The banking privilege [draft]

It is often held that banks have the privilege to create money. In a legal sense, this is not true though. But banks do have legal privileges that enable them to issue debt instruments that are used as money. This back-ground document summarizes these privileges as codified in European law and puts them in context.

Repayable funds

European financial law awards banks ("credit institutions") a privilege to carry out "the business of taking deposits or other repayable funds from the public" (article 9 CRD).

> Article 9
> 1. Member States shall prohibit persons or undertakings that are not credit institutions from carrying out the business of taking deposits or other repayable funds from the public. (…)

Non-banks can take repayable funds from the public too, but only upon issuance of securities (shares and bonds). This is subject to prospectus requirements (see: regulation (EU) 2017/1129) which ensure that risks are factored in and mitigated, accepted and allocated through market processes. Securities are negotiable instruments that exchange typically at market value.

Banks can take repayable funds from the public without honoring prospectus requirements. They take these funds exempt from transparency rules and market discipline, and without due market processes for mitigation, acceptance and allocation of risk. The resulting instruments "deposits" have a fixed value, equal to their nominal amount. This makes these instruments fit to be used as money.

The word "deposit" is somewhat misleading. It suggests that a depositor, deposited some money for safekeeping at his bank. However, deposits are a form of cheap (subsidized) funding for banks, that is not available to non-banks. Deposits are valued at their nominal amount, irrespective of the underlying risks. The public is expected to lend its money blindly to the banks.

Market processes

Securities are subject to financial oversight (supervision of financial conduct) to safeguard risk transparency and due market processes concerning these instruments. Deposits are exempted from these rules. They are subjected to prudential oversight instead. The institutional framework of the bank money system is designed to replace market processes concerning the soundness and valuation of bank deposits, by semi-public supervision, according to standards largely defined by the banking community itself. This is what sets bank deposits aside from other liabilities, such as equity and bonds.

By blocking due market processes the public is exposed to risks it is not aware of, and that are not incorporated in the value of these instruments. The public supposes to possess 'money in the bank', in the form of deposits, whereas it has actually lent its money to a bank, on conditions not defined nor disciplined by the markets, but by the banking community itself. This makes the bank money system inherently unstable. The institutional framework of the bank money system is designed to contain this instability. Not to fix it.

Institutional framework

The institutional framework of the bank money system ensures "parity" between deposits and the currency, which means they exchange 1 on 1. This framework consists of several arrangements, among which the following.

Prudential oversight: Issuance of 'deposits' is exempt from due market processes. Instead, risks in financial institutions that issue deposits (MFIs) are assessed and monitored by a government (or government related) institution. By implementing prudential oversight, the state implicates itself in the risks and business of banking.

Bank liquidity: To sustain trust in bank deposits the central bank provides liquidity to the banks (MFIs) in the form of central bank credit, issued on collateral. Collateral is accepted from eligible entities (MFIs) according to a collateral framework. Central bank credit is provided on demand to MFIs.

In general, state institutions are not allowed to offer credit to private businesses on non-commercial terms. A central bank does this routinely though, favoring MFIs. MFIs can even call for funding on non-commercial terms when they are at the brink of collapse, which gravely distort market processes. Economists don't see any harm in this. They normalized it by calling it "Lender of Last Resort", a respected function of a public institution systematically favoring MFIs.

Liquidity is provided by the central bank in the form of credit (monetary value). It is not provided in the form of cash (monetary objects).

Cash enters circulation only if MFIs purchase it from the central bank. They can only do so if they have an account with the central bank, which is debited to the amount of their cash purchases ('withdrawals'). Cash in circulation is accounted for as a liability. That is not because it represents a claim on the central bank. It is a reservation the central bank makes, because of its obligation to credit the account of the MFI that returns notes to the central bank. If the central bank goes bankrupt a note gives no claim on the estates of the central bank ('no-recourse'). Deposits at the central bank (commonly referred to as 'reserves') do.

Interbank settlement: Providing credit to banks is an integral part of the interbank settlement system. This is the heart of the central bank, which enables its member banks to run a payment system that is not based on cash, but on settlement of bank balances. It is instrumental for having a money system that is based on quasi money ('deposits') linked to the currency.

Due to 'interbank settlement' commercial banks can settle their mutual claims in 'central bank credit', which is backed by the money printing press, and in most cases in the EU, by the Member States, as the (main) shareholder of the central bank.

Physical cash: Traditionally, central banks have a legal monopoly on issuance of bank notes. In the European Union this monopoly is attributed to the ECB and the NCBs. Issuance of euro bank notes is exclusively authorized by the ECB (article 128 TFEU). Provision of bank notes is fully elastic with demand for bank notes.

Monetary policy is exercised via central bank credit. Not via cash. The ECB/ESCB-statutes are drafted such that issuing cash is not a duty of the central bank, and that credit activities are the core of monetary policy, which is completely at the discretion of the central bank. The ECB can discontinue issuance of notes at its discretion.

Still, cash has some relevance because MFIs can withdraw their 'reserves' at the central bank at any time in cash. They do not have to fear for a bank run because the central bank can print notes on demand, to the extent that it already supplied credit to the banks. Because of this, the quasi money that central banks issue (central bank balances, commonly referred to as 'reserves') are 'as good as money' and exchange at parity with the currency.

The currency is embodied in physical notes and coins, commonly referred to as 'fiat money', as they are created by decree; a legitimate unilateral act. They are issued however on demand and on the basis of a purchasing contract, which makes the applicability of 'fiat money' to the circulation of notes and coins questionable. In the present setup of the money system the circulation of notes and coins is an extension of bank credit, and not an expression of sovereign will.

