Motivation and research question  The recent European debt crisis unveiled the existence of a vicious loop between sovereign and banks' credit risk. As the former deteriorates, banks are hit through their holdings of domestic government bonds, increasing, in turn, the likelihood of a bailout. The goal of this paper is to study the origins of this deadly embrace and its macroeconomic effects. To this end, I build and test a simple model consistent with three facts observed during the crisis in the Euro periphery: banks (i) tilted their government bond portfolio towards domestic securities, (ii) reduced lending to the non-financial private sector, and (iii) remained undercapitalized throughout the crisis.

The model  In the proposed model, undercapitalized banks tilt their government bond portfolio towards domestic securities as these are highly correlated with other sources of banks' revenues. While, in case of domestic sovereign default, banks are protected by limited liability, home sovereign debt guarantees a high payoff in the good state of the world. In other words, weak banks optimally place a bet on the upside, being protected in case of bankruptcy. During sovereign crises, when sovereign yields are high, this “gambling-for-resurrection” incentive might cause banks to reduce the supply of private lending to increase even more domestic public debt holdings. Anticipating this mechanism, national regulators face a trade-off when setting capital requirements for the domestic financial sector. On the one hand, well capitalized banks foster growth. On the other hand, weak banks optimally act as buyers-of-last-resort for government debt, exactly when sovereigns need to borrow the most. Compared to governments with well capitalized banks, governments with undercapitalized domestic banks have higher debt capacity and might even attract foreign investors, potentially triggering a race to the bottom in capital regulation among countries.

Supporting empirical evidence  I test the model using stress test data provided by the European Banking Authority. I divide banks, according to their pre-crisis leverage, in high- and low-leverage banks and show that high leverage banks increased the ratio of domestic government bonds to total assets by 115% during the crisis, compared to 55% of low leverage banks.

Conclusion  Bank capital plays an important role in the formation of linkages between sovereign risk and domestic financial sector fragilities. A supranational regulator, that takes into account cross-country spillover effects, is the agent best suited to set capital regulation and to supervise banks. The European banking union is a step in the right direction.