

IN-DEPTH ANALYSIS

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# The impact of geopolitical shocks on banks' financial soundness in the Banking Union



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BANKING UNION

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# The impact of geopolitical shocks on banks' financial soundness in the Banking Union

## **Abstract**

Geopolitical tensions have emerged as a major source of macro-financial instability, with conflicts, sanctions, and global rivalries introducing risks that differ from traditional credit or market shocks. These events are difficult to anticipate and propagate through financial markets, the real economy, and operational channels, often amplifying into systemic consequences. Recent research shows that banks reallocate rather than withdraw—cutting cross-border lending but maintaining affiliate activity—while capital requirements calculated at consolidated level may transmit foreign shocks to domestic credit supply. Stronger capital buffers cushion these effects. Overall, major geopolitical shocks raise funding costs, weaken bank stability, and disrupt financial infrastructure, underscoring the need for robust governance, releasable buffers, scenario-based supervision, more coordinated micro and macro prudential regulation, and overall strengthened international coordination.

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## LIST OF ABBREVIATIONS

<b>CDS</b>	Credit Default Swap
<b>ECB</b>	European Central Bank
<b>EU</b>	European Union
<b>GDP</b>	Gross Domestic Product
<b>GPR</b>	Geopolitical Risk
<b>SSM</b>	Single Supervisory Mechanism
<b>US</b>	United States

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## EXECUTIVE SUMMARY

Geopolitical tensions have become a first-order threat to macro-financial stability. Events such as Russia's invasion of Ukraine, the Israel–Palestine conflict, United States (US)–China trade frictions and broader shifts in global power balances are reshaping the global landscape and introducing new risks for European banks and supervisors. While the Banking Union was designed to deal with more traditional risks such as credit, market and operational risk, geopolitical shocks are harder to anticipate *ex ante* and, once they materialise, propagate through multiple channels with the potential for systemic amplification. Reflecting their growing importance, geopolitical risks have been identified as the first priority in the Single Supervisory Mechanism (SSM) Supervisory Priorities for 2025–2027.

A useful way to organise the analysis is to distinguish between drivers, transmission channels and manifestations. The drivers of geopolitical risk include wars, sanctions, great-power competition and cyber hostilities, which differ from conventional risk drivers as they are less amenable to historical or statistical modelling. These shocks travel through three interconnected channels. The first is the financial markets channel, where shocks trigger uncertainty, valuation losses and higher funding costs. The second is the real economy channel, where disruptions to trade, supply chains and investment weaken corporate repayment capacity and loan demand. The third is the safety and security channel, where geopolitical tensions manifest as cyberattacks or operational disruptions that undermine financial infrastructure. Ultimately, these channels translate into familiar banking risk categories—credit, market, liquidity, operational, legal and reputational risk, but their interaction magnifies vulnerabilities and often leads to contagion, procyclical amplification, and cross-border spillovers. It also engenders financial market fragmentation, which poses a threat to financial stability in itself by reducing opportunities for international risk sharing and diversification

Measuring these risks remains a challenge. Drawing from recent literature, Caldara and Iacoviello's text-based Geopolitical Risk (GPR) index remains the standard reference and shows that rising geopolitical risk reduces investment and employment and increases volatility. Other approaches include market-based indicators drawn from options and spreads, expert ratings and, more recently, computational linguistics applied to earnings calls and industry transcripts. These newer methods capture exposures at the firm, sector and bank level, revealing a more granular picture of how risks are perceived and transmitted.

Recent research highlights how banks adjust their behaviour in response to geopolitical shocks. Banks with exposures to affected countries face higher credit risk not only on directly exposed loans but across balance sheets. Nevertheless, banks do not fully withdraw. They reduce cross-border lending but continue to lend through foreign affiliates, partly funded with local deposits, thereby limiting parent liability. Higher geopolitical risk abroad also spills over into domestic credit supply because consolidated capital requirements force banks to conserve capital by cutting lending at home. Stronger capital buffers mitigate but do not eliminate these effects. Other work shows that conflicts reshape lending patterns: foreign banks reduce overall exposure to affected countries but increase financing for military and dual-use sectors.

At the systemic level, geopolitical risk reduces bank stability and capitalisation, although the effects are non-linear. Moderate increases in geopolitical risk tend to have limited solvency effects, but extreme shocks erode capital ratios and increase systemic risk. For borrowers, geopolitical uncertainty raises financing costs: loan spreads widen, interest rates increase and funding costs rise, especially for globally integrated firms. Exposed banks also face higher market volatility, lower stock returns and elevated credit default swaps (CDS) spreads. Beyond balance sheets, geopolitical risk undermines financial infrastructure by reducing the likelihood of establishing cross-border fast payment system links, thereby raising transaction costs and counterparty risk and accelerating financial fragmentation.

For supervisors and policymakers, these findings highlight the need for stronger governance, risk data and capital and liquidity planning at the bank level, coupled with robust operational resilience against cyber and country-specific threats. Macroprudential tools, in particular releasable capital buffers, are well suited to absorbing shocks while preserving credit supply. Scenario analysis, both quantitative and qualitative, is essential for testing the resilience of banks and the system as a whole under unconventional shocks characterised by uncertainty and interconnection with other risks such as climate change or energy disruptions. Hybrid approaches, such as reverse stress testing, may also be particularly effective in combining the supervisory perspective with banks' own assessments of geopolitical exposure. These approaches leverage the granularity of data and analysis available only to banks, while operating within a sound and consistent supervisory framework. This makes them especially valuable given the inherently unpredictable nature of geopolitical risk, as they enable the development of plausible yet forward-looking scenarios that capture both systemic and institution-specific vulnerabilities. Finally, effective responses require close coordination within the European Union (EU) and with international partners. While global cooperation has become more difficult, a collective effort to strengthen engagement and prevent economic and financial fragmentation remains critical.

Overall, the emerging literature and supervisory debate underline that geopolitical risk is a distinct and increasingly important driver of financial instability. Its manifestations are diffuse, harder to forecast and more prone to systemic spillovers than conventional risks. Safeguarding financial stability in this environment requires a comprehensive agenda combining better measurement, scenario planning, robust micro- and macroprudential buffers, strengthened operational resilience and international coordination.

## 1. INTRODUCTION

In the past few years, geopolitical events have emerged as a significant threat to economies and societies. The war in Ukraine and the resulting economic sanctions, the Israel–Palestine conflict, the China–US trade disputes, and broader shifts in global power dynamics have all intensified uncertainty. These developments carry potential repercussions for the stability of financial markets and banking systems, including for European banks.

