Banks need to prepare more and worry less about a digital euro

Sam Theodore | February 2024

The likely establishment of a digital euro (dEUR) in a few years has triggered some anxiety among European banks around the stability of their deposit bases, especially in a crisis. Banks have been warning policymakers that they might be less able to lend to businesses and households if funding becomes more difficult.

Such a scenario would be unwelcome but is unrealistic. Fears of material deposit flight are unwarranted, especially since the ECB has gone some way to addressing banks' apprehensions. Indeed, at this stage, I find the dEUR project reassuring for banks in terms of sheltering their deposits.

Profitability and business model-related challenges

Banks should be focusing not on deposit instability but on profitability and business model-related challenges. Because an ECB/Eurosystem-run dEUR infrastructure will add to the payment disintermediation hurdles banks are already facing, brought about by digitalisation and existing or forthcoming financial regulations. I call them progressive regulations as opposed to protective regulations (which relate to prudential rules). In the progressive regulations category, I include the Digital Operational Resilience Act (DORA), payment services directives PSD2 and PSD3, Financial Data Access (FiDA) and the recently-approved SEPA Instant Credit Transfer (SCT Inst) that will mandate low-cost instant payments across the EU (another big challenge for banks).

Payments have been a bread-and-butter business for banks but one where new non-bank entrants and new business models are increasingly challenging them. These challenges are highest for banks that are behind in developing their payments-related tech infrastructure. Examples would be second-tier banks with historically stable local franchises that are happy to remain in their legacy comfort zones but also larger banks that are under-investing in technology – and there are several of those throughout Europe.

The dEUR threat for these banks is not deposit flight but shrinking or disappearing payment-related revenues. Equally, the inability to provide or delays in providing products and services via open platforms, among which a future dEUR infrastructure will be a very significant player, may turn into a structural weakness for many of those banks. Especially as competition from non-bank payment service providers (PSPs) – regulated alternative payment providers, payment enablers, or payment providers – would increase, facilitated by the free distribution of dEUR to end-users.

Some legacy banks with narrow product franchises that retail depositors use mainly for transactions could witness an erosion of their customer base. Again, the concern here is not about deposit flight but the loss of product cross-selling potential in cases where it is deposits that anchor relationships. This is important as banking gradually moves from being product-centric to customer-centric.

Advancing on the road to dEUR

The dEUR project entered its second stage – preparation – in November 2023. This followed the first stage – investigation – which was initiated in 2021 and is complete. At the end of the preparation stage in two years' time, a decision will be taken on whether to proceed with completion of the project, namely finalising, issuing, and rolling out a dEUR.

There are several roadblocks on the road to completion, though: legal, economic, socio-political, and institutional and these may in fact get tougher as the process advances. But the logical outcome will have to be the birth of the dEUR. Any other outcome would be counterintuitive and self-defeating. First, it would lead to a wide opening up to non-European private crypto-based options like the US-imported stablecoin. This is an option European policymakers and regulators are forcefully and openly not keen on.

Second, over time it will put the EUR in a less competitive position in global markets. A real possibility exists that cross-border payments and transactions will be increasingly carried out using digital currencies. The EUR will not want to miss the boat. And because the euro area (EA) of 20 countries is more than a large domestic market like the world's other major economies, having a wholesale dEUR for global payments but not a retail dEUR for payments within the EA would be a clumsy choice.

At this stage the alternative to the dEUR is not keeping the status quo. That bridge has already been crossed in the digital age.

Among the world's leading economies, the EA is in a more advanced stage of development for its digital currency project than the UK, where the Bank of England is still investigating the case for a digital GBP. The EA is also well ahead of the US, where a high dose of political and economic scepticism – especially from Republicans – persists around the usefulness of a hypothetical digital USD. The EA is behind China, Japan, and India, however. The three Asian economic powers have moved their CBDC projects into pilot (pre-launch) stages. Japan remains in a slightly contemplative mood (the launch of a digital JPY has not yet been decided upon), and so is India for the time being. But China has already tested the waters by rolling out a digital yuan in 20 cities on a trial basis.

Elsewhere in Europe, Sweden and Switzerland are at pilot stages but still on the fence as to whether and when to pull the trigger. The Danish central bank has already determined that cash usage in the country is low and dwindling and private payment systems are strong and performant so the use of a CBDC – and the costs attached – would not be warranted for the time being.

