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Measuring Systemic Vulnerability in European Banking Systems

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ABSTRACT

We construct a measure of systemic vulnerability in selected EU banking systems using an indirect, time-varying measure of the system covariance. Systemic vulnerability indicates the extent to which a banking system as a whole is sensitive to a negative shock. We proceed to examine to what extent the resulting measures of systemic vulnerability provide a convincing narrative of events during the period January 2000 to April 2016. The results provide evidence of: (i) rising vulnerability prior to the outbreak of the international financial crisis in 2007/08 in countries with banks exposed to toxic assets; (ii) vulnerability associated with the euro area sovereign debt crisis from 2009/10; and (iii) continued concerns from 2013 onwards regarding the need for euro area banks to improve their balance sheets and raise new capital at a time of sluggish profitability.

Keywords: euro area financial crisis, systemic vulnerability, financial instability, European banks

JEL Classification: E3, G01, G14, G21

Measuring Systemic Vulnerability in European Banking Systems

1. Introduction

The idea that systemic stress in the banking system can potentially result in financial instability, with its consequent costs for the real economy, is by no means new. As far back as the mid-1970s, Lamfalussy focused on the potential build-up of macroeconomic

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