

Joseph E. Stiglitz (Columbia Business School), winner of the Nobel Prize in economics (2001)

Bail-ins and Bail-outs: Incentives, Connectivity and Systemic Stability

Abstract

This paper endogenizes intervention in financial crises as the strategic negotiation between a regulator and creditors of distressed banks. Incentives for banks to contribute to a voluntary bail-in arise from their exposure to credit and price-mediated contagion. In equilibrium, a bail-in is possible only if the regulator's threat to not bail out insolvent banks is credible. Contrary to models without intervention or government bailouts only, sparse networks are beneficial in our model for two main reasons: they improve the credibility of the regulator's no-bailout threat for large shocks and they reduce free-riding incentives among bail-in contributors when the threat is credible.