Taking advantage of the diversity of bank business models and governance in Europe

The discussion showed that that various parameters and dimensions are needed to distinguish bank business models (i). The plurality of business models poses challenges for banking regulation and supervision in the banking Union (ii). It requires a flexible approach to cater for a variety of business models (iii).

1. Various parameters and dimensions are needed to distinguish bank business models

What constitutes a model and distinguishes it from another is not easy to define. Different criteria or features may be used. Bank business models can also be envisaged from the perspective of the transformations which are underway in the banking sector (ESG transition, new entrants such big techs and fintechs, technological advances such as smartphone technologies, artificial intelligence, big data…). But, in any case, business models need to be viable and sustainable.

1.1 It is difficult to define a business model, but it needs to be viable and sustainable

A regulator explained that the business model for a bank is that the bank collects deposits and grants credit. The way it has been looked at so far has mostly looked at the past, which may not be the main approach to what is going on, especially now that the banking sector is facing major transformations such as the green agenda, new entrants and everything related to technology. Bank business models should also be envisaged from the perspective of the transformations which are underway in the banking sector. It is therefore not very clear what a business model is at the outset.

A regulator noted that focus should be on viability and sustainability, and whether a bank can survive in the short term and in the long term. Evidence shows that when a bank does not perform well there is merit in changing the business model and in changing the segments in which it operates. The European Banking Authority (EBA) looks at it from three angles: a risk perspective, a regulatory perspective and an innovation perspective as new entrants (big techs, fintechs) will affect the more traditional activities. Over time large cross-border banks perform slightly better than others, because they have higher return on equity (RoE) and less capital depletion in the EBA stress tests.

1.1.1 Diverse criteria to define business models

A regulator explained that a viable and sustainable bank business model should meet the three criteria which are at the core of financial intermediation: ensuring a delegated monitoring of lenders and borrowers, providing them liquidity through the cycle (transforming risks, duration, currencies…) with sophisticated risk management and sustainable funding, and performing these critical functions efficiently, which does not necessarily mean bigger balance sheet anymore but requires reaping economies of scale and scope.

The Chair confirmed that a number of successful business cases have also showed that size may not represent the unique success factor any longer. Small and medium intermediaries have a more flexible cost structure and higher ability to react to market changes and are able to get competitive advantages. Reaching minimum scale does not represent a hurdle to invest in new technologies due to business opportunities offered by external platforms and access to information embedded in the banks' proprietary data.

An industry representative agreed with the previous speakers on the overall perspective of definition. There are well established criteria like activities, the structure of the balance sheet of financial institutions, the funding sources and the ownership structures. It is important to control the specific risks and vulnerabilities of financial institutions. The risk profiles can also take into account issues such as concentrations and can consider emerging trends such as digitalisation and provision of banking services via third-party providers. There should still be bucketing, but for the purposes of supervision and regulation there is a good basis to engage with banks in the course of the supervisory review process.

1.1.2 To preserve diversity, banks need to ensure the resilience of their banking models

A Central Bank official explained that a business model can be defined as the sum total of systems, mechanisms and methods through which a bank generates earnings and satisfies its owners, customers and other stakeholders. The key to sustainability is to maintain an adequate cost/income ratio and keep stakeholders satisfied with the services provided. Since the ECB is strongly committed to a neutral and objective approach to different business models, the starting point is measuring financial resilience The main parameters measuring financial resilience of bank business models are income mix, customer mix, funding mix, size and geographical exposure. Strategic management, risk appetite and development strategies are also taking into account. The Single Supervisory Mechanism (SSM) is doing work in the same spirit as the EBA has done for all supervisory tasks.

A Central Bank official noted that the European Central Bank (ECB) is not using the legal form. The legal form is very important, but the ECB is trying to analyse the capacity to absorb shocks. What is important in measuring the financial resilience is the analytical underground of the sustainability and viability of the bank. In Europe, lending remains the most important source of earning for a bank, but Europe has very different degrees of diversification.

A Central Bank official stated that the ECB has identified the importance of the six biggest banks in Europe, which is in line with EBA analysis for the whole EU. Those six banks make up nearly 50% of the total market of significant institutions directly supervised by the ECB. Universal banks form the majority of the EU banking sector. But the EU also benefits from specialised lenders and wholesale banks. The core issue is a bank's capacity to sustain its activity through the cycle, including absorbing risks in the event of a recession. Each bank needs to carefully assess the potential impact different macroeconomic scenarios could have on its customer base and prepare to respond proactively to difficulties that may emerge.

1.2 The diversity of banking business models is a key strength of the Banking Union

1.2.1 This diversity is beneficial for the European financial system

An industry representative observed that the diversity of business models is very important, because it is of benefit for the financial stability, for the resilience of the banking system overall, and for the ability of such banking systems to effectively serve the economy and society. The existing set of business models has to meet European market needs and provide adequate support to finance the economy. It is important to ensure that regulators provide a level playing field for banks of different business models to be able to compete, to provide financial stability, and to protect EU citizens and society from excessive risk taking.

