CEPS POLICY BRIEF
30 years CEPS

A Copernican Turn for Banking Union

Thomas Mayer

No. 290, 14 May 2013

At every meeting of central bankers, policy-makers and economists, there seems to be agreement that creation of a 'Banking Union' is essential for the survival of the euro. Yet, progress in building this union is painfully slow. The Single Supervisory Mechanism may not be ready before the middle of next year, the Single Resolution Mechanism may require a laborious change of the EU Treaty and common deposit insurance has been postponed into the indefinite future. What is making the establishment of Banking Union so difficult are the protracted fights over which government will be the payer of last resort when banks fail because of bad loans made in the past. If we continue along the present line, it does not seem likely that we shall ever reach full Banking Union.

Therefore, we need to learn from Copernicus who could not make sense of the movement of planets as long as he assumed that the sun moved around the earth. But everything fell into place for him, when he assumed the opposite. So, instead of trying to move from common bank supervision over to resolution and then on to deposit insurance, let's go backwards and start with deposit insurance, move from there to resolution, and end with supervision.

Step 1. A 100% reserve requirement for safe deposits

We start by defining the risk-free asset in our financial system: This is the asset that can be converted into legal tender at face value at any time. The concept of legal tender is very important in a fiat money system, in which money derives its value from government regulation or law, because it ensures that we can settle debt with almost worthless paper or electronic bits. In a fiat money system the only legal tender is by definition central bank money. Hence, an asset is risk-free if it can be converted into central bank money at any time. It is easy to see that only few assets would qualify as risk-free. Most importantly, the debt of governments that do not control the issuance of legal tender, as is the case in EMU, or deposits of banks that are backed by credit to entities that also do not control the issuance of legal tender, are not risk-free. All these assets are risky because the debtor may not be able to convert them into legal tender at any time and under any circumstance.

Hence, in EMU, where governments have no access to the money printing press of the ECB, the only risk-free asset is cash issued by the central bank and deposits that are fully backed by central bank reserves with the central bank. From this follows that we need to establish safe bank deposits as deposits that are fully backed by banks' holdings of central bank reserves. In other words, we can effectively insure deposits

Thomas Mayer is Senior Fellow at the Centre for Financial Studies at Goethe University Frankfurt and Senior Advisor to Deutsche Bank. He thanks Daniel Gros for valuable comments on an earlier draft.

by introducing a 100% reserve requirement for this type of deposits. No industry or state deposit insurance scheme is required. A simple 100% reserve requirement is sufficient.

But would a deposit insurance scheme based on a 100% reserve requirement be at all possible in our present system? The answer, of course, is yes: To back 'insured' deposits earlier created by fractional reserve banking, banks could borrow central bank reserves in the necessary amount and keep them on deposit with the central bank. The cost of this instrument for the banks would be determined by the difference between the lending rate and the deposit rate for central bank money. The cost for the bank customer would be determined by the net cost of central bank funds for the banks and the banks' operating costs for the insured deposits. The benefit for the customer would be to have a safe asset other than only central bank notes, and the ability to use this asset to make non-cash payments. A quantitative limit for safe deposits would not be necessary as the central bank could adjust the supply of reserves to the demand for safe deposits. But the central bank could influence the demand for safe deposits by changing the variable costs, which are given by the difference between the cost of central bank reserves and the rate that the central bank pays on deposits.

During an economic upswing, when the demand for safe deposits is weak, the central bank could narrow the difference between the lending and deposit rate and thus increase the attractiveness of safe deposits. All things being equal, an increase in deposits fully backed by central bank reserves would of course reduce the credit and money multiplier and militate against credit creation by the banking system during the upswing. In a recession, when the demand for safe deposits is high, the central bank could widen the corridor and make safe deposits more costly. A reduction of safe deposits relative to other deposits would tend to raise the credit and money multiplier. Thus, by influencing the demand for safe deposits relative to other deposits, the central bank would also influence credit extension by the banks. In the present circumstances, where banks are reluctant to extend credit and the demand for safe deposits is high, the central bank could move the deposit rate into negative territory and charge banks and their customers for holding safe deposits.[1]

