Short-term Debt, Liquidity, And The Financial Crisis
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2008 Financial Crisis: A 10 Year Review
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Evaluating recent responses to the crisis: Regulations and Policies

• What caused the fragility in the credit crisis?
  • Not the housing shock per se, but the system itself.

• New regulations did not take a position on the problem, tried to address them all. Belt and Suspenders.
  • Runs and the problems of short-term debt?
  • Too interconnected?
  • Anticipated bailouts (“Too Big to Fail”).
  • Shadow banking which avoided regulation
  • Too little capital?
The recent crisis was like all others

• *Private* financial crises are everywhere and always due to problems of short-term debt.
How do we evaluate crisis responses now?

• New regulations are binding (they changed behavior).
• No new crisis (none would occur this soon anyway).
• There also has been lots of liquidity in the corporate sector and the financial sector.
• Some liquidity has been due to policy (QE etc.)
• Liquidity provides a tail wind for the financial sector. The present looks “stable” from regulation and liquidity.
Good Regulation to deal with Runs: Runs on Institutional MMFs

Prime institutional and prime retail MMF assets

Lehman failure

Eurozone crisis

USD Million

0 200,000 400,000 600,000 800,000 1,000,000 1,200,000 1,400,000 1,600,000

Source: JCI
Institutional Money Market Funds

- Prime institutional assets
- Government institutional assets
All Money Market Funds

- Prime institutional assets
- Government institutional assets
- Prime retail assets
- Government retail assets
In the crisis there was too little liquidity and fire sale pricing: S&P/LSTA U.S. Leveraged Loan 100 Index 2008-2010

MTM Price Performance

- Average Bid
- Average Bid-Ask Spread

Source: LSTA/LPC MTM Pricing
If Too Little Liquidity is Bad, Is More Liquidity always Good?

• Too little liquidity in a crisis is bad and makes debt runs both self-fulfilling and contagious.

• However, recent a recent theory by Diamond-Hu-Rajan (2018), shows that too much liquidity in a boom reduces incentives to retain future financial capacity.

• Excess liquidity leads to market incentives for financial carelessness:
  • A boom in covenant-lite lending.
  • Lower voluntary accounting standards.
  • A reduction in monitored (Bank) Lending vs. bonds.
  • Less “skin in the game” for securitizations.
Are the risks for the next crisis building now?

• Large Boom in Covenant-Lite Lending (well more in level and percentage than 2006-07)
• Recent uptick in US audits which report Major Weakness of Internal Control.
Boom in Covenant Lite Loans

Covenant-Lite Leveraged Loans in US

Loan Amount (in Billions)

Year (Quarter)

Covenant-Lite Loan Amount (in Billions)
Percentage of Covenant-Lite Leveraged Loans
Weakness of Internal Control

percentage of firms that were reported as with weak internal control in an earnings restatement year and/or the two subsequent years.
Median of cross country distribution of financial conditions

Source: IMF GFSR 2018
With **moderate amounts of liquidity** in the system, the market encourages covenants:

- Market forces naturally limit leverage and encourage covenants, monitored lending and high accounting standards.
- **With Large Amounts of Liquidity** in the System, market forces do not naturally encourage covenants and low leverage.
- If we get a negative shock after a high industry liquidity period: “Only when the tide goes out do you discover who's been swimming naked.” (Warren Buffett).
- In moderate liquidity times, the market forces firms to wear “swim suits” (high covenants, lower leverage).
Why anticipated market liquidity crowds out future covenants or “pledgeability”

- High probability of high future liquidity
- High capacity to repay debt
- More borrowing available up front to buy firm
- Low incentive for firm to raise pledgeability
- Higher asset prices
Discretionary Increased Pledgeability

• Improved Pledgeability: Increases access to finance in the near future (access is improved by allowing larger credible payments in more distant future):

• Improving voluntary accounting standards and transparency.

• Extra Outside control: Stricter Loan Covenants (not “Covenant Lite”).

• Monitored (Bank) Lending vs. bonds.

• These are sticky, but change over time at business cycle frequencies.
Liquidity (the “tide”) is still high

- The financial system looks stable today, and there have been some beneficial changes in regulations and behavior.
- High anticipated liquidity allows firms to support higher leverage and permits intermediaries to increase leverage.
- Added funding is easy for both firms and intermediaries.
High Liquidity Makes the Present Stable, but Allows Choices Leading to Future Vulnerability

• High Liquidity makes new regulations appear to be very successful or even unneeded.

• But the high liquidity may mask some problems and prevent market incentives from limiting future vulnerability of the financial system.
Everything in Moderation: Including Liquidity

• Too much anticipated liquidity can be a bad thing.
• One factor in creating accommodative financing conditions (i.e., easy liquidity) is easy anticipated monetary policy.
• Monetary policy and financial stability cannot be separated.
• This is a lesson we have yet to digest.