The Banking Union, established to safeguard a stable and integrated banking system in the euro area, was originally designed to address risks such as credit, market, and operational risks. Geopolitical risks, however, introduce a new set of challenges that require heightened monitoring and preparedness from both banks and their supervisors. Reflecting their growing importance, geopolitical risks have been designated as the first key element in the SSM Supervisory Priorities for 2025–2027. Such risks, however, are inherently difficult to anticipate *ex ante* and, once materialized, can take multiple forms, directly or indirectly affecting banks' balance sheets.

This analysis first develops a conceptual framework for defining and understanding geopolitical risk. It then reviews the available literature on its measurement, transmission channels, and effects on banks. Finally, it discusses current and planned supervisory activities to address this emerging risk, as well as possible avenues for future improvement.

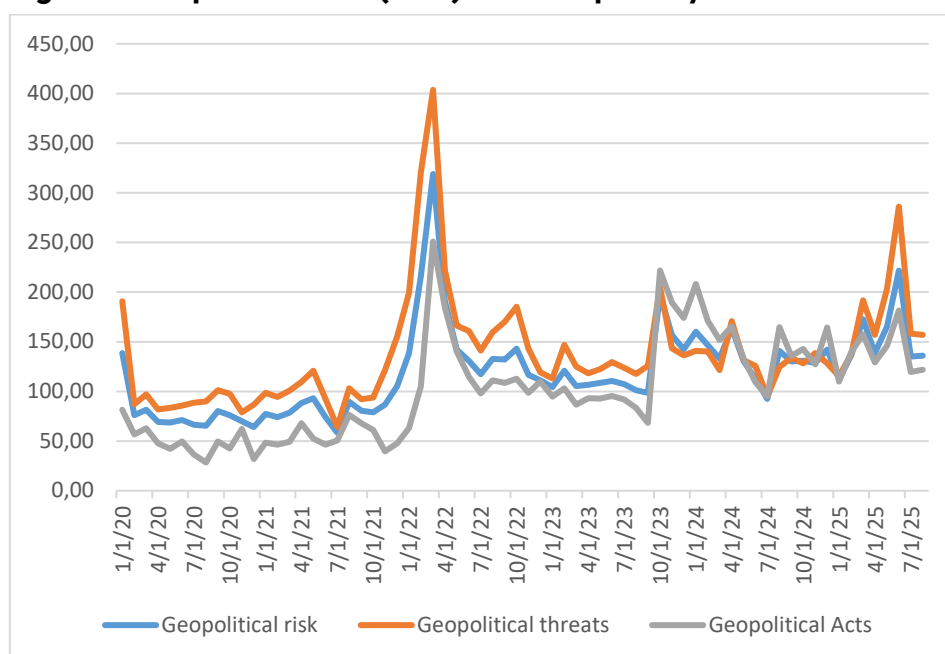
## 2. DEFINING GEOPOLITICAL RISK: DRIVERS AND TRANSMISSION CHANNELS

### 2.1. Definition and Risk Drivers

Although political and geopolitical risk is frequently discussed, its precise definition often remains unclear. A widely adopted definition, used in both academic studies on geopolitical risk and supervisory analyses (e.g., Behn et al., 2025), is provided by Caldara and Iacoviello (2022), who define geopolitical risk as the “threat, realisation, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations.”

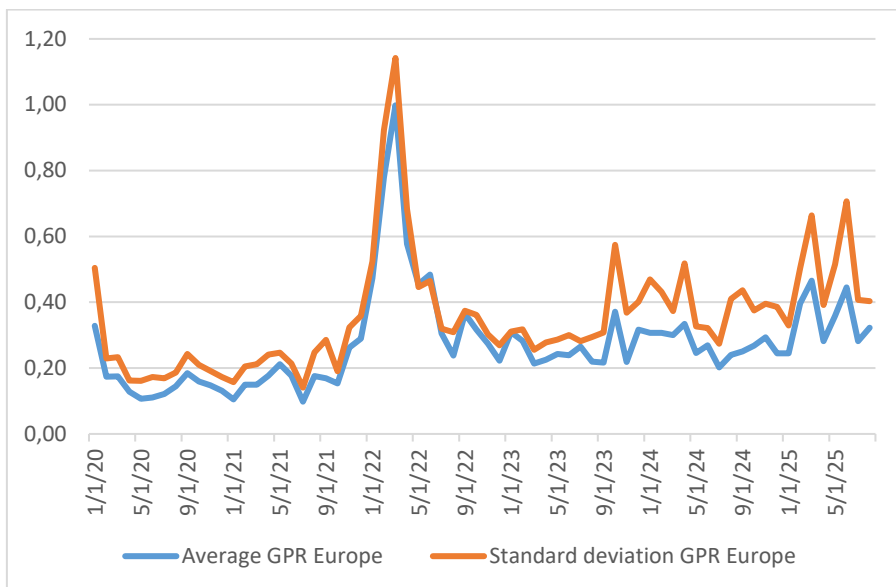
As shown in **Figure 1**, over the past 5 years, geopolitical risk has increased, both in terms of threats and acts, with peaks in early 2022, at the time of the Russian invasion of Ukraine and in spring 2025 with the trade war initiated by the US administration. However, as shown in **Figure 2**, while geopolitical risk has gone up for all European countries, it has affected different countries differently, as can be seen with an increase in the standard deviation across the 15 European countries, for which data are available (we exclude Ukraine).

**Figure 1: Geopolitical Risk (GPR) over the past 5 years**



Source: authors' calculations based on data by Caldara and Iacoviello (2022)

**Figure 2: Geopolitical Risk (GPR) over the past 5 years in Europe**



Source: authors' calculations based on data by Caldara and Iacoviello (2022)

Given this broad definition, the triggering events or risk drivers—namely the underlying factors or conditions that can initiate or increase the likelihood of a risk materializing—are multiple. According to Buch (2024), geopolitical risk drivers, which are the root causes influencing the severity or probability of a potential adverse outcome, differ fundamentally from conventional risk drivers. Conventional drivers, such as those behind credit, market, and liquidity risk, can typically be assessed using historical data, statistical models, and readily available economic indicators. By contrast, geopolitical risks arise from political events, shifts in international relations, or societal transformations, which are less amenable to quantitative analysis and therefore not easily captured by traditional risk measurement approaches.

**Table 1** provides examples of key geopolitical risk drivers, related events, and their potential impacts on economies, societies, and financial markets.

