A Pyrrhic Victory? –
Bank Bailouts and Sovereign Credit Risk

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J.E.L. Classification: G21, G28, G38, E58, D62.
Keywords: financial crises, forbearance, deleveraging,
sovereign debt, growth, credit default swaps

First draft: August 2010
This draft: May 2011

1We are grateful to Isabel Schnabel and Luigi Zingales (discussants), Dave Backus, Mike Chernov, Amir Yaron, Stan Zin, and seminar participants at Austrian Central Bank, AEA Meetings (2011), HEC Paris and BNP Paribas Hedge Fund Center conference, Bundesbank-ECB-CFS Joint Luncheon workshop, Federal Reserve Bank of Minneapolis, Oxford Said Business School, University of Minnesota, Indian School of Business, Indian Institute of Management (Ahmedabad), and Douglas Gale’s Financial Economics workshop at NYU Economics for helpful comments. Farhang Farazmand and Nirupama Kulkarni provided valuable research assistance.

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Abstract

We show that financial sector bailouts and sovereign credit risk are intimately linked. A bailout benefits the economy by ameliorating the under-investment problem of the financial sector. However, increasing taxation of the corporate sector to fund the bailout may be inefficient since it weakens its incentive to invest, decreasing growth. Instead, the sovereign may choose to fund the bailout by diluting existing government bondholders, resulting in a deterioration of the sovereign’s creditworthiness. This deterioration feeds back onto the financial sector, reducing the value of its guarantees and existing bond holdings and increasing its sensitivity to future sovereign shocks. We provide empirical evidence for this two-way feedback between financial and sovereign credit risk using data on the credit default swaps (CDS) of the Eurozone countries for 2007-10. We show that the announcement of financial sector bailouts was associated with an immediate, unprecedented widening of sovereign CDS spreads and narrowing of bank CDS spreads; however, post-bailouts there emerged a significant co-movement between bank CDS and sovereign CDS, even after controlling for banks’ equity performance, the latter being consistent with an effect of the quality of sovereign guarantees on bank credit risk.

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1 Introduction

Just two and a half years ago, there was essentially no sign of sovereign credit risk in the developed economies and a prevailing view was that this was unlikely to be a concern for them in the near future. Recently, however, sovereign credit risk has become a significant problem for a number of developed countries. In this paper, we are motivated by three closely related questions surrounding this development. First, were the financial sector bailouts an integral factor in igniting the rise of sovereign credit risk in the developed economies? We show that they were. Second, what was the exact mechanism that caused the transmission of risks between the financial sector and the sovereign? We propose a theoretical explanation wherein the government can finance a bailout through both increased taxation and via dilution of existing government debt-holders. The bailout is beneficial; it alleviates a distortion in the provision of financial services. However, both financing channels are costly. When the optimal bailout is large, dilution can become a relatively attractive option, leading to deterioration in the sovereign’s creditworthiness. Finally, we ask whether there is also feedback going in the other direction – does sovereign credit risk feedback on to the financial sector? We explain – and verify empirically – that such a feedback is indeed present, due to the financial sector’s implicit and explicit holdings of sovereign bonds.

Our results call into question the usually implicit assumption that government resources are vastly deep and that the main problem posed by bailouts is primarily that of moral hazard – that is, the distortion of future financial sector incentives. While the moral hazard cost is certainly pertinent, our conclusion is that bailout costs are not just in the future. They are tangible right around the timing of bailouts and are priced into the sovereign’s credit risk and cost of borrowing. Thus, aggressive bailout packages that stabilize financial sectors in the short run but ignore the ultimate taxpayer cost might end up being a Pyrrhic victory.

Motivation: The case of Irish bailout. On September 30, 2008 the government of Ireland announced that it had guaranteed all deposits of the six of its biggest banks. The immediate reaction that grabbed newspaper headlines the next day was whether such a policy of a full savings guarantee was anti-competitive in the Euro area. However, there was something deeper manifesting itself in the credit default swap (CDS) markets for purchasing protection against the sovereign credit risk of Ireland and that of its banks. Figure 1 shows that while the cost of purchasing such protection on Irish banks – their CDS fee – fell overnight from around 400 basis points to 150 basis points, the CDS fee for the Government...
of Ireland’s credit risk rose sharply. Over the next month, this rate more than quadrupled to over 100 basis points and within six months reached 400 basis points, the starting level of its financial firms’ CDS. While there was a general deterioration of global economic health over this period, the event-study response in Figure 1 suggests that the risk of the financial sector had been substantially transferred to the government balance sheet, a cost that Irish taxpayers must eventually bear.

Viewed in the Fall of 2010, this cost rose to dizzying heights prompting economists to wonder if the precise manner in which bank bailouts were awarded have rendered the financial sector rescue exorbitantly expensive. Just one of the Irish banks, Anglo Irish, has cost the government up to Euro 25 bln (USD 32 bln), amounting to 11.26% of Ireland’s Gross Domestic Product (GDP). Ireland’s finance minister Brian Lenihan justified the propping up of the bank “to ensure that the resolution of debts does not damage Ireland’s international credit-worthiness and end up costing us even more than we must now pay.” Nevertheless, rating agencies and credit markets revised Ireland’s ability to pay future debts significantly downward. The original bailout cost estimate of Euro 90 bln was re-estimated to be 50% higher and the Irish 10-year bond spread over German bund widened significantly, ultimately leading to a bailout of Irish government by the stronger Eurozone countries.¹

This episode is not isolated to Ireland though it is perhaps the most striking case. In fact, a number of Western economies that bailed out their banking sectors in the Fall of 2008 have experienced, in varying magnitudes, similar risk transfer between their financial sector and government balance-sheets. Our paper develops a theoretical model and provides empirical evidence that help understand this interesting phenomenon.

Model. Our theoretical model consists of two sectors of the economy – “financial” and “corporate” (more broadly this includes also the household and other non-financial parts of the economy), and a government. The two sectors contribute jointly to produce aggregate output: the corporate sector makes productive investments and the financial sector invests in intermediation “effort” (e.g., information gathering and capital allocation) that enhance the return on corporate investments. Both sectors, however, face a potential under-investment problem. The financial sector is leveraged (in a crisis, it may in fact be insolvent) and under-invests in its contributions due to the well-known debt overhang problem (Myers, 1977). For simplicity, the corporate sector is un-levered. However, if the government undertakes a

“bailout” of the financial sector, in other words, makes a transfer from the rest of the economy that results in a net reduction of the financial sector debt, then the transfer must be funded in the future (at least in part) through taxation of corporate profits. Such taxation, assumed to be proportional to corporate sector output, induces the corporate sector to under-invest.

A government that is fully aligned with maximizing the economy’s current and future output determines the optimal size of the bailout. We show that tax proceeds that can be used to fund the bailout have, in general, a Laffer curve property, so that the optimal bailout size and tax rate are interior. The optimal tax rate that the government is willing to undertake for the bailout is greater when the financial sector’s debt overhang is higher and its relative contribution (or size) in output of the economy is larger.

In practice, governments fund bailouts in the short run by borrowing or issuing bonds, which are repaid by future taxation. There are two interesting constraints on the bailout size that emerge from this observation. One, the greater is the legacy debt of the government, the lower is its ability to undertake a bailout. This is because the Laffer curve of tax proceeds leaves less room for the government to increase tax rates for repaying its bailout-related debt. Second, the announcement of the bailout lowers the price of government debt due to the anticipated dilution from newly issued debt. Now, if the financial sector of the economy has assets in place that are in the form of government bonds, the bailout is in fact associated with some “collateral damage” for the financial sector itself. Illustrating the possibility of such a two-way feedback is a novel contribution of our model.

To get around these constraints, the government can potentially undertake a strategic default. Assuming that there are some deadweight costs of such default, for example, due to international sanctions or from being unable to borrow in debt markets for some time, we derive the optimal boundary for sovereign default as a function of its legacy debt and financial sector liabilities. This boundary explains that a heavily-indebted sovereign faced with a heavily-insolvent financial sector will be forced to “sacrifice its credit rating” to save the financial sector and at the same time sustain economic growth.

We then extend the model to allow for uncertainty about the realized output growth of the corporate sector. This introduces a possibility of solvency-based default on government debt. Interestingly, given the collateral damage channel, an increase in uncertainty about the sovereign’s economic output not only lowers its own debt values but also increases the financial sector’s risk of default. This is because the financial sector’s government bond holdings fall in value, and in an extension of the model, so do the value of the government guarantees accorded to the financial sector as a form of bailout. In turn, these channels
induce a post-bailout co-movement between the financial sector’s credit risk and that of the sovereign, even though the immediate effect of the bailout is to lower the financial sector’s credit risk and raise that of the sovereign.

**Empirics.** Our empirical work analyzes this two-way feedback between the financial sector and sovereign credit risk. Our analysis focuses mainly on the Western European economies during the financial crisis of 2007-10.

In our non-parametric analysis, we examine sovereign and bank CDS in the period from 2007 to 2010 and find three distinct periods. The first period covers the start of the financial crisis in January 2007 until the bankruptcy of Lehman Brothers. Across all Western economies, we see a large, sustained rise in bank CDS as the financial crisis develops. However, sovereign CDS spreads remains very low. This evidence is consistent with a significant increase in the default risk of the banking sector with little effect on sovereigns in the pre-bailout period.

The second period covers the bank bailouts starting with the announcement of a bailout in Ireland in late September 2008 and ending with a bailout in Sweden in late October 2008. During this one-month period, we find a significant decline in bank CDS across all countries and a corresponding increase in sovereign CDS. This evidence suggests that bank bailouts produced a transfer of default risk from the banking sector to the sovereign.

The third period covers the period after the bank bailouts and until 2010. We find that both sovereign and bank CDS increased during this period and that the increase was larger for countries with significant public debt ratios. This evidence suggests that the banks and sovereigns share the default risk after the announcement of banks bailouts and that the risk is increasing in the relative size of countries’ public debt.

We confirm all of the above results also in our regression analysis linking levels and changes in financial sector CDS to levels and changes, respectively, of sovereign CDS in the three periods. We also confirm model’s implications that banks with higher leverage experience a stronger relationship between sovereign and bank credit risks after the bailouts.

Finally, in support of the collateral damage channel as being potentially relevant for the co-movement between financial sector and sovereign CDS, we collect bank-level data on holdings of different sovereign government bonds released as part of the bank stress tests conducted for European banks in 2010. We document that on average Eurozone banks stress-tested in 2010 held Eurozone government bond holdings that were as large as one-sixth of their risk-weighted assets. Consistent with the economic importance of the collateral damage channel, we show that bank CDS co-move with sovereign CDS on banks’ holdings.
of government bonds.

The remainder of the paper is organized as follows. Section 2 presents our theoretical analysis. Section 4 provides empirical evidence. Section 5 discusses the related literature. Section 6 concludes. All proofs not in the main text are in the online Appendix.

2 Model

There are three time periods in the model: \( t = 0, 1, \) and 2. The productive economy consists of two parts, a financial sector and a non-financial sector. In addition, there is a government and a representative consumer. All agents are risk-neutral.

Financial sector: The operator of the financial sector solves the following problem, which is to choose, at \( t = 0 \), the amount of financial services to supply at \( t = 1 \) in order to maximize his expected payoff at \( t = 1 \), net of the effort cost required to produce these services:

\[
\max_{s_0} E_0 \left[ \left( w_s s_0^s - L_1 + \tilde{A}_1 + A_G + T_0 \right) \times 1 \{ -L_1 + \tilde{A}_1 + A_G + T_0 > 0 \} \right] - c(s_0^s) .
\]  

(1)

where \( s_0^s \) is the amount of financial services supplied by the financial sector at \( t = 1 \). The financial sector earns revenues at the rate of \( w_s \) per unit of financial service supplied, with \( w_s \) determined in equilibrium. To produce \( s_0 \) units, the operator of the financial sector expends \( c(s_0) \) units of effort. We assume that \( c'(s_0) > 0 \) and \( c''(s_0) > 0 \).

The financial sector has both liabilities and assets on its books. It receives the payoff from its efforts only if the value of assets exceeds liabilities at \( t = 1 \). This solvency condition is given in equation (1) by the indicator function for the expression \( -L_1 + \tilde{A}_1 + A_G + T_0 > 0 \). \( L_1 \) denotes the liabilities of the financial sector, which are due (mature) at \( t = 1 \). There are two types of assets held by the financial sector, denoted \( \tilde{A}_1 \) and \( A_G \). \( A_G \) is the value of the financial sector’s holdings of a fraction \( k_A \) of outstanding government bonds, while \( \tilde{A}_1 \) represents the payoff of the other assets held by the financial sector.\(^2\) We model the payoff \( \tilde{A}_1 \), which is risky, as a continuously valued random variable that is realized at \( t = 1 \) and takes values in \([0, \infty)\). The payoff and value of government bonds is discussed below. Finally, the variable \( T_0 \) represents the value of the time 0 transfer made by the government to the financial sector and is discussed further below.

\(^2\)While we refer to government claims principally as government bonds, a broader interpretation can include claims on quasi-governmental agencies (e.g., Fannie Mae, Freddie Mac) and perhaps also the value of explicit and implicit government guarantees or support.
In case of insolvency, debtholders receive ownership of all financial sector assets and wage revenue.³

**Non-financial sector:** The non-financial sector comes into $t = 0$ with an existing capital stock $K_0$. Its objective is to maximize the sum of the expected values of its net payoffs, which occur at $t = 1$ and $t = 2$:

$$\max_{s_0^d, K_1} E_0 \left[ f(K_0, s_0^d) - w_s s_0^d + (1 - \theta_0)\tilde{V}(K_1) - (K_1 - K_0) \right]$$

(2)

The function $f$ is the production function of the non-financial sector, which takes as inputs at $t = 0$ the financial services it demands, $s_0^d$, and the capital stock, $K_0$, to produce consumption goods at $t = 1$. The output of $f$ is deterministic. Moreover, we assume that $f$ is increasing in both arguments and concave. At $t = 1$, the non-financial sector is faced with a decision of how much capital $K_1$ to invest, at an incremental cost of $(K_1 - K_0)$, in a project $\tilde{V}$, whose payoff is realized at $t = 2$. This project represents the future or continuation value of the non-financial sector and is in general subject to uncertainty. The expectation at $t = 1$ of this payoff is $V(K_1) = E_1[\tilde{V}(K_1)]$ and, as indicated, is a function of the investment $K_1$.

