TAKING ADVANTAGE OF BANK DIVERSITY IN EUROPE

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Navigating traditional and emerging risks in EU banking supervision

One of the primary objectives of European banking supervision is to push the EU banks to review their business models in order to ensure a steady growth of their profitability and its sustainability. SSM follows a risk-based strategy, in principle neutral towards the variety of business models, which represents a factor of bio-diversification, contributing to the system's overall resilience. Sometimes, high profitability is accompanied by imprudent or not well monitored risk-taking, both for financial risks and for operational risks. Hence, it is crucial to consider whether profits can be sustained and regularly maintained over an economic cycle.

The dynamic and ever-changing business environment poses several challenges to the sustainability of different business models. Traditional business models may appear to be preferable nowadays, due to the recent shifts in monetary policy and interest rates hikes and the related positive effects on interest margins, but the same factors can pose high risks when it comes for example to the asset evaluation. However, traditional banks are nevertheless the ones under higher regulatory and supervisory pressure. More innovative or "niche" business models, instead, may be more volatile in income generation, but might have some benefits due to a less "fit" regulation and supervision assumptions and approaches.

Recent crisis cases, which are still being analysed, first pose a very important question on the effective neutrality of supervisors towards different business models. The answer cannot ignore that the supervision becomes increasingly challenging, handling conventional risks, often altered and less discernible in the balance sheets, and emerging risks and opportunities, with a lack of well-developed toolkits and expertise.

The support of the regulation frequently comes with a slower pace, but in the meanwhile supervisors should act promptly, even though the rules are not completely defined. The SSM is working constantly in order to develop supervisory tools able to better capture risks of non-traditional activities or the link between banks' and non-banks' sectors, but the attention and the actions on traditional risks, such as credit risk, remains largely predominant. Against this background, I will elaborate on some of the features that supervision, and the SSM in particular, should work on.

Strengthen the supervisory framework

We can agree on the fact that a "one-size fits all" approach is inadequate for supervising many different entities. Combining the homogeneity of banking rules with the diversity of business models require a careful balancing between consistency and flexibility. We need to keep on customizing, differentiating, and adjusting the supervisory toolkit in order to face as many specific situations as possible. This may potentially weaken overall consistency, but the principle of a real level playing field requires us to handle comparable situations in a consistent manner. Accordingly, it is crucial to keep on improving benchmarking activities to mitigate the risk of inconsistency and to reinforce the focus on long-term viability.

To establish distinct 'standards' for different business models, certain measures would need to be taken. Firstly, develop a more nuanced and refined assessment methodology to duly acknowledge the idiosyncrasies of the different business models. This would require a deeper understanding of each bank's activities and the different risks they face.

In addition, data transparency, quality and comparability are crucial for meaningful analyses and decision-making, not just for large banks, but also for smaller institutions. Increased data transparency can also help to identify best practices and benchmark performance across the EU significant institutions and in the global comparison.

Get prepared to the ever-changing environment

Fostering a culture of innovation is also essential in encouraging banks to explore new business models and opportunities that are more resilient to exogenous shocks, also with benefits for their cost-effectiveness. At the same time, consistent investments are required to update knowledge and skills of supervisory teams, in order to be prepared to assess related risks that follow changes in banks' business models, and safeguarding the stability of the financial system.

Increase the cooperation

Lastly, supervisors and regulators should work closely with each other but also with industry representatives, academic experts and consumer advocacy groups, in order to facilitate dialogue and cooperation between all the different stakeholders involved and in order to share knowledge and best practices, especially for new or peculiar business models. Tackle with risks is a global challenge and recent crises cases pointed clearly out the need of a joint effort, so to have a comprehensive picture and act accordingly.

MARGARITA DELGADO
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Adapting SSM supervision to the diversity of banking business models

In the wake of the collapse of some local US banks, the debate on the risks inherent in their business strategies has heated up. Aggressive growth with strong ties to the technology industry, concentration in large deposits, and investment of ample excess liquidity in long-term bonds in times of low interest rates were the basic features of such strategies. This confirms that a clear business model, coupled with robust governance, is key to ensuring the viability of firms.

In the Single Supervisory Mechanism (SSM) banking landscape, with over 2,200 consolidated credit institutions, more than 10 different business models are used for peer comparison based on banks':

(i) main source of income;
(ii) customer and funding base;
(iii) size and geographical focus. These embody quite different competitive banking strategies, taking in everything from custodian banks to diversified lenders, consumer credit lenders to development lenders and G-SIBs to small market lenders, to name but a few contrasting examples. Each bank business model is typically associated with certain common vulnerabilities and is affected in different ways by market threats.