**Table 1: Key Drivers of Geopolitical Risk**

Driver	Examples	Potential Impact
<b>Military conflicts</b>	War in Ukraine; conflicts in the Middle East	Energy price shocks, financial market volatility, trade and supply chain disruptions
<b>Economic sanctions</b>	EU/US sanctions on Russia and Iran	Supply chain interruptions, higher input costs, reduced global trade flows
<b>Political instability</b>	Contested elections; abrupt government changes	Regulatory uncertainty, weakened policy credibility, reduced investor confidence
<b>Terrorism / Cyberattacks</b>	Terrorist incidents; large-scale cyberattacks	Operational disruptions, systemic market instability, heightened risk premia
<b>Trade tensions</b>	US–China trade disputes; regional power rivalries	Disrupted trade flows, reduced global growth prospects, increased market uncertainty
<b>Climate-related tensions</b>	Water scarcity in South Asia; disputes over Arctic routes	Resource competition, migration pressures, volatility in commodity markets
<b>Migration pressures</b>	Refugee flows from conflict zones; cross-border tensions	Strains on public finances, social unrest, increased populism and protectionism
<b>Technological rivalry</b>	US–China competition over semiconductors and AI	Supply chain fragmentation, reduced cross-border investment, bifurcation of standards
<b>Global governance gaps</b>	Fragmentation of multilateral institutions (e.g., WTO, UN)	Weaker conflict resolution mechanisms, rising uncertainty, erosion of investor trust

The numerosity of root causes, together with their interconnections with other emerging sources of risk (e.g., climate change and cybersecurity), explains why the effects of geopolitical risks are difficult to predict—not only in terms of probability but also in terms of intensity. Moreover, their multifaceted nature underscores the complexity of these risks. This complexity calls for a conceptual framework that can help clarify and interpret the relationships and impacts on banks and financial markets, which we will attempt to develop in the next section.

## 2.2. Transmission channels

As said, geopolitical risks affect banks and financial markets through multiple, often interconnected pathways. To analyse their impact consistently it is useful to distinguish between drivers, transmission channels, and risk manifestations, while also recognizing the potential for systemic amplification. As shown in **Table 1**, at the driver level, shocks can originate from diverse sources, which nonetheless share the potential to disrupt financial and economic stability on both a regional and global scale.

These shocks propagate through three primary transmission channels, as highlighted by European supervisors (see also Buch, 2024).

The first is the financial markets channel. Geopolitical shocks often trigger sharp increases in uncertainty and investor risk aversion. For banks, this may translate into mark-to-market losses on securities portfolios, higher value-at-risk exposures, and rising funding costs. Liquidity strains may also emerge as investors shift toward safe-haven assets, reducing market liquidity and creating sudden outflows from riskier jurisdictions. For instance, following the invasion of Ukraine in 2022, European banks suffered valuation losses on Russian exposures and faced higher spreads in bond markets.

The second is the real economy channel, through which geopolitical events disrupt trade flows, supply chains, and investment. Such disruptions reduce revenues, increase costs, and depress growth, effects

that spill over into banking balance sheets. The consequences include higher borrower defaults, especially in sectors reliant on international trade or energy inputs, and reduced loan demand and profitability for banks. As Aiyar et al. (2023) emphasize, geoeconomic fragmentation may transform temporary disruptions into more persistent breaks in global value chains and cross-border capital flows. A recent example is the rise in input costs for European corporates following EU sanctions on Russia, which weakened their repayment capacity and increased credit risk for banks.

The third is the safety and security channel, which reflects how geopolitical risks threaten the operational resilience of banks and the wider financial system. Cybersecurity threats, such as state-sponsored attacks, can compromise financial infrastructure. Operational disruptions may occur through interruptions in payment systems, cloud services, or other critical third-party providers, while physical risks may include terrorist incidents or localised conflicts that damage bank branches or data centres. The NotPetya cyberattack in 2017, widely linked to geopolitical tensions, is an example of how politically motivated cyber events can disrupt financial operations globally.

At the micro level, through these three channels, geopolitical risks ultimately materialise in the well-established categories of banking risk: credit risk, market risk, liquidity and funding risk, operational risk, and legal or reputational risk. For example, sudden geopolitical tensions can impair borrowers' repayment capacity, trigger abrupt asset price corrections, disrupt access to wholesale funding markets, interfere with the smooth functioning of operations, or expose institutions to litigation and reputational damage.

Importantly, these risk manifestations seldom remain confined to a single category or institution. Instead, they tend to interact and reinforce one another, creating feedback loops that magnify vulnerabilities (see also [Section 3.2](#)). Such dynamics can escalate into systemic consequences, including contagion across markets and institutions, procyclical amplification of shocks, and cross-border spillovers that extend far beyond the jurisdictions directly affected. In this respect, geopolitical risk differs from many conventional drivers: its manifestations are not only harder to anticipate with precision but also more likely to generate widespread and persistent instability in the financial system. At the macro-financial level, in particular, rising geopolitical tensions can further undermine stability through fragmentation of global financial markets. Measures such as the imposition of financial restrictions, or the uncertainty and increased risk aversion that geopolitical shocks generate, may prompt international investors to reallocate portfolios and credit lines away from geopolitically distant countries. This can determine capital outflows, depress asset prices, and place pressure on exchange rates, amplifying vulnerabilities in both advanced and emerging markets. Over the longer term, persistent financial fragmentation reduces opportunities for international risk-sharing and diversification, leaving countries more exposed to adverse domestic and external shocks and raising the probability of systemic crises. The effects are unlikely to be uniform across countries: those with stronger economic and financial ties to the source of geopolitical tensions are likely to be disproportionately affected if such tensions escalate (IMF, 2023).

### 3. HOW TO MEASURE GEOPOLITICAL RISK

Although difficult to assess, recent empirical work has attempted to measure both the exposure of banks and countries to geopolitical risk, along with its effects on the banking and financial system. In this section, we first illustrate the main findings of this nascent stream of literature. We then expand on scenario analysis as a more qualitative approach to gain a broad understanding of risk drivers and transmission channels, which may provide a conceptual framework to guide both banks' and policy makers' actions.

#### 3.1. Literature review on exposure to (and effects of) geopolitical risk

The recent geopolitical events have given rise to a small but rapidly expanding literature on the effects of such shocks on banks' behaviour. In the following, we offer a brief summary of this emerging literature, placing emphasis on how researchers have measured exposure to geopolitical risk and its effects—first, on macroeconomic variables, and second, more specifically, on the banking system.

Geopolitical events represent a source of uncertainty that is difficult to anticipate and quantify. Karagozoglu et al. (2022) provide a comprehensive overview of the main indices used to capture geopolitical risk, explaining their methodologies and applications. They propose three categories of measures. *Market-based indicators* derive information from asset price volatility, such as options or sovereign spreads, and thus reflect investors' perceptions of risk in real time. *Text-based measures* are constructed from systematic analysis of newspapers, policy reports, and other textual sources to identify and quantify geopolitical events. Finally, *rating measures* are based on expert assessments, often compiled by specialized agencies, and provide risk scores for specific countries or regions.