We assume that $V'(K_1) > 0$ and $V''(K_1) < 0$, so that the expected payoff is increasing but concave in investment. A proportion $\theta_0$ of the payoff of the continuation project is taxed by the government to pay its debt, both new and outstanding, as we explain next.

**Government:** The government’s objective is to maximize the total output of the economy and hence the welfare of the consumer. It does this by reducing the debt-overhang problem of the financial sector, which induces it to supply more financial services, thereby increasing output. To achieve this, the government issues bonds, that it then transfers to the balance sheet of the financial sector. These bonds are repaid with taxes levied on the non-financial sector at a tax-rate of $\theta_0$. In particular, the tax rate $\theta_0$ is set by the government at $t = 0$ and is levied at $t = 2$ upon realization of the payoff $\tilde{V}(K_1)$. We assume that the government credibly commits to this tax rate.

We let $N_D$ denote the number of bonds that the government has issued in the past – its outstanding stock of debt. For simplicity, bonds have a face value of one, so the face value of outstanding debt equals the number of bonds, $N_D$. The government issues $N_T$ new bonds.

³Note that we could include the wage revenues in the solvency indicator function, which would provide an additional channel for wages to feed back into the probability of solvency. Although such a channel would reinforce the mechanism at work in the model, we choose to abstract from this to avoid the additional complexity.
bonds to accomplish the transfer to the financial sector. Hence, at $t = 2$ the government receives realized taxes equal to $\theta_0 \tilde{V}(K_1)$ and then uses them to pay bondholders $N_T + N_D$. We assume that if there are still tax revenues left over (a surplus), the government spends them on programs for the representative consumer, or equivalently, just rebates them to the consumer. On the other hand, if tax revenues fall short of $N_T + N_D$, then the government defaults on its debt. In that case, it pays out all the tax revenue raised to bondholders. We assume that the government credibly commits to this payout policy.\footnote{We can consider more generally a policy whereby the government pays only a fraction $\tilde{m}$ of tax revenue and gives back any remaining tax funds to the consumer. Since it will actually be optimal for the government to commit to paying bondholders all the tax revenue raised, we restrict ourselves to the case $\tilde{m} = 1$.}

We further assume that default incurs a deadweight loss. In case of default, the sovereign incurs a fixed deadweight loss of $D$. Hence, default is costly and there is an incentive to avoid it.\footnote{Although $D$ here is obviously reduced-form, one can think of the deadweight cost in terms of loss of government reputation internationally, loss of domestic government credibility, degradation of the legal system and so forth. If a country’s reputation is already weak, it will have less to lose from default.} Finally, let $P_0$ denotes the price of government bonds, which is determined in equilibrium. This implies that the value of the financial sector’s holding of government bonds is $A_G = k_A P_0 N_D$.

The government’s objective is to maximize the expected utility of the representative consumer, who consumes the combined output of the financial and non-financial sector. Hence, the government faces the following problem:

$$\max_{\theta_0, N_T} E_0 \left[ f(K_0, s_0) + \tilde{V}(K_1) - c(s_0) - (K_1 - K_0) - 1_{\text{def}} D + \tilde{A}_1 \right]$$

(3)

where $s_0$ is the equilibrium provision of financial services. This maximization is subject to the budget constraint: $T_0 = P_0 N_T$ and subject to the choices made by the financial and non-financial sectors. Note that $1_{\text{def}}$ is an indicator function that equals 1 if the government defaults ($\theta_0 \tilde{V}(K_1) < N_T + N_D$) and 0 otherwise.

**Consumer:** The representative consumer consumes the output of the economy. He solves a simple consumption and portfolio choice problem by allocating his wealth $W$ between consumption, government bond holdings, and equity in the financial and non-financial sectors. Since the representative consumer is assumed to be risk-neutral, asset prices equal the expected values of asset payouts. Let $P(i)$ and $\tilde{P}(i)$ denote the price and payoff of asset $i$, respectively. At $t = 0$, the consumer chooses optimal portfolio allocations, $\{n_i\}$, that solve
the following problem:

$$\max_{n_i} E_0 \left[ \sum n_i \tilde{P}(i) + (W - \sum n_i P(i)) \right]$$

(4)

The consumer’s first order condition gives the standard result that equilibrium price of an asset equals the expected value of its payoff, \( P(i) = E_0 [\tilde{P}(i)] \).

3 Equilibrium Outcomes

We begin by examining the maximization problem of the financial sector. Let \( p(\tilde{A}) \) denote the probability density of \( \tilde{A} \). Furthermore, let \( A_1 \) be the minimum realization of \( \tilde{A}_1 \) for which the financial sector does not default: \( A_1 = L_1 - A_G - T_0 \). Then, the first order condition of the financial sector can be written as:

$$w_s p_{solv} - c'(s^*_0) = 0.$$  

(5)

where \( p_{solv} \equiv \int_{A_1}^{\infty} p(\tilde{A}_1) d\tilde{A} \), is the probability that the financial sector is solvent at \( t = 1 \). We assume that at the optimal \( s^*_0 \) the first-order condition is satisfied. The second-order condition of the financial sector’s problem is \(-c''(s^*_0) < 0\). The parametric choice we will use below for \( c(s_0) \) is \( c(s_0) = \beta \frac{1}{m} s^m_0 \) where \( m > 1 \).

Consider now the problem of the non-financial sector at \( t = 0 \). Its demand for financial services, \( \hat{s}^d_0 \), is determined by its first-order condition:

$$\frac{\partial f(K_0, s^d_0)}{\partial s^d_0} = w_s.$$  

(6)

Since \( f \) is concave in its arguments, the second order condition is satisfied: \( \frac{\partial^2 f(K_0, s^d_0)}{\partial^2 s^d_0} < 0 \). Henceforth, we will parameterize \( f \) as Cobb-Douglas with the factor share of financial services given by \( \vartheta: f(K_0, s_0) = \alpha K^{1-\vartheta} s^\vartheta_0 \).

In equilibrium the demand and supply of financial services are the same: \( \hat{s}^d_0 = \hat{s}^s_0 \). From here on, we drop the superscripts on \( s_0 \) and denote the equilibrium quantity of financial services simply by \( s_0 \).
3.1 Transfer Reduces Underprovision of Financial Services

Taken together, the first-order conditions of the financial sector (5) and non-financial sector (6) show how debt-overhang impacts the provision of financial services by the financial sector. The marginal benefit of an extra unit of financial services to the economy is given by $w_s$, while the marginal cost, $c'(s_0)$, is less than $w_s$ if there is a positive probability of insolvency. This implies that the equilibrium allocation is sub-optimal. The reason is that the possibility of liquidation $p_{solv} < 1$ drives a wedge between the social and private marginal benefit of an increase in the provision of financial services. The result is that as long as $p_{solv} < 1$, there is an under-provision of financial services relative to the first-best case ($p_{solv} = 1$). Hence, we obtain that

Lemma 1. An increase in the transfer $T_0$ leads to an increase in the provision of financial services since this raises the probability $p_{solv}$ that the financial sector is solvent at $t = 1$.

3.2 Tax Revenues: A Laffer Curve

Next, to understand the government’s problem, we first look at how expected tax revenue responds to the tax rate, $\theta_0$. Let the expected tax revenue, $\theta_0 V(K_1)$, be denoted by $\mathcal{T}$. Raising taxes has two effects. On the one hand, an increase in the tax rate $\theta_0$ captures a larger proportion of the future value of the non-financial sector, thereby raising tax revenues. On the other hand, this reduces the incentive of the non-financial sector to invest in its future, thereby leading to reduced investment, $K_1$. At the extreme, when $\theta_0 = 1$, the tax distortion eliminates the incentive for investment and tax revenues are reduced to zero. Hence, tax revenues are non-monotonic in the tax rate and maximized by a tax rate strictly less than 1.

Formally, the impact on tax revenue of an increase in the tax rate is given by:

$$\frac{\partial \mathcal{T}}{\partial \theta_0} = V(K_1) + \theta_0 V'(K_1) \frac{dK_1}{d\theta_0}$$

Note that at $\theta_0 = 0$, an increase in the tax rate increases the tax revenue at a rate equal to $V(K_1)$, the future value of the non-financial sector. It can be shown that since the production function $V(K_1)$ is concave, as taxes are increased the incentive to invest is decreased by the tax rate, which reduces the marginal revenue of a tax increase. This is given by the second term on the right-hand side of the expression. To see this, consider the first-order condition
for investment of the non-financial sector at $t = 1$:

$$(1 - \theta_0)V''(K_1) - 1 = 0$$

(7)

Since $V''(K_1) < 0$, the second-order condition holds. Taking the derivative with respect to $\theta_0$ by using the Implicit Function theorem gives:

$$\frac{dK_1}{d\theta_0} = \frac{V'(K_1)}{(1 - \theta_0)V''(K_1)} < 0$$

which shows that as the tax rate is increased, the non-financial sector reduces investment. In fact, since we know that at $\theta_0 = 1$ the tax revenue is zero, it must be the case that as the tax rate is increased, the marginal tax revenue decreases until it eventually becomes negative. To summarize, tax revenues satisfy the Laffer curve property as a function of the tax rate:

**Lemma 2.** The tax revenues, $\theta_0 V(K_1)$, increase in the tax rate, $\theta_0$, as it increases from zero (no taxes), and then eventually decline.

Henceforth, we parameterize $V$ with the functional form $V(K_1) = K_1^\gamma$, $0 < \gamma < 1$. As Appendix A.3 shows, (7) implies that $T = \theta_{t+1}^\gamma \gamma (1 - \theta_{t+1})^{1-\gamma}$. It can then be shown that:

**Lemma 3.** The tax revenue, $T$, is maximized at $\theta_0^{max} = 1 - \gamma$, is increasing ($dT/d\theta_0 > 0$) and concave ($d^2T/d\theta_0^2 < 0$) on $[0, \theta_0^{max})$, and decreasing ($dT/d\theta_0 < 0$) on $(\theta_0^{max}, 1)$.

### 3.3 Optimal Transfer Under Certainty and No Default

We analyze next the government’s decision starting first with a simplified version of the general setup. We make two simplifying assumptions: (1) we set to zero the variance of the realized future value of the non-financial sector, so that $\tilde{V}(K_1) = V(K_1)$, (2) we force the government to remain solvent. In subsequent sections we remove these assumptions.

If the government must remain solvent, it can only issue a number of bonds $N_T$ that it can pay off in full, given its tax revenue. By assumption (1), the tax revenue is known exactly (it is equal to $T$), and hence by assumption (2), $N_T + N_D = T$. Moreover, since every bond has a sure payoff of 1, we know that the bond price is $P_0 = 1$.

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6This functional form is a natural choice for an increasing and concave function of $K_1$. Appendix A.2 provides a more structural motivation for this choice based on the calculation of a continuation value under our choice of production function. This calculation suggests that the continuation value implied by a multiperiod model should take a similar functional form.
Under the two simplifying assumptions, we have that the transfer to the financial sector is \( T_0 = \theta_0 V(K_1) - N_D \) and there is no probability of default, \( E[1_{\text{def}}] = 0 \). Hence, the only choice variable for the government in this case is the tax rate. Since there is no change in the non-financial sector’s investment opportunities between \( t = 0 \) and \( t = 1 \), the government’s information regarding expected tax revenue is the same at \( t = 0 \) as at \( t = 1 \), and we can consider the problem directly at \( t = 0 \). Appendix A.4 shows that the first-order condition for the government can be written as:

\[ \frac{dG}{dT} + \frac{dL}{dT} = 0 \]  

\( (8) \)

where

\[ \frac{dG}{dT} = \partial f(K_0, s_0) \left( 1 - p_{\text{solv}} \right) \frac{ds_0}{dT_0} \]

\[ \frac{dL}{dT} = \theta_0 V'(K_1) \frac{dK_1}{dT} \]

which expresses the first-order condition in terms of the choice of transfer size and expected tax revenue, rather than in terms of the tax rate. As we explain below, this condition is intuitive since it equates the marginal gain and marginal loss of increasing tax revenue.

**Gain From Increased Provision of Financial Services:** The term \( \frac{dG}{dT} \) in (8) is the marginal gain to the economy of increasing expected tax revenue. Equations (5) and (6) show that it reflects the wedge between the social and private benefits of an increase in financial services. Since, as shown above, \( \frac{ds_0}{dT_0} > 0 \), the marginal gain from increasing tax revenue (and hence the transfer) will be large when \( p_{\text{solv}} \) is low, that is, when the financial sector is at high risk of insolvency and debt-overhang is significant. For illustration, the graph of \( \frac{dG}{dT} \) is given by the solid curve in the top panel of Figure 2.\(^7\)

**Under-Investment Loss Due to Taxes:** The term \( \frac{dL}{dT} \) in (8) is the marginal under-investment loss to the economy due to a marginal increase in expected tax revenue, which distorts the non-financial sector’s incentive to invest. Equation (7) shows that it reflects the size of the tax-induced distortion, which is greater than zero as long as the tax rate is positive. Since \( \frac{dK_1}{dT} < 0 \), then \( \frac{dL}{dT} < 0 \). For illustration, a graph of \( -\frac{dL}{dT} \) is shown as the upward-sloping dashed curve in the top panel of Figure 2.\(^8\)

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\(^7\)As the graph indicates, and as the proof to Proposition 1 shows, \( G \) is concave in \( T \) since the marginal gain from increasing tax revenues (to increase the transfer) is decreasing.

\(^8\)The curve shows that \(-L\) is convex as raising additional tax revenues incurs an increasingly large marginal...
The Optimal Tax Rate and Issuance of Debt: The following proposition, which describes the solution to the government’s problem under assumptions 1 (certainty), 2 (no default) and \( m \geq 2\bar{\theta} \), is proven in Appendix A.6.

**Proposition 1.** There is a unique optimal tax rate, \( \hat{\theta}_0 \), which is strictly less than \( \theta_0^{\text{max}} \). Let \( \hat{T} \) represent the associated tax revenues. Then newly issued sovereign debt has face value \( N_T = \hat{T} - N_D \) and a price of \( P_0 = 1 \). Moreover,

1. The optimal tax rate and revenue are **increasing** in \( L_1 \), the financial sector liabilities, and in \( N_D \), the outstanding government debt.

