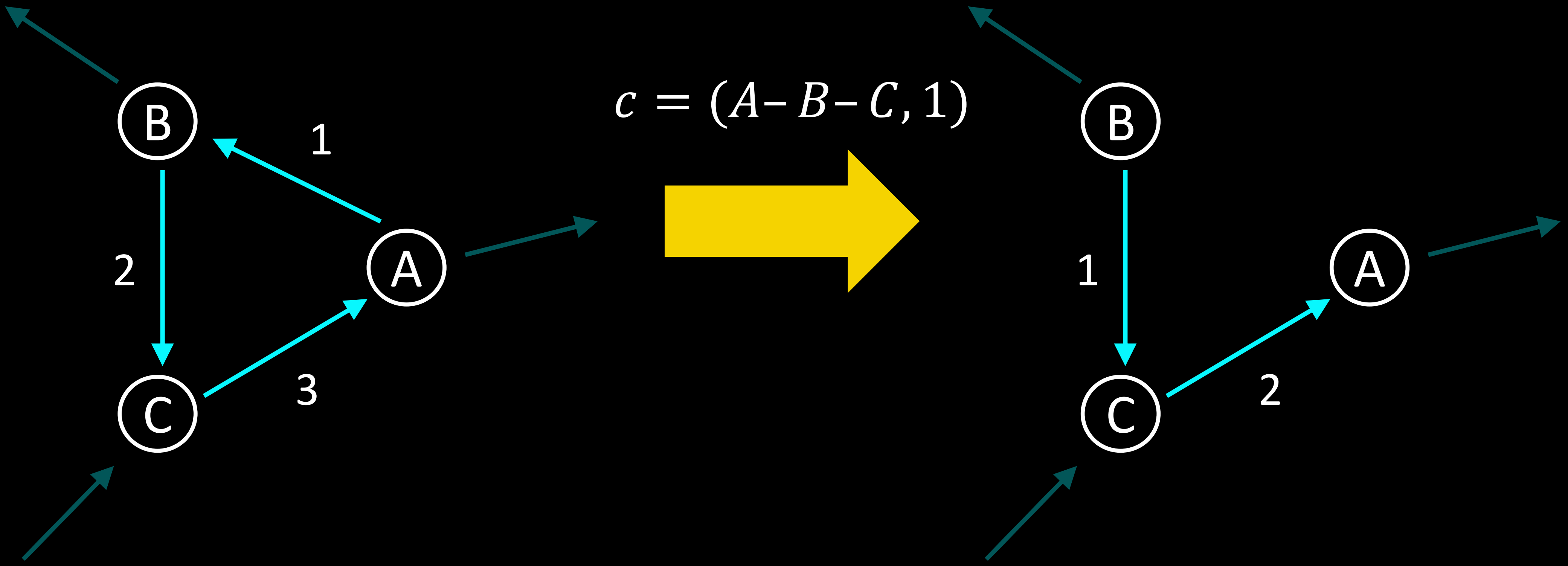
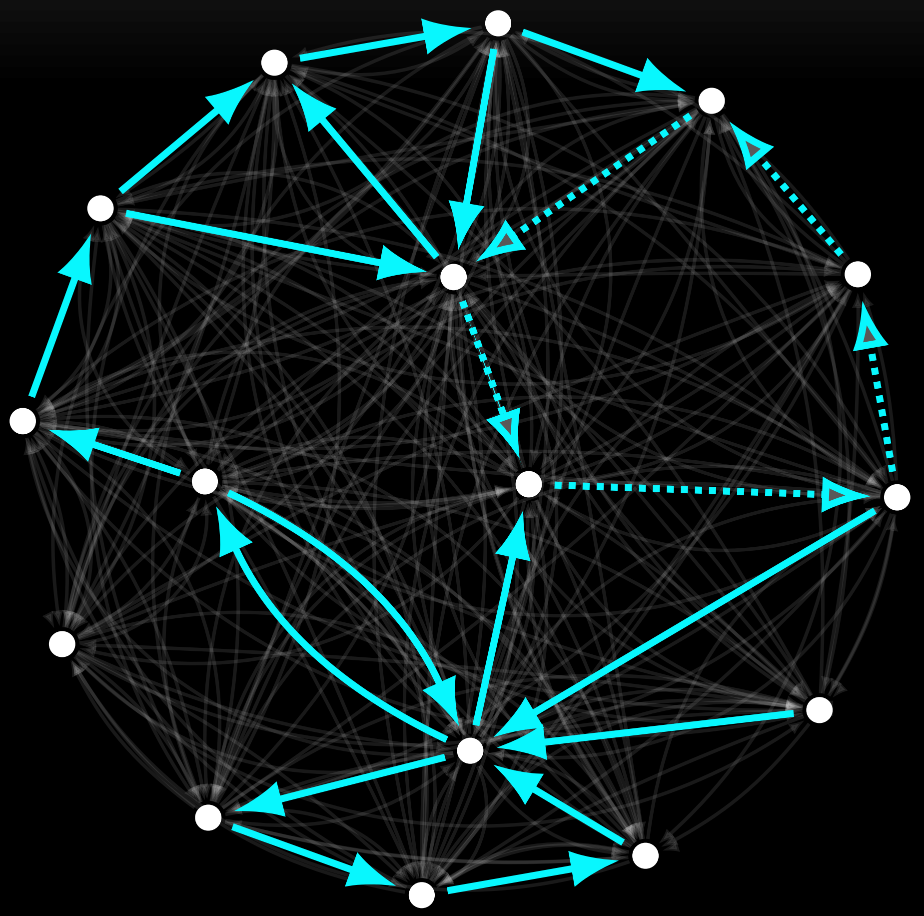
Financial interconnectedness gives rise to systemic risk via financial contagion

Recent policy to reduce interconnectedness: eliminate cycles = Portfolio Compression



Research Question: Systemic effects of portfolio compression



Research Questions:

Given a specific compression:

1. When socially beneficial?
2. Banks' incentives to agree to it?

Conventional wisdom:
1. always, 2. always

Portfolio Compression in Financial Networks: Incentives and Systemic Risk

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Results:

- Conventional wisdom is wrong
  → Non-trivial trade-off: loss sharing vs. contagion
- Sufficient conditions: Pareto improvement (bank balance sheets, network structure)
- Sufficient conditions: Incentivized compression (network structure)