**GPR and real effects.** The most widely used benchmark in the literature is the text-based GPR index developed by Caldara and Iacoviello (2022), which measures the monthly share of newspaper articles discussing adverse geopolitical events and related threats. The authors show that heightened geopolitical risk reduces aggregate investment and employment.

Because it provides a consistent and replicable measure of geopolitical tensions over time, the Caldara and Iacoviello index remains the standard reference. Using this indicator, Wang et al. (2025) find that geopolitical risk lowers corporate investment at the firm level, with stronger effects for firms facing more irreversible investment or possessing greater market power. The effect, however, is less significant for firms with a stronger ability to substitute labour for capital. Smales (2021) shows that increases in geopolitical risk are associated with higher oil prices and stock market volatility, as well as positive oil returns and negative stock returns—consistent with geopolitical risk being closely linked to supply disruptions.

Other research has developed more granular measures that capture the heterogeneity of geopolitical risk for different firms and sectors. A first step in this direction is provided by Hassan et al. (2019), who apply computational linguistics to quarterly earnings calls of US companies to measure the share of discussions devoted to political risks. This methodology offers a firm-level perspective, linking geopolitical concerns directly to corporate exposures and extending the analysis beyond aggregate indices. Building on this approach, Culver et al. (2025) construct an industry-level sentiment index of geopolitical risk based on

more than 240,000 earnings call transcripts from 2002 to 2024. By capturing both the frequency and tone of discussions, their measure distinguishes between perceived threats and opportunities.

Using an event study methodology, Anttonen and Lehmus (2025) examine the real macroeconomic effects of the Russia–Ukraine war and the Israel– Hamas conflict on the euro area. The authors find that both events reduced gross domestic product (GDP), although with opposite inflationary effects: the Russia–Ukraine war was inflationary (a supply-side shock), whereas the Israel– Hamas conflict was deflationary (a demand-side shock). This heterogeneity illustrates how different geopolitical events can have distinct macroeconomic implications, including for the financial sector.

**GPR and credit supply.** By combining US supervisory data with geopolitical risk indices, Niepmann and Shen (2025) construct a bank-specific indicator of exposure and analyse banks' reactions to geopolitical shocks. They examine how US banks adjust their exposure to countries experiencing rising geopolitical risk and explore the implications for domestic credit—specifically, whether spillover effects occur. The authors find that when geopolitical risk increases in countries where banks operate, US banks continue lending to those markets through their foreign affiliates while simultaneously reducing cross-border lending. This asymmetric adjustment appears specific to geopolitical risk, as banks do not exhibit similar behaviour in response to more traditional forms of country risk, such as macroeconomic or sovereign risk. The authors argue that this pattern reflects differences in liability: in cross-border lending, parent banks remain fully liable for losses, whereas lending through foreign affiliates—partly funded by local deposits—limits the parent's exposure. Geopolitical risk abroad also generates spillovers into domestic credit supply through capital requirements applied at the consolidated level. This occurs because higher geopolitical risk increases consolidated risk-weighted assets, which—*ceteris paribus*—tightens the regulatory capital constraint for the parent company. As a result, US global banks reduce commercial and industrial lending to domestic firms when foreign geopolitical risk rises. Better-capitalized banks, however, adjust less, underscoring the role of balance sheet strength, via a sounder capital position, in mitigating transmission. Finally, the authors show that these spillovers are driven more by perceived threats than by realized events, highlighting uncertainty as a key transmission channel.

Using syndicated loan data across countries over the period 1989–2020, De Haas et al. (2025) find that foreign banks reduce overall lending to affected countries relative to domestic banks, but significantly increase financing to military and dual-use sectors during conflicts. This reallocation is stronger among foreign banks that are less specialised in the conflict country, but more specialised in military lending, and domiciled in politically non-aligned nations. Conflicts thus imply a reallocation of bank lending, redirecting finance toward military sectors, despite a reduction in banks' overall country exposure.

Focusing on a specific conflict, the pre-2022 conflict in Eastern Ukraine, Pham et al. (2022) show that banks with higher loan exposure in the conflict area are also left with a higher level of non-performing loans in the non-conflict markets following the onset of the dispute. This spillover effect is stronger in the regional markets geographically closer to the conflict zone. There is also evidence of the “flight to headquarters” effect in local lending, with lending declining in regional markets located farther from head offices.

Using a sample of over 2,400 banks from 19 countries during the period 2010–2019, Demir and Danisman (2021) compare the effects of economic uncertainty and geopolitical risk on bank credit growth and find

that economic uncertainty causes a significant decrease in overall bank credit growth, while no such significant overall effect of geopolitical risk is documented. Analysis by loan type shows that the strongest negative impact of economic uncertainty is observed on corporate loans, whereas geopolitical risk primarily dampens consumer and mortgage lending.

Nguyen and Thuy (2023), using US syndicated loan data between 1991 and 2019, show that geopolitical risk is associated with higher loan prices and more stringent non-price loan terms. They also find that the effects of geopolitical acts on the cost of bank loans and non-price terms are more pronounced than those of geopolitical threats.

Paltalidis and Zhang (2025) use a firm-level measure of GPR exposure and US syndicated loans to investigate banks' lending behaviour under heightened perceived geopolitical risk. They find that borrowers face higher loan spreads (equivalent to about 30 basis points) when their lenders perceive geopolitical risk to be high. This effect is amplified for borrowers with greater reliance on global supply chains or foreign markets, and for lenders with higher foreign exposure, those headquartered in politically conservative states, or those issuing loans during periods of political uncertainty. Under elevated geopolitical risk, lenders also tend to reduce lending to firms in high-GPR-exposure industries while reallocating funds toward firms in low-exposure industries.

Geopolitical risk also influences banks' funding costs, as evidenced after the Russian invasion of Ukraine. Dadoukis et al. (2025) find that banks with higher direct credit exposures to Russia, more branches located in affected areas, and larger investments in energy-intensive corporations experienced higher funding costs, lower stock returns, greater stock price volatility, and higher CDS spreads throughout 2022.

**GPR and bank stability.** Using data on 540 US banks over the period 1999 to 2019, Phan et al. (2022) show that geopolitical risk (as measured by the Caldara and Iacoviello index) reduces bank stability (as measured by the z-score, a balance-sheet measure of distance from default); however, higher capital buffers mitigate such effect.