2. The face value of newly issued sovereign debt (the transfer) is **increasing** in the financial sector liabilities \( L_1 \), but **decreasing** in the amount of existing government debt \( N_D \). Moreover, the gross transfer, \( T_0 + k_A N_D \), is also **decreasing** in \( N_D \).

3. If also \( m \leq 2 \), then the optimal tax rate, revenue, and newly issued sovereign debt, are **increasing** in the factor share of the financial sector.

The optimal tax rate is less than \( \theta_0^{\text{max}} \) due to the Laffer-curve property of tax revenues, whereby the marginal underinvestment loss induced by raising revenue becomes infinite as the tax rate rises to \( \theta_0^{\text{max}} \). In addition, if there is any debt-overhang (i.e., \( p_{\text{solv}} < 1 \)), then the optimal tax rate will be strictly greater than zero, since at a zero tax rate there is a marginal benefit to having a transfer but no marginal cost.

The optimal government action is to increase the transfer, by increasing tax revenue and outstanding debt, until the marginal gain from the transfer no longer exceeds the associated marginal loss due to underinvestment. For illustration, in the top panel of Figure 2, this is at the intersection point of the two curves, the x-coordinate of which represents \( \hat{T} \). The bottom panel of Figure 2 graphs the value of the government’s objective function, whose slope is given by (8). As the graph illustrates, the objective is concave in \( T \) and the unique optimum occurs at \( \hat{T} \), corresponding to the intersection point in the top panel.

Next, consider the three parts of Proposition 1.

For any level of transfer, the marginal gain available is greater the more severe is the debt-overhang, since a lower probability of solvency increases the distortion in the provision of financial services. This represents an upward shift in the marginal gain curve. Therefore, underinvestment loss. Furthermore, as shown in Appendix A.5, this marginal loss due to underinvestment worsens as \( T \) is increased, i.e., \( d^2\mathcal{L}/dT^2 < 0 \).
as (1) and (2) of Proposition 1 state, an increase in $L_1$, the financial sector liabilities, leads to a higher tax rate, more tax revenue, and greater issuance of new sovereign debt to fund a larger transfer.

If the level of pre-existing government debt ($N_D$) is increased, there is again an upward shift in the marginal gain curve, as shown by the dash-dot curve in the top panel of Figure 2. The reason is that for any level of tax revenue, the effective transfer ($T_0$) is smaller, and therefore the probability of solvency is lower. As is clear from the new intersection point in the top panel, and as (1) of Proposition 1 states, this pushes the government to increase the optimal tax rate, tax revenue, and overall amount of sovereign debt.

However, as (2) of Proposition 1 shows, the rate of increase in total sovereign debt is less than the increase in $N_D$. Hence, under the no-default and certainty assumptions, an increase in pre-existing government debt corresponds to a decrease in newly issued sovereign debt and a smaller transfer $T_0$. The reason for this decrease is that the underinvestment cost of raising additional tax revenues is increasing.\(^9\)

Finally, Proposition 1 shows that, ceteris paribus, a larger factor share of the financial sector in aggregate production implies that the government will issue a greater amount of new debt and a larger transfer. Intuitively, if the financial sector’s output is a more important input into production, then there will be a greater marginal gain from an increase in the provision of financial services due to the transfer.\(^10\)

### 3.4 Default Under Certainty

Now we allow the government to deviate from the no-default choice of setting $N_T = \mathcal{T} - N_D$. Increasing $N_T$ above this threshold has both an associated cost and benefit. The benefit is that this can increase the transfer to the financial sector. Recall that the transfer $T_0$ equals $P_0N_T$, where $P_0 = \max(1, \mathcal{T} / (N_T + N_D))$ is the price of the government bond. The cost is that when $N_T > \mathcal{T} - N_D$, the government will not be able to fully cover its obligations. In that case, $P_0 < 1$ and the government will default, triggering the dead-weight loss of $D$.

Hence, the government’s decision on how many new bonds to issue, $N_T$, splits the parameter space into two regions:

1. $N_T = \mathcal{T} - N_D$ and $1_{\text{def}} = 0$ (No Default)

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\(^9\)Later, we show that the possibility of default or the introduction of uncertainty can alter this result.

\(^10\)The factor share is given by $\vartheta$. Note, however, that the comparative static is not simply to vary $\vartheta$, but to hold total output constant while doing so. Equivalently, we may think about comparing the ratio to total output of our variable of interest while varying the factor share.
2. $N_T > T - N_D$ and $1_{def} = 1$ (Default)

As shown in Appendix A.7, if the choice to default is made, then it is optimal for the government to issue an infinite amount of new debt in order to fully dilute existing debt ($P_0$ becomes 0) and hence capture all tax revenues towards the transfer. The resulting situation is the same as if pre-existing debt $N_D$ had been set to zero. Therefore, to determine whether defaulting is optimal, the government evaluates whether its objective function for given $N_D$ and no default exceeds by at least $D$ (the deadweight default cost) its objective function with $N_D$ set to zero.

Formally, let $W_{no,def}$ denote the maximum value of the government’s objective function conditional on no-default, $W_{def}$ denote the maximum value conditional on default, and $W = \max(W_{no,def}, W_{def})$. The following lemma characterizes the optimal government action and resulting equilibrium:

**Lemma 4.** Conditional on default, it is optimal to set $N_T \to \infty$ (and hence $P_0 \to 0$). This implies that $W_{def} = W_{no,def} |_{N_D=0} - D$. Moreover, if default is undertaken then (1) the optimal tax rate is lower, $\hat{\theta}_{0,def} < \hat{\theta}_{0,no,def}$ (2) provided that $k_A N_D < \hat{T}_{def}$, the gross transfer is bigger, $\hat{T}_{0,def} > \hat{T}_{0,no,def} + k_A N_D$, and (3) equilibrium provision of financial services is higher, $\hat{s}_{0,def} > \hat{s}_{0,no,def}$.

Appendix A.7 proves the lemma. We next consider the factors that push the sovereign towards default.

### 3.4.1 Default Boundary

Figure 3 displays the optimal default boundary in $L_1 \times N_D$ space along with the No-Default and Default regions. The following proposition characterizes how a number of factors move the ‘location’ of the sovereign relative to the default-boundary, or shift the default-boundary itself.

**Proposition 2.** Ceteris paribus, the benefit to defaulting is:

1. **increasing** in the financial sector liabilities $L_1$ (severity of debt-overhang), the amount of existing government debt $N_D$, and in the factor share of the financial sector

2. **decreasing** in the dead-weight default cost $D$, and in the fraction of existing government debt held by the financial sector $k_A$
Appendix A.8 provides the proof. Consider a worsening of the financial sector’s health, leading to a decreased provision of financial services. This increases the marginal gain from further government transfer, and, in turn, increases the gain to the sovereign from defaulting. This is represented by a move towards the right in Figure 3, decreasing the distance to the default-boundary. A similar kind of result holds if the factor share of financial services is increased, since the marginal gain of further transfer is higher at every level of transfer.

An increase in existing debt implies a bigger spread between the optimal transfer and optimal tax revenue with and without default. Both the extra transfer and decreased underinvestment represent benefits to defaulting. This is represented by a move upwards in Figure 3, again decreasing the distance to the default-boundary.\(^{11}\)

It is clear that an increase in the deadweight loss raises the threshold for default. If the sovereign has a lot to lose from defaulting (think a sovereign with strong domestic credibility or international reputation) then the net benefit to default will be relatively lower.

Finally, and importantly, an increase in the fraction of existing sovereign debt held by the financial sector also raises the threshold for default since the act of defaulting, which is aimed at freeing up resources towards the transfer, causes collateral damage to the financial sector balance sheet. From the vantage point of Figure 3, both an increase in \(D\) and \(k\) cause an outwards shift in the default boundary.

### 3.4.2 Two-way Feedback

Propositions 1 and 2 indicate that there is a two-way feedback between the solvency situation of the financial sector and of the sovereign. First, by Proposition 1, a severe deterioration in the financial sector’s probability of solvency (e.g., an increase in \(L_1\)) leads to a large expansion in new debt \((N_T)\) by the sovereign, as it acts to mitigate the under-provision of financial services. As the marginal cost of raising the tax revenue \((dL/dT)\) to fund this debt expansion is increasing, the sovereign is pushed closer to the decision to default (Proposition 2), as well as is its maximum debt capacity (lemma 3). Hence, a financial sector crisis pushes the sovereign towards distress.

Going in the other direction, by Proposition 1, a distressed sovereign, e.g., one with high existing debt \((N_D)\), will have a financial sector with a worse solvency situation. This is because it is very costly for such a sovereign to fund increased debt to make the transfer to the financial sector. Hence, a more distressed sovereign will tend to correspond to a more

\(^{11}\)Moreover, since the marginal loss from funding extra debt is increasing, this benefit is convex in \(N_D\).
distressed financial sector (lower post-transfer $p_{solv}$). Strategically defaulting is an avenue for a distressed sovereign to free debt capacity for additional transfer. However, large holdings of sovereign debt ($k$) by the financial sector means that taking this avenue simultaneously causes collateral damage to the balance sheet of the financial sector, limiting the benefit from this option (Proposition 2). In this case, a distressed sovereign is further incapacitated in its ability to strengthen the solvency of its financial sector.

### 3.5 Uncertainty, Default, and Pricing

We now introduce uncertainty about future output (i.e., growth) by allowing the variance of $\tilde{V}(K_1)$ to be nonzero. Instead of a binary default vs. no-default decision, the government now implicitly chooses a continuous probability of default when it sets the tax rate and new debt-issuance. In this case, if raising taxes further incurs a large under-investment loss, the government can choose to increase debt issuance while holding the tax rate constant. This dilutes the claim of existing bondholders to tax revenues, thereby generating a larger transfer without inducing further underinvestment. The trade-off is an increase in the government’s probability of default and expected dead-weight default loss. In this case, the sovereign effectively ‘sacrifices’ its own creditworthiness to improve the solvency of the financial sector, leading to a ‘spillover’ of the financial sector crisis onto the solvency of the sovereign.

Although $\theta_0$ and $N_T$, are the variables the government directly chooses, it will turn out to be more enlightening to look at two other variables that map to them in a one-to-one fashion. The first variable is $T$, which again equals $\theta_0 V(K_1)$, the expected tax revenue. The second variable is:

$$H = \frac{N_T + N_D}{T}$$

In words, $H$ is the ratio of outstanding debt to expected tax revenue. It measures the sovereign’s ability to cover its total debt at face value. The government’s problem (3) then is equivalent to optimally choosing $T$ and $H$.\footnote{Formally, the mapping from $\theta_0$ to $T$ is invertible on $[0, \theta_0^{\text{max}}]$ (as before, we can limit our concern to this region) and given $T$, the mapping from $H$ to $N_T$ is invertible. Hence, these alternative control variables map uniquely to the original ones on the region of interest.} Note that the no-default and total-default cases under certainty correspond to setting $H = 1$ and $H \to \infty$, respectively.

To represent uncertainty we write $\tilde{V}(K_1) = V(K_1)\tilde{R}_V$, where $\tilde{R}_V \geq 0$ represents the shock to $\tilde{V}(K_1)$. By construction, $E[\tilde{R}_V] = 1$. We also assume that the distribution of $\tilde{R}_V$
is independent of the variables $K_1$, $\theta_0$, and $N_T$.

**Pricing, Default Probability and the Transfer:** Using $H$ we can easily express the sovereign’s bond price, $P_0$, and probability of default, $p_{def}$, as follows:

$$P_0 = E_0 \left[ \min \left( 1, \frac{\theta_0 \tilde{V}(K_1)}{N_T + N_D} \right) \right] = E_0 \left[ \min \left( 1, \frac{1}{H} \tilde{R}_V \right) \right]$$

(9)

$$p_{def} = \text{prob} \left( \theta_0 \tilde{V}(K_1) < N_T + N_D \right) = \text{prob} \left( \tilde{R}_V < H \right)$$

(10)

Note that these quantities depend only on $H$ and do not directly change with $T$. Next, as $N_T = (T - N_D/H)H$, we express the transfer in terms of $T$ and $H$:

$$T_0 = N_T P_0 = (T - \frac{N_D}{H})E_0 \left[ \min \left( H, \tilde{R}_V \right) \right]$$

(11)

**The Optimal Probability of Default:** Appendix A.9 and A.10 derive the first-order conditions for $T$ and $H$, respectively. The first-order condition for $T$ involves the same transfer-underinvestment trade-off as under certainty, adjusted to account for $H$. Varying $H$ involves a new trade-off. As (9)–(11) show, increasing $H$ while holding $T$ constant increases the transfer, but also increases the probability of sovereign default and decreases the sovereign bond price. Intuitively, raising $H$ increases the transfer by diluting existing bondholders—it raises outstanding debt but without increasing expected tax revenue. This captures a greater fraction of tax revenues towards the transfer but raises the probability of default.

The top panel of Figure 4 illustrates the marginal gain (solid line) and loss (dashed line) incurred by increasing $H$ for a fixed level of $T$. The dash-dot line represents the marginal gain curve at a higher level of $L_1$ than for the solid line. To generate the plots, we need to assume a specific distribution for uncertainty. For simplicity, we let $\tilde{R}_V$ have a uniform distribution. As the figure shows, and as proven in Appendix A.10, the marginal gain curve is downwards sloping. This is because, as $H$ increases, the marginal increase in the transfer due to further dilution decreases. The marginal cost of an increase in $H$ is the rise in expected dead-weight default cost. This is shown by the dashed green line in Figure 4. For $\tilde{R}_V$ uniformly distributed, this cost is a flat function of $H$ until the upper end of the support of the distribution, falling to zero beyond this upper point. Raising $H$ beyond this point represents sure default ($p_{def} = 1$).

