Bail-ins and Bailouts under Systemic Risk

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Abstract

This paper investigates the impact of supervisory resolution tools, specifically bail-ins versus bailouts, on the ex-ante banks' portfolio composition and resulting default probabilities in the presence of both idiosyncratic and systematic shocks. Banks make decisions regarding short-term versus long-term asset investments while considering the expected supervisory resolution policy. Their investment decisions involve a trade-off between the profitable purchase of long assets after a high return of the short asset and the prospect of low bank payoffs following a low return of the short asset. In the baseline model without aggregate risk, I find that bailouts increase the likelihood of default and supervisory interventions. In contrast, bail-ins reduce risky short asset investments and prevent bank liquidations. When introducing aggregate risk, I show that bailouts may deter systemic events. In contrast, the ex-ante portfolio reallocation effect of bail-ins can potentially be a source of systemic risk.

Keywords: bailouts, bail-ins, bank resolution, systemic risk, bank portfolio allocation, fire sales.

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