Clarifying misconceptions about the role of banks in creating money is of strategic importance for accountability and audit

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Against the backdrop of climate change and a global pandemic, public audit institutions, as the independent guardians of the financial interests of citizens, have an important role to play regarding the public sector's financial challenges and financial stability in general. Lise Marie Bruun and Patrick Alix work as managers and senior auditors for an international supreme audit institution. Their contribution addresses a topic outside the realm of their daily work, as they share their personal view on how to strengthen public sector accountability and the audit of European banking supervision.[1] According to the two authors, there is a need for more transparency and a strengthened role for parliaments, for the benefit of public policy-makers and the public at large.

Strategic goal to address accountability gaps, including in relation to banking supervision activities

In today's context of greater uncertainty and risks, supreme audit institutions (SAIs) need to become more innovative in how they can address society's current and future concerns. From a strategic point of view, a public audit institution needs to look at risks from a wider policy perspective, where possible by acquiring new knowledge and expertise, and focusing on the links between complex financial information, public policy objectives and societal concerns. Building on ISSAI 12, the international audit standard of the International organisation of Supreme Audit Institutions (INTOSAI)[2], SAIs should incorporate an agile and forward-looking mindset in their strategic plans, in order to remain relevant to their citizens, parliament and other stakeholders. In line with ISSAI 12, the European Court of Auditors included a goal in its 2021-2025 Strategy on improving accountability, transparency and audit arrangements across all types of European Union action, together with identifying audit and accountability gaps.

1 The views expressed in this article are solely those of the authors and do not reflect in any way those of their employer.

2 See particularly Principle 5 of ISSAI 12.

One accountability and audit gap of strategic concern for SAIs relates to banking supervision, which aims to contribute to the safety and soundness of the banking sector and the stability of the financial system. In 2018, the Contact Committee of the Presidents of SAIs of the EU reported on deficiencies in the accountability and audit arrangements of the supervisory mechanism for banks in the euro area. This is because, with the establishment of the Single Supervisory Mechanism (SSM)[3], prudential supervision responsibilities over the most 'significant' banks were transferred from national authorities to the European Central Bank (ECB). In 2019, 117 significant banks represented over 80% of the total asset value of banks in the euro area.[4]

The ECB is audited by the ECA, but under a limited mandate restricted to an examination of the operational efficiency of the management of the ECB[5], which also applies to its banking supervisory tasks.[6] Within its mandate to audit the operational efficiency of the management of the ECB, the ECA has issued a number of reports covering the ECB's banking supervision tasks.[7] The ECB's accounts are audited by private sector external auditors.

The ECB enjoys independence in its exercise of powers as reflected in the Treaty on the Functioning of the EU (TFEU) and the Statute of the European System of Central Banks (ESCB) and the ECB. The ESCB is made up of the ECB and the national central banks of the euro area. According to Article 127 of the TFEU, 'The primary objective of the European System of Central Banks (ESCB) shall be to maintain price stability.' This article also states that 'Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.' These EU objectives are broad and include for example *sustainable development, balanced growth* and *improvement of the quality of the environment*. The objectives of the ECB, including objectives related to banking supervision, reflect well its general aim to contribute to the achievement of wider public policy goals, without prejudice to the objective of price stability.

Clarifying misconceptions about the role of banks in creating money

For those of us who do not work in the banking sector, its inner workings, especially regarding the public role of banks, are largely unknown territory. During the last decades, the increased use of bank deposit money, the disappearance of public facilities for payments and savings, and concentration in the banking sector, have resulted in an imbalance between public and private interests. This imbalance has only very recently been the focus of public policy debate.[8]

The acquisition of new knowledge and relevant expertise is a critical part of strategic planning. One key challenge regarding the audit of banking supervision is to gain sufficient knowledge of the banking system, especially given the complexity of banking sector terminology and regulations.

During the last few years, the Bank of England[9] (2014), the Deutsche Bundesbank[10] (2017) and the Banque de France[11] (2019), published articles that provide new knowledge, at

3 See Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

4 ECB Annual Report on supervisory activities 2019.

5 Article 27 of the Protocol on the statute of the European system of Central Banks and the European Central Bank.

6 Council Regulation (EU) No 1024/2013, idem, Article 20.

7 For example: special report 05/2014: *European Banking Supervision taking shape – EBA and its changing context,* and special report 29/2016: *Single Supervisory Mechanism – good start but further improvements needed*.

8 The Netherlands Scientific Council for Government Policy, *Money and Debt. The Public Role of Banks*, 2019.

9 Bank of England, by Michael McLeay, Amar Radia and Ryland Thomas , *Money creation in the modern economy*, Quarterly Bulletin 2014 Q1.

10 Deutsche Bundesbank, *The role of banks, non-banks and the central bank in the money creation process*, Monthly Report, April 2017.

