St Augustine, banking union and sovereign risk weights

Blog post by Partner Stephen Adams, 11 May 2016

There has been some comment this week at the German decision to use Monday's Eurogroup to push for a change to the way sovereign debt is risk weighted by EU banks, as part of a wider set of steps to move the banking union dossier forward. The German argument is that there is a necessary political trade-off between accepting a measure of collective liability through a new deposit guarantee scheme and a change to what Berlin sees as the subsidy of zero risk weights across all Eurozone sovereigns.

This is a familiar political picture: Germany complaining about others getting an easy ride while Berlin agrees to underwrite things. It is certainly hard to argue that the practice of zero-weighting some classes of sovereign debt for capital purposes in banks fits with the wider principle that risk weights should vary with risk. If there is no such thing as risk free debt, there should probably be no such thing as zero weighted debt. Even high profile defenders of zero weighting, like Ignazio Visco of the Bank of Italy (in a speech this week) acknowledge the anomaly, while defending the exception.

There is a case for zero weighting, and Visco and others have made the best possible fist of it: disincentives for banks to hold sovereign debt crimp their willingness for countercyclical lending to states and sovereigns have fiscal and monetary tools that shield them from insolvency in a way that firms don't, at least when they print their own currency. Defaulting states will typically take down their banking sector anyway, so worrying about the transmission mechanism of sovereign debt is to ignore the bigger problem or how you make states prudent and sound – an EU policy perennial.

But the elephant in the room is just the practical reality that requiring European banks to reprice huge volumes of sovereign debt in capital terms after five years of sharp recapitalisation and at a time of general uncertainty looks impractical and even imprudent. This is part of the reason for the general Augustinian mood in most quarters on sovereign debt reweighting of 'make us virtuous, but not yet'.

So how serious is the German sense of urgency? And would Berlin really hang progress on banking union on the EU front-running the BCBS on moving on sovereign risk weights? If they would, they may well be over-reaching.