Taking a different perspective, Behn et al. (2025) rely on bank-level data from 17 countries over the past 120 years to examine the long-run impact of geopolitical risk on bank solvency. Drawing on the Caldara and Iacoviello geopolitical risk index, the authors show that a two standard deviation increase in geopolitical risk is associated with a decline of approximately 0.2 percentage points in the capital-to-asset ratio. Importantly, the relationship is non-linear: while small or moderate increases in geopolitical risk have limited effects, very high levels of geopolitical risk lead to a meaningful deterioration in bank capital. This suggests that only major geopolitical events—such as wars or large-scale international conflicts—are likely to threaten bank solvency to a degree that poses risks to financial stability. The authors also find that the effects vary across countries, with larger impacts observed in those more directly affected by geopolitical events. Their historical perspective allows them to capture extreme episodes often missed in more recent datasets, and they highlight several channels through which geopolitical shocks may weaken bank capital, including macroeconomic disruptions, declines in asset valuations, and heightened sovereign risk. Overall, the study underscores the importance of

distinguishing between routine geopolitical fluctuations and rare but severe shocks when assessing the financial system's resilience.

Focusing on the euro area, Avril et al. (2025) use bank-level data spanning from the first quarter of 2015 to the third quarter of 2024 to examine the effects of a surge in trade policy uncertainty on bank stock prices, CDS spreads, bond spreads, the cost of risk, return on assets, and lending. The results indicate that an increase in trade policy uncertainty has significant adverse effects on banks' stock prices as well as on CDS and bond spreads. It also leads to higher provisioning, lower profitability, and reduced lending to the real economy. The gradual build-up of these effects over time highlights the persistent impact of heightened uncertainty on economic activity. Higher solvency ratios help mitigate some of the negative consequences of trade policy uncertainty, whereas the adverse effects are more pronounced for banks with greater exposure to sectors reliant on extra-EU trade.

Finally, geopolitical risk affects financial infrastructure. Minesso et al. (2025) highlight disruptions in cross-border payment systems, showing that geopolitical distance significantly reduces the likelihood of establishing and maintaining fast payment system links. This increases transaction costs, settlement delays, and counterparty credit risk. The authors conclude that geopolitical alignment is the most powerful predictor of global payment interlinking, and that rising geopolitical risk diminishes cross-border payment connectivity, potentially fragmenting the global financial system into regional blocs.

**Table 2** provides a schematic overview of the literature, grouping papers according to the channels through which geopolitical risk affects the financial system.

**Table 2: Recent evidence on geopolitical risk and its effects on banking**

Channel / Dimension	Paper	Measure / Metric	Main Contribution / Findings
Financial-markets channel	Caldara & Iacoviello (2022)	Text-based GPR index from newspapers	Heightened geopolitical risk raises the probability of economic downturns and reduces investment and employment.
	Karagozoglu et al. (2022)	Survey of GPR indices (market-, text-, and rating-based)	Classifies major GPR measures and compares methodological strengths and limitations.
	Smales (2021)	Oil and stock market volatility, returns	GPR increases oil price volatility and returns, and lowers stock returns—consistent with supply-disruption effects.
	Minesso et al. (2025)	Cross-border payment-system (FPS) data	Geopolitical distance reduces payment connectivity and increases transaction costs and counterparty risk.
	Paltalidis & Zhang (2025)	Loan-level spreads (US syndicated loans)	Higher perceived GPR raises loan spreads; effects stronger for firms with global-supply-chain exposure.

Channel / Dimension	Paper	Measure / Metric	Main Contribution / Findings
<b>Real-economy channel</b>	Wang et al. (2025)	Firm-level investment data + GPR index	GPR lowers corporate investment, especially for firms with irreversible investment or high market power.
	Anttonen & Lehmus (2025)	Event-study (Russia–Ukraine; Israel–Hamas)	Both conflicts reduced euro-area GDP; Ukraine war inflationary (supply shock), Israel–Hamas deflationary (demand shock).
	De Haas et al. (2025)	Global syndicated-loan data (1989–2020)	Foreign banks reduce total lending but reallocate credit toward military / dual-use sectors during conflicts.
	Pham et al. (2022)	Ukrainian conflict, regional bank data	Conflict exposure raises NPLs and causes “flight-to-headquarters” in regional lending.
<b>Credit-supply and bank-behaviour channel</b>	Niepmann & Shen (2025)	Bank-specific exposure index (US supervisory data + GPR)	Banks with higher foreign GPR exposure cut cross-border lending but maintain affiliate lending; spillovers to domestic credit.
	Demir & Danisman (2021)	Cross-country bank-credit data (2010–2019)	Economic uncertainty strongly reduces credit growth; GPR mainly affects consumer / mortgage loans.
	Nguyen & Thuy (2023)	US syndicated loans (1991–2019)	GPR raises loan prices and tightens non-price terms; effects stronger for geopolitical acts than threats.
	Dadoukis et al. (2025)	Market pricing of bank equity & debt	Banks exposed to Russia face higher funding costs, CDS spreads, and volatility.
<b>Bank stability &amp; systemic risk channel</b>	Phan et al. (2022)	US bank panel (z-score, 1999–2019)	Higher GPR lowers bank stability; stronger capital buffers mitigate the effect.
	Behn et al. (2025)	Long-run bank-level panel (17 countries, 1900–2020)	Major GPR shocks reduce bank capital ratios; nonlinear effects—only large shocks threaten solvency.
	Avril et al. (2025)	Euro area bank-level panel (2015–2024)	Trade policy uncertainty can have adverse repercussions for euro area banks through financial markets and balance sheet effects.
<b>Financial-infrastructure channel</b>	Minesso et al. (2025)	Cross-border payment-system data	Geopolitical alignment predicts payment-system links; rising GPR fragments global payment networks.

Taken together, the literature highlights the multifaceted impact of geopolitical risk, with important distinctions between its effects on real macroeconomic variables and the banking system, as well as across different regions. On the macroeconomic side, heightened geopolitical tensions are consistently associated with reductions in investment, employment, and GDP, largely due to increased uncertainty and shifts in risk perception. These effects emerge both globally and at the country level, with recent conflicts showing measurable declines in economic activity and heterogeneous inflationary consequences depending on the nature of the shock. At the micro level, firm-specific evidence shows that geopolitical risk dampens corporate investment and increases financing costs, particularly for firms more exposed to international markets and global supply chains.

The effects on the banking system are more complex and often operate through indirect channels such as increased credit risk, capital constraints, and funding pressures. In the US, studies point to an asymmetric response in foreign exposures: banks tend to reduce cross-border lending to high-risk countries while continuing to lend through local affiliates, reflecting differences in liability structures. These foreign shocks also spill over into domestic credit markets, as higher consolidated risk leads to tighter capital constraints and reduced lending to domestic firms. However, better-capitalised banks are more resilient to these pressures. These effects also translate into weaker firm-level outcomes, such as reduced investment and employment, especially when firms are unable to substitute toward less-exposed lenders. At the systemic level, historical evidence suggests that only major geopolitical events lead to meaningful declines in bank capital ratios, particularly in countries directly affected by conflict.

