Chapter 2. Sovereign-Bank Nexus Risks Need to Be Addressed

The close link between the banking sector and the government, a situation known as the sovereign-bank nexus, stands at a decade high in EMDEs. This situation exposes the sector to risks through elevated government debt and fiscal pressures. *A moderate increase of the sovereign-bank nexus can reflect healthy financial sector deepening and support economic growth. However, in just 12 years the exposure of banks to government debt in EMDEs rose by over 35 percent (from 12 to 16 percent of total bank assets on average in 2023) and is 8 percentage points higher in state-owned banks (SOBs) than in private banks. The exposure rose even more—by over 50 percent—in debt-distressed countries. The COVID-19 pandemic further increased EMDE government borrowing, and banking sectors, particularly SOBs, were natural lenders (and were encouraged to acquire government debt through suasion and regulatory policy). The surge in sovereign debt exposure among EMDE banks reached its highest point in the past decade, nearly three times higher than in advanced economies. This escalation reinforced the interconnection between the financial well-being of EMDE governments and that of domestic banks, intensifying the potential for feedback loops that could jeopardize macroeconomic and financial sector stability.*

The sovereign-bank nexus in EMDEs is particularly concerning in countries that face government debt distress and could default, and it has the potential to trigger a joint banking-government debt crisis. *Banking stress has usually affected the sovereign, rather than the other way around, but currently the situation is reversed. The sovereign-bank nexus is even higher in countries already facing government debt distress—the share of government debt held by banks as percentage of assets in these countries is on average 6 percentage points higher than in non-debt-distressed countries. Out of 33 EMDEs with high government exposures of banks (where government debt is more than 20 percent of bank assets), 16 countries face high government debt risks. A deterioration of the value of government debt in these countries caused by debt restructurings could significantly damage banking sectors and might trigger a crisis. World Bank staff analysis indicates that a 5-percent loss on banks' government debt holdings—which is small by historical standards—would cause one-fifth of banks in the sample in debt-distressed countries to become undercapitalized. Moreover, countries with a high sovereign-bank nexus also tend to be less prepared to deal with financial stresses, which can amplify adverse feedback loops. Several countries already face a joint banking-government debt crisis. Historically, such crises are among the costliest, resulting in a reduction in real income per capita of up to 7 percent, on average, compared to pre-crisis levels.*

Regulatory standards designed to capture the risks banks take do not account for the tail risk of a government debt default (including restructuring), which is significant in some EMDEs. *Although banks are required to carry minimum holdings of government securities for liquidity management purposes, they do not face maximum limits on government exposures. Only limited disclosure on their sovereign exposures is required from banks, which renders their balance sheets less transparent and makes it difficult for markets to estimate impacts of various sovereign stress scenarios. In practice, banks also currently are not required to apply capital charges for their sovereign exposures in local currency. As a result, regulatory standards have not limited a sizable buildup of unsustainable government debt on bank balance sheets in some EMDEs.*

EMDE banking authorities should foster more prudent risk taking by banks and strengthen financial sector resilience, even if they cannot resolve risks posed by the sovereign-bank nexus alone. Sound fiscal and other policies to preserve public debt sustainability and macroeconomic stability are required. *Banking authorities alone will not be able to fully resolve sovereign-bank nexus risks, which will require sound fiscal and macroeconomic policies. However, banking authorities should consider introducing granular disclosure requirements for banks' public exposures to encourage market discipline. Within their individual country contexts,*[31] *banking authorities should explore the benefits and drawbacks of carefully designed capital charges on local currency government debt (such as for exposures that exceed certain thresholds) to strengthen banks' resilience and mitigate excessive buildup of government debt holdings. Authorities also need to encourage stronger bank buffers well in advance of potential crises, implement effective financial safety nets and crisis management frameworks, put in place appropriate institutional arrangements to allow decision makers to coordinate and act decisively, and conduct regular stress-testing for banks that also considers possible impacts of sovereign debt stress. In the medium term, EMDEs should continue to promote the deepening of domestic capital markets and the institutional investor base, which will help mitigate sovereign-bank nexus risks.*