SPECIAL TOPICS

Predicting A Crisis Coming – The Prelude to the Minsky Moment

Minsky´s Financial Instability Hypothesis (FIH) saw a growth in relevance during the 2008 crisis. It will also help explaining several aspects of the systemic behaviour patterns in the course of the 2020 coronavirus-related crisis.

High debt is not a bad thing as such, if used to fund investments that deliver profits or create financial assets worth more than the debt. In his FIH Hyman Minsky argued, though, that stability and low volatility eventually destabilises itself, swinging from robustness to fragility: This is, because periods of financial stability breed complacency and encourage excessive risk-taking. Especially banks as profitmaking institutions and with an incentive to increase lending, eventually undermine the stability of an economy. Excessive leverage as well as loosening credit standards at the end of a FIH-related cycle illustrate this. Simultaneously one may observe both, hyped valuation levels as well as muddy coverage ratios of corporates relying on private equity-backed balance sheets: All too frequently add-backs reported in adjusted EBITDAs aim to smooth or even blend out a crisis´s impact of extra costs or lost revenues, as in times of Brexit or the coronavirus.

As per FIH such dynamics would eventually culminate in – what economists later called - the Minsky Moment: A sudden, major collapse of asset values that marks the end of the growth phase of a cycle in credit markets or business activity. Borrowers and banks all of a sudden "realise" that there is debt in the system which can never be paid back, with people rushing to sell assets causing an even larger fall in prices.

However, the fundaments for this butterfly moment occurring – triggered by some type of external event - have been laid over years:

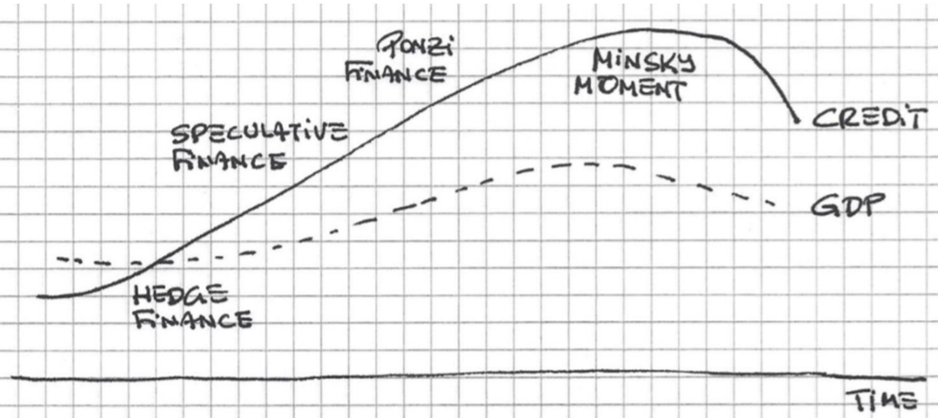
In regards to the debt component, the FIH identifies the following three phases eventually leading to a collapse, broadly amplifying the general economic momentum and sentiment:

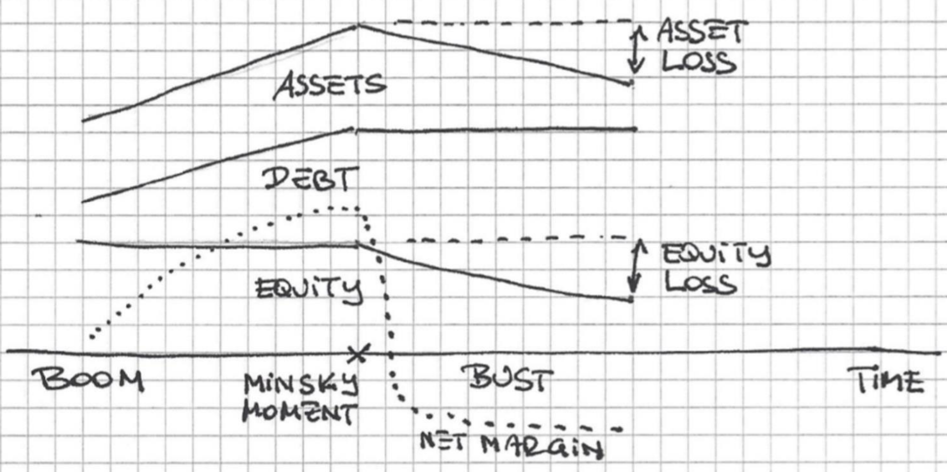
- **Hedge Phase**: Debt used to purchase assets that produce cash flow to cover interest and principal payments
- **Speculative Phase**: Debt used to purchase assets produces only enough cash flow to cover interest payments - but not the principal
- **Ponzi Phase**; Cash flow from the assets not enough to cover even the interest payments, let alone the principal. Hence, the system is entirely reliant on increasing asset prices to enable borrowers to refinance to be able to keep debt obligations in place