An industry representative underlined that banks and regulators should foster diversity, just as assessing the business model of a bank everyone looks for diversification of resources.

A Central Bank official added that the existence of different business models can be beneficial and sometimes necessary. Some credit institutions focus on specific areas or social objectives, whereas larger universal banks compete in global markets. Diversity in business models is also a source of financial stability for the EU banking sector.

1.2.2 Taking into account different models

An industry representative stated that there are business models in Europe not conforming to the traditional banking framework, but they are relevant institutions in their country of operations. He mentioned institutions not taking credit risk and devoted to specific purposes, like, for example playing as intermediaries between sovereign issuers and the general public. He explained that there are financial institutions, often operating in different businesses and, apart from credit risk taking, they are subject to the same regulatory framework of banks. However, these institutions are important as they create diversity in the financial ecosystem and they have a long experience in the industry, though not often fully appreciated for their diversity in the EU prudential framework. As example of their relevance, some of these institutions have the mandate and ability to gather for the interest of some of those clients that are not at the centre or at the core of many other banks. Secondly, there are specific financial indicators that are used for banks which are not always adapted to the model, which sometimes provides a constraint as to what Poste Italiane can do for its clients. At the same time, he noted that these kinds of non-dogmatic financial institutions, often deposit taking or universal service providers, are a clear proxy of new entrants into the European financial ecosystem and they provide some insight on how to manage a series of newcomers offering only a selection of the solutions and products as a traditional bank may do.

1.2.3 Market share data

The EU banking ecosystem comprises 5,179 individual credit institutions with diverse characteristics, operating in a complex mix of 27 Member States with differences in national history, culture, financial markets and local regulatory frameworks.

A Central Bank official stated that market share in the banking system can be defined in various ways. The most common indicator is total assets in terms of loans to households and non financial corporations, but some banks specialise in certain activities so for them the market needs to be defined more narrowly. Global systemically important banks (G-SIBs) in the euro area make up nearly 50% of the total market of significant institutions directly supervised by the ECB, 25% are other universal and investment banks, less than 15% are diversified lenders, and around 5% are other bank business models.

The Chair summarised that the definition of business models seems to be good, and regulators are looking at the right issues so there is adequate biodiversity in the system.

2. Prudential authorities need to adopt a flexible approach to cater for a variety of business models

2.1 Assessing the performance of a business model is a complex issue, and the plurality of business models poses challenges for banking regulation and supervision in the Banking Union

A regulator stated that strong conclusions should not be taken on what is a good or what is a bad business model. It cannot be one-size-fits-all and has to be a good comparison of a number of dimensions. Supervisors and regulators have to be business model agnostic, but need to compare, ask questions, come across benchmarks and challenge what banks do, otherwise they cannot go anywhere.

An industry representative observed that supervisors and regulators represent the public interest and are only accountable to them. Diversity of business models is needed, but care is needed when defining good and bad business models. Performance is usually defined as financial performance relating to the amount of profit made, but the definition of performing should also include playing a role in good and bad times, in managing deposits and lending money….in other words serving the economy. The key performance indicators (KPIs) should also be examined. Looking only at profitability is not sufficient.

A Central Bank official underlined that the plurality of business models poses some challenges for supervisors. Europe has G-SIBs and very small-sized banks, so there is a supervisory challenge. Combining homogeneity in banking rules with diversity in business models is a difficult task. Close scrutiny of how business models are evolving, combined with a flexible approach, is more justified than ever. The role of the Joint Supervisory Teams (JSTs) is to use their expert judgement. Many efforts have been devoted to improving the management of the teams and the trust of the teams, and after almost eight years of joint supervision the SSM is up and running. It is doubtful that after eight years someone could think that local or national supervisors could be more understanding of different banks and different situations. The SSM compares peers with peers. G-SIBs across all jurisdictions are an excellent element for benchmarking and is very relevant for the supervision. In the meantime, SSM supervisors have to find the right balance between horizontal standardisation and banks' singularities.

2.2 Profitability assessed on a case-by-case basis should not be the sole compass for supervisors to assess the viability and the sustainability of business models

An industry representative stated that profitability is important in order to make sure that banks can resist shocks and can perform through the cycle. That enables banks to build reserves and face shocks. Certain business models such as cooperative bank business models force banks to keep a large part of their profits within the bank. Cooperative banks have raised money in tough times without much difficulty on a fairly stable basis. Sufficient indicators are in place, possibly with the addition of new ones. Profitability is an interesting factor, but the retained amount of profitability i.e. the residual income after distribution of the payout to equity holders - is the proper way to judge the ability of a number of banks to go through the cycle, resist shocks, pay for risks when it happens, and still raise money.