Figure 4 indicates that (with $T$ held constant) there are two potential candidates for the
optimal choice of $H$. The first is the value of $H$ at which the gain and loss curves intersect. The second is to let $H \to \infty$, representing a total default and full dilution of existing bondholders. The bottom panel of Figure 4 plots the corresponding value of the government’s objective as a function of $H$. The plot shows that for the configuration displayed, a relatively small value of $H$ achieves the optimum, which is at the intersection of the gain and loss curves in the top panel. As this optimal $H$ is beyond the left end of the support of $\tilde{R}_V$ (which is the origin in the figure), it corresponds to an optimal non-zero probability of default. Note that beyond the upper end of the support of $\tilde{R}_V$, the objective function again rises in $H$. The reason for this is that, once debt issuance is large enough that default is certain, it is optimal for the government to fully dilute existing bondholders to obtain the largest possible transfer.

Finally, the dash-dot curves in Figure 4 correspond to an increase in $L_1$ (more severe debt-overhang) relative to the solid lines. As indicated, this worsening of financial sector solvency increases the marginal gain from an increase in $H$, pushing up the marginal gain curve in the top panel. In the bottom panel, it pushes down the curve because it lowers overall welfare. As is apparent in the top panel, the optimal response of the sovereign is to increase the optimal $H$ (by issuing more debt) in order to increase the transfer. This comes at the cost to the sovereign of a further increase in the probability of default. From the bottom panel it is apparent that while total default is still suboptimal, it would become optimal for a sufficiently high level of $L_1$.

### 3.5.1 Comparative Statics Under Uncertainty

The government jointly chooses $T$ and $H$ in an optimal way by comparing the relative marginal cost and benefit of adjusting each quantity. When the marginal benefit of additional transfer is large, but the marginal underinvestment loss due to taxation is already high, the government will optimally begin to ‘sacrifice’ its own creditworthiness to generate additional transfer. Therefore, a high $L_1$ (i.e., a financial sector crises) will be associated with both a high $T$ and a high level of $H$, up to the point where total default becomes optimal. The following proposition characterizes how different factors impact $\hat{H}$ and $\hat{T}$, the government’s optimal choices of $H$ and $T$ in equilibrium:

**Proposition 3.** If $(\hat{T}, \hat{H})$ is an interior solution to the government’s problem on a region of the parameter space, then $\hat{H}$ is increasing in $L_1$, in $N_D$ and in $\vartheta$, and decreasing in $D$. Furthermore, $\hat{T}$ is also increasing in $L_1$. 

To obtain more precise results we choose a specific distribution for $\tilde{R}_V$. For simplicity, we again let $\tilde{R}_V$ have a uniform distribution. We then plot in Figure 5 comparative statics of the equilibrium (optimal) values of $T$, $H, T_0,$ and $P_0$ as $L_1$ and $N_D$ are varied. The discontinuities that appears in the plots, as indicated by the dotted lines, represent the point at which total default becomes optimal.

The top panel of Figure 5 is for $L_1$. It shows that $T$ increases monotonically in $L_1$, up to the point where the sovereign chooses total default. The corresponding plot for $H$ tells a different story. For low levels of $L_1$, $H$ is held constant at a low value. This value corresponds to the lower end of the support of $\tilde{R}_V$, so the probability of sovereign default remains 0. Correspondingly, the plot shows that in this range, $P_0$ remains fully valued at 1. For sufficiently high $L_1$ (e.g., financial crisis), the government chooses to increase $H$. As discussed above, it ‘sacrifices’ its own creditworthiness in order to achieve a larger transfer. The increase in the transfer is apparent in the subplot for $T_0$, while the damage to the sovereign’s creditworthiness is apparent in the plot for $P_0$, which begins to decrease once $H$ begins to rise.\(^{13}\)

The plots also show that, when the financial sector’s situation is severe enough ($L_1$ is large), the optimal government response can be a total default. The outcome of a total default is illustrated in the plots at the point of the dotted line. As in the certainty case, total default fully dilutes existing bondholders, freeing extra capacity for the sovereign to generate the transfer. As indicated in the plots, this leads to a jump up in $T_0$ and a jump down in $T$. At the same time, $P_0$ drops to 0.

The bottom panel of Figure 5 shows the comparative statics for $N_D$. It is apparent that for low levels of debt the sovereign keeps $H$ constant at the low end of its support, so there is no probability of default and $P_0$ remains at 1. For these values of $N_D$, the government funds the transfer exclusively through increases in tax revenues. Note that in this range the transfer is decreasing in $N_D$, similar to the case of certainty. Once $N_D$ is sufficiently high, the underinvestment costs of increasing tax revenue becomes very high and again the sovereign begins to increase $H$ to fund the transfer. Consequently, the probability of default rises and $P_0$ begins to decrease, as shown in the plot. Interestingly, in this range the combination of increased $H$ and $T$ imply that the transfer is actually increasing in $N_D$. The reason for this is that for large $N_D$, the dilution of existing bondholders is an effective channel for increasing the transfer. Moreover, as the plots show, at high enough $N_D$, total default becomes optimal.

\(^{13}\)Note that the transfer increases more rapidly in $L_1$ once $H$ begins to increase. This occurs because higher $H$ means a a greater proportion of expected tax revenue is captured towards the transfer
3.6 Government ‘Guarantees’

Government guarantees of financial sector debt have been an explicit part of a number of countries’ financial sector bailouts, notably Ireland. Moreover, it has been common for sovereigns to step in to prevent the liquidation of banks by guaranteeing their debt, which strongly suggests that there is an implicit ‘safety net’. 14

In this section, we add to the model a simple notion of a government guarantee of financial sector debt. We do this for two reasons. First, guarantees are a measure that serves to prevent liquidation of the financial sector by debtholders, which is necessary pre-condition for the sovereign to act to alleviate debt-overhang and increase the provision of financial services. Second, guarantees are rather unique in that, by construction, their benefit is targeted at debtholders and not equity holders. This unique feature is important in helping us identify empirically a main implication of our model, that there is direct feedback between sovereign and financial sector credit risk.

In the interest of simplicity, and since debt-overhang alleviation is the central feature of bailouts in the model, we do not explore the feedback of the guarantees on the transfer and taxation decisions analyzed above. Instead, we simply set the stage for the implications of the guarantees for our empirical strategy.

3.6.1 Avoiding Liquidation

A precursor to the government’s actions to increase the provision of financial services is to prevent liquidation of the financial sector. We model debtholders as potentially liquidating (or inducing a run on) the financial sector if they are required to incur losses in case of financial sector default. To prevent debtholders from liquidating, the government ‘guarantees’ their debt. That is, it pledges to bondholders

\[ L_1 - \bar{A}_1 - T_0 \]

from tax revenues in case of insolvency. This ‘guarantee’ is pari-passu with other claims on tax revenue. Hence, the ‘guarantee’ has the same credit risk as other claims on the sovereign. In fact, the ‘guarantee’ is just equivalent to a claim that issues \( L_1 - \bar{A}_1 - T_0 \) new government bonds to debtholders in case of insolvency.

Note that this claim accrues exclusively to debtholders and not to equityholders. This

14The fallout from the failure of Lehman brothers and the apparent desire to prevent a repeat of this experience has strongly reinforced this view
differentiates it from general assets of the financial sector, such as the asset paying $\tilde{A}_1$ or the transfer, $T_0$. Importantly, a change in the value of general assets of the firm changes the value of equity and debt in a certain proportion, while a change in the value of the guarantee changes the value of debt but not the value of equity. This implies that, if there are guarantees, the change in equity value will not be sufficient for determining the change in debt value. The following proposition gives a formal statement of this, derived under a uniform distribution for $\tilde{A}_1$ (same as used above to generate the figures).

**Proposition 4.** Let $D$ be the value of debt, $E$ the value of equity, and $\tilde{A}_1$ be distributed uniformly. In the absence of a guarantee, the return on equity is sufficient for knowing the return on debt. In contrast, in the presence of a guarantee, the return on debt is a bivariate function of both the return on equity and the return on the sovereign bond price.

This bivariate dependence is approximated by the following relation, which is derived in the Appendix,

$$
\frac{dD}{D} \approx \frac{(1 - p_{\text{solv}})(1 - P_0)}{p_{\text{solv}}} \frac{D}{E} dE + \frac{(1 - p_{\text{solv}})^2}{2} L_1 P_0 dP_0
$$

The term involving the equity return captures the impact on the debt value of any changes in the value of the general pool of assets of the firm, including expected future profits of the firm. This corresponds to the canonical model of debt, following Merton (1974), where changes in the total value of the firm are reflected in both debt and equity values. In the presence of a guarantee, there is the additional second component, which picks up the change in the value of debt coming from changes in the value of the government guarantee. The change in value of the guarantee, which reflects variation in the credit risk of the sovereign, is concentrated primarily with debt. It is therefore not captured adequately by the return on equity and requires the second term.\textsuperscript{15}

\subsection*{3.6.2 Two-way Feedback}

As illustrated by Proposition 3 and the discussion of Figure 5, a severe financial sector crisis ‘spills over’ onto the sovereign via an increase in $H$ and deterioration of the sovereign’s

\textsuperscript{15}Note that there is theoretically also an indirect feedback of sovereign credit risk on financial sector credit risk. This is because the guarantee represents additional (state-contingent) debt issuance by the sovereign, which raises expected default costs of the sovereign and potentially reduces the size of the transfer to the financial sector. As mentioned above, to maintain simplicity we will not incorporate the impact of the guarantee on the government’s optimal choice of tax revenue or debt issuance. Instead, we will mainly use the above result to motivate some of our empirical work.
creditworthiness. With the introduction of uncertainty about realized tax revenues, the increase in $H$ varies continuously with the severity of the financial sector crisis ($L_1$) and is reflected continuously in the price of the sovereign’s bonds (equivalently, in CDS levels). Moreover, as we have shown, there is an upper value where total default becomes optimal. In addition, as the bottom panel of Figure 5 shows, higher pre-existing sovereign debt is associated with lower post-transfer sovereign bond prices.

Going in the other direction, higher pre-existing debt corresponds to a smaller transfer and therefore, ceteris paribus, a weaker post-transfer financial sector (lower post-transfer $p_{solv}$). Moreover, if the financial sector has substantial holdings of existing sovereign bonds (substantial $k_A$), then any resulting decrease in the sovereign’s bond price due to increasing $H$ causes collateral damage to the financial sector’s balance sheet. This decreases the net transfer to the financial sector, leaving it less well-off post transfer. There is, furthermore, an additional important consequence of increased $H$ that can be seen from the model with uncertainty. Once $H$ is increased, not only does the probability of default increase, but so does the sensitivity of the bond’s final payoff to realized growth (and hence tax revenue) shocks. Since the financial sector’s solvency post-transfer is dependent on this payoff due to its holdings of transfer and pre-existing government bonds, the increase in $H$ will make the financial sector more sensitive to shocks to $\tilde{R}_V$ (e.g., growth). This implies that, post-transfer, there will be increased co-movement between the likelihood of sovereign and financial sector solvency.

4 Empirics

In this section we present empirical evidence in favor of the main arguments made by this paper: (1) the bailouts reduced financial sector credit risk but were a key factor in triggering the rise in sovereign credit risk of the developed countries and (2) there is a two-way feedback between the creditworthiness of the sovereign and the financial sector.

The setting for our empirical analysis is the financial crisis of 2007-10. We divide the crisis into three separate periods relative to the bailouts: pre, around, and after. The pre-bailout period, which culminated in Lehman Brother’s bankruptcy, saw a severe deterioration in banks’ balance sheets, a substantial rise in the credit risk of financial firms, and a significant loss in the market value of their equity. This negative shock generated substantial debt overhang in the financial sector and significantly increased the likelihood of failure of, or runs on, financial institutions. We interpret this as setting the stage for the initial time
period in the model, and the bank bailouts as the sovereign’s response, per the model.

We present our empirical results in two parts. The first part focuses on point (1). We present evidence that the bailouts transmitted risk from the banks to the sovereigns and triggered a rise in sovereign credit risk across a broad cross-section of developed countries. We then confirm a prediction of the model by documenting the emergence post-bailout of a positive relationship between sovereign credit risk and government debt-to-gdp ratios. We also analyze the ability of the pre-bailout credit risk of the financial sector and pre-bailout government debt-to-gdp ratio to predict post-bailout credit risk. This relationship is predicted by the model and is supportive of argument that the bailouts induced increases in sovereign credit risk.

The second part of our analysis focuses on point (2) by testing for the sovereign-bank two-way feedback. We make extensive use of a broad panel of bank and sovereign CDS data to carry out tests that establish this channel and show that it is quantitatively important. A significant challenge in demonstrating direct sovereign-bank feedback is the concern that another (unobserved) factor directly affects both bank and sovereign credit risk, giving rise to co-movement between them even in the absence of any direct feedback. We address these concerns by utilizing a particularly useful feature of government ‘guarantees’—that they are targeted specifically at bank debt holders—to control for changes in bank fundamentals.

We also gather and exploit data on the sovereign bond holdings of European banks that was released after the stress tests conducted in the first half of 2010. Using this data we show that banks’ holdings of foreign sovereign bonds has information about how foreign sovereign credit risk affects a bank’s credit risk.

We next describe the data construction and provide some summary statistics. This is followed by the two sections of detailed results and the evidence based on the European bank stress test data.

4.1 Data and Summary Statistics

We use Bankscope to identify all banks headquartered in Western Europe, the United States, and Australia with more than $50 billion in assets as of the end of fiscal year 2006. We choose this sample because smaller banks and banks outside these countries usually do not have traded CDS. We then search for CDS prices in the database Datastream. We find CDS prices for 99 banks and match CDS prices to bank characteristics from Bankscope. Next, we search for investment grade credit ratings using S&P Ratings Express. We find credit
ratings for 86 banks and match these data to CDS prices and bank characteristics. Finally, we match these data to sovereign CDS of bank headquarters and OECD Economic data on public debt.

Panel A of Table 1 presents summary statistics for all banks with CDS prices and investment grade credit ratings. As of July 2007, the average bank had assets of $589.3 billion and equity of $26.8 billion. The average equity ratio was 5.1% and the average Tier 1 ratio was 8.5%. The average bank CDS was 21.8 basis points and the average sovereign CDS (if available as of July 2007) was 6.6 basis points.

Panel B of Table 1 present summary statistics of weekly changes in bank CDS and sovereign CDS for the main bailout periods. We drop all observations with zero changes in bank CDS or sovereign CDS to avoid stale data. All results presented below are robust to including these observations. Before the bank bailouts, the average bank CDS was 98.2 basis points. This level of bank credit risk reflected primarily banks’ exposure to subprime mortgages and related assets. The average sovereign CDS was 12.1 basis points. This low level of sovereign credit risk suggests that financial market participants did not anticipate large-scale bank bailouts prior to September 2008.

