Regulatory Challenges in Managing the Sovereign-Bank Nexus

CENTRAL BANK OF TRINIDAD & TOBAGO

Alvin Hilaire,
Governor, Central Bank of Trinidad and Tobago

Financial Stability Board,
Regional Consultative Group for the Americas,
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www.central-bank.org.tt; email: info@central-bank.org.tt

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Key Points

1. Caribbean banks furnished some of the additional sovereign funding occasioned by COVID-19.
2. There are many positives to banks' exposure to sovereigns.
3. However, large sovereign exposures pose several risks.
4. In principle regulatory standards take due account of the risks of sovereign exposure.
5. Domestic debt restructurings in the Caribbean showed that sovereign credit risk could materialise.
6. Moreover, domestic regulators confront important practical challenges in managing the sovereign-bank nexus.
7. Continued vigilance is essential given the likely trajectory of public debt.

*Contributors: Shanta Dhoray-Baig (Statistics Department) and Tanisha Mitchell (Research Department)

1. Caribbean banks furnished some of the additional sovereign funding occasioned by COVID-19.

In response to COVID-19, governments implemented **large fiscal stimulus programs** that pushed public debt to historically high levels. (*IMF Research Perspectives, Volume 25, February 2023*)

The average **public debt to GDP ratio in emerging markets surged** to a record 72% in 2021 from about 52% before the pandemic. The **domestic debt exposure of these banks** reached 17% of total banking sector assets in 2021. *(IMF WP/22/223, November 2022)*

In Trinidad and Tobago, banks' sovereign exposure reached **over a quarter of total assets**. *(Central Bank of Trinidad and Tobago)*

Chart 1: General Government Debt to GDP

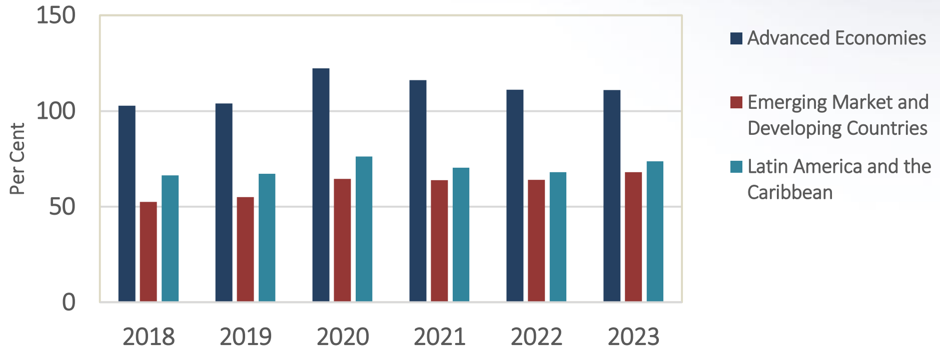
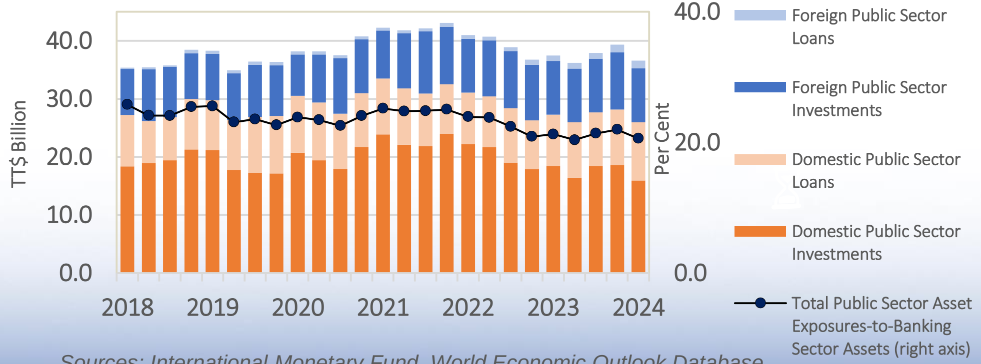


Chart 2: Trinidad and Tobago Sovereign Exposure



Sources: International Monetary Fund, World Economic Outlook Database, April 2024 and Central Bank of Trinidad and Tobago

2. There are many positives to banks' exposure to sovereigns.

- The sovereign-bank relationship is complex and operates principally through the **exposure, safety net** and **macroeconomic** channels.