At the SSM we have to deal with this considerable diversity of banking models in the context of a common European banking regulation that seeks to preserve a level playing field. Under the coordination of the European Banking Authority (EBA), the Single Rulebook comprises a set of harmonised prudential rules, which all banks in the European Union must respect so as to ensure a resilient, transparent and efficient European banking sector. However, the characteristics of individual banks, especially the specific features of their different business models, need to be factored in when enforcing these common rules. Banking supervision can play an important role in this respect, with supervisory activities tailored to specific groups of banks.

The supervisory risk management framework at the SSM is made up of four sequential phases:

1. Identifying and monitoring of risks to the SSM banking sector;
2. Formulation of strategic priorities;
3. Operationalisation of strategy;
4. Monitoring priorities and supervisory activities.

The SSM deals with a great diversity of banking models while applying risk based expert judgement.

In the first two phases we generally adopt a universal approach for the entire set of banks, paying limited attention to business model-related aspects. It is at the operationalisation stage where banking business models come into play, with detailed action plans for particular banks or clusters. This typically results in the design of thematic reviews or horizontal analyses for off-site activities and the planning of OSI campaigns for on-site supervision and the selection of participating banks. Business models are among the elements considered when assembling these samples. Finally, the SREP benchmarking exercises include a peer comparison within each business model group.

Taking into consideration all the available tools, the SSM could take a further step forward in the continuous improvement of its banking supervisory practices if needed. The risk and vulnerabilities assessment could be tailored to the specific business models from the very beginning, while also allowing for more targeted strategic priorities as a prior step to defining the detailed action plans. This would help to better focus the supervisory efforts on the risks that are relevant for each institution.

A supervisory risk management framework more centred around banking business models offers certain clear benefits for SSM banking supervision, given that it would:

- Contribute to a more focused process, by contemplating from the outset the risks associated with the specific vulnerabilities of the different banking models, allowing potential common problems for groups of banks with similar attributes to be identified.
- Help to better estimate the impact of events affecting some specific activities according to business models, facilitating proportionality and a more risk-based approach to supervision, by further tailoring the intensity and focus of supervisory activities to banks' characteristics.
- Enhance the level playing field treatment of SSM banks, by better accounting for their similarities and differences and facilitating peer comparison throughout the entire supervisory process.

Recent events have shown the importance of proper risk management, backed by the appropriate analysis and supervision of business models.

Here at the SSM, we must analyze the tools required to fine-tune the methodology and the supervisory and risk tolerance framework in order to better adapt them to the different business models. This process calls for seamless implementation, taking cautious steps so as not to overcomplicate matters and always considering the expert judgment that the Joint Supervisory Teams bring to risk-based supervision.

HELMUT ETTL

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Sound supervision of diverse markets, business models and products

Europe still does not have a single financial market. As part of the financial market, the banking market is also highly fragmented within Europe and the SSM. How does supervision take this situation into account?

When examining the cause of these differences, one of the main reasons lies in the specific design of respective financial markets. Namely, whether bank-based or capital market-based financing is more prevalent in a financial market. Indicators for a capital market's development include, for instance, the structure of the real estate market and the extent to which pension financing is provided via the capital market. In this respect, one could bemoan a country's less developed capital market, for example in Austria, but the fact remains in this context that banks are required to take over the financing function. Incidentally, there is no definite answer about whether bank-based or capital market-based financial markets perform better overall.

Another factor determines differences in a respective financial market: business models. On the supervisory side, the SSM takes different business models into account, for example in stress testing or in the institution-specific SREP, which reflects credit institutions' individual business models. With regard to the regulatory framework component, defining what exactly constitutes a business model is far from trivial. For this reason, a risk of over-complication also exists if banking regulations are directly broken down in too much detail by business models. This is reflected in the fact that supervisors ensure the best possible and most sound supervision within the framework of the existing regulations.

The next level concerning diversity are the distributed financial products. Respective geographic and market-specific circumstances have to be taken into account in this regard. One suitable example in this regard is the granting of mortgage loans to retail customers in different regions and markets. Mortgage loans function very inhomogeneously in different real estate markets, not least due to relevant national (borrower-based) measures to safeguard financial market stability. Consequently, banks with a focus on mortgage lending should not automatically be considered similar to one another, even if their business models are almost identical. At the beginning of the banking union, it had indeed been mused that banks should ideally have a pan-European portfolio, regardless of their location. The positive consequence in this context would be greater independence from a geographical component in the event of problems or crises.

