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EBF contribution to the ongoing debate on a Central Bank Digital Euro

#2: Impact on bank funding

1. Introduction

The European Banking Federation (EBF) is following with keen interest the European Central Bank (ECB) work on a digital euro. The industry shares the objectives of the ECB to support the digitalisation of the European economy and tackle sovereignty concerns that could be brought about by private sector stablecoins or foreign Central Bank Digital Currencies (CBDCs). This is a key topic for the European banking industry as it seeks to respond to the unprecedented speed of transformation in the area of digitalisation of the economy and payments, which has the potential to fundamentally change the current banking system. We therefore wish to constructively contribute to the discussion, so that the ECB and European banks work closely together in finding the best possible solutions to current and future challenges.

This paper is part of a series of contributions that the EBF intends to make to the ongoing discussion on a Central Bank Digital Euro (CBDE), continuously analysing in detail the various aspects in the debate. Following the first EBF paper on strategic considerations[1], this paper #2 focuses on the impact on bank funding and the consequences for the banking system that a digital euro could have, even with a potential cap on its holdings. We understand that the ECB and the European authorities are well-aware of these possible risks and are currently analysing the impact of a digital euro. With this paper we wish to

[1] https://www.ebf.eu/wp-content/uploads/2021/01/EBF_043862-EBF-Position-Central-Bank-Digital-Euro-January-2021.pdf

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engage in the discussion on how to preserve banks' intermediation capacities in order to avoid negative effects on the banking system and the economy as a whole.

All the concerns raised in our paper covering the strategic considerations for the EU banking sector that we submitted to the ECB's public consultation in January 2021 are still very relevant. To justify its introduction, a CBDE should benefit European end-users and the economy as a whole, while avoiding any destabilizing effect on the financial system and it should be very clear how it could go hand in hand with private payment and deposit solutions.

2. Impact on bank funding: cyclical and structural disintermediation

The ECB report on digital euro stated that the use of a digital euro as a form of investment, and the associated large shifts from bank deposits, should be avoided. More recently, ECB officials have referred to the possibility of limiting digital euro holdings to, for instance, 3,000 euros in order to prevent negative impact on bank deposits and consequently on banks' lending capacity. It has been discussed that the limit could be directly imposed as a cap on wallets/accounts or be indirectly implemented through a two-tiered remuneration structure that penalizes holdings above that target limit (i.e. a soft rate disincentive).

We appreciate that the ECB shares our concern on the importance of maintaining financial stability and, in particular, the availability and stability of bank deposits and we recognize that this proposal is a first step towards defining measures that would limit any negative effects. However, even though a digital euro with a 3,000 euro cap on holdings per person could look innocuous, its impact could be considerable, especially when leaving the current excess liquidity regime. In addition, it is not clear whether a holding limit would apply to business users – if this were not the case, it could lead to re-circulation by merchants and business use, or even circulation outside the EU.

We are mostly concerned by the **cyclical disintermediation** that the CBDE could imply. The outflow of bank deposits could be considerable in the event of financial stress of a particular institution or a broader financial crisis. Setting a cap to the CBDE amount per client might look reassuring at this stage. However, unlike most prudential measures in which the ECB and other EU institutions can take their own decisions with little or no external influence, the caps set for CBDE could be subject to market and/or public pressure. There is uncertainty as to how the approaches of other Central Banks and private institutions that create digital money will evolve. If other currencies, existing or new, raise their caps significantly, the ECB will be put under considerable pressure to follow suit. Such scenarios typically happen in times of stress or crises when there is less room for manoeuvre. The current excess liquidity context might hide a problem of cyclical disintermediation in a context of more restricted liquidity. We assume that the crowding out of deposits would be much higher than in any normal scenario and moreover any cap could be very hard to maintain in such circumstances. A severe scenario would result in multiplying the outflows compared to normal circumstances. We therefore believe that it is imperative to abandon the idea of a soft rate disincentive in favour of a hard cap which could be enshrined in a legislative framework, ensuring that it is maintained even in times of financial stress or crisis. The hard cap could only be raised in a pre-agreed manner not related to crisis circumstances, for instance linking it to the inflation rate. Indeed, in times of stress, the soft rate would not be sufficient to deal with deposit outflows.

We are also concerned by **structural disintermediation**, whereby the shift of retail bank deposits to CBDE could have unintended consequences on the role of banks in maturity transformation and the funding of the economy as well as on the ability of fixed rates financing. The effect could be important in the euro area banking system because it is based on retail deposits, and currently deposits from households constitute approximately 46 percent[2] of the funding of European banks.