In sum, while the macroeconomic effects of geopolitical risk operate primarily through heightened uncertainty and delayed investment, the banking sector plays a critical role in amplifying and transmitting these shocks, both across borders and into the real economy. Evidence from both the US and Europe underscores the importance of capital strength, the nature of foreign exposures, and the severity of geopolitical events in shaping the transmission of risk.

### 3.2. Exploring the channels through scenario analysis

Geopolitical shocks are only one example of unconventional shocks that can hit the financial system, alongside pandemics, climate shocks, cyber risks, or energy outages. To make the context even more complex, geopolitical risk is often interconnected with these novel risks. For example, cyberattacks on energy grids, ports, or telecommunications infrastructure during geopolitical conflicts can cascade into financial risks, as disruptions affect firms that banks lend to or the value of collateral. Likewise, geopolitical competition (e.g., between the US and China) influences access to critical minerals such as lithium, cobalt, and rare earths, which are essential for green technologies. Restrictions or sanctions raise costs and increase uncertainty for banks financing the energy transition.

Given the Knightian uncertainty surrounding these shocks (i.e., the likelihood of such shocks materialising cannot be observed or measured), traditional risk management tools face limitations when applying them to this kind of shock. Similarly, the lack of equivalent shocks in recent history might make the calibration and thus modelling of such shocks more difficult.

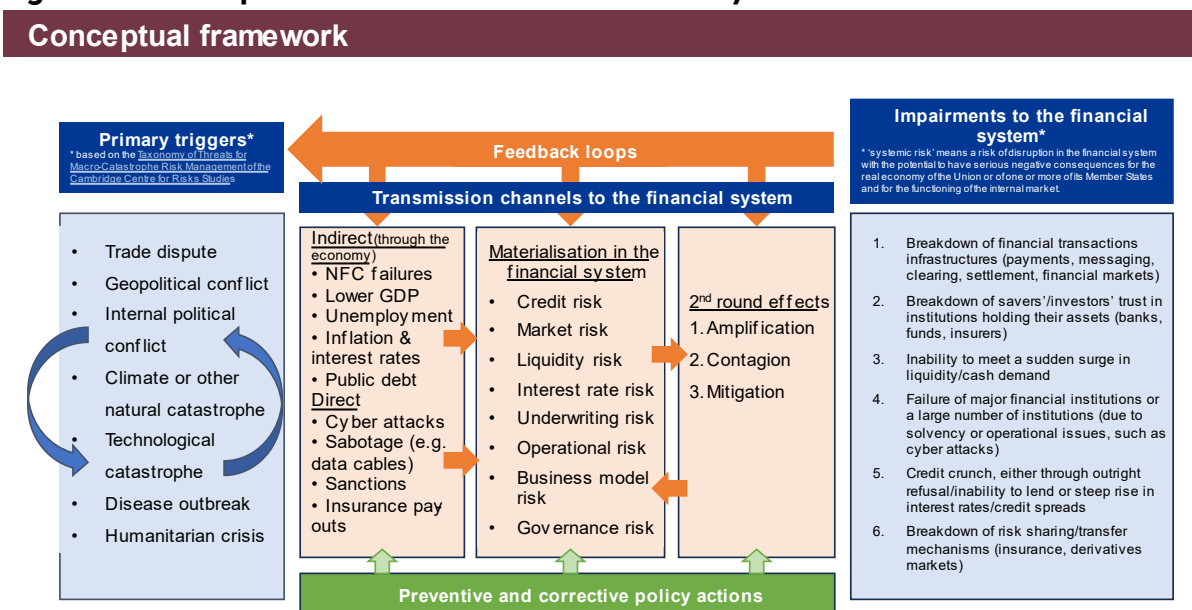
Scenario analysis, both quantitative and qualitative, can be helpful in this context. **Figure 3** reports the

risk drivers presented in [Section 2.1](#) and illustrates how (through which mechanism) they can affect financial system through feedback loops. Primary triggers outside the financial system can result in a deterioration of the macro-financial environment, including lower growth, higher unemployment, inflation and higher interest rates, debt sustainability, asset price corrections (real estate, financial assets). In addition, different shock triggers may be causally connected with each other, occur simultaneously or in sequence and thus exacerbate the impact on the real economy and the financial system.

The direct and indirect channels through which geopolitical shocks affect the financial system—discussed earlier—manifest within individual financial institutions as various types of risks that both banks and their supervisors are already accustomed to monitoring and managing, including credit, market, liquidity, interest rate, and operational risks. Such shocks may also trigger spillover and contagion effects across different institutions, market segments, and borders, thereby amplifying the initial impact. At the same time, a resilient financial system, supported by appropriate regulatory and supervisory responses, can not only withstand such shocks but also help mitigate their broader effects on societies and economies.

The goal of such scenario analysis would be to find, for a given geopolitical shock scenario, the main weaknesses of the financial system as a whole (which might consist of a subset of institutions with a particular exposure to assets severely impaired in the scenario, or a more generalised weakness) and the main propagation channels through which the shocks linked to the scenario could destabilise the financial system (e.g. a second-round variation in asset prices, the contagion effects of the failure of a systemic institution, a wave of defaults, a credit crunch, etc.). This would allow for policy responses aimed at strengthening the resilience of the financial system in such a scenario. Likewise, it can provide banks' risk management functions and boards with a clearer understanding of risk drivers, transmission channels, and potential impacts on their balance sheets, thereby feeding risk models and management practices in a more analytical manner.

**Figure 3: A conceptual framework for a scenario analysis**



Source: Source: ESRB Secretariat; list of primary triggers based on the [Taxonomy of Threats for Macro-Catastrophe Risk Management of the Cambridge Centre for Risks Studies](#)

### 3.3. Examples of plausible GPR scenarios and their effects

Given the uncertainty around the rapidly changing geopolitical and –economic environment, scenario analysis can support traditional risk analysis and stress testing. Unlike stress tests for financial institutions, which are based on general macro–financial assumptions, scenario analysis does not focus on the performance of individual financial institutions, but rather on finding the main weaknesses of the financial system as a whole under a specific scenario, such as a geopolitical shock. Such weaknesses might include a subset of institutions with a particular exposure to assets severely impaired in the scenario and the main propagation channels through which the shocks linked to the scenario could destabilise the financial system, including second–round variation in asset prices, the contagion effects of the failure of a systemic institution or a wave of defaults.

One specific scenario to be considered would be a conflict in the Taiwan strait. Such a scenario could start with a Chinese blockade, cutting off all shipping and air traffic. Even if such confrontation stays below the threshold of military confrontation, there would be important repercussions for the global economy and global financial system. Supply chains relying on Taiwanese providers would be severely disrupted. External fund providers to industries affected by these disruptions, in turn, would see losses increase. This in turn could result in a more general deleveraging cycle within the financial system, affecting sectors and industries not affected in the first round. Even the perspective of such first– and second–round effects, in turn, could lead to swift and dramatic financial market corrections, requiring central banks to step in, providing liquidity and possibly serving as market maker of last resort. The situation would be complicated and possibly exacerbated by political countermeasures by the EU and the US, such as sanctions against China.

