Bank holdings of sovereign bonds, contagion, and moral hazard during the European sovereign crisis

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Abstract

From 2010 to 2012, there was a negative relation between bank stock returns from European Union (EU) countries and the returns on sovereign CDS of peripheral (GIIPS) countries. We use days with tail sovereign CDS returns of peripheral countries to identify the effects of shocks to the cost of borrowing of these countries on EU banks from other countries. The impact of such shocks is a convex function of the number of peripheral countries that have a tail sovereign CDS return on a given day. As expected, CDS tail return events affect banks with greater exposure to the country experiencing such an event more, but they have an impact on banks regardless of exposure. The exposure effect is strongly asymmetric, as banks benefit more from a sovereign CDS premium decrease than they are hurt by an increase. Such a result can be explained by the fact that shareholders were not expected to bear fully the losses from their exposures to peripheral countries but were expected to gain more fully from positive developments.