The crowding-out of bank deposits in normal circumstances will depend on the design features of a digital euro (beyond the caps/limits), such as what type of payments it intends to serve and the associated functionality (cash-like or far more), how it interoperates with existing payment solutions, the cost structure and even how the authorities frame and "advertise" the digital euro. In addition, the profit and loss (P&L) effects for banks will be increased by the costs of developing, building and operating the infrastructure for a digital euro, and it can become a significant burden for credit institutions.

In the current context of abundant liquidity provided by the ECB, the structural disintermediation does not seem to pose an immediate threat, but it should however be carefully considered when designing a future-proof digital euro. In the context of more restrained liquidity, the potential of structural disintermediation of banks becomes much more important.

In the banking prudential framework, the most immediate impact would be on the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The prudential regulatory framework considers retail deposits as stable funding, which gives banks ample scope to provide long term loans. Currently, retail deposits are considered stable to a 95% extent in the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The impact on those ratios needs to be carefully examined. It is important that the regulatory balance sheet ratios and stress scenarios in connection with the CBDE are adjusted by the regulators to avoid any negative impact on banks. In order to have an estimated impact assessment, we have contemplated different scenarios of CBDE holdings and have concluded that the loss of funding capacity could be material with a range between several hundred billion to a trillion. We would be keen to engage with the ECB to discuss about the potential impact on the basis of plausible assumptions in order to quantify the possible structural disintermediation and its effect on the banking system.

3. Implications of reduced bank funding

The issuing of a CBDE and the reduction in bank deposits would mean that to maintain their financing capacity, banks would have to consider alternative sources of funding, as a hard cap or a soft rate disincentive will clearly not be sufficient to address their possible funding deficit. As a consequence of the impact on banks' funding composition, the CBDE could also have an impact on the extent to which banks can perform maturity transformation. Market-based financing cannot be expected to compensate for the lost stable resources.

Barring significant developments of capital market funding, it is very likely that ECB funding in a more permanent and structural manner would be required as an alternative source of funding in order to maintain financial stability. This permanent ECB funding facility may have to be installed to compensate: i) for temporary peak losses that might

[2] I.e., 14426bn (total depo exc. MFI) + 3524bn (debt) = 17950 (end-2020). Deposits from households = 8343bn. Source: ECB Statistical Data Warehouse

occur in crisis situations, and ii) for the permanent loss of bank deposit funding. Such a facility would necessitate that the ECB accepts and is comfortable with having permanent large long-term funding facilities in place for banks and, therefore, a permanently more important and bigger role in the financial system. In recent years, the prudential framework has sought to reduce the central bank funding of banks and this would be an important change to that policy. The permanent ECB long-term facility should also be designed in such a way that it is considered as stable funding. Furthermore, to avoid that the ECB financing is costlier than retail deposits (with the resulting impact that this would have on banks' balance sheets), it should have easy collateral requirements and be structurally as cheap as retail deposits.

This effect raises a more fundamental question on the role of banks in maturity transformation and the funding of the economy. The ECB is currently playing an enlarged role in the financial monetary system, controlling interest rates on a large amount of loans and bank reserves, and further managing the yield curve with substantial asset purchases. In principle, these measures are considered temporary and extraordinary. With the establishment of a CBDE however, and the associated permanent bank long-term funding facility needed to maintain financial stability, the ECB influence on lending capacity, lending sectors (through eligible collateral to access those central bank facilities) and rate setting in the system would remain enlarged permanently. This would be a major evolution of the ECB role. Currently, banks get central bank term funding from the refinancing facility of the ECB (i.e. Target Long Term Refinancing Operations, TLTROs). In the context of a CBDE, the ECB term funding would have to become recurrent. The functioning of such a facility would have to be examined in detail. In general, a systematically higher volume of refinancing operations would probably affect the availability and price of collateral, thus making the system more vulnerable to episodes of volatility in market rates. This increased need for collateral would probably require the development of a well-functioning market for the securitization of bank loans with the aim of creating assets that have ratings adequate to make them eligible collateral. As for the central bank, it would have to accept a larger and riskier balance sheet, given the likely need to broaden the pool of assets it accepts as collateral.

Therefore, further analysis and continuous dialogue with the industry is required on the effectiveness of different tools in preventing the shift of bank deposits, under both normal and crisis situations, as well as on how the ECB would compensate for the need of stable funding.

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About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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