Financial interconnectedness gives rise to systemic risk via financial contagion.
Recent policy to reduce interconnectedness: eliminate cycles = Portfolio Compression

c = (A – B – C, 1)
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
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)