In the bailout period, we see a significant rise in both bank and credit risk with average bank and sovereign CDS of 301.3 and 33.6 basis points, respectively. As we discuss below, the increase in bank credit risk was triggered by the Lehman bankruptcy. After Lehman, most governments announced bank bailouts aimed at reducing bank credit risk. As a result of the bailouts, some of the financial sector risk was transferred to sovereigns, which increased average sovereign credit risk. We note that bank equity values declined sharply during this period with a negative weekly return of 7.4%.

In the post-bailout period, average bank and sovereign CDS were 194.1 and 90.8 basis points, respectively. These CDS levels are suggestive of a significant transfer of financial sector credit risk on sovereign balance sheets. We also find significant variation in sovereign CDS with a standard deviation of weekly changes of 12.9%. This evidence suggests the emergence of significant sovereign credit risk after the bank bailouts.

### 4.2 The Sovereign Risk Trigger

The first bank bailout announcement in Western Europe was on September 30, 2008 in Ireland. Therefore we define the pre-bailout period as ending on September 29, 2008. We start it in March 2007, prior to the start of the financial crisis. Note that this period
includes the bankruptcy of Lehman Brothers on September 15, 2008, but also the period immediately afterwards, so that it includes the immediate effect of Lehman’s bankruptcy on other banks prior to the Ireland announcement. Hence, the pre-bailout period captures both the prolonged increase in bank credit risk during 2007-2008 and the post-Lehman spike that occurs before the bank bailouts.

We compute the change in sovereign CDS and bank CDS during this period for all countries in our data set. For each country we compute the change in bank CDS as the unweighted average of all the banks with CDS prices. We omit countries for which either sovereign CDS or banks CDS are not available. Figure 6 summarizes the results for the pre-bailout period. For each country, the first column depicts the change in sovereign CDS and the second column depicts the change in bank CDS over the pre-bailout period. The figure shows that there is a large increase in banks CDS prior to the bank bailouts. For example, the average bank CDS in Ireland increases by 300 basis points over this period. However, there is almost no change in sovereign CDS. Overall, the figure shows that the credit risk of the financial sector was greatly increased over the pre-bailout period but that there was little impact on sovereign credit risk.

We note that some investors may have expected bank bailouts even before the first official announcement on September 30, 2008. Such an expectation would reduce the observed increase in bank CDS and shift forward in time the rise in sovereign CDS. To the extent that investors held such expectations prior to September 30, 2008, they can explain the small rise in sovereign CDS that occurs late in the pre-bailout period. However, the fact that the impact in this period is so small quantitatively suggest that the bank bailouts were a surprise to the majority of investors.

Almost every Western European country announced a bank support program in October 2008. Most bank support programs consisted of asset purchase programs, debt guarantees, and equity injections or some combination therefore. Several countries made more than one announcement during this period. As noted above, the first country to make a formal announcement was Ireland on September 30, 2010. Many other countries soon followed Ireland’s example, in part to offset outflows from their own financial sectors to newly secured financial sectors. As a result, the bank bailout announcements were not truly independent since sovereigns partly reacted to other sovereigns’ announcements. We therefore define the around-bailouts period as the period in which the bank bailout announcements occurred.

Figure 7 plots the average change in bank CDS and sovereign CDS over the bailouts period. As shown in the figure, bank CDS significantly decreased over this one-month period.
For example, the average bank CDS in Ireland decreased by about 200 basis points. Similarly, most other countries had a significant decrease in bank CDS, especially ones that had a large increase over the pre-bailout period. At the same time, there is a significant increase in sovereign CDS. For example, the sovereign CDS of Ireland increased by about 50 basis points. Most other countries exhibit a similar pattern with decreasing bank CDS and increasing sovereign CDS.

The appearance of this striking pattern across a broad cross-section of countries is directly in line with the predictions of our model. It shows that the sovereigns responded to the distress in the financial sector with the bailouts, achieving a substantial reduction in banks’ credit risk. However, in accordance with our model, this caused a contemporaneous, immediate increase in the sovereigns’ credit risk. Indeed the figures clearly show that these sharp increases were aligned tightly with the bailout announcement period.

We define the post-bailout period as beginning after the end of the bank bailouts and ending in March 2010. We choose March 2010 because this is the date for which the European bank stress data results were released. The results are robust to using other cut-off dates in 2010. Figure 8 plots the change in bank CDS and sovereign CDS over this post-bailout period. It shows that both sovereign CDS and bank CDS increased across all countries. Moreover, it is clear that bank CDS and sovereign CDS move together after the bank bailouts. This suggests that they are tied together and feedback on each other as our model suggests.

Our model predicts that the bailouts should lead to an increase in sovereign credit risk and that the post-bailout level of credit risk should depend on pre-bailout debt and the pre-bailout level of financial sector distress. Moreover, the model suggests that there should emerge after the bailouts a positive relationship between measures of government debt-to-gdp even if such relationship appears before.

We test these predictions using data on sovereign CDS, financial sector distress, and government debt-to-gdp ratios. We measure pre-bailout financial sector distress at the country level by averaging bank CDS on September 22, 2008. We choose this date midway between Lehman’s bankruptcy and the first bailout announcement. We measure the government debt-to-gdp ratio as the government gross liabilities as a percentage of gdp. For the post-bailout date we choose March 31, 2010, the reporting date for the European bank stress tests.

Table 2 presents the result of our analysis. Column (3) shows the result from regressing post-bailout log sovereign CDS on post-bailout debt-to-gdp. There is a clear, positive
relationship and the coefficient is statistically significant. This relationship is shown in the bottom panel of Figure 9. Column (4) shows the result when the log of the pre-bailout financial distress variable is also added as a dependent variable. As Column (4) shows the coefficient on pre-bailout financial distress is large and highly statistically significant. The coefficient shows that a 1% increase in pre-bailout financial sector distress increases post-bailout sovereign CDS by 0.965%. The coefficient on debt-to-gdp decreases slightly but remains marginally significant. The R-squared of the regression is close to 50%.

In contrast, Column (1) of Table 2 shows that in the pre-bailout period there is only a very weak relationship between debt-to-gdp and sovereign CDS. The coefficient is small and is statistically insignificant. This is displayed in the upper panel of Figure 9. Column (3) shows that the coefficient on financial sector distress in the pre-bailout period is also statistically insignificant.

From these results we can see that there emerged a relationship between debt-to-gdp and sovereign credit risk that was not present beforehand. Note, moreover, that the emergence of this relationship coincides with an overall rise in sovereign debt ratios. From the point of model, the sovereigns have increased debt-ratios into the region where dilution occurs and there is a negative relationship between debt-ratio and price (see Figure 5).

Columns (5) examines the ability of pre-bailout financial sector distress to predict the change in government debt-to-gdp from the pre-bailout to the post-bailout period. Consistent with the model, we find that financial sector distress is positively related to the increase in debt-to-gdp. The coefficient is positive and marginally statistically significant. Column (6) shows that consistent with the model’s predictions, post-bailout debt-to-gdp is predicted by pre-bailout debt-to-gdp and pre-bailout financial sector distress. Both coefficients are statistically significant and together the two variables explain 84% of the variation in post-bailout debt-to-gdp.

4.3 The Sovereign-Bank Feedback

In this section we analyze the two-way feedback between sovereign and bank sector credit risk. Once the sovereign opens itself up to credit risk due to bailouts, the price of its debt

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16 We make note of two points. First, the model predicts that $H$ determines the level of sovereign CDS. However, the debt-to-gdp ratio corresponds to $\theta_0 H$ in the model rather than simply $H$. Nevertheless, the prediction of the model carries over to $\theta_0 H$ since $\theta_0$ is increasing in financial sector distress. Second, debt-to-gdp ratios are an imperfect proxy for $\theta_0 H$ because $H$ takes into account any future issuance of debt to pay for current obligations related to the bailouts, whereas debt-to-gdp ratios are lagging. We can address this to some extent by using leading debt-to-gdp.
becomes sensitive to macroeconomic shocks. This leads a second direction of feedback, from
the sovereign to the financial sector. Our model indicates that subsequent changes in the
sovereign’s credit risk should impact the financial sector’s credit risk through three channels:
(i) ongoing bailout payments and subsidies,\(^\text{17}\) (ii) direct holdings of government debt, (iii)
explicit and implicit government guarantees.

The feedback channels imply that we should find that changes in sovereign and bank
credit risk are positively correlated. We start by estimating the following relationship in the
post-bailout period:

\[
\Delta \log(\text{Bank CDS}_{ijt}) = \alpha + \beta \Delta \log(\text{Sovereign CDS}_{jt}) + \varepsilon_{ijt}
\]

where \(\Delta \log(\text{Bank CDS}_{ijt})\) is the change in the log CDS of bank \(i\) headquartered in country
\(j\) from time \(t\) to time \(t - 1\) and \(\Delta \log(\text{Sovereign CDS}_{jt})\) is the change in the log Sovereign
CDS of country \(j\) from time \(t\) to time \(t - 1\). At the weekly frequency, the estimate of \(\beta\) is
0.47 and is highly statistically significant. This means that a 10% increase in sovereign CDS
is associated with a 4.7% increase in bank CDS. This result shows that sovereign and bank
CDS exhibit a strong comovement and is consistent with direct sovereign-bank feedback.

However, an obvious concern is that there is another (unobserved) factor that affects
both bank and sovereign credit risk. Such a factor would explain their co-movement without
there necessarily being an underlying direct channel between them. More specifically, we
interpret changes in sovereign credit risk as changes in expectations about macroeconomic
fundamentals, such as employment, growth, and productivity. These fundamentals also have
a direct effect on the value of bank assets such as mortgages or bank loans. Hence, changes
in macroeconomic conditions may generate a correlation between sovereign and bank credit
risk even in the absence of direct feedback. Therefore, establishing that there is indeed direct
feedback between sovereign and financial sector credit risk is a significant challenge.

We take a number of steps to address this concern. In the first step, we add controls
that capture market-wide changes that affect both bank and sovereign risk directly. Our
market-wide controls are a CDS-market index and a measure of aggregate volatility. Our
CDS market index is the iTraxx Europe index, which is comprised of 125 of the most liquid

\(^{17}\)While we model the bailout as happening in one stage, in practice bailouts may occur in multiple steps.
This may occur when early efforts are deemed to be insufficient. As with the one-stage bailout in our model,
the sovereign’s creditworthiness is important in determining the potential for and magnitude of future bailout
steps. This presents another, dynamic channel through which changes in sovereign creditworthiness impact
both financial sector debt and equity values.
CDS names referencing European investment grade credits. The CDS market index captures market-wide variation in CDS rates caused by changes in fundamental credit-risk, liquidity, and CDS-market specific shocks.\footnote{Collin-Dufresne, Goldstein, and Martin (2001) find that a substantial part of the variation in corporate credit spread changes is driven by a single factor that is independent of changes in risk factors or measures of liquidity. They therefore conclude that this variation represents ‘local supply/demand shocks’ in the corporate bond market.} For the volatility index we follow the empirical literature and use a VIX-like index, the VDAX, which is the DAX-counterpart to the VIX index for the S&P 500. This captures changes in aggregate volatility which is an important factor in the pricing of credit risk. In the second step, we include weekly fixed effects. For each week, the fixed effect captures any variation that is common across all banks. In the third step, we include bank-specific coefficients on all the control variables and bank fixed effects. This accommodates potential non-linearities in relationships.

We implement this approach by estimating the following regression:

\[ \Delta \log(\text{Bank CDS}_{ijt}) = \alpha_i + \delta_t + \beta \Delta \log(\text{Sovereign CDS}_{jt}) + \gamma \Delta X_{ijt} + \varepsilon_{ijt} \]

where $\Delta X_{ijt}$ are the changes in the control variables from time $t$ to time $t-1$, $\delta_t$ are the weekly fixed effects, and the $\alpha_i$ are bank fixed-effects.

Table 3 shows the results for the pre, around, and post-bailout periods. For each period there are three columns of results. The left column reports the coefficient estimates including the market-wide control variables. The middle column adds the weekly fixed effects. The right column adds the bank-specific coefficients on the controls and bank fixed effects.

Our main focus is on testing for the sovereign-bank feedback, so we examine the post-bailout results first. Column (7) shows that $\beta$ is positive, as expected, and highly statistically significant. The magnitude is also economically important, implying that an independent increase in sovereign CDS of 10% translates into a 1.63% increase in bank CDS. The control coefficients are both statistically significant and the signs are as expected; an increase in aggregate CDS levels or volatility is associated with a rise in banks’ CDS. As would be expected, the coefficient on CDS market is large. Altogether, the variables explain 31.6% of the variation in weekly bank CDS.

Column (8) adds the weekly fixed effects. The coefficient on sovereign CDS decreases but remains highly statistically significant. The decrease is not surprising, as time fixed effects represent a very rich set of controls. Note that the weekly fixed effects are collinear with the market-wide control variables. Therefore, we do not estimate coefficients on the market-wide
controls. There is an increase in the R-squared of about 7% over column (7), indicating that most of the variation was already captured by the market-wide controls.

Column (9) shows that the coefficient on sovereign CDS is essentially unchanged and remains highly statistically significant after adding bank-specific coefficients on the control variables. Given the flexibility of this specification we interpret the survival of the coefficient on sovereign CDS as robust evidence in favor of direct sovereign-bank feedback.

Comparing these results with those for the around-bailout period in columns (4)-(6) shows interesting differences. For the around-bailout period, the coefficient on sovereign CDS is negative. In other words, in the around-bailout period an independent increase in sovereign CDS is associated with a decrease in bank CDS. This is very much consistent with the evidence presented above that the sovereigns took onto themselves credit risk from their financial sectors during this phase. More precisely, it is evidence that in fact sovereigns that took on more credit risk, and hence saw a greater increase in their CDS, decreased by a greater amount their banks’ CDS. Perhaps due to the short time-series, the coefficients are only marginally significant. When the panel is estimated at the daily frequency they do in fact come up significant (unreported).

