BANK MODEL DIVERSITY IN THE BANKING UNION CONTEXT: BENEFITS AND CHALLENGES

The essence of banking lies in assessing, balancing, and managing risks and benefits. As different types of risk/reward are needed to satisfy different types of customer needs, there is place for different types of banks. A business model can be seen as the sum of the systems, mechanisms and methods through which a bank generates earnings and satisfies its stakeholders in a way that ensures it continues its business.

This panel discussed the diversity of banking models in the European Union, how to preserve them, what the challenges are and what the disadvantages are.

1. Bank variety is shaped by history

Business model diversity is rooted in various features of a culture, including ownership, governance, the extent and complexity of the product mix and value chain arrangements. All bank business models in Europe face similar challenges: fragmentation, lack of profitability and the digital and climate transitions.

1.1 The structure of a banking industry

The Chair remarked that when considering banking diversity in the EU, most people only think of the Sparkassen sector and public banks as the dominant models, and that they do not always seem to be compatible. When considering the structure of financial and banking systems, history is central. The best example is probably the US and the dominance of capital markets there. For a long time there was a ban on interstate banking in the US, so banks could not operate cross-border from one US state to another. Moreover, the holding of equity in non-financial companies by banks in the US was also banned, so the capital market developed by default. Therefore, the banking sector when compared to the level of GDP is very weak in the US, in comparison to Europe. The UK, meanwhile, has both an important capital market and an important banking sector, because the banking sector orients itself towards the European model while the capital market developed because the UK had to finance numerous wars against France. It is unclear that Europe can actually emulate these models and have a free-flow structure that it can change at will.

A regulator noted that regulators have to take the regulated entities into that context. In Europe the structure of the banking sector is often the product of national history more than European history, so there is diversity. What is sought is a regulatory framework that fosters financial stability, adequate provision of services across the board and good services to citizens while preserving financial stability. The differences are not about favouring one business model over another or having a single business model that is superior.

1.2 The structure of the corporate sector

The Chair explained that the structure of the corporate sector is also central when considering the structure of financial and banking systems. Most financing by companies is done by retained profits. The rest of the money that companies need comes from that part of the market where there is the least friction. Markets are never frictionless but depending on the company structure and corporate governance, it is either easier to resort to the banking sector or to capital markets.

1.3 The roots of business model diversity

A regulator emphasised that when discussing about business models we often refer to two quite different parts of the structure of banking institutions. One is the liability structure, particularly the ownership structure, whether these are public banks or cooperatives versus shareholder-based institutions. The other aspect is the kind of activities that the banks perform. That is more on the asset side and whether they are investment banks, retail banks or mortgage banks. Those very different categories are usually grouped within the business model discussions, while the characteristics and requirements underneath are quite different.

1.4 Driving the characteristics of the financial sector

An industry representative pointed out the important role of small and medium-sized enterprises (SMEs) in the EU's economy. One driver for shaping a financial sector is the degree of centralisation in the real economy in the respective state. In Germany, SMEs generate more than half of the value added and stand for 60% of all employment. Bank lending in Europe is between 70% and 80%. Therefore, the diversified banking structure in Germany is the perfect fit to the real economy.

1.5 The added value of universal banks

An industry representative noted, regarding universal banks, that the real complexity is international competition. Europe's biggest competitors for market activities are US universal banks. After 2008 US authorities encouraged universal banks to take over huge parts of the market activities and investment banking activities that used to be in specialised banks. Europe is not isolated, and the trend should be considered. Market activities are worldwide activities and the example of interest rate swaps in euro-denominated swaps is a good one.

1.6 What banking diversity should not mean

An industry representative warned that diversity should not mean keeping banks afloat in the market at all costs. Nor should it mean that some banks should disproportionately finance the collective costs of the system. It should not make people believe that only the biggest banks are dangerous for financial stability. Savings and loans can be very dangerous if they all fail at the same time.

An industry representative noted that too-long business models that do not float, do not meet market needs and cannot be profitable should not be

permitted. Moreover, there is a risk of unnecessary complexity. It should be ensured that the burdens and the complexity of structures, products and business models that lead to organisations that are too big or too hard to manage should not be created. Additionally, the risk of institution size can lead to inappropriate risk-taking. There are quite effective ways to deal with that, like being part of larger organisations or associates. Finally, there is a lack of comparability and transparency. These are increasingly important topics for the banking sector. Efforts should be made to develop measurable impacts that are easily understood and comparable, but which do not create much complexity.

