LIQUIDITY INSURANCE WITH MARKET INFORMATION

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Abstract
This paper studies how market signals – such as stock prices – can help alleviate the severity of
the asymmetric information problem in credit and liquidity management. Asymmetric information
hinders the ability of borrowers (firms, investment banks, etc.) to undertake profitable investment
opportunities and to insure themselves against liquidity shocks. I show that on the equilibrium path
creditors do not learn anything from market signals because they can use a menu of contracts to
screen the different types of borrowers. However, by conditioning liquidity insurance on ex-post
price signals, creditors are able to provide the borrowers with better incentives for truth-telling. At
the same time, prices depend on the liquidity that creditors offer to the borrowers. This two-way
feedback impacts the design of the optimal contract and potentially generates multiple equilibria in
financial markets.

The editor in charge of this paper was Claudio Michelacci.

Acknowledgments: I would like to thank Ruchir Agarwal, George-Marios Angeletos, Stefano Giglio,
Guido Lorenzoni, Mikhail Golosov, Bengt Holmstrom, Adriano Rampini, Jean Tirole, and participants at
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