Columns (1)-(3) show the results for the pre-bailout period. They show a small coefficient on sovereign CDS that is indistinguishable from 0. Hence, in the pre-bailout period there is no evidence for sovereign-bank feedback. In contrast, the CDS market control coefficient is significant and has a large magnitude, similar to the results for the other periods.

4.3.1 Controlling for Bank Fundamentals

The results above establish that there is a strong sovereign-bank feedback. However, there may remain a concern that our strategy to this point does not control for country-specific macroeconomic shocks that bank-level fundamentals. For example, a negative macroeconomic shock will decrease the value of banks’ assets or future earnings power, while at the same time reducing national output. This will raise bank and sovereign CDS even in the absence of a direct feedback between them. This shock may not be fully captured by our market-wide controls if it has a heterogenous impact across countries.

We address this concern using a strategy that utilizes a particularly useful feature of government ‘guarantees’—they are targeted specifically at bank debt holders. This implies that sovereign-specific shocks should have a disproportionate impact on debt holders because, in addition to changing the value of bank assets, such shocks change the value of government ‘guarantees’ (implicit or explicit). Therefore, to establish whether there is a direct channel
we can test if sovereign CDS is still a determinant of bank CDS after we control for the impact of shocks to bank fundamentals.

Our strategy for dealing with this concern is motivated by the model. Proposition 4 shows that bank equity returns are sufficient for determining changes in bank CDS in the absence of government ‘guarantees’. This implies that once we control for bank equity returns we should not find that changes in sovereign CDS have any further explanatory power for changes in bank CDS. Indeed, a-priori it seems that even if there are direct sovereign-to-bank channels, their impact may be subsumed into an equity control, making it difficult to document their existence. On the other hand, if one finds that sovereign CDS does have further explanatory power beyond equity returns, then this is strongly supportive of a sovereign-to-bank feedback channel. Proposition 4 shows that ‘guarantees’ present a source for such a potential finding because they discriminate precisely in favor of debtholders. In the presence of ‘guarantees’, a regression that controls for equity returns should still find a (negative) beta on changes in sovereign CDS.

We therefore augment the regression with banks’ weekly equity returns. The estimates are shown in Table 4. The structure is similar to Table 3. Columns (7)-(9) show that in the post-bailout period we find that the coefficient on sovereign CDS survives and is highly statistically significant. As shown in columns (7) and (8), although the bank stock return coefficient is highly statistically significant and possesses the expected negative sign, its inclusion has little impact on the magnitude of the sovereign CDS coefficient. Column (9) includes bank-specific coefficients on bank stock returns. The results show that the coefficient on sovereign CDS decreases somewhat but remains highly significant.

For the bailout and pre-bailout periods, the results are quite similar to those in Table 3. As shown in columns (1) to (6), we again find a negative coefficient on sovereign CDS in the bailout period and an essentially zero coefficient in the pre-bailout period.

### 4.3.2 Bank-level Heterogeneity

To analyze further sovereign-bank feedback we also examine whether heterogeneity in bank characteristics affects banks’ sensitivity to changes in sovereign CDS. To this end, we estimate the coefficient on an interaction term of changes in sovereign CDS and a bank’s Tier 1 capital ratio. The Tier 1 capital ratio is commonly used in the banking industry as a proxy for a

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19This result is in fact quite general. It holds in models of defaultable bond pricing that build on the canonical model of Merton (1974), where stock returns contain all information about changes in bank asset values and therefore can (locally) capture all variation in the price of debt.
bank’s probability of solvency. This specification is motivated by the model. Equation (12) suggests that we should find that the magnitude of the coefficient on changes in sovereign CDS is decreasing in banks’ Tier 1 ratios. Intuitively, the impact of changes in the value of government guarantees stronger for less well-capitalized banks.

Table 5 reports the results. The coefficient of interest is the interaction term. For the post-bailout period, the negative estimates for the interaction term indicate that banks with higher Tier 1 ratios were less sensitive to variation in sovereign CDS rates. Although the estimates are negative in columns (7) to (9), only column (9), which includes the full set of controls is statistically significant.

The results in the bailout period are surprising. Similar to the post-bailout period, the coefficient on the interaction term is negative. However, this implies that well-capitalized banks experienced a larger CDS decrease relative to poorly capitalized banks during the bailout period. In the pre-bailout period, the interaction term is positive but small and statistically insignificant.

4.3.3 The Impact on Equity Value

For the purposes of establishing the existence of a two-way feedback we have mainly focused on changes in bank CDS. It is also interesting to look at the impact of bailouts on bank stock returns. From the viewpoint of the model, bank stock returns should reflect changes in sovereign credit risk due to their impact on the value of continuing bailout payments and banks’ holdings of government bonds. To that end, we estimate the following regression:

\[
\text{Bank Stock Return}_{ijt} = \alpha_i + \delta_t + \beta \Delta \log(\text{Sovereign CDS}_{jt}) + \gamma \Delta X_{ijt} + \varepsilon_{ijt}
\]

where Bank Stock Return$_{ijt}$ is the stock return of bank $i$ headquartered in country $j$ from time $t$ to time $t-1$. We use the same control variables as in Table 4.

Table 6 presents the results. Columns (7) to (9) show that in the post-bailout period an increase in sovereign CDS is associated with a decrease in bank stock returns. This result is robust to the inclusion of the full set of controls. Note also that the coefficients on the controls have the expected signs and are significant.

Perhaps somewhat surprisingly, the coefficient on sovereign CDS is not distinguishable from zero during the bailout period. The point estimate is positive in columns (5) and (6), but is not statistically significant. Still, across the board, the point estimates are clearly higher than for the post-bailout period, which is consistent with the idea that equity holders
benefitted from bank bailouts. One potential offsetting effect on this result is that in some countries the benefits of bailouts to equity holders were offset by charges (or expectations of charges) levied by the government. Columns (1) to (3) show that as before, the coefficient on sovereign CDS in the pre-bailout period is essentially zero.

4.4 European Bank Stress Test Analysis

As a final part of our analysis, we use data on the sovereign bond holdings of European banks. These data were released as part of the European bank stress tests, which were conducted in the first half of 2010. The data provide a view of a bank’s bond holdings of both its own government bonds and those of other European countries.

We first describe the data and provide summary statistics. We collect the stress test data from the websites of national bank regulators in Europe. The data consists of bank characteristics and holdings of European sovereign bonds. A total of 91 banks participated in the bank stress tests. These banks represent about 70 percent of bank assets in Europe. For all banks, we search for CDS prices in the database Datastream. Using bank names, we match 51 banks to CDS prices. Unmatched banks are mostly smaller banks from Spain and Eastern Europe that do not have publicly quoted CDS prices. For each bank we match sovereign holdings to sovereign CDS and compute a measure of exposure to sovereign credit risk.

Table 7 presents summary statistics for all banks that participated in the European bank stress tests. As of March 2010, the average bank had risk-weighted assets of 126 billion euros and a Tier 1 capital ratio of 10.2%. The average holdings of gross and net European sovereign bonds are 20.6 billion euros and 19.7 billion euros, respectively. Hence, the average bank holds about one sixth of risk-weighted assets in sovereign bonds. Banks have a strong home bias in their sovereign holdings: about 69.4% of bonds are issued by the country in which a bank is headquartered. This is supportive of the model’s assumption that banks are exposed to home-country sovereign risk through their holdings of government bonds.

We use these data to conduct an alternative test of the impact of sovereign credit risk on bank credit risk. Our test focuses uses information on changes in the value of foreign-sovereign holdings rather than own-country sovereign holdings. The benefit of this approach is that it circumvents the usual concerns about omitted country-specific macro shocks.

To implement this test, we construct a bank-specific variable measuring variation in the value of banks’ foreign sovereign bond holdings. Let $\text{SovBond}_{ik}$ be the share of for-
eign sovereign holdings of country $k$ by bank $i$. We calculate the foreign holdings variable, \( \text{ForeignBondCDS}_{it} \), as the following weighted average:

\[
\text{ForeignBondCDS}_{it} = \sum_{i \neq j} \text{SovBond}_{ik} \times \text{SovereignCDS}_{kt},
\]

where \( \text{SovereignCDS}_{kt} \) is the sovereign CDS of country $k$ on day $t$. Note that for each bank the foreign holdings variable excludes home-sovereign bonds. We then estimate the following:

\[
\Delta \log(\text{Bank CDS}_{it}) = \delta_t + \gamma \Delta \log(\text{ForeignBondCDS}_{it}) + \epsilon_{it}. 
\] (13)

where \( \delta_t \) are time fixed effects. The coefficient of interest is \( \gamma \), which captures the effect of changes in the value of foreign bond holdings on the bank’s CDS.

We estimate the regressions using the period one month before and one month after the reporting date for the sovereign bond holdings. By estimating this regression, we are implicitly assuming that the marginal CDS investor either knows or at least has some idea of the bank holdings.

Table 8 shows the results. Column (1) shows a positive and statistically significant association between changes in banks’ CDS and their foreign sovereign holdings. This coefficient suggests that a one-standard deviation increase in the change in the foreign sovereign holdings variable leads to an increase of about half of a one-standard deviation in the change of the bank CDS. Column (2) shows that the coefficient remains unchanged when bank fixed effects are included. Column (3) controls for week fixed effects. The coefficient of interest decreases from 0.325 to 0.261. This suggests that common shocks affect both the change in bank CDS and the change in the foreign holdings variable. Column (4) controls for day fixed effects. In this case, the coefficient is identified only off the cross-sectional variation in the value of foreign sovereign holdings. The coefficient decreases to 0.141 but remains statistically significant at the 1%-level. This result suggests that variation in foreign sovereign holdings contains economically important information about variation in bank credit risk.

To further check for robustness, column (5) adds back bank fixed effects. This does not have any effect on the coefficient. Column (6) estimates the same regression as in Column (5) but excludes the holdings of German bonds from the construction of the foreign-holdings variable. We do this to address a potential concern about reverse causality due to the possibility that Germany may provide bailouts to other countries, or banks in other countries. The column shows that this has no effect on the coefficient of interest.
5 Related literature

Our paper is related to three different strands of literature: (i) the theoretical literature on bank bailouts; (ii) the literature on costs of sovereign default; and, (iii) the recent empirical literature on effects of bank bailouts on sovereigns.

The theoretical literature on bank bailouts has mainly focused on how to structure bank bailouts efficiently. While the question of how necessarily involves an optimization with some frictions, the usual friction assumed is the inability to resolve failed bank’s distress entirely due to agency problems. This could be due to under-investment problem as in our setup (e.g., Philippon and Schnabl, 2009), adverse selection (e.g., Gorton and Huang, 2004), risk-shifting or asset substitution (e.g., Acharya, Shin and Yorulmazer, 2008, Diamond and Rajan, 2009), or tradeoff between illiquidity and insolvency problems (e.g., Diamond and Rajan, 2005). Some other papers (Philippon and Schnabl, 2010, Bhattacharya and Nyborg, 2010, among others) focus on specific claims through which bank bailouts can be structured to limit these frictions.

A large body of existing literature in banking considers that bank bailouts are inherently a problem of time consistency and induce moral hazard at individual-bank level (Mailath and Mester, 1994) and at collective level through herding (Penati and Protopapadakis, 1988, Acharya and Yorulmazer, 2007). Aghion, Bolton and Fries (1999) consider the cost that bank debt restructuring can in some cases delay the recognition of loan losses. Brown and Dinc (2009) show empirically that the governments are more likely to rescue a failing bank when the banking system, as a whole, is weak.

A small part of this literature, however, does consider ex-post costs of bailouts. Notably, Diamond and Rajan (2005, 2006) study how bank bailouts can take away a part of the aggregate pool of liquidity from safe banks and endanger them too. Acharya and Yorulmazer (2007, 2008) model, in a reduced-form manner, a cost of bank bailouts to the government or regulatory budget that is increasing in the quantity of bailout funds. They provide taxation-related fiscal costs as a possible motivation. Panageas (2010a,b) considers the optimal taxation to fund bailouts in a continuous-time dynamic setting, also highlighting when banks might be too big to save.

In the theoretical literature on sovereign defaults, Bulow and Rogoff (1989a, 1989b) initiated a body of work that focused on ex-post costs to sovereigns of defaulting on external debt, e.g., due to reputational hit in future borrowing, imposition of international trade sanctions and conditionality in support from multi-national agencies. Broner and Ventura
(2005), Broner, Martin and Ventura (2007), Acharya and Rajan (2010) and Gennaioli, Martin and Rossi (2010), among others, consider a collateral damage to the financial institutions and markets when a sovereign defaults. They employ this as a possible commitment device that gives the sovereign “willingness to pay” its creditors. Our model considers both of these effects, an ex-post deadweight cost of sovereign default in external markets as well as an internal cost to the financial sector through bank holdings of government bonds.

One strand of recent empirical work focuses on the distortionary design of bank bailout packages. Acharya and Sundaram (2009) document how the loan guarantee program of the Federal Deposit Insurance Corporation in the Fall of 2008 was charged in a manner that favored weaker banks at the expense of safer ones, producing a downward revision in CDS spreads of the former. Veronesi and Zingales (2009) conduct an event study and specifically investigate the U.S. government intervention in October 2008 through TARP and calculate the benefits to banks and costs to taxpayers. They find that the government intervention increased the value of banks by over $100 billion, primarily of bank creditors, but also estimate a taxpayer cost between $25 to $47 billion. Panetta et al. (2009) and King (2009) assess the Euro zone bailouts and reach the conclusion that while bank equity was wiped out in most cases, bank creditors were backstopped reflecting a waiting game on part of bank regulators and governments.

Another strand of recent empirical work relating financial sector and sovereign credit risk during the ongoing crisis shares some similarity to the very recent papers on this theme. Sgherri and Zoli (2009) and Attinasi, Checherita and Nickel (2009) focus on the effect of bank bailout announcements on sovereign credit risk measured using CDS spreads. Some of their evidence mirrors our descriptive evidence. Dieckmann and Plank (2009) analyze sovereign CDS of developed economies around the crisis and document a significant rise in co-movement following the collapse of Lehman Brothers. Demirguc-Kunt and Huizinga (2010) do an international study of equity prices and CDS spreads around bank bailouts and show that some large banks may be too big to save rather than too big to fail. Our analysis corroborates and complements some of this work. In particular, our empirical investigation of banking sector holdings of government debt and how this introduces a linkage between bank CDS and sovereign CDS is novel.