1.7 Challenges for all business models

A regulator stated that in the EU the sector as a whole has challenges. First is excessive fragmentation. Then there is a lack of sufficient private risk sharing within the Banking Union. There is the viability of business models in the medium and long term, because the returns to equity that banks are obtaining are too low to attract private capital from capital markets. Lastly, there is medium-term sustainability in an environment where change may need to be driven by technology, and the industry has to adapt. There is also change driven by society and the environmental, social and governance (ESG) challenges. Going forward, the question is how to ensure that the different business models comply with three basic principles: sustainability over the medium term, adequate returns to shareholders and the ability to transfer from savings to investments to finance the investments that European society needs.

2. Banking model diversity as a European asset

A diversified banking sector is beneficial for the real economy and enhances financial stability. Preserving this diversity requires ensuring the sustainability of banking business models. Whatever choices they make, banks need to ensure their business performance is sustainable throughout the economic cycle, including in challenging business environments.

The diversity of the business models may not be considered sufficiently in EU policymaking and even in euro-area supervision. There will not be financial autonomy without competitive and large enough EU entities in trading and investment banking activities.

2.1 Diversity satisfies different stakeholder needs

2.1.1 Diversity as an asset for the financing of the economy

A Central Bank official stated that business models coming from history means that they met their demand. That there are different demands and different ways to meet those demands is good.

An industry representative recalled that the Committee on Economic and Monetary Affairs (ECON) of the EU Parliament has stressed the importance of a diversified banking sector in Europe in a number of reports. All highlight that banking model diversity is a European asset. Empirically, this has been proven during the financial crisis and the COVID-19 crisis. The diversified banking structure in different European member states has supported the supply of financial means for ailing industries and has maintained a viable level of economic activity. More generally, in the EU there are about 4,300 credit institutions, 9% of which are large, 29% mid-sized, and 62% small and not complex. This diversity increases financial stability and allows the demand of the real economies of EU member states to be met.

An industry representative stated that the issue of sustainability is key. Diversity should not be kept simply because of history or because it is seen as a given. Even if diversity has passed the test of time, if it had no strong positives, it would have disappeared along the way. The question is how to work on improving sustainability and RoE of the banking system in Europe while preserving the strong positives and resisting some of the negatives. The ability of various models to follow and take into account customer expectations, to cover a full range of customer segments, and to address various demands like social responsibility, ESG and financial exclusion should all be preserved.

2.1.2 The diversity increases financial stability

The Chair noted that there is an implicit assumption that the European banking system is more diverse than the US system, but the US has more than 8,000 community banks, a number of regional banks and a handful of large money centre banks.

An international official suggested that both the US and European financial systems are fairly diverse. The US has institutions Europe does not have, like Fannie Mae and Freddie Mac, while Europe has other things. Diversity is good in a financial ecosystem, including to support financial stability, as history has shown. The savings and loan crisis in the US in the 80s was a crisis of large numbers of small retail-funded banks. The subprime crisis was a crisis of a relatively small number of large wholesale-funded banks. Generally, one doesn't want to have all eggs in one basket.

Diversity is also good for service provision. An SME might like to go to a smaller bank with which it has a relationship for its financing. A large blue-chip corporate with a great deal of liquidity looking for a safe place to park it goes to larger bank, and because deposit insurance does not help when amounts are large, it goes for the next-safest thing, placing deposits using repos. It is also important to observe that the large banks are very often the link between the banking system and the capital markets. There are many invisible links at play all of the time, links that cannot necessarily be seen on balance sheet. Europe has a larger preponderance of SMEs than the US. Arguably, it therefore naturally has a proportionately larger role for small banks.

An industry representative remarked that if the system is functioning well, it should not be fixed. This does not mean nothing has to be done. It is good that the ECB is concerned with preserving the diversity of the business model. Banking model diversity in Europe should be defended somewhat because it is rooted in the economic system. A diverse model also brings added value to the customers. Having some specialised banks focusing on certain regions, industries and ways of banking makes for greater choice for customers. Diversity brings added strength by diversifying risk. If one bank has problems and there are different banking models, or if one banking

model is in dire circumstances, then the others will not necessarily face the same trouble at the same time. The banking system is here to finance, manage savings and play a role in the life and growth of the European Union.

2.2 Ensuring the sustainability of banking business models

2.2.1 What is at stake

A Central Bank official stated that the issue is how to preserve the diversity. Here the problem is financial sustainability. There is a problem of financial sustainability because there is a problem of profitability in the larger sense of the word where profit means the difference between the revenue and the cost that allows the bank not only to cover its costs but to be able to invest in the future. Profit here is not distributable profit to shareholders. Investing in the future is absolutely necessary because there are huge things to finance in Europe. As Europe has a bank finance economy it needs banks that are able not only to continue the provision of the services they currently provide, but also to scale up to finance recovery and transition. However, taking into account the current levels of return on equity (4-6%), there are very few banks that can invest heavily in the future with the current low margins between cost and revenue.