Another scenario would be a further escalation of the global trade conflict beyond the US. This could include Increasing tensions between China and the EU due to trade diversion by Chinese producers from the US to Europe and/or spillover effects from the current standoff between the US and China on rare earth export controls. While this would hit some industries, sectors and countries more than others, there could be wider repercussions in the form of a recession in the EU, with consequent negative effects for the banking system, including for their household credit exposure. If governments react with support measures for affected industries, this could also raise again sovereign debt viability concerns and affect sovereign debt yields.

A third scenario would see a further deterioration of relationships between the US and Europe, resulting in hostile US actions in the areas of payment systems and finance, more generally. Such actions could include taxation of returns on US government bonds held by non–US citizens or limiting access to USD liquidity by non–US based financial institutions. The primary direct impact of such actions would be on financial markets, but could also imply sharp exchange rate move changes, which might affect financial institutions with net foreign currency exposures. It would require swift and strong intervention by the ECB, but also close cooperation with central banks in other friendly jurisdictions to address access to USD liquidity and possible market interventions.

A further step in strengthening preparedness involves the use of reverse stress testing, which inverts the traditional approach: rather than evaluating the effects of a predefined shock, it asks which combination of geopolitical events could bring a bank close to failure or cause it to breach regulatory capital thresholds.

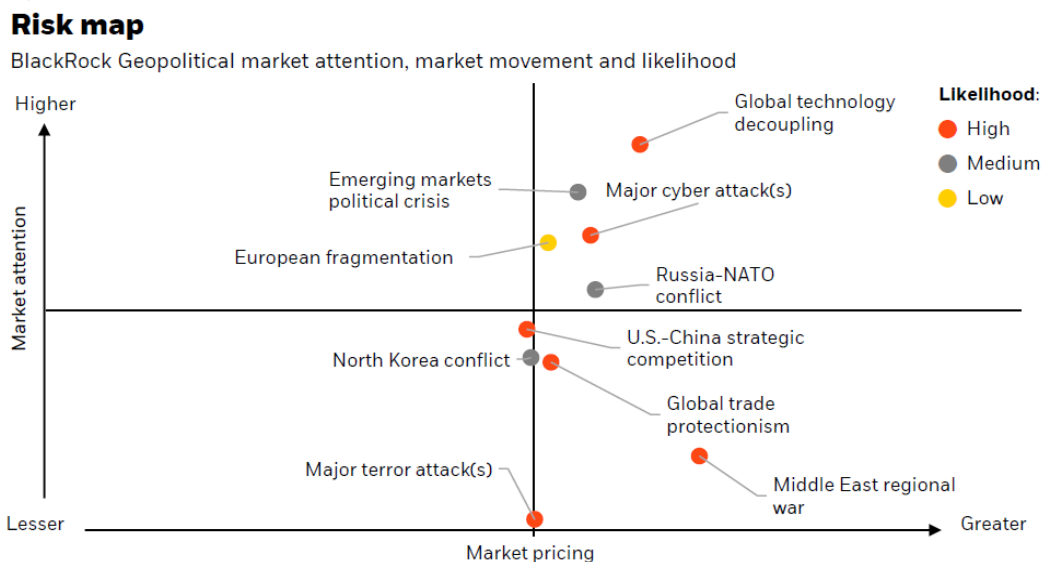
Building on this concept, the ECB's 2026 reverse stress test will provide all significant institutions with a predefined level of capital depletion. Based on this reference point, banks will be required to design specific, plausible geopolitical stress scenarios—along with the underlying assumptions—that could lead to such an outcome. This approach will equip supervisors with a diverse set of institution-specific scenarios while fostering greater self-awareness among banks regarding their vulnerabilities. Ultimately, the combination of forward-looking scenario design and reverse stress testing can help bridge the gap between systemic and institution-level assessments, strengthening the overall resilience of the European banking sector to geopolitical shocks.

### 3.4. Banks' approaches to geopolitical risk

More generally, to ensure that scenarios are both credible and coherent, banks should employ analysts capable of conducting rigorous geopolitical analysis and producing well-grounded forecasts. In this respect, initiatives such as BlackRock's Geopolitical Risk Dashboard (BlackRock, 2025) provide a useful analytical benchmark. The report identifies key risks in the current global landscape and evaluates both their likelihood (ranging from low to high) and their potential impact on asset valuations.

**Figure 4**, for example, maps these triggers by likelihood and illustrates the relationship between market attention to each risk—measured through the frequency of mentions in brokerage reports and financial news—and corresponding market movements. By integrating natural language processing and machine learning techniques, the analysis captures shifts in investor sentiment and market perception over time. This approach offers valuable insights into when geopolitical risks begin to surface on investors' radar and when they start to fade, thereby illuminating how asset prices and market dynamics respond to changes in the geopolitical environment.

**Figure 4: Indicative GPR Map**



Source: BlackRock. Geopolitical risk dashboard (2025)

Financial institutions can leverage such insights to benchmark their own exposures and assess the potential implications for their performance should these risks materialise. It is important to emphasise, however, that the effects of heightened geopolitical risk are highly bank-specific, depending on factors such as sectoral and geographical asset composition, funding structure (particularly the extent of reliance on international financial markets), and the institution's overall business model

For example, a US trade conflict could affect European banks' balance sheets through a combination of credit, funding, and market channels. Weaker global trade and business confidence would first weigh on export-oriented European firms, eroding their revenues and credit quality, which in turn would raise non-performing loans and provisioning needs for banks. At the same time, heightened uncertainty and tighter global liquidity—exacerbated by potential US monetary tightening—could increase banks' funding costs and strain access to dollar liquidity. Financial market volatility triggered by trade tensions would also depress trading income and investment banking revenues, as corporate clients delay capital market activities such as bond issuance, IPOs, and M&A transactions. Together, these effects would compress profitability, reduce capital buffers through lower retained earnings and valuation losses, and heighten liquidity and market risks, leaving banks' balance sheets more vulnerable to adverse shocks.

Yet assessing exposures solely by geography or industry may not be sufficient to capture the full extent of vulnerabilities. For instance, in the context of rising global trade protectionism, credit impacts for investment-grade European corporates are likely to remain relatively moderate in the short term, as many EU products are difficult to substitute in the short to medium run (De Lemos Peixoto et al., 2025). However, pressures may be more pronounced for small and medium-sized, highly leveraged companies. Moreover, these risks may extend beyond direct exposure to the US market, encompassing broader global supply chains whose vulnerabilities are often difficult to assess. Only banks' in-depth understanding of their borrowers' business models, interconnections, and supply dependencies can reveal the true scale and nature of these risks—highlighting once again the importance of granular, institution-level analysis within a sound supervisory framework.

