27 July 2022

The birth of a digital euro (dEUR) is no longer a question of if but of when. It won't be implemented in the immediate future but at this stage it is no longer the 'who-needs-this project?' that was the case before the pandemic. Despite their current non-committal wait-and-see positioning, European banks could benefit from the introduction of central-bank digital currencies (CBDCs), including for funding stability.

Central banks in countries with developed banking systems have stated unequivocally that their CBDC initiatives will be unambiguously pursued in close partnership with their banks. In the case of the ECB, it is doubtful that a dEUR would be of any use if not in close relation with banking activities. This should be an essential starting point when assessing the impact of CBDC on banks.

The ECB's messaging related to a dEUR is becoming less hypothetical and more convincing, mainly because the argument for its establishment has become clearer. In a recent blog[1], the ECB cited three risks of inaction:

1 As cash is used less and less, public money could lose its role as monetary anchor in the absence of a digital equivalent.

2 Private crypto currencies, notably stablecoins, cannot guarantee one-to-one convertibility with central-bank money and are vulnerable to runs.

3 Digital private-sector payment solutions – crypto or otherwise – are dominated by non-European tech players, which can represent material threats to Europe's monetary sovereignty, especially in a crisis.

At the same time, CBDCs are gaining ground worldwide, raising the competitive stakes in the monetary playing field. According to the latest statistics[2], 10 countries have already launched national CBDCs: Nigeria, Jamaica, the Bahamas, and seven East Caribbean states. Fifteen countries have a CBDC at pre-launch pilot stage – notably China, Russia, and, alone in the EU, Sweden. The Euro Area is at the next stage, of CBDC development, alongside Switzerland, Japan, Canada, India, Australia, Brazil, and several others. The US, the UK, Norway, and

[1] https://bit.ly/3ba6ues
[2] https://www.atlanticcouncil.org/cbdctracker/

other countries are one step behind still, in the pre-development research phase. At the bottom, a few countries, including Denmark, are not yet actively pursuing CBDC initiatives.

Doubts persist about the need for dEUR…

When it comes to a dEUR, banks so far have expressed hardly any details or views in calls with investors and analysts, who in turn generally ignore the topic.

This is understandable to some extent, given the growing shelf space taken by the headwinds building up for European banks. Nonetheless, as the dEUR project advances – it will reach a pilot stage some time next year – banks will need to tackle the topic head-on in their dialogue with investors.

A major concern of the banks, so far expressed by the European Banking Federation and the Institute of International Finance (IIF), is about the impact of a dEUR on financial stability in general (largely related to bank funding) and on bank profitability. The IIF's managing director recently contrasted the ECB's 'how to launch' position with the US Fed's 'whether to launch'.

Specifically, there is unease about the scenario of bank depositors shifting their funds to dEUR in the event of a real or perceived crisis, contributing to banks' funding shortages. To address this, the ECB is considering, first, imposing limits on dEUR holdings by individuals and businesses. And second, discouraging the use of dEUR holdings as an investment by applying disincentivising remuneration above a certain threshold, with larger holdings subject to more punitive rates.

In my view, the most pragmatic way to look at a dEUR is simply as a cash substitute; no more no less. Within a generation at most, notes and coins will hardly be used. The pandemic has been a powerful catalyst in this respect, and not only for Millennials and Gen-Z.

Through the gradual substitution of cash with CBDC, the ECB and other central banks will avoid cash hoarding: most EUR 100 notes are held rather than transferred through the banks, for instance. This will further help financial inclusion. As dEUR becomes widely used, cash will become as infrequent and obsolete as paper cheques today.

… But banks should not fear it

One of the main advantages of a successful dEUR for banks will be avoiding uncertainties generated by mainstream usage of stablecoins and other cryptocurrencies in payments and financial transfers. Banks can raise concerns about the potential impact of CBDC on funding, but they should acknowledge that such concerns would be substantially heightened if, in the absence of CBDC, private crypto currencies played that role.

The alternative to CBDC is not keeping digital money out. The barn doors are open, and the horses are out. Unattractive for banks as this is, the alternative is witnessing the growing role of stablecoins and their private crypto equivalents in mainstream payments. China took the decision to ban private crypto currencies and promote a digital yuan. In the US, debate about which is better – CBDC or private stablecoins – is ongoing, although the latest runs on cryptocurrencies and price collapses suggest that the digital dollar may have a future.

It is unlikely that dEUR, with caps on holdings and yields, will even partially replace bank deposits. Banks sometimes mention the 80-90/10-20 rule, where 80%-90% of revenues are generated by 10%-20% of clients, leaving a large category of bank customers less profitable for the bottom line due to the running costs of servicing small-amount deposits.

Unlike in the US and to a lesser extent in the UK, in the EU there are restrictions on deposit servicing fees, so banks cannot dissuade small depositors from carrying out all kinds of transactions (the so-called under-banked category that covers some 20% of households in the US).

A dEUR could remove some of the burden from banks with many small depositors through a safe and effective alternative that could help ease those banks' cost bases.

Concerns that, in a crisis, bank deposits could be depleted through migration to CBDC should be taken with a pinch of salt. A recent report by the US Office for Financial Research[3] suggests that access to CBDC decreases the amount of maturity transformation performed by banks and thus, intuitively, would make a liquidity shock less costly for depositors. In other words, when banks perform less maturity transformation, they are less exposed to the possibility of a run.

Equally, observing the flow of funds from bank deposits into CBDC can give supervisors more information about the state of the banking system, specifically about depositors' confidence in their banks. Accordingly, they would be in a better position to react quickly to address a bank's weaknesses. If depositors anticipate a faster supervisory reaction, their incentive to join the run decreases.

[3] https://bit.ly/3J3XLa2

This report is published by Scope Group. The content is an independent view not related to Scope's credit ratings.

Scope SE & Co. KGaA

Lennéstraße 5
10785 Berlin
info@scopegroup.com

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

info@scoperatings.com

Scope Ratings UK Limited

52 Grosvenor Gardens
London SW1W 0AU

info@scoperatings.com

Scope ESG Analysis GmbH

Lennéstraße 5
D-10785 Berlin

esg@scopegroup.eu

Scope Analysis GmbH

Lennéstraße 5
D-10785 Berlin

info@scopeanalysis.com

Scope Investor Services GmbH

Lennéstraße 5
D-10785 Berlin

info@scopeinvestors.com

Scope Hamburg GmbH

Stadthausbrücke 5

D-20355 Hamburg

info@scopehamburg.com

www.scopegroup.com

www.scoperatings.com

www.scopeanalysis.com

www.scopeinvestors.com

www.scopehamburg.com

Disclaimer