Executive summary for "NonBank Fragility in Credit Markets: Evidence from a Two-Layer Asset Demand System" (authors: Darmouni, Xiao, Siani)
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Market fragility is often at the center of economic crises, featuring spirals of depressed asset prices and illiquidity, with potentially devastating consequences for the economy. Traditionally, the focus has been on the banking sector, particularly in the wake of the 2008 Global Financial Crisis. However, in recent decades, nonbanks have been growing rapidly and now perform a large share of intermediation in the economy. This growth is, however, not without systemic risk. In March 2020, for example, bond markets experienced severe turmoil, prompting a large-scale intervention by the Federal Reserve. Nonbank fragility was an important driver of the pandemic crisis, with historical levels of outflows suffered by bond mutual funds, significantly contributing to the spike in credit spreads and the drop in firms' ability to borrow.

Our paper develops a framework to analyze the fragility of the corporate bond market. The model features two layers: households allocate wealth to institutions, which in turn allocate funds to specific assets. The model yields three intuitive characteristics of crises. First, it captures a feedback loop between prices and flows that is characteristic of crises. A negative shock to asset prices reduces fund returns, leading to fund outflows that force asset sales, further depressing prices. Second, the model captures contagion across assets. Shocks to the fundamental value of one asset can spill over to other assets through investor outflows. Third, there is contagion across institutions. Even institutions that do not face significant outflows are affected through their portfolio holdings.

We construct an asset fragility measure that captures the contagion and amplification mechanisms. This measure can help policymakers evaluate the source of systemic fragility in credit markets and better target ex-post interventions. We find that the least fragile asset class is long-term investment-grade (IG) bonds, while short-term bonds more likely to be held by mutual funds with high flow sensitivity are more fragile.

We study the effects of four policy interventions to stabilize the market. First, we find that a rate cut (conventional monetary policy) improves prices and restores some of the loss in fund value. IG bonds rebound significantly more than high-yield (HY) bonds because they are of longer duration. Second, we evaluate a policy where the central bank purchases outstanding short-term IG bonds. While these asset purchases target IG bonds, there is nevertheless a small price benefit for HY bonds because of the rebound in fund assets under management as well as increased demand for HY assets from investment mandates. The timing of both interventions matters relatively little for the size of the eventual rebound.

Next, we study two types of interventions targeting the mutual fund sector specifically. We consider the effects of lending directly to mutual funds. We find that this policy is extremely effective at supporting prices and limiting outflows, but only if it is implemented early. This evidence suggests that a "lender of last resort" stance towards nonbanks can be effective if executed swiftly. We then consider a policy of freezing mutual fund redemption. Regulators did not mandate this policy in spring 2020, but a significant number of funds facing severe liquidity issues suspended redemption. Similar to direct lending, this policy is very effective,

but only if executed quickly. Redemption restrictions, a classic tool of bank regulation, might thus also be a consideration for nonbanks.

We compare the cost-effectiveness of these policies and find that asset purchases have the largest “bang for the buck” since they target short-term IG bonds that are extremely fragile due to their investor base of flow-sensitive mutual funds.

Our framework's underlying economics are general enough and its estimation methodology is flexible enough to be applied to other settings, such as equity, government bonds, or currency markets.