11 Banque de France, *Qui crée la monnaie*, 2019.

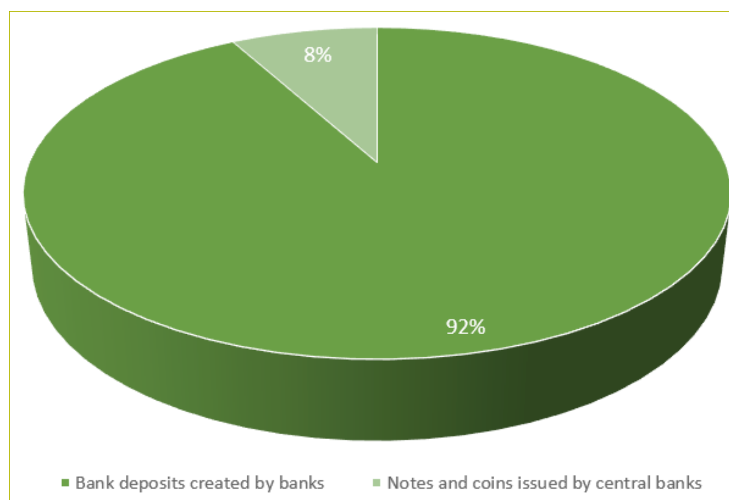
least for non-experts, on how the banking system really works. This new central bank narrative dismisses the 'money multiplier' fractional reserve theory, which incorrectly assumes that banks lend out reserves, i.e., money that was first deposited in their bank as reserves. According to this inaccurate theory, central banks are able to determine the overall amount of money in the economy by controlling the quantity of base money reserves, and by setting a reserve ratio for bank deposits. This theory is still frequently applied by policy makers and taught in economics courses and textbooks.[12] However, this is not the way banking works nowadays.

> Banks do not lend out reserves.
>
> When banks grant a loan, they create new money by an accounting double-entry.

The central banks of England, Germany and France, sought to shed light on those misconceptions, clarifying that banks do not lend out reserves. Banks mainly use central bank reserves to make interbank payments, not for payments outside of the banking system. In fact, banks do not need reserves to be first deposited in their bank before they can grant a loan or purchase an asset. This is because banks are able to create new money in the form of bank deposits, by an accounting double-entry when they grant loans - this process is also called *credit creation*.[13] Banks also create new money when they purchase assets. Conversely, by applying the reverse accounting double-entry, banks also destroy money every time they are repaid loan capital instalments or when they sell assets.

In order to estimate monetary aggregates and to have a comprehensive picture of the monetary developments in the euro area, the ECB prepares a consolidated balance sheet of Monetary Financial Institutions (including money-issuing banks).[14] This consolidated balance sheet shows that approximately 92% of the money supply in the euro area is made up of bank deposits created and reported on the balance sheets of money-issuing banks (see **Figure 1**).

Figure 1 – Money supply in the euro area



Source: Lise Marie Bruun and Patrick Alix, based on information drawn from the MFI consolidated balance sheet

Regulatory basis for creating money…without initial reserves

A limited amount of academic literature can be found to explain the regulatory basis allowing banks to create and destroy money without first holding reserves. According to some experts[15], this basis is provided by the 'banking exemption' from client money rules, which allows banks to record money as a liability and not as a segregated asset placed in a separate bank account. In EU regulations, this exemption to client money

12 By Joe Earle, Cahal Moran and Zach Ward-Perkins, *The econocracy. The perils of leaving economics to the experts,* Manchester University Press, 2016.

13 Standard & Poor's Ratings Services, by Paul Sheard, *Economic Research: Repeat After Me: Banks Cannot And Do Not "Lend Out" Reserves*, August 2013.

14 Based on information drawn from the MFI consolidated balance sheet.

15 See for example Richard A. Werner, *How do banks create money, and why can other firms not do the same? An explanation for the coexistence of lending and deposit-taking,* International Review of Financial Analysis 36, 2014, 71–77.

rules is found in the Markets in Financial Instruments Directive (MiFID ii).[16] Further analysis is needed to confirm the precise regulatory basis of the monetary creation process by banks provided by this banking exemption.

From a regulatory standpoint, EU banking regulations do not refer to the way banks are able to create money without first holding reserves. To illustrate this point, in the EU a bank is called a credit institution[17], which is officially defined as '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.'[18] This definition appears to indicate that a credit institution first takes deposits from the public and then uses these deposits to grant loans, as described in the 'money multiplier' theory. The way a credit institution is defined in EU regulations may therefore be an indication that the current regulatory framework is based on the outdated 'money multiplier' fractional reserve theory. We think that a more accurate definition of a bank, reflecting its public role, could for instance be: a financial institution exempted from client money rules when transacting with non-banks, and thereby authorised to create and destroy money.

