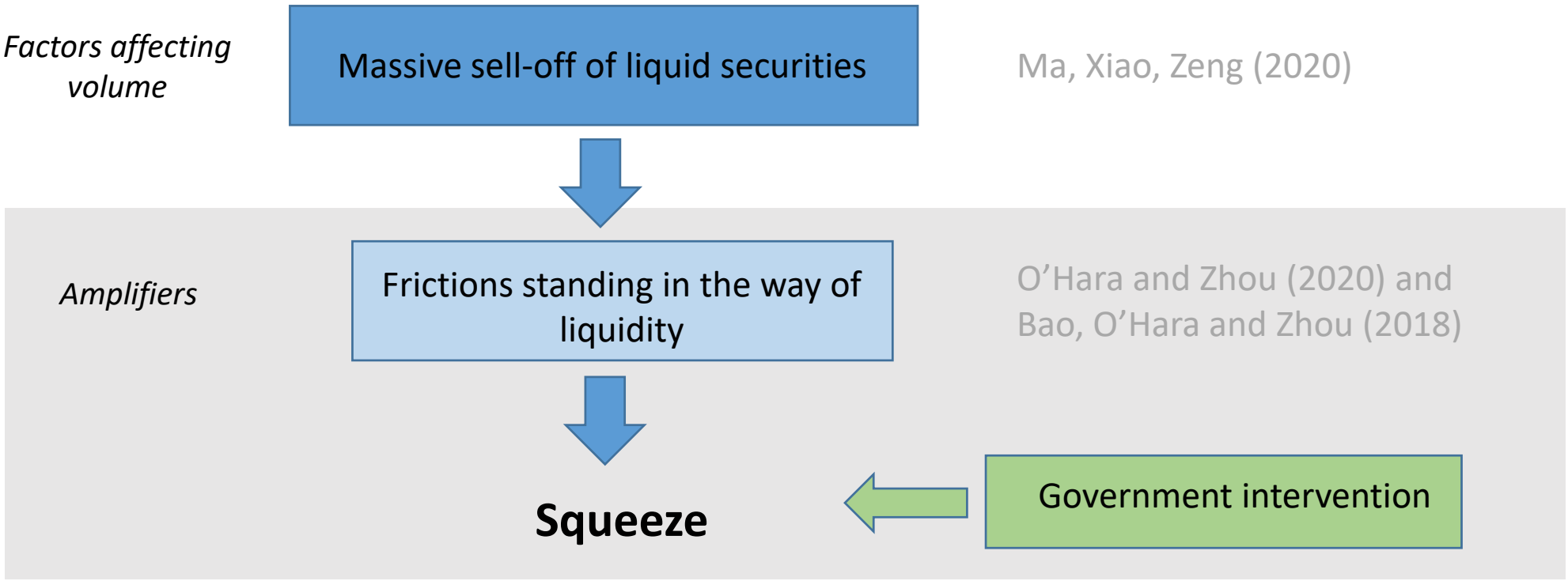


Core Facts and Conclusions

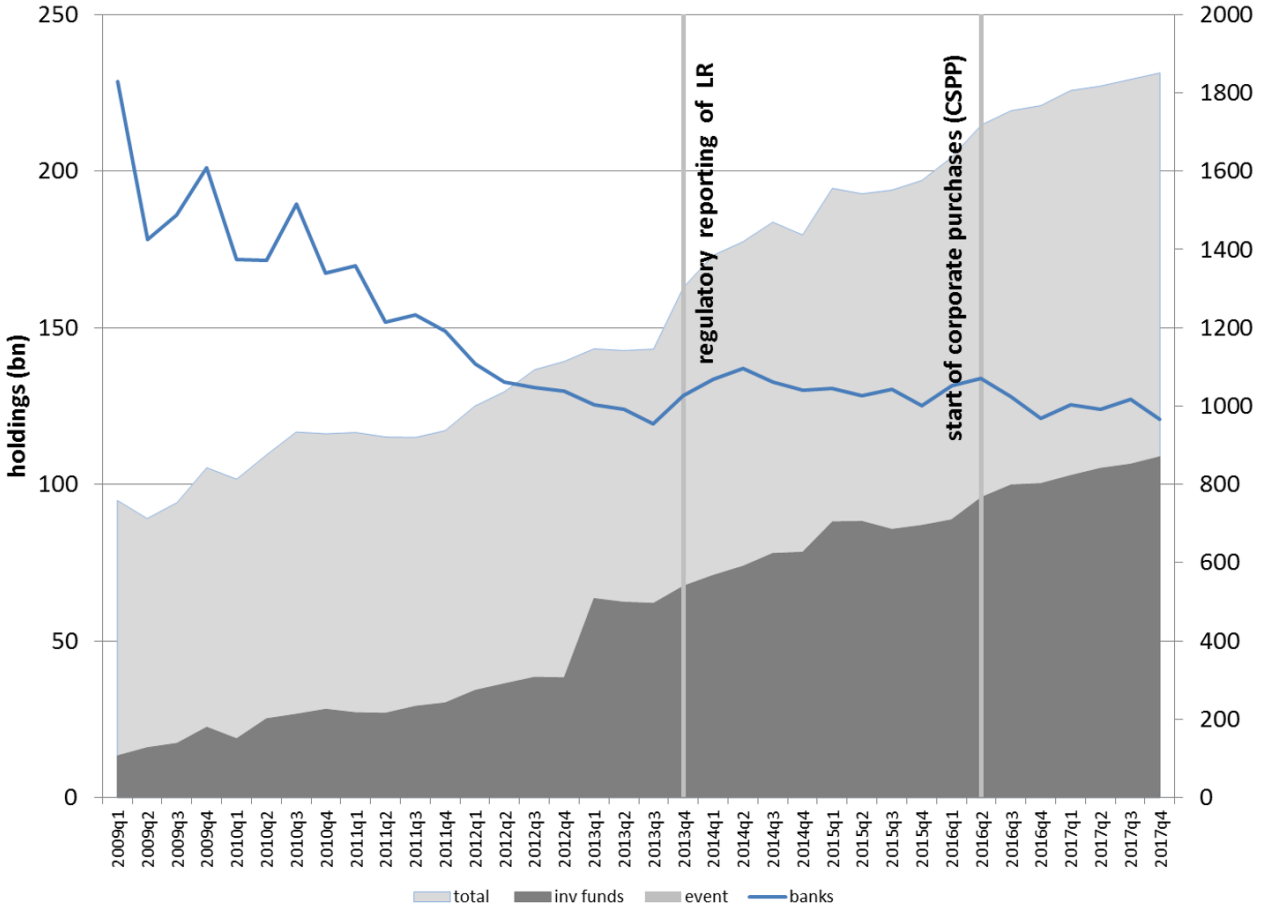
- A lot of detail on cost of trade through March:
  - IG block trade transaction cost: 24 bps (normal) vs. 150 bps March 2020 (60 bps above retail trade, the opposite of the normal)
- Evidence consistent with dealers' constraints, and its relief through government intervention – i.e., the frictions matter, not just demand for liquidity
  - Clarifying question: Why exactly did the dealers become net sellers? What is the source of pressure?
- C2C liquidity provision falls short in 2020
- Novel policy intervention: "Fed as a market maker" (diff-in-diff identification)
  - "A-" (my read) for policy actions