2.2.2 The role of supervisors

A Central Bank official noted that if the onus of managers and directors at a bank is on anything it is on the business model. It is their core role to define the business model of their bank. That is certainly not for supervisors to do. The banks are those who take the risk and those who run and manage the risk. Supervisors should not be dictating the business models or how to correct the business model to attain sustainability.

The approach being taken is to scale up the governance requirements to ask whether the credibility of the business model in the medium term is discussed enough and if the credibility of the revenue projections is challenged sufficiently. Revenue projections are currently not globally credible: if the projections for the banks that will increase revenue in two years were summed up, the result would be an unprecedented explosion of profitability. The first who should be affected by that credibility issue are the management and the governance, so supervisory actions should be increased on those who are responsible for the definition of the business model so that the projections become credible. This is why a great deal of benchmarking is needed. The business model should always be resolvable, but there are different forms not only one to ensure this resolvability.

2.2.3 Profitability will likely differ according to liabilities or asset structure

An industry representative noted that profitability is necessary to maintain the sustainability needed to be able to scale up and to face difficult times. Therefore, profitability has to be judged in comparison to the liabilities and risks. The same type of profitability should not necessarily be expected for banks that have different liabilities or asset structures or for cooperatives and listed banks. Comparisons should be made with comparable banks using the same banking models and not a one-size-fits-all idea about profitability.

2.2.4 Avoiding an obsession with profitability

An industry representative stated that it is necessary to have banks taking higher risks or being capable of executing complex mergers. However, this has to be balanced by locally or regionally rooted smaller institutions covering the needs of the local communities. Investment banking can lead to high gains, but they are very cyclical and volatile; retail banking lacks those peaks, but it is more stable.

It is essential to have more than one business model in Europe, with some focusing on long-term sustainable growth and not on short-term maximisation of profits. The profitability of Europe's banks is considered crucial, but there must be caution not to become too obsessed with it.

2.2.5 Preserving business models as long they are sustainable

A regulator noted that it is important to preserve business models only as long as they are sustainable. Business models have to be coherent with overall financial stability as well. In the global financial crisis, several very small banks with similar business models, but that they all have sustainability problems, they ended up being systemic in their problems. This coherence is important, as is making sure the dynamics of competition, as technology is introduced, work to the benefit of society and consumers.

2.3 The requirements on policymakers when considering regulation

2.3.1 A well-functioning EU single market for financial services should not be at the expense of a diversified banking sector

An industry representative remarked that it is particularly difficult for less significant institutions (LSIs) to cope with the enormous amount of European regulation. Thus far, the implementation of Basel III and the establishment of the Banking Union alone have resulted in more than 500 different legislative texts, and 50,000 pages of rules and instructions. Small or medium-sized banks with a balance sheet of about €1 billion should not be expected to cope with that amount of regulation. It is the resulting fixed costs and economics of scale elements that are affecting smaller banks disproportionately.

It is highly welcome that the European Banking Authority (EBA) is undertaking efforts to reduce administrative costs via its work on the cost of compliance. This will contribute to the objective of a proportionate regulatory environment for the EU's diversified banking sector. It should lead to nothing less than the creation of a level playing field by introducing measured, proportional approaches allowing the entire EU banking sector to strive.

2.3.2 The diversity of the business models is not sufficiently well understood in EU policymaking or in euro-area supervision

An industry representative stated that in EU legislation projects the diversity of banking models has not

been appropriately reflected, even in areas where the underlying international standards have actually been neutral. Notably, the transposition of Basel IV agreements puts at stake the decentralised model of cooperative banks with a central body. This is aggravated by supervision practice. The ECB has benchmarked all banks on the profitability of global listed institutions while robustness, rather than profitability, is the main objective of mutual banks. Its horizontal directorates tend to create a one-size-fits-all approach which undermines models and diversity. On governance, there is a fit and proper issue whereby the technical competence of managers is favoured at the expense of the knowledge of local businesses.

