Comment on "Open-ended bond funds: systemic risks and policy implications" by Stijn Claessens and Ulf Lewrick

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The paper by Stijn Claessens and Ulf Lewrick addresses several highly important and policy-relevant issues, especially given the continued rise of non-bank financial intermediaries (NBFIs) and open-ended funds (OEFs) in particular. One of the most prominent features of OEFs is liquidity transformation. Although funds may invest in illiquid assets such as lower-rated corporate bonds, investors can typically redeem their shares on a daily basis. To meet large investor withdrawals, funds may have to sell illiquid holdings at discounted prices, and the liquidation cost is often borne by the remaining investors. Therefore, investors have a strong incentive to redeem ahead of others. This first-mover advantage can lead to large redemptions from open-ended funds, particularly during market downturns. Furthermore, the redemptions and funds' subsequent selling may lead to a further decline in the price of illiquid assets.

To provide evidence for this potential feedback loop, the authors use supervisory data on bond OEFs from Luxemburg during the recent Covid-19 market turmoil. The study shows that redemptions during the stress period exceeded the OEFs' available cash holdings, and funds resorted to procyclical sales of corporate bonds. Consistent with this result, the authors show that bonds held by OEFs exhibit larger price falls and tend to be less liquid. They also show that redemptions tend to be correlated across fund classes, and also find that funds with common asset holdings experienced larger redemptions. The authors then conclude that funds' liquidity management tools appear to be ineffective. More precisely, funds seem reluctant to use cash buffers to meet redemptions, and OEFs appear to experience larger outflows when they use swing pricing.

The policy implications of these results are important. According to the authors, funds' current use of swing pricing may be ineffective, potentially due to the loose calibration of swing factors. However, if swing factors are too tight and only activated during stress, this could potentially lead to pre-emptive runs and regulatory arbitrage. Second, the study warns that portfolio managers overestimate their portfolio liquidity under duress. Moreover, the stigma around suspensions prevents the use of this additional line of defense. The authors then put forward three potential remedies: countercyclical liquidity buffers, the alignment of

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redemption terms with portfolio liquidity and conservatism in assessment of portfolio liquidity.

The study contributes to a recent strand of the literature that provides conflicting results on the price impact of flow-induced sales of corporate bonds. For example, Jiang et al. (2021) show that investor redemptions generate price pressures and predict a reversal of corporate bond returns during high uncertainty periods. Similarly, Jiang et al. (2022) find that bonds with higher latent fragility experience higher return volatility and more flow-induced fund selling. In stark contrast to these findings, Choi et al. (2020) find little evidence that bond fund redemptions drive fire sale price pressure after controlling for time-varying issuer-level information.

An important assumption in all of these studies is that funds use vertical slicing (i.e., selling of both liquid and illiquid assets to preserve overall portfolio liquidity) in stress periods. However, the experience from the UK gilt market during the Covid-19 market turmoil suggests that OEFs use horizontal slicing: funds sell their more liquid gilts and reduce repo lending in response to outflows, with a large subsequent price impact (Czech et al. 2021). This finding is corroborated by Ma et al. (2022), who provide novel evidence that investors engage in a "reverse flight to liquidity" by selling their most liquid assets first under duress.

In terms of the data, the authors use a relatively limited sample of 179 high-yield funds, and they match bonds held by OEFs with bonds issued by the same firm with similar maturity and not held by OEFs. Given the relatively small size of the European high-yield bond market, the question arises whether the authors could extend their study to the more prominent market for investment grade bonds. Moreover, there are two further extensions that could help to increase the study's impact. First, the authors could try to account for actual flows in and out of these open-ended bond funds. Second, it would be interesting to replicate the regression results of Choi et al. (2020) using issuer-time fixed effects.

The authors also note that "the differences in prices and spreads persisted for several months". The long-lasting price impact may therefore indicate that the observed pattern is not a selling pressure story, but could rather be driven by unobserved bond fundamentals, such as duration, callability, seniority, currency, etc. (e.g., Cesa-Bianchi et al., 2021). The bonds' subsequent underperformance might be erroneously attributed to funds' selling pressure if such discretionary sales were to be misspecified as flow-driven. The authors could provide additional robustness tests to dismiss this alternative motivation for the funds' bond selling.

An important contribution of the paper is to investigate the effectiveness of swing pricing. The authors conclude that "swing factors may have thus fallen short of what investors perceived to be the true impact of liquidating assets on the funds' share price". This finding stands in sharp contrast to the prior literature. In their seminal paper, Jin et al. (2022) show that swing pricing eliminates the first-mover advantage and reduces outflows from UK funds, also during market stress. A way to reconcile these opposing views is to analyze the drivers behind the apparent inertia of swing factors during the early days of the crisis. In a joint Bank of England and Financial Conduct Authority survey of UK open-ended funds and their liquidity management practices (Bank of England and FCA, 2020), for instance, the results indicate that most funds use a standard swing factor (141), which they reviewed only weekly (37), monthly (48) or quarterly (53). Furthermore, fund managers often rely on historical bid-ask spreads of the underlying securities, which may dramatically underestimate trading costs under duress. Even when using current bid-ask spreads, quotes are often "stale", especially for illiquid securities such as high-yield bonds.

Overall, Claessens and Lewrick provide an excellent study on the feedback loops in OEFs, with several important policy implications. Consistent with their suggestions, a robust international consensus appears to emerge on aligning funds' redemption terms with their portfolio liquidity, as well as on establishing more adequate and responsive swing factors in stress periods. The authors' third suggestion to expand funds' liquidity buffers may prove to be more controversial, not least due to the drag on portfolio performance and the resulting impact on the availability of funding for real economy firms. To conclude, there is a clear necessity for more international evidence on the impact of flow-induced trading on corporate and sovereign bond prices.

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