Ma, Xiao, Zeng (2020)

Mutual Fund & Reverse Flight to Safety

- Important takeaway: Mutual funds are an essential piece to understand the sell-off pressure of liquid securities in 2020 crisis

- Corporate bonds in the Eurozone



Astonishing growth of fixed income mutual funds

From Breckenfelder and Ivashina (2020)

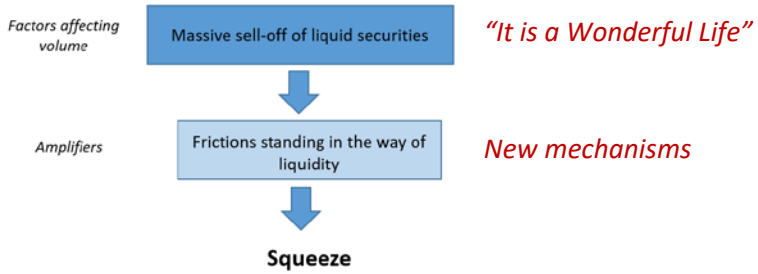
Mutual Fund & Reverse Flight to Safety

- Important takeaway: Mutual funds are an essential piece to understand the sell-off pressure of liquid securities in 2020 crisis
- As a conceptual point, it might not be that surprising (i.e., what is a credible H0?)
  - Flight to safety in bank is not a directly comparable phenomenon: it is a consequence of risk-based capital requirement constraint
  - Left unregulated, institutions with illiquid & runnable liabilities, ideally would have a “cash-like” buffer and use it when needed… or Liquidity Coverage Ratio (LCR) makes no sense
    - Chernenko and Suderam (2017), Jiang, Li and Wang (2020) – evidence for MFs form normal times

Example of a Bank Reverse Flight to Liquidity

Where did the money came from?
$2K form honeymoon fund
$6K cash donations from neighbors

Clarifying note: O'Hara and Zhou's paper stresses that "in current markets, a credit crunch or liquidity crisis arises in a different way from the lender-based problem of times past." The need for liquidity however arises very much in the way of times past.



Mutual Fund & Reverse Flight to Safety/Liquidity

- Post GFC, the growth of mutual fund fixed income (less liquid) assets were not missed in the public debate
- Externality imposed through illiquidity leading to the run dynamic (several of the cited papers)
- We were hoping that MFs are well prepared (by voluntarily complying with an equivalent to liquidity coverage ratio (LCR)), and it looks like they were (IG vs NIG graph)
- The novel insight is the “unintended consequence” of this setup (volume pressure from the 1st slide)

Final Thought for Both Papers

- A squeeze in safe securities is easily remedied by Fed/ECB interventions. Politically, this is “easy” to execute. So, isn’t this as good as it gets?
- And all the folks complaining about reduced liquidity due to dealers’ balance-sheet constraints—myself included—might be missing the bigger point: removing banks as dealers in IG is not such a big deal. What setup would be better from a welfare perspective, and why?

To reiterate:

- Timely, carefully-researched and insightful work
- Both are essential papers to understand core elements of the 2020 liquid securities squeeze!