Banking Supervisory Architecture and Sovereign Risk

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This paper analyzes the influence of the banking supervisory architecture on sovereign risk. We focus on the implementation of the Single Supervisory Mechanism (SSM) Europe, as it involved a change in supervisor – from national to supranational authorities – for a significant fraction of the European banking industry. Using a sample of 31 European countries (19 of them under the SSM framework) during the 2011–2018 period, we obtain that the implementation of a supranational banking supervisor leads to relatively lower sovereign risk in countries subject to the SSM framework compared to countries where banking supervision is conducted exclusively by national authorities.

We also demonstrate that banking stability is one of the channels underlying the positive relationship between the establishment of a supranational banking supervisory framework and sovereign risk. Specifically, we find evidence that an increase in the degree of banking stability caused by the implementation of supranational supervision reduces sovereign risk. Moreover, we find evidence that this effect is shaped by the characteristics of the banking sector, in terms of profitability and the market structure, and by the quality of the institutional environment. The risk-reducing effect associated with the SSM is more relevant in banking systems that are less profitable and less concentrated and in countries where the quality of institutions and regulatory features do not assist in properly disciplining banking market participants.

This research paper sheds light on the importance of the regulatory tightening imposed on banks following the Global Financial Crisis in 2008. In fact, that crisis period launched a debate about the optimal design of bank supervision. Although national supervisors may have informational advantages over a supranational supervisor, supranational supervision may create synergies among different supervisory functions as well as expertise. At the same time, supranational supervision could mitigate the local biases of national supervisors. In this sense, our study highlights the positive effect of the SSM framework, which enhances bank stability and reduces sovereign risk in Europe. Hence, international authorities should consider these results when designing policies (including those regarding the next steps in completing the European Banking Union) to prevent bank failures and ensure the financial stability of the entire system.