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Predatory Short Selling

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Abstract

Financial institutions may be vulnerable to predatory short selling. When the stock of a financial institution is shorted aggressively, leverage constraints imposed by short-term creditors can force the institution to liquidate long-term investments at fire sale prices. For financial institutions that are sufficiently close to their leverage constraints, predatory short-selling equilibria coexist with no-liquidation equilibria (the *vulnerability region*) or may even be the unique equilibrium outcome (the *doomed region*). Increased coordination among short sellers expands the doomed region, where liquidation is the unique equilibrium. Our model provides a potential justification for temporary restrictions on short selling of vulnerable institutions and can be used to assess recent empirical evidence on short-sale bans.

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