Can Regulatory Changes Mitigate the Sovereign-Bank Nexus?

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1. Introduction

- Negative feedback loop between sovereign and bank risk highlighted by the Euro-area sovereign debt crisis
- BIS have noted interconnectedness between banks and the sovereign
- Emerging market banks place reliance on sovereign debt
  - High quality liquid assets (HQLA)
  - Corporate bond markets - undeveloped or underdeveloped/ illiquid
- Basel II and III implementation are at different stages throughout different jurisdictions in sub-Saharan Africa

2. Why do banks hold sovereign debt?

- Requirements of the liquidity coverage ratio (LCR)
  - Adequate stock of HQLA
  - Predominant source is typically local sovereign debt
- Government bonds serve as collateral
  - Repo markets, collateral for counterparty risk in traded markets
- Sovereign debt is held to manage capital adequacy
  - Risk free/ zero per cent risk weights
- Some banks may be primary dealers for governments bonds
  - In environments where demand for bonds are low primary dealers will warehouse large stocks

3. Role of sovereign debt in financial markets

- Government bonds form part of eligible collateral in central banks' monetary policy operating frameworks
- Government bond yield curves are used as benchmark curves to price corporate bonds and credit
- Government debt can either be increased or decreased to support government's fiscal stance

4. Extent of concentration and potential shocks - a South African perspective

- South African sovereign debt holding makes up around 10 per cent of total banking assets
  - LCR, trading book stock, market making activities
- South Africa has experienced the transmission of shocks first hand
  - Failed Treasury auctions in 2013 - anticipated a move to sub-investment grade (asked banks to run stress tests for 4 consecutive years)
  - Minister of Finance replaced in December 2015 (10 year sovereign bond yield spiked 158 bps in 2 days, currently trading at 8.61%)
  - Banks realised significant value destruction in sovereign bond portfolios, downward fair value adjustments and reduction in LCR buffers
- South Africa was downgraded to sub investment grade by Fitch on 7 April 2017
  - Banks are bound by the sovereign ceiling
  - Premiums paid to tap into foreign markets for hard currency liquidity, anti-competitive ito hard currency lending into Africa

4. Extent of concentration and potential shocks - a South African perspective (continued)

- Potential cyclicality brought by sovereign exposure
  - Government fiscal consolidation reduces supply but banks need to meet prudential requirements
  - Other participants like money manager communities have own prudential requirements that require sovereign bond holdings
- Regulatory consolidation of prudential requirements
  - Banks with subsidiaries in sub investment grade jurisdictions required to hold those bonds for HQLA purposes but on consolidation from a credit risk perspective these exposures carry a positive risk weighting

5. Possible policy options and considerations- a South African perspective

Credit Risk (views expressed by South African Banks through Banking Association South Africa)

- Design, calibration and risk sensitivity
  - Consider difference between local currency and foreign currency denominated issuance (where ratings differ) and liquid vs illiquid exposures when considering risk weights
  - Bilateral loan to a sovereign vs a liquid bond (visibility), illiquid loans to state owned enterprises supported by explicit guarantees from government, real estate transactions supported by government backed leases
  - Retail credit – government is one of the largest employers in South Africa
  - Consider using default experience and loss rates from sovereign default studies as benchmarks
  - Consider using IRB approach with appropriate calibration of risk parameters such as floors or ranges for PD and LGD
  - Consider that sovereign bonds held for HQLA purposes could be subject to a 0% risk weight, and could be exempt from concentration risk assessment
  - The proposed marginal risk weight add-on approach could be problematic for international banking groups operating in emerging markets, because many emerging markets have excessive liquid asset and cash reserve requirements. This may prove challenging for existing business models
  - Consideration should be given to the use of moral suasion and the pillar 2 framework

5. Possible policy options and considerations- a South African perspective (Continued)

Liquidity Risk

- Incentives already built into the LCR framework to allow banks to diversify their HQLA holding
- Consideration should be given to allow banks to invest in other sovereign debt in a foreign currency
  - Introduce other FX, translation risks and potential funding mismatches
  - Potentially allows exposure to different economic cycles and developed economies which may have less volatility
- Possible option of developing corporate bond markets
  - Increase credit risk to banks but less dependency on the sovereign
  - Money manager community would have to substantially increase their ability to assess credit risk and monitor it more carefully
- Widening of the eligibility and use of the committed liquidity facility (CLF) from the SARB
  - CLF is a liquidity facility provided by the central bank to aid banks to comply with the LCR in jurisdictions with limited supply of HQLA relative to their needs
  - Currently capped at 40%, could consider increasing the cap
  - Removes some sovereign reliance for liquidity by unlocking liquidity from illiquid loan portfolios

6. Conclusion

- Regulation has the potential to mitigate the effect of the sovereign-bank nexus
- Regulation is unlikely to mitigate the interconnectedness in its entirety
- From the perspective of emerging markets, it is important to foresee the consequences of whatever actions we consider taking

7. Comments and questions?

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