Public debt: The main backing of central bank money (and shadow bank money) is provided by public debt. Public debt is preferred by quasi money issuers because it provides a most reliable cash flow, which is backed by the power of taxation. The sovereign can service its debts simply by taxing its subjects. In this way, quasi monies are backed by state power.

Deposit guarantee schemes: The government imposes statutory deposit guarantee schemes (and/or insurance schemes) to enhance trust in deposits. Even banks that do not want to be part of the risk-sharing structure of the banking system, are obliged to participate.

Shadow banking: As deposit guarantees are limited to small deposits, large deposits are secured by other mechanisms (e.g. Money Market Funds and repurchasing contracts) that use collateral, preferably government bonds. In response to the banking crises, the EU increasingly extends prudential oversight to the private sector wholesale money markets. Shadow banking concepts can choose to become part of the approved quasi money system and become subject to prudential oversight, in which case the public sector takes responsibility for the solvency of private entities. They can also choose to become an investment, valued at market value.

As the shadow banking system thrives on collateral, the good collateral flows to these wholesale money markets. The lesser collateral stays in the regular banking system, is absorbed by central banks and used to back deposits, weakening the banking sector, and weakening the stability of insured deposits.

The business of banking

The foregoing explains why and how certain claims on banks (bank liabilities) can be used as money. But this does not fully describe the business of banking. That business concerns a combination of taking deposits or other repayable funds from the public AND granting credits for its own account (article 4 CRR).

> Article 4 (…)
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> "credit institution" means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account;

Non-banks are not allowed to combine borrowing money from the public with lending.[1] Member States must see to it that this is not breached (article 66 CRD). Only banks ("credit institutions") that are subjected to prudential oversight are authorized to commence the business of banking.

> Article 8
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> 1. Member States shall require credit institutions to obtain authorisation before commencing their activities. (…)

[1] Under severe conditions, an exemption applies only for group financing companies.

Article 66
1. Member States shall ensure that their laws, regulations and administrative provisions provide for administrative penalties and other administrative measures at least in respect of:
(a) carrying out the business of taking deposits or other repayable funds from the public without being a credit institution in breach of Article 9;
(b) commencing activities as a credit institution without obtaining authorisation in breach of Article 9;(…)

The combination of borrowing and lending is the magic of the banker, who seems to multiply money miraculously. In fact, however, no money is created by the bankers. It is promised. The institutional frameworks monetizes these promises by ensuring "parity" between those promises and the currency.

The banks take and extend credit. The institutional framework ensures the credit of the bank is as good as the currency.

How to end the banking privilege?

Prerequisite for ending the banking privilege is provision of an alternative. Ideally, the state provides adequate quantities of monetary objects, that do not represent a claim on the issuing entity nor anyone else (debt free money) to provide sufficient liquidity to society at large. I refer to this as MONEY. This is not to be confused with central bank money ('reserves') which are claims on the central bank, and thus not monetary objects. MONEY embodies the general unit of value. It is not *exchanged* at parity with the currency. It *is* the currency, providing 'inherent' liquidity, as distinguished from contractual liquidity ('deposits' and 'money market instruments') or market liquidity (securities).

The traditional forms of MONEY (notes and coins) are not as convenient as bank money. To provide an alternative the state must start issuing digital MONEY, next to physical MONEY (notes and coins). The European Union for instance should start issuing a digital euro.

Repayable funds

For banks and non-banks the same rules should apply regarding the taking of repayable funds from the public. Banks should only be allowed to attract funding on the same conditions as non-banks: that is in the form of securities and subjected to prospectus requirements.

Business of banking

The ban on combining borrowing from the public, and lending must be lifted.[2] Instead, a ban should apply to all businesses on borrowing money under conditions in which the loan can be reclaimed on demand.

Usual objections

The banks will object that the credit markets would dry up. That is nonsense. The new Monetary Authority (which is not a bank) can issue as much MONEY as society needs. It will provide liquidity to society at large, not just to banks. Society (the markets) can then decide what activities/business to invest in, and what activities/business not to invest in. The credit system will become liberalized, decentralized and market oriented. Moreover, assets can be tokenized and be used as market liquidity to fund economic activity.

[2] This ban stands in the way of getting the public more involved in lending. It protects the position of an ever-smaller group of increasingly bigger financial institutions that dominate credit markets. Lifting this ban would enhance fair competition in credit activities.

Central banks will object that the amount of digital MONEY cannot be adjusted. That is nonsense too. digital MONEY can simply be taxed away when and where-ever it accumulates too much. MONEY must not be hoarded. It must circulate. If it is not recirculated by the holder the Monetary Authority will tax it away, and recirculate it, as it sees fit, by handing it to the government to be re-spent into circulation.

Note that no existing value is taxed away. Digital MONEY is a new asset that never existed before. Accountants have yet to find a name for it. My suggestion to them is ‘intangible liquid asset’ or in short ‘MONEY’. Holding MONEY must not yield (nor cost) interest. Holding reasonable liquidity buffers in MONEY is encouraged. But hoarding MONEY beyond that must not be allowed. That would endanger the stability of the MONEY-system.

MONEY embodies the unit of value. It is a means of payment (which must not be compromised by inflation nor deflation) but it is not a store of value. It is inherent liquidity, provided debt free as a public utility, to make the peoples and the planet prosper.

Edgar Wortmann – June 13, 2018