> **Business model supervision is accurate when considering the relevant risk profile and diversity.**

An overarching dimension has come to the fore against the backdrop of current events in the banking sector. The question arises whether size dimensions really (should) create a cliff effect in supervision. The diversity of business models is taken into account with regard to systemically important banks, as there are differences in monitoring, the frequency of supervisory contacts and governance. Thus, even in the "standardized" Pillar 1, the leeway is utilized. We supervise banks in a way that permits them to manage the risks inherent in their business model, taking into account their risk situation and profitability. Of course, macroeconomic scenarios are also taken into account in supervision - a bank's business model must be able to withstand a recession or similar negative scenarios. In recent years, especially regarding diversity, one must also consider the extent to which regionally active banks, which fulfil the important financing function for SMEs, for example, are adapting to the risks of digitalization, with the greatest risk being not to participate in the digitalization.

Overall, it should be noted that banks and their business models in Europe are already supervised on the basis of proportionality and an individual assessment. However, exercising of supervisory leeway is explicitly not to be understood in the sense of a deregulated approach. The current imbalance in the U.S. has arisen as a result of deregulation in the late 2010s, where thresholds for the full application of banking regulations where raised considerably. In my view, falling below the obligation to apply the strictest supervisory standards has allowed the situation to develop as it did.

Current events should be a timely wake-up call that brings a renewed purpose back into the regulation debate. In the light of recent developments, the discussion on deregulation in the banking market should find a more realistic direction again. We have seen that the failure of smaller, non-significant banks can also have systemic effects, so that they should be analysed (even) more closely in this respect. Admittedly, this would mean a half-step away from simply "too big to fail" to "what happens if it fails". In my view, however, it is a positive sign overall if occasional market exits happen, because this is evidence of the disciplined application of reasonable and accurate regulations.

MARIJA KOLAK

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Diversity is a valuable resource

The banking structure in Europe is based on historically shaped and evolved traditions. It is characterized by diversity. This includes the coexistence of big banks, savings banks, cooperative banks and specialized institutions. This is associated with different legal forms, but above all with very different business models.

Institutional diversity in the banking sector is associated with major advantages. Different business models of banks and savings banks are matched by different customer needs. Major international banks are geared to supporting companies worldwide. They have branches all over the world wherever their corporate customers are active. Regional banks, on the other hand, are mainly domestically active. They are not only located in places where major banks are also established, but also in sparsely populated or structurally weak regions, for example. This is because there is demand for financial services from private customers, small and medium-sized enterprises and traders in all regions. If they do not find suitable offers, this reduces the future potential of these regions.

Diversity can increase the resilience of the banking industry. Since the impact of financial crises also depends on the business model, a diversity of business models can ensure that restrictions on supply can be reduced or even largely offset in difficult times. This is particularly the case if the institutions themselves are sufficiently crisis-proof. Adequate prudential regulation on the one hand and a high level of competition on the banking market on the other contribute to this.

The German banking industry is a good example of the benefits of diversity. It is characterized by a three-pillar structure. This consists of the financial networks of the savings banks and cooperative banks and the other banks, which include not only internationally known major banks, but also numerous other regional banks.

The Volksbanken Raiffeisenbanken Cooperative Financial Network is one of the three main pillars of the German banking industry. The majority of the 737 credit cooperatives are Volksbanken and Raiffeisenbanken, which provide local banking services throughout Germany. The Volksbanken and Raiffeisenbanken are legally independent banks and know their regional markets. At the same time, they are part of the financial network and can thus achieve economies of scale and offer a wide range of financial services. In addition to the cooperative banks, the Cooperative Financial Network includes, for example, DZ BANK as a central bank, Union Investment as an investment company, R+V Versicherung as insurance company and DZ HYP as a mortgage bank. The DZ BANK is also present worldwide and supports the international business of companies that require a supra-regional banking partner.

> **Like biodiversity in nature, institutional diversity is an important resource in the economy.**

Like biodiversity in nature, institutional diversity is as an important resource in the economy. However, diversity in banking regulation is currently hardly taken into account in the prevailing “one-size-fits-all” approach to banking regulation with its focus on large banking groups. Divergent business models thus have to contend with disadvantages and diversity is likely to tend to decline.

An important area for action is proportionality in banking regulation, so that smaller and medium-sized credit institutions do not have to contend with regulation that is oversized in relation to their risks. This also applies to reporting, where institutions below a critical size can be significantly relieved through simplification options, graduations and exemptions.