2.3.3 One size does not fit all

An international official emphasised that, regarding regulation, supervision and resolution, one size does not fit all. The business of overseeing a large, complex bank is fundamentally different from that for a smaller bank, and the rules should reflect that. Nowhere is this difference starker than in resolution. For small banks the basic function of resolution is often matchmaking. The resolution agency looks for a suitor or an acquirer and uses a purchase and assumption (P&A) transaction. For megabanks, it is a completely different game. It is also important for regulators and supervisors to look at how the large and small banks interact with each other in life. If someone takes a mortgage from a bank in West Virginia it is likely being sold on to a big bank. That sort of interaction should be encouraged for financial deepening.

Finally, proportionality by business model and bank size is desirable, but regulatory and supervisory differences by country are not. The Single Supervisory Mechanism (SSM) and EBA have done good work in reducing the number of European national options and discretions from around 250 to about 160. That good work should be taken forward.

2.4 Financial autonomy requires competitive and large EU entities in trading and investment banking activities

2.4.1 National interests impede progress toward a banking union

An industry representative noted that large banks are the usual link between companies and capital markets. Currently, the concept of financial autonomy is everywhere in Brussels. It is not a consensual notion, but it is discussed and even promoted by the European Commission. There will not be financial autonomy without competitive and large enough EU entities in trading and investment banking activities. Business models have to be improved, and the preparatory work should also be improved. Part of the regulation, and the context, is the lack of a real common capital market. Progress toward the completion of the Banking Union is held back by national interests, which leads to fragmentation.

2.4.2 The Brexit example

An industry representative stated that, after Brexit, one of the objectives both of the ECB and the European Commission is to ensure that clearing activities in major euro-denominated derivatives take place in the EU, especially for interest rate swaps. They want to force EU banks to quit London, which nearly has a monopoly on clearing for interest rate swaps, and to go to the EU. However, they have run into problems because they discovered too late that the overwhelming majority of those swaps, clearing activities, in euro-denominated assets are no longer made by EU banks. In the present state of EU legislation, there is no way to force those non-EU banks to leave London and to go to the EU for clearing.

2.5 The fast-changing environment and financial stability

2.5.1 The new competitive environment and banking diversity

An industry representative conceded there is competition with fintechs, new banks and similar new entrants. However, the basis of banking and what has been the role of banks for at least five centuries is taking the savings of people, companies or states, which have more money than debt, and lending to individuals, corporates and so on. That requires some expertise, which is hard to build. Banks create models and supervisors look at them. This is relatively complex and it is a business where the margins and the margin for error are quite thin. It may be felt that there is excessive or insufficient profit, but the truth is that a bank cannot afford to get it wrong too often. This is somewhere fintechs do not go. There is therefore a role for banks.

An industry representative noted that traditional banks have to create confidence so that people trust them enough to put money there and not on these new platforms. Bankers have to be professional enough to understand the business prospects of a new venture or to make a new investment or an acquisition. This is something that is not easily achieved by artificial intelligence on a platform.

The Chair suggested that, with different parts of the banking business being stripped from banks themselves, there may be a platform-based economy where banks are left with the least profitable bits of banking. An industry representative replied that that is the rule of competition. Supervisors are there to make sure the banks stay profitable and, so far, the relationship has been maintained. Trust is very important and not easily built by the newcomers

2.5.2 New entrants may create financial instability

A regulator added that there should be ex-ante neutrality about whether a technology is good or bad. The implications and risks of the introduction of the technology should be assessed and there should be neutrality about who brings the technology, be it an incumbent, large firm or a new firm coming from the outside, so that there is only consideration of the implications of the technology for the system. One concern is that as new entrants come into the industry they are 'taking the cream' from more profitable parts of the business and leaving banks with the least profitable activities. That might actually be creating financial instability in the incumbent institutions doing multi-products. An industry representative remarked that the new entrants do not 'take the cream' as they all lose money.

A regulator stated that the largest increase in competition can be seen in payments. The relative fees and the relative structure of payments have changed

drastically thanks to innovation and competition, to the benefit of consumers, all while preserving stability. Preserving stability is very important. It is important to look into the future and ensure that if an entity does not have a viable business model then failure is fine. Society moves on. Firms are there to serve citizens; they are not to preserve themselves forever.

2.5.3 Diversity also means adaptability and innovation

An industry representative added that increasingly many fintechs want to integrate into more traditional banking groups. There is also a supervision challenge. Those entities are not ready to fit immediately into everything and there are sometimes tense discussions with supervisors to make them understand what is needed. Supervisors admit that the entity has to be integrated while retaining the innovative spirit, but it is difficult to ask the entity to rapidly become fully compatible with all of the rules. There is also the development of the bank as a platform, where banks go to platforms and begin to offer their services. Both aspects are vital for the profitability of the banking system in Europe for the years to come.