



The vicious circle of bank and public finance distress

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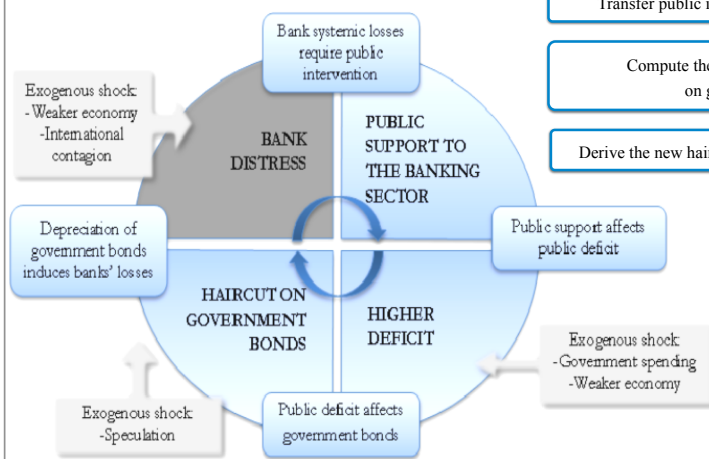


Background

The recent financial crisis highlighted how the **interconnection between banks and sovereign risk** can translate a banking crisis into a sovereign crisis (and vice versa):

•Banks are affected by sovereign risk via: **sovereign bonds**, collateral, ratings, likelihood of public intervention.

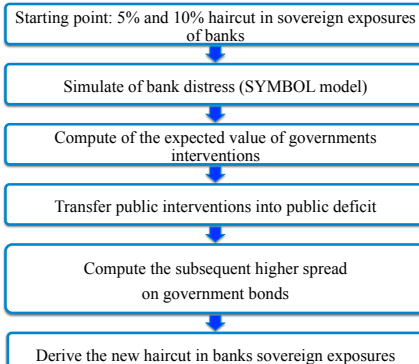
•Public finances can be hit by banking crises as recovery, that causes higher **deficit**, is expected.



Aim

Quantify the effects of the circular relationship between banks and public finances distress

Methodology



Results

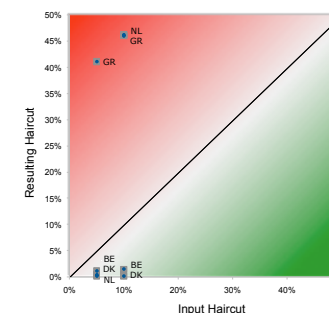
•If the system is **robust enough** to absorb losses (or, alternatively, if the shock is not big enough), the circular mechanism tends to weaken at each step, and eventually stops (All the no contagion cases and in the contagion cases for **BE and DK**).

•If the system is **not robust enough** (or, alternatively, if the initial shock is strong enough) the crisis exacerbates at each turn. (**GR** and - only with the higher shock - **NL**).

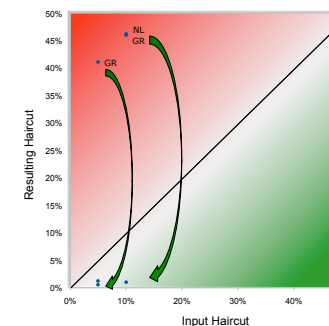
•The **exposures of banks into foreign sovereign bonds** can be an important channel of international contagion, and transform a national crisis into an international crisis.

•The introduction of a bail-in of 8% of total liabilities can be really effective in breaking the vicious circle

Financial systems stability



Bail-in effect



Expected value of excess losses (th Euro and incidence on GDP)

	BE	DK	GR	NL
No contagion				
Base scenario	28,797 0.01%	28,829 0.01%	192,429 0.08%	51,403 0.01%
5% haircut	227,867 0.06%	34,676 0.01%	533,936 0.23%	100,953 0.02%
10% haircut	657,131 0.19%	61,799 0.03%	886,098 0.39%	243,899 0.04%
With contagion				
Base scenario	175,315	122,194	47,758,354	1,175,302
			20.76%	0.20%
5% haircut	562,692	138,166	50,069,671	2,524,474
			21.77%	0.43%
10% haircut	1,801,314	175,284	52,376,886	135,390,422
	0.51%	0.07%	22.77%	22.91%

Incidence of sovereign exposures on banks capital – EBA sample

	BE	DK	GR	NL
BE	75.20%	0.00%	0.70%	0.90%
CY	0.90%	0.00%	111.10%	0.00%
DK	0.40%	28.00%	0.30%	-1.20%
ES	0.00%	0.00%	0.20%	0.10%
FR	17.70%	0.10%	4.30%	5.60%
NL	16.10%	0.10%	1.10%	66.80%
SE	0.10%	34.80%	0.20%	1.30%

Main Literature references

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