A Central Bank official noted that a key question is whether there is a direct link between business models and profitability, whether that is more connected to governance and different arrangements that Europe has, and whether they are linked to the cost of equity and the return of equity. Speaker's view is that all of them are interconnected. The technology on digitalisation and appropriate governance will be major drivers for the future and for structural changes in the financial industry. More precisely, the expected level of profitability relies and depends on its particular business model, the bank's funding configuration or the ownership arrangement. The SSM observed great differences of RoE or return on assets (RoA) across peer groups. The level of profitability of a bank needs to be carefully assessed on a case-by case basis. Good governance is an additional key component, and digitalisation will play a very important role in the coming months and years.

The Chair summarised that panellists' feedback reassured that the SSM has no ex ante assessment of a unique or common level of profitability, but conducting a case-by-case assessment is key. One development that has been seen is for players that do traditional banking with very innovative processes. Parts of the banking business are being moved outside the banking business with credit funds. Regulators also see an increasing role of the non-regulated firm, which is why it is important to strike the right balance to ensure both a proper assessment of risk and a compliance with the EU regulatory framework. Both the SSM and national supervisors are looking beyond the traditional scope of regulation and supervision.

2.3 Given the diversity of business models, a one-size-fits all that is based on one predetermined set proxies for assessing the performance of business model does not fit

A regulator noted that the regulators and supervisors have always wanted to be business model agnostic. They wanted to be able to compare, and to draw conclusions out of different types of indicators using judgement. It has never been as simple as looking at an indicator would immediately draw conclusions. The new EBA guidelines categorises banks into four categories: It is not only about size, but also about what a bank is doing, the complexity of its business lines and its respective weights. On the basis of this preliminary business model and strategy analysis, supervisors will determine the materiality of business areas and lines, identify different peer groups, and apply proportionality in what will be expected from the banks. The EBA considered it very important that supervisors go back to first principles and do not look at the past. Europe has a number of players which have superior information and good technology, and which might be in a position to do exactly what banks have been doing for decades. It is important for banks to understand that and see how they want themselves to deliver their role and their key functions. Having this competition in mind, it is also important for regulators and supervisors to see who should be put under the safety net to make sure that the landscape remains even, and that Europe does not have undue competition and risks arising around undue competition.

2.4 Benchmarking should be done in an intelligent way

The Chair stated that one of the many strengths of the SSM is that supervisors can benchmark the recovery plans, internal models, and peers against peers. Benchmarking should be done in an intelligent way. It is also important to talk about return or risk, not just profitability. The crisis in 2007 showed that an entity might have excessive profitability which hides excessive risk. The issue is the sustainability of the business model, and whether the high profitability is sustainable over time.

An industry representative explained that benchmarking may lead to the favouring of certain business models or criteria that are fit for some businesses but not necessary for all of them.

Another example (different from profitability) is visible in the analyses on the cost income ratio, which is very high for some European banks: the weight of real estate credit in the balance sheet should be taken into account as it mechanically explains a high-cost income ratio for those banks because the margin is low (and the risk too). Moreover, the ECB's analyses of European averages lead to comparisons of very different business models without more in-depth analysis. The regulation could. lead to numerous unintended consequences on different business models if the broad picture is not considered.

This industry representative also took the example of the cumulative effect of the leverage ratio and the NSFR which is very significant: the first ratio tends, if it is applied individually and not globally, to favour risky activities, and the second one favours long-term activities. We are therefore potentially left with a non-diversified risky long-term business model. Since analysts and rating agencies focus on the same ratios, they reinforce the trend.

To ensure that supervision is respectful of the diversity of the business models, the transparency of different benchmarks should be the cornerstone of supervision analysis. Each bank should be able to position itself vis-à-vis the benchmark and either comply or explain. A set of relevant diversification indicators should be defined and applied by the SSM in this perspective.

A Central Bank official noted that a concrete analysis of the situations of banks needs to be improved, as well the proportionality. More elaboration is needed on general benchmarking and individual assessments. The ECB does not have any precise rule on profitability by itself, because profitability should be commensurate to risk. Return on risk is an essential issue for the ECB. The nature of the costs incurred is also important. A bank with high costs for maintaining under-used branches is not the same as a bank investing large sums in digital transformation for the future. Only concrete case by case analysis of the numbers allows to assess the resilience of a bank.

A Central Bank official does not see a mismatch in the relationship between the ECB and the national supervisor. Indeed, they use for the supervision of less significant institutions (LSIs) the same methodology and mindset that the ECB has for significant institutions (SIs). The national authorities have also the payment institutions in their remit. It is important to see that sustainable business models are reached for all types of institutions when practices are evolving.