Of central importance for the German financial networks is an appropriate consideration of the institutional protection systems that guarantee the protection of the institutions and thus also of customer deposits. Institutional protection schemes exist not only in Germany but also in a number of Member States, including Austria, Italy, Poland and Spain. The Genossenschaftliche FinanzGruppe’s protection scheme has been in existence for more than 80 years, making it the oldest private protection scheme in the world. Since its inception, depositors have never had to be compensated, nor has there ever been an insolvency of an affiliated bank.

Communitization of deposit insurance in the euro area, as envisaged by the European Commission, would amount to the elimination of these tried and tested systems. Equally to be rejected are the Commission’s plans to significantly change the European framework for crisis management of banks. The planned extension to small and medium-sized banks would create problems where there are none today, to the point of unsettling customers who rightly rely on the current system.

The work of institution-based protection schemes should not be made more difficult by additional requirements. The existing banking union already provides a solid foundation for bank stability.

BENOÎT
DE LA CHAPELLE
BIZOT

Head of Public Affairs -
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Acknowledging banking diversity in Europe through tailored supervision

The European banking sector is fundamentally different today than in 2014, when the principles of the Banking Union were approved in Brussels. At the time, EU economies were still recovering from the financial crisis. It was essential to create a Single Supervisory Mechanism, which could efficiently and swiftly assess the financial stability of Europe's biggest banks.

Almost ten years later, it is undeniable that the SSM has largely fulfilled its main role: keeping the banking system safe and sound through a variety of harmonized prudential tools that are used daily by Joint Supervisory Teams (JSTs). In this regard, the Supervisory Review and Evaluation Process (SREP) should be regarded as a breakthrough.

However, European banks' business models and corporate structures are diverse. Cooperative banks, which were once disregarded for their risk aversion and their locally grounded culture, effectively act as a source of resilience for the entire financial sector during difficult times, thanks to the non-dilutive nature of their capital, long term business models and low risks approach. This diversity is a key driver behind Europe's financial stability and economic resilience, and this has been repeatedly recognized by European supervisors.

It is true that cooperative banks, on average, may have lower profitability than some of their commercial counterparts. But there are several reasons for this: a very high management buffer (profitability is a ratio which compares results on equity), a low-risk business model which leads to low profitability (high proportion of mortgages in the balance sheet), and a nationwide granular presence allowing a decentralised decision making close to clients (BPCE has 6500 branches in France).

It is therefore key to adapt supervisory procedures and processes so that supervisors' approaches fit better with the different business models. Benchmarks should not be the gold standard of supervision if they do not recognise in practice the specificity of banking models in Europe, especially those who proved to be sustainable over time. JSTs should thus not be guided only by standardised benchmarking for banks' profitability, cost and risk management, and governance.

> **Time has come to combine the homogeneity of banking rules with the diversity of business models.**

In terms of profitability for instance, our Group has a pay-out ratio around 10%. Its capacity to put earnings into reserves is therefore comparable to listed groups even though their net incomes are higher. Furthermore, our reserves are not distributable, and our high level of capital, which is a choice of the group, naturally explains the relatively lower profitability.

On the same vein, analyses on the cost income ratio should encapsulate some characteristics of the business model, as the ratio remains high for some banks: the weight of real estate credit in the balance sheet should be considered as it mechanically explains a high cost income ratio because the margin is low (and the risk too), while the number of branches also has an impact (see above) ...

Hence, a better indicator could be the residual income after distribution and a proper assessment of the risk/return ratio. Other indicators could also be put in place in terms of cost efficiency and governance. In short: it is the right time to combine the homogeneity of banking rules with the diversity of business models. Moreover, the SSM should make sure that the transparency of different benchmarks and the suitably of the samples are the cornerstone of supervision analysis: each bank should be able to position itself vis-à-vis the benchmark and either comply or explain.

Our capacity to serve customers and small companies in all regions should also be a key indicator for supervisors, who should consider that maintaining banking activities in all regions of France is key for our business.

Beyond supervision, regulation itself could lead to numerous unintended consequences on the different business models if we don't look at the big picture. I have one example in mind: the cumulative effect of the leverage ratio and the NSFR. The first ratio, if applied individually and not globally, tends to favour risky activities, while the second one favours long-term activities. Those indicators would incentivize banks to favour a non-diversified risky long-term business model.

For BPCE, it is essential to preserve the DNA of our Group and support our 36 million customers, whether they are individuals, professionals, associations, corporates, or local authorities, over the long term and at every stage of their lives. We stand ready with European cooperative banks to work hand in hand with the SSM on this matter: it is time to acknowledge banking diversity in Europe through tailored supervision.