## 4. CONCLUDING REMARKS AND SUGGESTIONS FOR FUTURE ANALYSIS

The ECB has acknowledged that geopolitical risk has intensified in recent years, significantly affecting banks by heightening economic policy uncertainty and introducing a range of threats—including credit, market, operational, and funding risks—as highlighted in several blogs and speeches by the Chair of the Supervisory Board. European banking supervisory authorities have recognised the importance of addressing these risks by incorporating them into supervisory priorities, conducting stress tests, and providing guidance on sound risk management practices. At the same time, supervisors expect banks of all sizes and degrees of international exposure to identify, assess, and manage geopolitical risks through strong governance, reliable risk data, prudent capital planning, and robust operational resilience, thereby safeguarding financial stability amid geopolitical upheaval.

As noted by the Chair of the Supervisory Board, Claudia Buch (2024), addressing geopolitical risks requires a comprehensive framework that captures both known and unknown threats, since such risks can affect banks through financial markets, the real economy, and operational security. Owing to their unpredictable and interconnected nature, traditional risk models are often insufficient, underscoring the need for scenario planning and resilience strategies. Effective management also depends on close cooperation between micro- and macroprudential authorities: while macroprudential policies strengthen system-wide resilience, microprudential oversight focuses on the vulnerabilities of individual institutions.

Key supervisory measures to address geopolitical uncertainty include enhancing governance, strengthening risk management, ensuring sound capital and liquidity planning, prudent credit risk provisioning, and bolstering operational resilience—particularly against cyber threats and country-specific vulnerabilities.

Evidence from recent literature can further inform policy discussions by identifying which banks are most exposed, how they respond to heightened geopolitical shocks, and how their lending behaviour evolves. Studies indicate that the effects of geopolitical risk on the banking system often operate through indirect channels, such as increased credit risk, capital constraints, and funding pressures. A key conclusion is that a strong capital position cushions shocks and reduces—though does not fully eliminate—spillover effects.

At the same time, existing capital and liquidity rules may amplify spillovers from more exposed to less exposed economies, as these requirements are calculated at the consolidated level. Global banks with extensive cross-border operations are particularly vulnerable, while the degree and structure of financial integration influence both deposit and lending dynamics. Releasable macroprudential capital and liquidity buffers are particularly effective tools for addressing geopolitical risk, as they can be deployed when shocks materialise, allowing banks to absorb losses while continuing to provide essential financial services to the real economy. This flexibility is a crucial feature given the inherently unpredictable nature and magnitude of geopolitical events. Moreover, the emerging literature on the financial impact of geopolitical risk suggests that only severe shocks—such as wars or large-scale conflicts—meaningfully erode capital buffers and constrain credit supply. This implies that while banks may react to heightened geopolitical tensions, systemic threats to financial stability tend to arise only from large-scale events.

Against this background, scenario analysis emerges as an effective approach for assessing how extreme geopolitical shocks could affect bank balance sheets. Such analysis requires a careful conceptualisation of risk drivers, transmission channels, and potential impacts on banks (see [Section 3.3](#)). Industry- and country-specific indicators of geopolitical risk can help supervisors develop a granular understanding of banks' direct and indirect exposures, including lending to conflict-affected regions, dependence on vulnerable supply chains, funding from geopolitically exposed sources, and operations in politically unstable jurisdictions. Combining quantitative measures—such as risk-weighted assets by geography or sector—with qualitative intelligence on sanctions, policy shifts, or energy dependencies enables a more comprehensive identification of emerging risks.

At the same time, banks themselves must develop a deeper understanding of the sources of geopolitical risk, given their unique insight into client relationships, investor structures, and interconnected exposures. This institution-specific knowledge is essential for accurately assessing vulnerabilities that may not be visible at the system level. A more granular perspective is therefore needed. In this respect, reverse stress testing represents an important complementary tool. The ECB's 2026 thematic stress test will adopt this approach to examine how geopolitical shocks could impair profitability and solvency. Supervisors will design forward-looking systemic scenarios, while banks will apply them to their internal data to gauge the impact on capital, liquidity, and operations. This hybrid model ensures consistency across institutions while capturing bank-specific vulnerabilities.

An area that has not received sufficient attention, but which may warrant closer scrutiny by supervisors, is the ownership structure of banks. Importantly, ongoing monitoring should include a deeper understanding of banks' ultimate beneficial owners and control mechanisms. This aspect has so far been relatively underexplored, yet it deserves greater focus, as large shareholders—such as influential entrepreneurs, conglomerates, or sovereign wealth funds from politically aligned countries—could, under certain conditions, pose governance or strategic risks. Such ownership structures may influence management decisions, risk appetite, or lending practices in ways that compromise the sound and independent functioning of banks, potentially amplifying vulnerabilities in periods of geopolitical tension.

Effective responses to geopolitical risk require coordination across borders and sectors. Within the EU, closer alignment among supervisory and resolution authorities—and with partners such as the United Kingdom—remains essential. Because geopolitical shocks often intersect with fiscal, energy, cyber, and foreign policy domains, banking authorities may need to coordinate with other public bodies when designing scenarios that involve sanctions, cyberattacks, or supply-chain disruptions. Strengthening such cooperation is critical to maintaining financial stability and ensuring that the European banking system remains resilient in an increasingly uncertain geopolitical environment.

In conclusion, the growing prominence of geopolitical risk underscores the need for a more forward-looking and integrated approach to prudential supervision. Strengthening governance frameworks and risk management tools—alongside the use of rigorous scenario analysis, reverse stress testing, and enhanced cross-sectoral coordination—will be essential to anticipate, mitigate, and absorb shocks. Through these measures, both supervisors and banks can reinforce resilience at the institutional and system-wide levels, ensuring that the European financial system remains robust in the face of persistent and evolving geopolitical uncertainty.

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Geopolitical tensions have emerged as a major source of macro-financial instability, with conflicts, sanctions, and global rivalries introducing risks that differ from traditional credit or market shocks. These events are difficult to anticipate and propagate through financial markets, the real economy, and operational channels, often amplifying into systemic consequences. Recent research shows that banks reallocate rather than withdraw—cutting cross-border lending but maintaining affiliate activity—while capital requirements calculated at consolidated level may transmit foreign shocks to domestic credit supply. Stronger capital buffers cushion these effects. Overall, major geopolitical shocks raise funding costs, weaken bank stability, and disrupt financial infrastructure, underscoring the need for robust governance, releasable buffers, scenario-based supervision, more coordinated micro and macro prudential regulation, and overall strengthened international coordination.

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