

Title:

Hedge Funds as Liquidity Providers: Evidence from the Lehman Bankruptcy

Abstract:

Using the September 15, 2008 bankruptcy of Lehman Brothers as an exogenous shock to funding costs, we show that hedge funds act as liquidity providers. Hedge funds using Lehman as prime broker could not trade after the bankruptcy, and these funds failed twice as often as otherwise-similar funds after September 15 (but not before). Stocks traded by the Lehman-connected hedge funds in turn experienced greater declines in market liquidity following the bankruptcy than other stocks; and, the effect was larger for ex ante illiquid stocks. We conclude that shocks to traders' funding liquidity reduce the market liquidity of the assets that they trade.