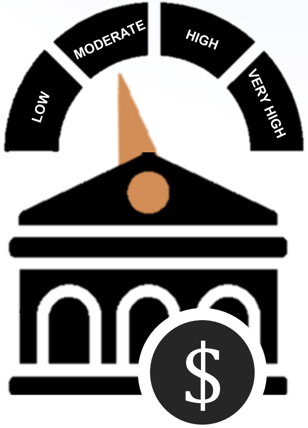
- This relationship has many positive elements as:

  - banks use sovereign exposures for **liquidity management, credit risk mitigation, asset pricing, financial intermediation** and **investment** purposes.

  - banks play a role in the operationalisation of **fiscal** as well as **monetary policy.**

3. However, large sovereign exposures pose several risks.

- However, risks of large sovereign exposures (adverse feedback loops) include:
  - Sovereign **credit risk**.
  - **Mandate of financial institutions distracted**, resulting in the diversion of funds away from the private sector.
  - Heightened **contagion and systemic risks** due to linkages with the real sector.
  - **Over-dependence on financial institutions** to satisfy sovereign financing needs.
  - Sovereign **cost of bailouts** of distressed banks.



- The **current regulatory treatment** may exacerbate the situation by **incentivising the holding of sovereign debt.**

4. In principle regulatory standards take due account of the risks of sovereign exposure.

- **International standards on sovereign exposure** suggest a **risk weighting** between 0 per cent to 150 per cent based on the credit rating of the sovereign.
- Like most other countries, Trinidad and Tobago's regulator allows a **zero-weight preferential risk** domestically to TTD denominated exposures to the local sovereign.
- Sovereign exposures are exempted from the **large exposure** framework.
- No limits are generally applied to domestic sovereign exposures in rating **liquidity** standards.
- Sovereign exposures are included as part of the **leverage ratio** framework.
- The basic idea is that **debt issued by a sovereign in its local economy is liquid and bears little risk**.

5. Domestic debt restructurings in the Caribbean showed that sovereign credit risk could materialise.

Several Caribbean governments have **restructured their domestic** debt since 2000.

Financial institutions have also had their **share of trouble** and required fiscal support.

Dominica
2004

Grenada
2005

Antigua and Barbuda
2010

St. Kitts and Nevis
2011

Jamaica
2010, 2013

Barbados
2018

Suriname
2020

Trinidad and Tobago
1980s – International Trust, Workers Bank and 5 non-bank financial institutions
2009 – Clico Investment Bank, CLICO Insurance Company and British American Insurance Company

Barbados
1986 – Trade Confirmers

Jamaica
1995 - Banks, insurance companies, merchant banks and building societies

6. Moreover, domestic regulators confront important practical challenges in managing the sovereign-bank nexus.

- The ‘**moral suasion**’ tactics employed by sovereigns can affect banks, and also the **approach of regulators** in assessing/treating with exposure.

- Pressure can be more intense on **domestically and publicly owned financial institutions**.

- Even **measuring sovereign exposure** can be tricky e.g defining state enterprises or quasi-state agencies and verifying that debt is guaranteed by the government.

- Foreign-owned banks may internally use higher risk weights for sovereign exposure, and **curb lending to domestic/publicly owned banks** due to the latter’s high sovereign exposure.

- Regulators may be faced with a **2-tier banking system** involving higher concerns for domestic vs foreign-owned entities based on relative sovereign exposures.

7. Continued vigilance is essential given the likely trajectory of public debt.

- The **upward path of public debt** in the wake of the pandemic is not likely to be reversed soon.
- The IMF staff themselves have raised stark concerns:
  - "**Persistently higher interest rates** raise the cost of servicing debt, adding to fiscal pressures and posing risks to financial stability." *(Tobias et al 2024)*
  - The combination of higher public debt and challenging economic conditions has **elevated sovereign default risk**, **tightening governments' borrowing constraints** and triggering a **wave of sovereign debt downgrades**, especially in emerging market economies and low-income countries. *(IMF Research Perspectives, Volume 25, February 2023)*
- Improved **regulatory standards**, **international cooperation** and **comprehensive monitoring** by regulators can contribute to averting the negative aspects of the sovereign-bank nexus.
- Ultimately, success in **developing capital markets** can go a long way towards diversifying government financing sources and reducing undue reliance on banks.

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