Finally, Reinhart and Rogoff (2009a, b) and Reinhart and Reinhart (2010) document that economic activity remains in deep slump “after the fall” (that is, after a financial crisis), and private debt shrinks significantly while sovereign debt rises, especially beyond a threshold of 90% debt to GDP ratio of the sovereign. These effects are potentially all consistent with our
model of how financial sector bailouts affect sovereign credit risk and economic growth.

6 Conclusion

This paper examines the intimate and intricate link between bank bailouts and sovereign credit risk. We develop a model in which the government faces an important trade-off: bank bailouts ameliorate the under-investment problem in the financial sector but reduce investment incentives in the non-financial sector due to costly future taxation. In the short-run, bailouts are funded through the issuance of government bonds, which dilutes the value of existing government bonds and creates a two-way feedback mechanism because financial firm hold government bonds for liquidity purposes. We also provide supporting evidence for our model using data from the financial crisis of 2007-10. In particular, we document that developed country governments transferred credit risk from the financial sector to taxpayers during the height of the crisis in October 2008. Using credit ratings data and data on sovereign bond holdings from the European bank stress test in May 2010, we find that sovereign credit risk in turn affected bank credit risk.

Overall, we consider the emergence of meaningful sovereign credit risk as an important potential cost of bank bailouts. This cost is a reflection of the future taxation (or more generally, even inflation) risk imposed on corporate and household sectors of the economy. Such an ex-post cost of bailouts has received little theoretical attention and has also not been analyzed much empirically. Taking cognizance of this ultimate cost of bailouts has important consequences for the future resolution of financial crises, the design of fiscal policy, and the nexus between the two.

References


Figure 1 plots the sovereign CDS and bank CDS for Ireland in the period from 3/1/2007 to 8/31/2010. The bank CDS is computed as the unweighted average of bank CDS for banks headquartered in Ireland (Allied Irish Bank, Anglo Irish Bank, Bank of Ireland, and Irish Life and Permanent). The data are from Datastream.
The top panel of Figure 2 plots the marginal gain ($dG/dT$) of raising tax revenues (solid line and dash-dot line) and the marginal loss ($dL/dT$, dashed line) as functions of $T$ for the certainty model of Section 3.3. The dash-dot line corresponds to a higher level of existing government debt, $N_D$, than the solid line. The bottom panel of the Figure shows the resulting value of the government’s objective function (equation (3)), with the the solid and dash-dot line corresponding to their counterparts in the top panel. The plots correspond to a parameterization of the model where $A_1 \sim U[0, 1]$, $L_1 = 0.5$, $\alpha = 1$, $\vartheta = 0.3$, $\gamma = 0.2$, $\beta = 0.5$, $m = 1.3$, $D = 0.02$, $k = 0$, and $N_D = 0.25$ (solid line).
Figure 3 shows the Default and No-Default Regions in the space of $L_1 \times N_D$ (financial sector leverage/debt overhang $\times$ pre-existing sovereign debt) for the certainty model parameterized as in Figure 2. The black curve separating these two regions gives the Default Boundary.
The top panel of Figure 4 plots the marginal gain of increasing $H$ while holding constant $T$, $dG/dH$ (solid line and dash-dot line) and the resulting marginal increase in expected dead-weight default cost $D\frac{dpdef}{dH}$ (dashed line). Uncertainty over growth/tax revenues, $\tilde{R}_V$, is assumed to have a uniform distribution. The dash-dot line corresponds to a higher level of $L_1$ than for the solid line. The bottom panel of the Figure shows the resulting value of the government’s objective function, with the the solid and dash-dot line corresponding to their counterparts in the top panel. The plots correspond to a parameterization of the model where $\tilde{R}_V \sim U[0.6, 1.4]$, $A_1 \sim U[0, 1]$, $L_1 = 0.5$ (solid line), $\alpha = 1$, $\vartheta = 0.3$, $\gamma = 0.2$, $\beta = 0.5$, $m = 1.3$, $D = 0.06$, $k = 0$, and $N_D = 0.25$. 
Figure 5 plots the equilibrium values of $\mathcal{T}$ (expected tax revenue), $H$, $T_0$ (the transfer), and $P_0$ (price of sovereign bond) as $L_1$ (top panel) and $N_D$ (bottom panel) are varied. The dotted line in the plots represents the point at which total default ($H \to \infty$) is optimal, resulting in a discontinuity in the plot. The parameters of the model correspond to those in Figure 4.
Figure 6 plots the sovereign CDS and bank CDS for Ireland in the period from 3/1/2007 to 8/31/2010. The bank CDS is computed as the unweighted average of bank CDS for banks headquartered in Ireland (Allied Irish Bank, Anglo Irish Bank, Bank of Ireland, and Irish Life and Permanent). The data are from Datastream.
Figure 7 plots the change in average bank CDS and sovereign CDS for Western European countries in the period from 9/26/2008 to 10/21/2008. The bank CDS is computed as the unweighted average of bank CDS for banks headquartered in that country. The data are from Datastream (no data available for Switzerland Country CDS and Greek banks CDS during this period).
Figure 8 plots the change in average bank CDS and sovereign CDS for Western European countries in the period from 10/22/2008 to 6/30/2010. The bank CDS is computed as the unweighted average of bank CDS for banks headquartered in that country. The data are from Datastream.
Figure 9: Correlation between Sovereign CDS and Public Debt before and after bank bailouts

Figure 9 shows the correlation between sovereign CDS and public liabilities (as a percentage of GDP) for Western European countries before and after the bank bailouts. The top figure shows no correlation before the bailouts (as of 3/1/2007). The bottom figure shows a strong correlation after the bank bailouts (as of 3/1/2010). The data are from Datastream and the OECD Economic database.
Table 1: Summary Statistics


Panel A: Cross-Section (7/1/2007)

<table>
<thead>
<tr>
<th></th>
<th>#</th>
<th>Mean</th>
<th>Std.Dev</th>
<th>50th Percentile</th>
<th>5th Percentile</th>
<th>95th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets ($ billion)</td>
<td>81</td>
<td>589.3</td>
<td>594.9</td>
<td>362.6</td>
<td>77.9</td>
<td>1,896.9</td>
</tr>
<tr>
<td>Equity ($ billion)</td>
<td>81</td>
<td>26.8</td>
<td>29.3</td>
<td>20.2</td>
<td>3.5</td>
<td>112.4</td>
</tr>
<tr>
<td>Equity Ratio (%)</td>
<td>81</td>
<td>5.1</td>
<td>2.7</td>
<td>4.8</td>
<td>1.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Tier 1 Ratio (%)</td>
<td>66</td>
<td>8.5</td>
<td>1.9</td>
<td>8.2</td>
<td>6.5</td>
<td>12.4</td>
</tr>
<tr>
<td>Bank CDS (bp)</td>
<td>75</td>
<td>21.8</td>
<td>13.4</td>
<td>10.5</td>
<td>6.5</td>
<td>41.0</td>
</tr>
<tr>
<td>Sovereign CDS (bp)</td>
<td>56</td>
<td>6.6</td>
<td>11.5</td>
<td>2.0</td>
<td>1.5</td>
<td>52.1</td>
</tr>
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</table>

Panel B: Time-Series

Pre-Bailout Period (1/1/2007-8/31/2008)

<table>
<thead>
<tr>
<th></th>
<th>#</th>
<th>Mean</th>
<th>Std.Dev</th>
<th>50th Percentile</th>
<th>5th Percentile</th>
<th>95th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank CDS (bp)</td>
<td>3,633</td>
<td>98.2</td>
<td>159.4</td>
<td>65.5</td>
<td>6.6</td>
<td>293.3</td>
</tr>
<tr>
<td>Sovereign CDS (bp)</td>
<td>3,633</td>
<td>12.1</td>
<td>10.9</td>
<td>8.8</td>
<td>1.6</td>
<td>37.2</td>
</tr>
<tr>
<td>CDS Volatility</td>
<td>3,633</td>
<td>0.001</td>
<td>0.028</td>
<td>0.001</td>
<td>-0.038</td>
<td>0.042</td>
</tr>
<tr>
<td>Bank Stock Return (%)</td>
<td>2,859</td>
<td>-0.008</td>
<td>0.079</td>
<td>-0.004</td>
<td>-0.102</td>
<td>0.082</td>
</tr>
<tr>
<td>Δ Bank CDS (%)</td>
<td>3,630</td>
<td>0.027</td>
<td>0.249</td>
<td>0.017</td>
<td>-0.281</td>
<td>0.324</td>
</tr>
<tr>
<td>Δ Sovereign CDS (%)</td>
<td>3,610</td>
<td>0.016</td>
<td>0.341</td>
<td>0.018</td>
<td>-0.302</td>
<td>0.333</td>
</tr>
<tr>
<td>Δ CDS Market Index (%)</td>
<td>3,633</td>
<td>0.015</td>
<td>0.138</td>
<td>0.000</td>
<td>-0.199</td>
<td>0.217</td>
</tr>
</tbody>
</table>

Bailout Period (9/1/2008-10/31/2008)

<table>
<thead>
<tr>
<th></th>
<th>#</th>
<th>Mean</th>
<th>Std.Dev</th>
<th>50th Percentile</th>
<th>5th Percentile</th>
<th>95th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank CDS (bp)</td>
<td>606</td>
<td>301.3</td>
<td>615.1</td>
<td>138.7</td>
<td>65.9</td>
<td>727.5</td>
</tr>
<tr>
<td>Sovereign CDS (bp)</td>
<td>606</td>
<td>33.6</td>
<td>21.9</td>
<td>28.2</td>
<td>9.5</td>
<td>81.8</td>
</tr>
<tr>
<td>CDS Volatility</td>
<td>606</td>
<td>0.067</td>
<td>0.103</td>
<td>0.058</td>
<td>-0.079</td>
<td>0.278</td>
</tr>
<tr>
<td>Bank Stock Return (%)</td>
<td>455</td>
<td>-0.074</td>
<td>0.246</td>
<td>-0.033</td>
<td>-0.364</td>
<td>0.140</td>
</tr>
<tr>
<td>Δ Bank CDS (%)</td>
<td>605</td>
<td>0.041</td>
<td>0.378</td>
<td>0.032</td>
<td>-0.515</td>
<td>0.518</td>
</tr>
<tr>
<td>Δ Sovereign CDS (%)</td>
<td>606</td>
<td>0.137</td>
<td>0.177</td>
<td>0.101</td>
<td>-0.095</td>
<td>0.519</td>
</tr>
<tr>
<td>Δ CDS Market Index (%)</td>
<td>606</td>
<td>0.055</td>
<td>0.168</td>
<td>0.043</td>
<td>-0.267</td>
<td>0.373</td>
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</table>

Post-Bailout (31/10/2008 - 31/8/2010)

<table>
<thead>
<tr>
<th></th>
<th>#</th>
<th>Mean</th>
<th>Std.Dev</th>
<th>50th Percentile</th>
<th>5th Percentile</th>
<th>95th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank CDS (bp)</td>
<td>6,496</td>
<td>194.1</td>
<td>178.9</td>
<td>131.5</td>
<td>65.5</td>
<td>567.8</td>
</tr>
<tr>
<td>Sovereign CDS (bp)</td>
<td>6,496</td>
<td>90.8</td>
<td>100.0</td>
<td>58.7</td>
<td>24.7</td>
<td>244.7</td>
</tr>
<tr>
<td>CDS Volatility</td>
<td>6,496</td>
<td>-0.002</td>
<td>0.034</td>
<td>-0.002</td>
<td>-0.045</td>
<td>0.043</td>
</tr>
<tr>
<td>Bank Stock Return (%)</td>
<td>4,814</td>
<td>0.003</td>
<td>0.100</td>
<td>0.003</td>
<td>-0.122</td>
<td>0.136</td>
</tr>
<tr>
<td>Δ Bank CDS (%)</td>
<td>6,495</td>
<td>0.001</td>
<td>0.129</td>
<td>-0.003</td>
<td>-0.174</td>
<td>0.174</td>
</tr>
<tr>
<td>Δ Sovereign CDS (%)</td>
<td>6,495</td>
<td>0.000</td>
<td>0.122</td>
<td>-0.002</td>
<td>-0.207</td>
<td>0.208</td>
</tr>
<tr>
<td>Δ CDS Market Index (%)</td>
<td>6,496</td>
<td>-0.005</td>
<td>0.089</td>
<td>-0.009</td>
<td>-0.124</td>
<td>0.130</td>
</tr>
</tbody>
</table>
Table 2: Emergence of Sovereign Credit Risk

This table shows the relation between sovereign credit risk, public debt, and bank quality. The sample includes all Eurozone countries and Australia, Denmark, Great Britain, Sweden, and Switzerland with publicly available data on sovereign and bank CDS. The data are at the country-level. The independent variable in Columns (1) and (2) is the sovereign CDS before the bank bailouts (as of 1/1/2008). Columns (1) and (2) control for Public Debt measured as General Government Gross Financial Liabilities as percentage of GDP (collected from the OECD Economic Outlook). Column (2) controls for average bank quality measured as the average banks CDS before the bank bailouts (as of 9/22/2008). The independent variable in Columns (3) and (4) is the sovereign CDS after the bank bailouts (as of 3/31/2010). The dependent variables are the same as in Columns (1) and (2), respectively. The independent variable in column (5) is the change in public debt from June 2008 to June 2010. The dependent variable is the average bank quality. The independent variable in column (6) is public debt in June 2010. The dependent variables are the public debt in June 2008 and average bank quality. We report robust standard errors. ** 1% significant, * 5% significant, and + 10% significant

| % Public Debt (June 2008) | Log (Sovereign CDS) | % Public Debt | % Public Debt | % Public Debt |
|--------------------------|---------------------|---------------|---------------|
|                          | Pre-Bailout         | Post-Bailout  | Around Bailout| Post-Bailout  |
| % Public Debt (June 2008)| 0.006 (0.004)       | 0.005 (0.005) | 0.015* (0.006)| 0.013+ (0.007)| 1.107** (0.144) |
| Log (Average Bank CDS Sep 2008) | 0.311 (0.208) | 0.965* (0.357) | 20.118+ (10.168) | 21.726+ (11.555) |
| Constant                 | 2.137** (0.320)     | 0.601 (1.154) | 3.112** (0.401) | -1.593 (2.019) | -86.920 (49.456) | -101.548 (60.923) |
| Observations             | 15                  | 14            | 17            | 15            | 15              | 15               |
| R-squared                | 0.134               | 0.171         | 0.261         | 0.488         | 0.364           | 0.843             |
Table 3: Change in Bank and Sovereign Credit Risk