Because banks are able to create money by an accounting double-entry without first holding reserves, central banks cannot determine the overall quantity of credit and money in the economy via a 'money multiplier' or reserve ratio. Instead, central banks use monetary policy to ensure that the amount of money creation in the real economy is consistent with low and stable inflation, by setting the interest rate on base money, i.e., on central bank reserves, which in turn may influence bank interest rates. In addition, central banks may provide monetary stimulus to the real estate and financial markets sectors through non-conventional monetary policy programmes of asset purchases - Quantitative Easing. Central banks and national bank supervision authorities may also seek to influence decisions made by banks using micro- or macro-prudential instruments, but this remains mostly of a persuasive nature with no guarantee of providing sufficient incentives to banks to take action.[19]

Creating money has societal consequences

The fact that central banks cannot determine the overall quantity of credit and money in the economy is of strategic relevance for policy makers and consequently also for SAIs. Money creation has an impact on wider public policy objectives. This is because decisions made by banks on how to allocate credit in the economy may directly impact financial stability. For example, decisions made by banks to increase net credit creation in the real estate or financial markets sectors may lead to the build-up of asset bubbles and financial instability in those sectors.

Moreover, other public policy areas, such as climate change and sustainable finance, are directly or indirectly impacted by the way money is created by banks. For example, decisions made by banks to continue allocating credit to the high-carbon sector and thereby most often to the most highly polluting activities of the economy, may jeopardise the success of sustainable finance public policy objectives.

How banks allocate credit in the economy, both in terms of geographical location and by sector may have considerable effects on the general state of the economy. In addition, short-term financial market forces are not necessarily aligned with long-term public policy objectives. At a time of climate change, high pollution levels and the destruction of biodiversity, it is important that policy makers have better insight into and oversight of the scale and characteristics of money creation by banks, financing the different sectors of the economy. The question is whether sufficient information to gain this insight and

16 Article 16(9) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID) and Article 4(1) of the Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU (MiFID Delegated Directive).

17 In this article, we refer to credit institutions as banks for the sake of clarity, except when we are referring to a specific regulation or definition.

18 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

19 European Systemic Risk Board, *Flagship Report on Macro-prudential Policy in the Banking Sector*, 2014.

oversight is available and if so, whether it is possible to grasp its meaning and impact. The question is also, whether policy makers currently have sufficient means – regulatory, fiscal or other – to steer decisions made by banks regarding money creation into line with long-term objectives and limits set through democratic processes.

Strengthening public sector accountability and audit of banking supervision

Having evidence-based information to enable proper decision-making is a strategic concern for a government at any level. This makes accountability of banking supervision activities in the EU a strategic concern.

The accountability arrangements of the ECB are described in the EU Treaties and in the regulations concerning banking supervision.[20] The ECB submits two annual reports to a number of stakeholders including the European Parliament and the Council. One annual report covers the activities of the ESCB and monetary policy[21], part of which relates to banking supervision activities. The other annual report focuses entirely on the ECB's banking supervision activities.[22] In normal times, these two annual reports are presented to the European Parliament at a public hearing, subject to a parliamentary debate, and may form the basis of a parliamentary resolution. The European Parliament's oversight over the ECB's banking supervision tasks therefore relies significantly on the information presented in these two reports.

The annual report covering the activities of the ESCB includes the consolidated balance sheet of the ESCB, which shows the net creation of central bank reserves (base money) in a given period. This annual report does not include the consolidated balance sheet of the money-issuing banks (Monetary Financial Institutions) which is produced by the ECB for monetary policy purposes. However, given the dismissal of the 'money multiplier' theory, the consolidated balance sheet of the money-issuing banks becomes an important basis for accountability of banking supervision, as it would also show the net monetary creation by banks in a given period.

The consolidated balance sheet of the money-issuing banks produced by the ECB and available on their website is, to our knowledge, not presently subject to an annual audit at consolidated level or used for external accountability of banking supervision activities. Only the individual balance sheets of banks are audited by statutory financial auditors to ensure that they are true and fair. Such audited information at consolidated level could be useful for overseeing on an annual basis the achievement of banking supervision objectives, but also the achievement of the general policy objectives of the EU, such as sustainable development, balanced growth and improving the quality of the environment. As a minimum, information about money creation in the eurozone should become more readily available and reported upon to allow for discussion by policy makers at both national and EU level.

In summary, given the magnitude of current and future concerns in society, and the public role of banks in creating money, strengthening public sector accountability and audit of European banking supervision is a strategic concern for the EU. The new central bank narrative on how money is primarily created by banks without first holding reserves brings to light the importance of the consolidated balance sheet of the banking sector, as a macro-prudential banking supervision tool. It is essential that as part of this public sector accountability, the new knowledge provided by central banks on the dismissal of the 'money multiplier' fractional reserve theory, and its implications for the stability of the financial system and wider public policy goals, becomes more transparent and is reported upon to parliaments, public policy-makers and the public at large.

20 Monetary Dialogue Papers, How Can the European Parliament Better Oversee the European Central Bank?, September 2020.

21 Article 284 of the consolidated versions of the Treaty on the European Union and the Treaty on the Functioning of the European Union.

22 Article 20 of Council Regulation (EU) No 1024/2013, idem.