Step 2. A hierarchy of loss-absorbing bank liabilities

Once we have established reserve-backed deposits as safe assets, all other bank liabilities would of course be risky. We can now define a hierarchy of loss absorption in a bank resolution regime. The first loss would of course be borne by the equity tranche on the liability side of banks' balance sheets. After having set aside assets pledged to cover secured debt, the second and third losses would be borne by junior and senior unsecured bank debt. The fourth and last loss would accrue to deposits uncovered by central bank reserves. When all bank liabilities except deposits fully covered by central bank reserves contribute to cover losses on bank assets, taxpayer-funded bank bailouts would become significantly less likely (and may eventually become unnecessary). As long as banks engage in maturity transformation, liquidity crises remain possible and a lender-of-last resort is necessary. However, the risk of a liquidity crisis could be reduced if the scope for maturity transformation would be limited in the regulatory framework. Moreover, when the public fully understands the risk associated with an exposure to banks beyond the reserve-backed safe deposit, it would be up to banks to reassure bank equity investors and creditors that their assets are being managed in a way that makes illiquidity and losses become unlikely.

Step 3. Divest banks from governments by revised regulations for government debt

To be able to fund their assets at reasonable costs, banks would need to have a comfortable equity cushion and a well diversified and reasonably liquid portfolio of assets. Most importantly, they would have to reduce their exposure to government debt to a level consistent with this debt being subject to default risk. Hence, in the new regulatory regime,

[1] Banks in Germany and certain other euro area countries today already hold large amounts of central bank reserves. However, these reserve holdings are motivated by the banks' reluctance to lend to other banks in other euro area countries and are not earmarked to back deposits.

government debt would have to be backed by equity at least in part (with the rest back by other loss-absorbing bank liabilities), and it would have to be subject to limits for single credit exposure. To allow banks' divestment from government debt, the European Central Bank could buy in a one-off operation the government bonds that banks have pledged to the central bank as collateral for obtaining central bank credit, and place them in a special account that will be wound down over time.

As a result of this operation, risky claims of the banks on governments would be replaced by risk-free claims of the banks on the ECB or, in other words, by central bank reserves. The ECB would of course want to reduce its exposure to government debt over time.

Since it is very doubtful that all highly indebted euro-area countries could repay their debt, governments and the ECB could agree that all income from seigniorage would be used to pay down the government debt held by the ECB in the special account. Since the present discounted value of seigniorage can be very large, reaching several trillion euros in the case of the euro area, depending on interest rates on central bank credit and the growth rate of non-interest-bearing central bank money, it seems likely that this would be sufficient to eventually retire the government debt acquired by the ECB from the banks. Moreover, since a significant part of the government bonds acquired by the ECB from banks would have fairly short maturities, the position of the ECB could be reduced by simply letting the bonds run down.

The arrangement outlined here has some resemblance to the debt redemption fund proposed by the German Council of Economic Experts. However, an important difference is that in the arrangement above, the ECB would withhold revenue to pay down the debt and would not have to rely on governments to allocate revenue for this purpose.

Part of the reserves obtained by selling government bond holdings to the ECB can be used by the banks to back safe deposits. The rest can be released by the ECB into the banking system and the economy at large by setting a rate for central bank deposits below the risk-adjusted bank lending rates. With their debt now subject to default risk, highly indebted governments may have difficulties accessing the market at reasonable costs to roll over expiring debt. But market access could be improved if the ECB agreed to assume the status of a junior creditor for the government bonds they have acquired from banks in case of a debt restructuring. Like the orderly pay down of the debt, the costs for such a restructuring could be covered by future seigniorage income. This would represent a partial mutualisation of public debt, but because of its limited character it would probably be acceptable for countries with stronger balance sheets.

A more level playing field

The proposed structure for Banking Union would of course change the way in which banks operate and governments fund themselves. Banks would no longer extend credit and create book money at will; rather, they would assume the dual role of 1) safe keeper of the risk-free assets, i.e. central bank money, for depositor-savers and 2) intermediary of funds between investor-savers and entrepreneurs.