This table shows the effect of sovereign credit risk on bank credit risk during the financial crisis. The sample includes all European, U.S., and Australian banks with available data on bank CDS and share prices. The data are at the weekly level. Columns (1) to (3) cover the pre-bailout period (1/1/2007-31/8/2010), Columns (4) to (6) cover the bailout period (9/1/2008-10/31/2008), and Columns (7) to (9) cover the post-bailout period (November 2008 to August 2010). The dependent variable is the weekly change in the natural logarithm of bank CDS. The main independent variable is the weekly change in the sovereign CDS. The sovereign CDS is assigned based on the country where the bank is headquartered. The control variables are the change in CDS market index, volatility, and bank stock return. Columns (2), (3), (5), (6), (8), and (9) include week fixed effects. Column (3), (6), (9) include bank fixed effects and interactions of bank fixed effects with volatility, bank stock return, and the CDS Market index. The standard errors are clustered at the bank-level. ** 1% significant, * 5% significant, and + 10% significant

<table>
<thead>
<tr>
<th>Period</th>
<th>Pre-Bailout (Jan 07-Aug 08)</th>
<th>Around Bailout (Sep-Oct 08)</th>
<th>Post-Bailout (Nov 08-Sep 10)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>Δ Log(Sovereign CDS)</td>
<td>0.023*</td>
<td>0.015</td>
<td>0.019</td>
</tr>
<tr>
<td></td>
<td>(0.010)</td>
<td>(0.014)</td>
<td>(0.015)</td>
</tr>
<tr>
<td>Δ Log(CDS Market Index)</td>
<td>0.860**</td>
<td>0.932**</td>
<td>0.689**</td>
</tr>
<tr>
<td></td>
<td>(0.041)</td>
<td>(0.094)</td>
<td>(0.027)</td>
</tr>
<tr>
<td>Δ Volatility Index</td>
<td>0.214</td>
<td>-0.539**</td>
<td>0.122*</td>
</tr>
<tr>
<td></td>
<td>(0.155)</td>
<td>(0.081)</td>
<td>(0.050)</td>
</tr>
<tr>
<td>Week FE</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Interactions</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Observations</td>
<td>3,508</td>
<td>3,508</td>
<td>3,508</td>
</tr>
<tr>
<td>Banks</td>
<td>84</td>
<td>84</td>
<td>84</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.171</td>
<td>0.253</td>
<td>0.387</td>
</tr>
</tbody>
</table>

** 1% significant, * 5% significant, and + 10% significant
### Table 4: Change in Bank and Sovereign Credit Risk

This table shows the effect of sovereign credit risk on bank credit risk during the financial crisis. The sample includes all European, U.S., and Australian banks with available data on bank CDS and share prices. The data are at the weekly level. Columns (1) to (3) cover the pre-bailout period (1/1/2007-31/8/2010), Columns (4) to (6) cover the bailout period (9/1/2008-10/31/2008), and Columns (7) to (9) cover the post-bailout period (November 2008 to August 2010). The dependent variable is the weekly change in the natural logarithm of bank CDS. The main independent variable is the weekly change in the sovereign CDS. The sovereign CDS is assigned based on the country where the bank is headquartered. The control variables are the change in CDS market index, volatility, and bank stock return. Columns (2), (3), (5), (6), (8), and (9) include week fixed effects. Column (3), (6), (9) include bank fixed effects and interactions of bank fixed effects with volatility, bank stock return, and the CDS Market index. The standard errors are clustered at the bank-level. ** 1% significant, * 5% significant, and + 10% significant

<table>
<thead>
<tr>
<th>Period</th>
<th>Pre-Bailout (Jan 07-Aug 08)</th>
<th>Around Bailout (Sep-Oct 08)</th>
<th>Post-Bailout (Nov 08-Sep 10)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>∆ Log(Sovereign CDS)</td>
<td>0.019*</td>
<td>0.008</td>
<td>0.014</td>
</tr>
<tr>
<td></td>
<td>(0.009)</td>
<td>(0.013)</td>
<td>(0.015)</td>
</tr>
<tr>
<td>Bank Stock Return</td>
<td>-0.142</td>
<td>-0.062</td>
<td>-0.255+</td>
</tr>
<tr>
<td></td>
<td>(0.118)</td>
<td>(0.106)</td>
<td>(0.132)</td>
</tr>
<tr>
<td>∆ Log(CDS Market Index)</td>
<td>0.929**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.043)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>∆ Volatility Index</td>
<td>0.043</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.120)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Week FE | N | Y | Y | N | Y | Y | N | Y | Y |
| Interactions | N | N | Y | N | N | Y | N | N | Y |
| Observations | 2,745 | 2,745 | 2,745 | 437 | 437 | 437 | 5,278 | 5,278 | 5,278 |
| Banks | 63 | 63 | 63 | 53 | 53 | 53 | 60 | 60 | 60 |
| R-squared | 0.224 | 0.308 | 0.481 | 0.208 | 0.403 | 0.728 | 0.359 | 0.424 | 0.491 |
Table 5: Change in Bank and Sovereign Credit Risk (by Tier 1 Capital)

This table shows the effect of sovereign credit risk on bank credit risk during the financial crisis. The sample includes all European, U.S., and Australian banks with available data on bank CDS and share prices. The data are at the weekly level. Columns (1) to (3) cover the pre-bailout period (1/1/2007-31/8/2010), Columns (4) to (6) cover the bailout period (9/1/2008-10/31/2008), and Columns (7) to (9) cover the post-bailout period (November 2008 to August 2010). The dependent variable is the weekly change in the natural logarithm of bank CDS. The Tier 1 capital ratio is the regulatory bank capital ratio. All other variables are defined in Tables 3 to 5. The regression includes the Tier 1 capital ratio and an interaction between the Tier 1 capital ratio and the change in sovereign CDS. All other controls are the same as in Table 5. The standard errors are clustered at the bank-level. ** 1% significant, * 5% significant, and + 10% significant.

<table>
<thead>
<tr>
<th>Period</th>
<th>Pre-Bailout (Jan 07-Aug 08)</th>
<th>Around Bailout (Sep-Oct 08)</th>
<th>Post-Bailout (Nov 08-Sep 10)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>∆ Log(Sovereign CDS)*Tier 1</td>
<td>0.648</td>
<td>0.340</td>
<td>1.014</td>
</tr>
<tr>
<td></td>
<td>(0.882)</td>
<td>(0.712)</td>
<td>(1.035)</td>
</tr>
<tr>
<td>∆ Log(Sovereign CDS)</td>
<td>-0.031</td>
<td>-0.019</td>
<td>-0.079</td>
</tr>
<tr>
<td></td>
<td>(0.072)</td>
<td>(0.066)</td>
<td>(0.096)</td>
</tr>
<tr>
<td></td>
<td>(30.883)</td>
<td>(32.400)</td>
<td>(108.792)</td>
</tr>
<tr>
<td>Stock Return</td>
<td>-0.347**</td>
<td>-0.335**</td>
<td>-0.117</td>
</tr>
<tr>
<td></td>
<td>(0.095)</td>
<td>(0.115)</td>
<td>(0.139)</td>
</tr>
<tr>
<td>Other Controls</td>
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<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Week FE</td>
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<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Interactions</td>
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<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Observations</td>
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<td>2,256</td>
<td>2,256</td>
</tr>
<tr>
<td>Bank</td>
<td>48</td>
<td>48</td>
<td>48</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.261</td>
<td>0.345</td>
<td>0.510</td>
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</tbody>
</table>
Table 6: Bank Stock Return and Change in Sovereign Credit Risk

This table shows the effect of sovereign credit risk on bank stock returns during the financial crisis. The sample includes all European, U.S., and Australian banks with available data on bank CDS and share prices. The data are at the weekly level. Columns (1) to (3) cover the pre-bailout period (1/1/2007-31/8/2010), Columns (4) to (6) cover the bailout period (9/1/2008-10/31/2008), and Columns (7) to (9) cover the post-bailout period (November 2008 to August 2010). The dependent variable is the weekly bank stock return. The main independent variable is the weekly change in the sovereign CDS. The sovereign CDS is assigned based on the country where the bank is headquartered. The control variables are the change in CDS market index and volatility. Columns (2), (3), (5), (6), (8), and (9) include week fixed effects. Column (3), (6), (9) include bank fixed effects and interactions of bank fixed effects with volatility and the CDS Market index. The standard errors are clustered at the bank-level.

** 1% significant, * 5% significant, and + 10% significant

<table>
<thead>
<tr>
<th>Period</th>
<th>Pre-Bailout (Jan 07-Aug 08)</th>
<th>Around Bailout (Sep-Oct 08)</th>
<th>Post-Bailout (Nov 08-Sep 10)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>∆ Log(Sovereign CDS)</td>
<td>-0.011**</td>
<td>-0.002</td>
<td>-0.002</td>
</tr>
<tr>
<td></td>
<td>(0.004)</td>
<td>(0.002)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>∆ Log(CDS Market Index)</td>
<td>-0.106**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.015)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>∆ Volatility Index</td>
<td>-0.368**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.070)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Week FE</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Bank FE</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Interactions</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Observations</td>
<td>2,895</td>
<td>2,895</td>
<td>2,895</td>
</tr>
<tr>
<td>Banks</td>
<td>65</td>
<td>65</td>
<td>65</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.070</td>
<td>0.240</td>
<td>0.311</td>
</tr>
</tbody>
</table>
Table 7: Summary Statistics of European Bank Stress Test Sample

The table shows summary statistics for all banks that participated in the EU Bank Stress Tests from July 2010. The data was collected from the website of the Committee of European Banking Regulators and nation websites of the respective bank regulators. The sovereign holdings are computed as the total value of sovereign holdings relative to risk-weighted assets. We report both the gross and net exposure as reported to bank regulators. The share of trading book and banking book are the share of sovereign holdings held in the respective book. The shares are computed based on gross exposure (net exposure was not reported).

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Mean</th>
<th>Std.Dev</th>
<th>50th Percentile</th>
<th>5th Percentile</th>
<th>95th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank Characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk-weighted Assets (EUR million)</td>
<td>91</td>
<td>126,337</td>
<td>179,130</td>
<td>63,448</td>
<td>3,269</td>
<td>493,307</td>
</tr>
<tr>
<td>Tier 1 Capital Ratio (%)</td>
<td>91</td>
<td>10.2</td>
<td>2.4</td>
<td>9.8</td>
<td>7.2</td>
<td>14.4</td>
</tr>
<tr>
<td><strong>Sovereign Exposure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sovereign Holdings (gross, EUR million)</td>
<td>91</td>
<td>20,668</td>
<td>27,948</td>
<td>7,930</td>
<td>105</td>
<td>81,765</td>
</tr>
<tr>
<td>Sovereign Holdings (net, EUR million)</td>
<td>91</td>
<td>19,719</td>
<td>27,329</td>
<td>6,960</td>
<td>105</td>
<td>78,959</td>
</tr>
<tr>
<td>Home Sovereign Holdings (gross, EUR million)</td>
<td>91</td>
<td>11,493</td>
<td>14,422</td>
<td>5,774</td>
<td>182</td>
<td>42,800</td>
</tr>
<tr>
<td>Home Sovereign Holdings (net, EUR million)</td>
<td>91</td>
<td>11,023</td>
<td>13,956</td>
<td>5,348</td>
<td>117</td>
<td>42,800</td>
</tr>
<tr>
<td>Home Share (%)</td>
<td>91</td>
<td>69.4</td>
<td>30.0</td>
<td>81.6</td>
<td>18.9</td>
<td>100</td>
</tr>
<tr>
<td>Greek Sovereign Holdings</td>
<td>91</td>
<td>669</td>
<td>2,844</td>
<td>0</td>
<td>0</td>
<td>5,601</td>
</tr>
<tr>
<td>Share Banking Book (%)</td>
<td>91</td>
<td>84.9</td>
<td>19.9</td>
<td>92.2</td>
<td>35.4</td>
<td>100.0</td>
</tr>
</tbody>
</table>
The table shows regression of change in bank CDS on change in exposure to sovereign bank holdings. The sovereign bond holdings data were collected from the website of the Committee of European Banking Regulators and nation websites of the respective bank regulators. We construct the exposure variable as the weighted average of country CDS with sovereign holdings as weights. Changes are computed as log changes. The data covers the period from 3/1/2010 to 4/30/2010. Columns (2), (5) and (6) include bank fixed effects. Column (3) includes week fixed effects. Column (4) to (6) include day fixed effect. The exposure variable in Column (6) excludes German bonds. The standard errors are clustered at the bank-level (51 banks). ** 1% significant, * 5% significant, and +10% significant

<table>
<thead>
<tr>
<th>Sample</th>
<th>All (1)</th>
<th>All (2)</th>
<th>All (3)</th>
<th>All (4)</th>
<th>All (5)</th>
<th>All (6)</th>
<th>Excluding Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Sovereign Exposure</td>
<td>0.325** (0.027)</td>
<td>0.326** (0.028)</td>
<td>0.261** (0.027)</td>
<td>0.141** (0.049)</td>
<td>0.135** (0.046)</td>
<td>0.137** (0.046)</td>
<td></td>
</tr>
<tr>
<td>Bank FE</td>
<td>N</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Week FE</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Day FE</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Banks</td>
<td>51</td>
<td>51</td>
<td>51</td>
<td>51</td>
<td>51</td>
<td>51</td>
<td>0.357</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.173</td>
<td>0.188</td>
<td>0.228</td>
<td>0.342</td>
<td>0.357</td>
<td>0.357</td>
<td>0.357</td>
</tr>
<tr>
<td>Adjusted R-Squared</td>
<td>0.173</td>
<td>0.170</td>
<td>0.224</td>
<td>0.329</td>
<td>0.329</td>
<td>0.329</td>
<td>0.329</td>
</tr>
</tbody>
</table>