Jiří Rusnok: Basel Consultative Group Meeting - welcome speech

Welcome speech by Mr Jiří Rusnok, Governor of the Czech National Bank, at the Basel Consultative Group Meeting, Topic "Regulatory Treatment of Sovereign Exposures - Survey of Recommendations", Czech National Bank and Bank for International Settlements, Prague, 4 October 2016.

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Dear Basel Consultative Group members,

Dear experts from all around the world,

Dear ladies and gentlemen,

Let me warmly welcome you to the Czech National Bank (CNB). We are proud to host the expert meeting on the Basel regulatory reform and its design, using the perspective of emerging markets and developing countries.

In the wake of the recent global financial crisis, the Basel Committee on Banking Supervision (BCBS) is making reform steps towards more healthy, stable, and resilient banks and financial systems. The latest Basel reform includes more and better bank capital, leverage and liquidity requirements, as well as macro-prudential measures, ranging from G-SIB surcharges to countercyclical capital buffers. The reform effort is successfully underway and new standards are gradually being implemented worldwide, covering advanced as well as emerging markets and developing countries.

When designing further details of the regulatory reform, we have to pay special attention to differences in financial systems among countries and regions. Namely, financial systems in emerging markets and developing countries are often shallower and less liquid than in advanced economies. Therefore, emerging market countries can hardly take over all regulatory measures without modifications. On the contrary, they need to contribute to the design of the measures to make them robust and effective across countries. Similar holds for regulatory objectives, as what is considered a priority for regulators in advanced countries, like the G20 countries, might not be considered as urgent in emerging market countries.

In this regard, I welcome and strongly support the effort of the Basel Consultative Group (BSG) as a forum for deepening the engagement of the BCBS with non-member authorities, international institutions, and regional groups of banking supervisors on the regulatory reform and banking supervisory issues. I see cooperation between the BCBS and the BCG as a key component helping to design robust regulation and supervision, taking into account financial sector aspects in both advanced and emerging markets and developing countries. As a member of the BCG, the CNB has actively participated in the work of the group. We contributed to the work agenda evaluating major intended and unintended consequences of Basel III implementation for emerging and smaller economies in the past. We also hosted a workshop on this topic in 2013.

As I see your workshop agenda, I appreciate that you are going to discuss the timely issue of sovereign exposures in emerging markets. The reasons for the high share of government bonds in commercial bank assets in emerging markets are clear and straightforward. Financial markets in these countries are still under development and shallow, which is limiting their ability to diversify assets. Banks can also choose to be exposed to sovereign debt in some countries as the alternative (private lending) is riskier given existing legal and institutional imperfections. Finally, the current regulatory setup gives preferential treatment to sovereign exposures, as banks’ exposures to domestic government in domestic currency are subject to low or even zero risk weights.

While banks' sovereign exposures in advanced countries are considered to hover at reasonable levels, exposures in many emerging market countries are significant. The current level or its buildup is becoming a relevant concern to emerging market countries, mainly owing to credit and concentration risks. As the sovereign debt crisis in Europe showed recently, the zero risk weight commonly applied to sovereign exposures in domestic currency might not be fully consistent with empirical observations of the risks of sovereign debt defaults. Hence, the default risks of sovereign issuers need to be reflected accurately in risk weights to ensure that banks have appropriate ex-ante incentives to take on such exposures. Besides credit risks, excessive sovereign exposure concentration reinforces the link between sovereign and banking sector stress. In fact, the close relationship between sovereigns and banks is seen as one of the major reasons for the severity of the Eurozone crisis. Therefore, breaking the sovereign-bank nexus is needed in order to strengthen macroeconomic stability.

Nevertheless, our prudential treatment of sovereign exposures needs to strike a balance. It has to bear in mind the specific role sovereign debt plays in financial markets. Government securities are used by central banks as collateral in managing market liquidity and implementing monetary policy through money market operations. Furthermore, given their low risks, they are used by banks and pension funds as investment instruments. These aspects need to be borne in mind when designing prudential treatment of banks' sovereign exposures. This is particularly true of emerging and developing countries, as their financial markets are shallow and low-risk equivalents to government securities and central bank papers are hard to find.

As I have already mentioned at the beginning of my speech, the CNB hosted the BCG workshop on the impacts of Basel III implementation on emerging markets and smaller economies three years ago. The workshop was efficient and successful, resulting in a memo highlighting the effects of the reforms on these economies for the BCBS and supervisors. I am happy that we are meeting here again to discuss regulation of sovereign exposures and other topical issues related to Basel III regulatory reform. I hope that this workshop will reach similar success.

Ladies and gentlemen, thank you and I wish you success in your work.