It is possible that bank lending rates would increase, but if they do, it would only be because savers realise that in a fractional reserve banking system bank deposits carry credit risk, unless they are fully backed by banks' holdings of central bank reserves. In fact, the widespread notion that bank deposits in our present system of fractional reserve banking are completely safe and can be converted into central bank money at any time and in all circumstances represents a subsidy to bank lending rates (and bank profits).

Governments could no longer rely on banks to fund their debt and would have to obtain funding from the capital markets. Borrowing costs could also increase for them as they would no longer be regarded as offering risk-free assets and could no longer benefit from preferential treatment on banks' balance sheets in the form of zero-risk weighting for the calculation of regulatory capital requirements and exemption of single-credit exposure limits. Again, such an increase in borrowing costs would represent the end of a subsidy to government borrowing as a result of special regulatory treatment.

Conclusion

To sum up, Banking Union could be built in three steps. In the first step, deposit insurance could be introduced in the euro area by requiring banks to fully back safe deposits with central bank reserves. This would be the only safe asset in EMU, where, as already noted, governments have no command over the money printing press of the central bank. All other bank liabilities would participate in covering losses on the asset side of banks' balance sheets in a hierarchical order established by the common bank resolution regime in the second step. To help banks divest from government bonds, the ECB could buy these bonds from them, replacing risky claims of banks on governments by risk-free claims of banks on the ECB in the third step. Governments and the ECB could agree to use future seigniorage income to pay down the government debt held by the ECB.

Appendix 1. The Copernican turn for Banking Union

Present approach	Proposed approach
Step 1 Establish SSM on the basis of the regulatory framework mapped out in CRDIV.	**Step 1** Establish deposit insurance by requiring safe deposits to be backed 100% by banks' holding of reserves with the central bank.
Step 2 Establish SRM backed by a government-funded restructuring and resolution fund.	**Step 2** Establish SRM with hierarchical loss absorption of all bank liabilities except safe deposits. Resolution fund would operate only in the transition to new regime, and then would no longer be required.
Step 3 Keep deposit insurance under national authority.	**Step 3** Establish SSM on the basis of CRDIV, modified to introduce positive risk weights and single credit exposure limits for government debt. The ECB would help divest banks from government bonds and redeem the ECB's acquired government bond portfolio by withholding seigniorage income over time.

Appendix 2. The structure of bank balance sheets in the new regime

Assets	Liabilities
Central bank reserves	Safe deposits
Ring-fenced assets	Covered bonds
Other assets	Investor deposits* Senior debt* Junior debt* Equity*

* Participating in losses in ascending order.

ABOUT CEPS

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is widely recognised as the most experienced and authoritative think tank operating in the European Union today. CEPS acts as a leading forum for debate on EU affairs, distinguished by its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

Goals

- Carry out state-of-the-art policy research leading to innovative solutions to the challenges facing Europe today,
- Maintain the highest standards of academic excellence and unqualified independence
- Act as a forum for discussion among all stakeholders in the European policy process, and
- Provide a regular flow of authoritative publications offering policy analysis and recommendations,

Assets

- Multidisciplinary, multinational & multicultural research team of knowledgeable analysts,
- Participation in several research networks, comprising other highly reputable research institutes from throughout Europe, to complement and consolidate CEPS' research expertise and to extend its outreach,
- An extensive membership base of some 132 Corporate Members and 118 Institutional Members, which provide expertise and practical experience and act as a sounding board for the feasibility of CEPS policy proposals.

Programme Structure

In-house Research Programmes

Economic and Social Welfare Policies
Financial Institutions and Markets
Energy and Climate Change
EU Foreign, Security and Neighbourhood Policy
Justice and Home Affairs
Politics and Institutions
Regulatory Affairs
Agricultural and Rural Policy

Independent Research Institutes managed by CEPS

European Capital Markets Institute (ECMI)
European Credit Research Institute (ECRI)

Research Networks organised by CEPS

European Climate Platform (ECP)
European Network for Better Regulation (ENBR)
European Network of Economic Policy Research Institutes (ENEPRI)
European Policy Institutes Network (EPIN)