Banks express dEUR concerns on deposit flight…

A report by the European Banking Federation (EBF) published in 2023 highlighted European banks' vision for a dEUR: on balance positive but with caveats and warnings. For example, banks raised the alarm about a potential shift of funds held as bank deposits to dEUR accounts/wallets that will be a direct liability of the ECB. In function of the magnitude of this shift, there could be consequences on banks' ability to meet prudential requirements, hence on their ability to extend loans to the economy.

The report pointed to the need to limit the level of dEUR holdings, which should be envisaged solely as a means of payment not as a store of value. There should also be limits on the amounts of each transaction, given the envisaged automatic mechanism (reverse waterfall) where online dEUR payments above a holding cap are allowed but any excesses are automatically transferred to linked commercial bank accounts.

As well, there should be no remuneration for dEUR holdings. In addition, the EBF called for an ECB liquidity facility to compensate for potential deposit outflows as well as no direct distribution of dEUR by the ECB/Eurosystem. As the report put it: "the digital euro should be the 'raw material' issued by the ECB, on which the private sector can add products and services for the end-users".

Another study, also commissioned by the EBF and published last December by consulting firm Copenhagen Economics, is less even-keeled and more alarmist. It warns about the potential impact of a retail dEUR on financial stability and consumer welfare (the role of a wholesale dEUR is not disputed), wondering if it is worth the effort. The three areas of concern are:

1. Risk of displacement of bank deposits,
2. High cost of implementing such a large-scale project potentially leading to the reduction of innovation capacity and banks' competitiveness,
3. Overlap with existing payment means threatening the retail banking model thus impacting profitability.

The ECB has addressed the first point. The second and third points are more backward looking as they do not recognise banks' need to invest more intensely and comprehensively in technology and digital transformation. If anything, a dEUR option sitting alongside open banking/finance and instant payments, should stimulate not stifle banks' innovation capacity and competitiveness in the new digital space.

… Which the ECB tries to address

On the report's first point, the ECB, in its investigation phase, tried to respond to some of the banks' legitimate concerns. In a recent blog entitled "Digital euro: debunking banks' fears about losing deposits", the central bank points to some key features being contemplated about the dEUR preventing unwanted bank deposit disintermediation:

1. Individual dEUR holdings will be limited (the amount will be decided closer to the launch date, in function of the economic and financial realities at that time).
2. Businesses would transact and process dEUR but would not be able to hold them at all.
3. dEUR holdings would not be remunerated.
4. Users will be able to seamlessly link their dEUR accounts to payment accounts with their bank, enabling the reverse waterfall. This will eliminate the need to pre-fund dEUR holdings for payments, as shortfalls would be automatically covered from the linked bank accounts (provided they have sufficient funds available).

Assuming all those steps are implemented, they would credibly mitigate the threat of individual user funds shifting on a large scale from bank deposits to dEUR accounts. These constraints hold true even in a crisis, when customers would plausibly be keen to withdraw funds from banks considered as weak. Besides, even in a severe crisis, many banks would remain safe, and central-bank funding support would continue. The ECB also highlights that in recent decades bank runs have not been triggered by large numbers of retail customers pulling out small deposits (fully covered by deposit insurance schemes) but by wholesale market funding bottlenecks/repricing or large-amount deposit withdrawals.

Using data from the Italian banking sector, a study by Banca d'Italia published this month estimates that the impact of a dEUR on the funding structure of banks would be manageable as long as its demand were below 15% of retail deposits. If this assessment holds true across the EA, with strict individual dEUR holding limits in place, exceeding that threshold is an unrealistic scenario.

A strong and in my view very convincing argument by the ECB for establishing a dEUR is reducing Europe's dependency on foreign payment-service providers. This is a critical priority in the more threatening geopolitical environment we live in.

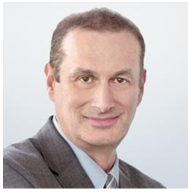
First, it would ensure that, in addition to private payment solutions (which remain national), there would be a payments solution for the EA as a whole.

Second, a dEUR would rely on its own infrastructure, an additional protection against cyberattacks. Third, a dEUR would provide a pan-European platform on which European banks as well as other regulated PSPs could add products and services with pan-European reach for their customers.

This last aspect, which directly addresses a key point on the European banks' initial wish list, is a very powerful benefit for banks at an advanced stage of digitalisation, which have recognised and accepted the shift of finance from vertical legacy structures to horizontal platforms open to all interested and qualifying PSPs.

As is the case with other digital-related developments, we should view the adoption of CBDCs in a dynamic, not static scenario: look to where banks are going, not to where they are right now.

Analyst



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