

Central banks' new challenges: Separating banks from states – the example of Banking Union

Central bank (r)evolution, Madrid, 17 June 2013

Thomas Mayer

Senior Fellow at the CFS, Goethe University
Frankfurt, and Senior Advisor at Deutsche Bank

mayer@ifk-cfs.de
tom.mayer@db.com
(+49) 69 910 30800

Some problems with the present approach

- Fractional reserve banking creates liquidity and solvency risks
- Central bank needed to deal with systemic liquidity risk
- State back-up needed to deal with systemic solvency risk
- Problem in EMU: We do not have a state
- Result: ECB ends up backing both systemic liquidity and solvency risk

Solutions (theoretical)

- Create a Euro State
- Replace fiat money system and fractional reserve banking by gold standard and 100% reserve requirements for banks
- Privatisise money creation in a Free Banking System (Hayek 1976)

A practical solution for Banking Union

- Step 1: Define as safe asset deposits fully backed by central bank reserves
- Step 2: Create a hierarchy of loss-absorbing bank liabilities
- Step 3: Divest banks from governments by treating government debt as „credit“

A Copernican Turn for Banking Union

Present approach	Proposed approach
<p>Step 1</p> <p>Establish SSM on the basis of the regulatory framework mapped out in CRDIV.</p>	<p>Step 1</p> <p>Establish deposit insurance by requiring safe deposits to be backed 100% by banks' holding of reserves with the central bank.</p>
<p>Step 2</p> <p>Establish SRM backed by a government-funded restructuring and resolution fund.</p>	<p>Step 2</p> <p>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.</p>
<p>Step 3</p> <p>Keep deposit insurance under national authority.</p>	<p>Step 3</p> <p>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.</p>

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.

Disclaimer and disclosure of interests

© Copyright 2013. Thomas Mayer.

The above information does not constitute the provision of investment, legal or tax advice. Any views expressed reflect the current views of the author alone and must not be attributed to Deutsche Bank. The author is an external adviser to Deutsche Bank.