The Minsky Moment, a period of instability when risks are realized as losses, will subsequently exhaust market participants and end in a conservative backlash marked by risk-averse trading (de-leveraging), restoring stability and eventually set up the next cycle. Whereby the Minsky Cycle can be applied to a wide range of human activities, reaching far beyond investment economics.

The debt momentum is key to understand the cycle of the FIH: From a Corporate Finance (and corporate life cycle) point of view the FIH is especially relevant for corporates with at least some debt capacity. Whereby a firm´s positioning in its stage of the corporate life cycle, its unique ownership structure, its credit rating policy as well as willingness to optimize its cost of capital are all aspects which need to be specifically addressed. For example, numerous family-owned businesses avoid debt financing and therefore may intentionally position themselves in a (more or less permanent) Hedge Phase regardless of the underlying economic cycle. On the other hand, publicly listed corporates could hardly justify such an "inefficient" cost of capital strategy vis-a-vis their shareholders. Focus is therefore firms in the stages of mid/later growth and maturity. In this context the FHI has been validated when analysing firms´ access to the banking or capital markets, but in particular when assessing to the terms of raising debt capital over the Minsky Cycle.

Signals leading to a Minsky Moment are, for example: Excessive leverage in a historical context, loosening of credit terms and conditions, loosening regulatory standards, innovative practices (securitisation, off-balance sheet leverage), inflated (valuation- and interest-/ debt- related coverage) multiples, increasing engagement by and dependence on the shadow banking sector. - Having said all this, approaching the Minsky Moment feels like entering an avalanche prone valley: The avalanche may be coming, but one cannot really predict if, when and from which peak or ridge it will eventually start rolling down.


PONZI FINANCE
MINSKY MOMENT
SPECULATIVE FINANCE
CREDIT
GDP
HEDGE FINANCE
TIME


ASSET LOSS
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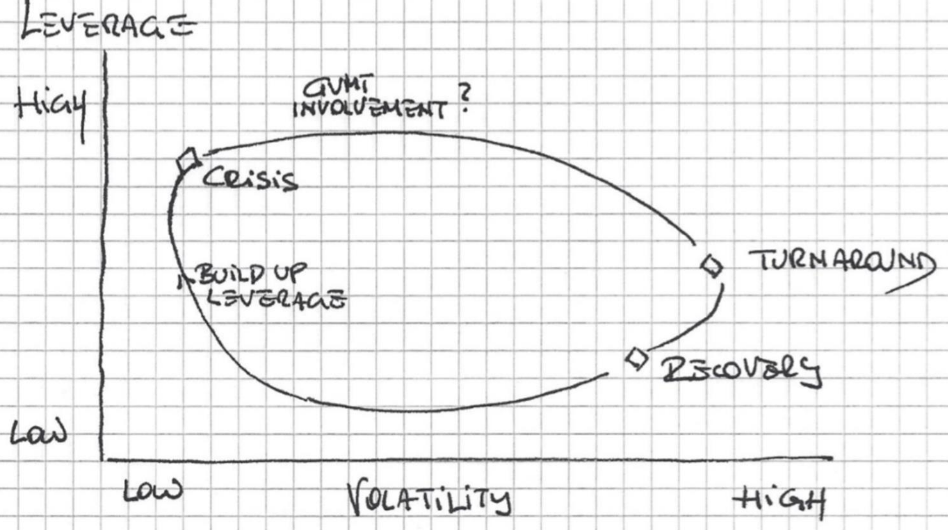
BUST
TIME
NET MARGIN


LEVERAGE
HIGH
GVMT INVOLVEMENT ?
CRISIS
TURNAROUND
BUILD UP LEVERAGE
RECOVERY
LOW
LOW
VOLATILITY
HIGH