2.5 Risk-based proportionality is requested

A regulator stated that proportionality is essential. The EBA is at the second revision of the set guidelines, which will come into force in 2023.

The Chair noted that there is a potential limit to proportionality. Small banks might be exposed to huge risks, and then the size cannot be an excuse for not applying proper supervision.

An industry representative stated that proportionality should generate proportionally to risk, except for the understanding that if everything else is equal the smaller a bank is the less risky it is for the overall system. Risk-based proportionality should exist.

2.6 There is a need for regulatory changes, but Basel III can improve diversity in the banking sector

An industry representative stated that the role of banking regulation and supervision should be to provide for financial stability and protect EU citizens and society at large from excessive risk-taking in the banking sector – among others, by creating, and preserving a level playing field for banks of different sizes and business models. In almost every European country the five largest banks account for more than 50% of all banking assets, and the average number across the EU is almost 70%. The EU's 37 largest banks account for 71,4% of domestic banking total assets.

Truly levelling the playing field between banks of different business models and sizes requires a faithful implementation of the Basel reforms without the so-called 'EU-specific adjustments', which stand to benefit mostly large banks, as they account for over 80% of the total capital shortfall that would result from the undiluted implementation of Basel III in the EU per the EBA estimates. A large number of smaller and mid-sized EU banks would remain either largely unaffected or even benefit from the combined effect of (i) the modifications of the Standardised Approach introduced by Basel III, and (ii) the output floor, which caps the 'cost of capital' advantage of banks using the IRB approach.

An industry representative noted that the capital rules for non-rated corporates are meant to serve smaller and medium-sized enterprises which are largely serviced by the big banks. There is a need to remove the use-specific rules, which would allow bigger banks to keep lower risk rates and therefore have a competitive advantage in credit pricing over their small and medium-sized competitors.

The Chair observed that it has been 15 years since the financial crisis started, and Basel III was designed at the beginning to try to tackle that crisis. The question is whether 15 years with transitional provisions that are in place until 2032 is the right regulatory feedback.

2.7 A case for structural reform

2.7.1 Separation of investment banking and retail banking

An industry representative stated that Europe has entities which run both businesses in the same entity, but the intention to address this – ie the separation of deposit-taking and commercial banking activities from capital markets-related activities- is no longer there on the table. However, banks that run big investment banking businesses have a very different risk profile during the business cycle and continue to benefit from the fact that their funding costs are lower because they have an implicit bailout guarantee from the state. The bank regulators' paradox is that large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis. Splitting different business segments would remove the benefit of implicit public support for banks' trading activities, increase financial stability and prevent systemic contagion between banks.

An industry representative is doubtful whether regulators should separate investment banking and retail banking, as diversity is something to foster. Maybe we should not necessarily change any regulation, but more rely on tools that would be a diversity score of the European financial system because at the end of the day, judgement has to be exercised. Different types of business models with different types of financing is appropriate for European societies, citizens and the financial system and they need to be preserved by European regulation and supervision.

2.7.2 Ensuring the sustainability of the business models for fintechs and newcomers

An industry representative stated that her organisation sees many non-banking financial institutions competing with banks, which puts a competitive pressure on the banks as they are more regulated. There is a need to subject those entities which provide the same services and run the same risks to the same level of regulation.

The Chair noted that size is not the only driver to sustain. Individuals accessing a bigger data repository might become a replacement for size, as then different types of banks could be added.

An industry representative underlined that more and more institutions use fintech solutions and outsourcing in order to accelerate the digital transition and to resolve some of the complexities that an in-house development may have. He argued that fintechs add not only to the competitive landscape, but they are enablers of innovation and new solutions, with relatively low implementation costs for the incumbents. Nevertheless, it is important that regulation develops in-house its own capacity to address these new solutions, like the use of sophisticated algorithms, artificial intelligence, till the expanding tokenisation of financial instruments. The landscape is changing rapidly and some of the fintechs may expand their activities or become attractive targets for larger tech companies, with a potential and more radical shift on the financial European landscape. So, he argued, it is important that innovation is well understood and, thus supported, also regulated to avoid distortions in competition and fair pricing of financial instruments.

An industry representative agreed that fintech can allow people to access data that can supplement the existence of a large customer base. Fintechs force banks to adapt. Relying on other sources of data than a bank's own is the way forward. The same kind of data needs to be able to be used by everybody in the same way. That is an issue that is becoming more and more prevalent, because data is growing in size and more and more open to value sectors, including the financial actors.

The Chair agreed that banks have different business models. Panellists agreed that Europe should not use regulation on supervision to reduce the diversity and should not change Basel III. The overall paradigm has changed. Governance includes informed management of new and current risks, monitoring aggregation, data aggregation, and interaction with all the counterparties, including unregulated ones, in order to apply the regulation and supervision tools, but not in a mechanical way. There will not be automation in the SSM to assess the business model.