ABSTRACT

Heterogeneity in creditor incentives may hinder potentially Pareto–improving creditor collective actions. In this paper, a game–theoretic model of lending with banks heterogeneous by size is introduced. In equilibrium, atomistic small banks free ride on the conciliatory–relending efforts of the large bank. An empirically–testable corollary conclusion suggests that "news" concerning the underlying economic condition of the debtor nation will have a greater impact on the large bank.

This empirical prediction is validated for the Latin American Debt Crisis period using evidence from long–term bond spread data. Poolings of cross–sectional time series data reveal that the equity values of large banks are relatively more sensitive to adverse "news" concerning the quality of Latin American loans. The reported results are robust to a variety of sensitivity experiments concerning model specification.