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Crises, Liquidity Shocks, and Fire Sales at Financial Institutions

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Abstract

We investigate liquidity shocks and shocks to fundamentals during financial crises at commercial banks, investment banks, and hedge funds. Liquidity shock amplification models assume that widespread funding problems cause fire sales. We find that most banks do not experience funding declines during crises. Banks that do face debt shortages circumvent fire sales by shifting to deposits, issuing equity, and cherry picking. Similarly, we find that hedge funds facing large redemption requests often sell more stock than necessary and use excess proceeds to buy new stock. We conclude that shocks to fundamentals, not illiquidity-induced fire sales, are central to financial crises.

Keywords: Liquidity shocks, funding shocks, fire sales, financial crisis, banks, investment banks, hedge funds, financial constraints

JEL Classification: G21, G24, G28, G32, G33, E44, E58, E61

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