Taking advantage of bank diversity in Europe

1. What is at stake

1.1 The variety of banks' business models contributes to the EU system's overall resilience

The Chair detailed that while there was consensus that bank diversity in the business model is an asset, past Eurofi discussions have resulted in disagreement about whether the Single Supervisory Mechanism (SSM) and European Supervision were applying a one-size-fits all approach to different business model.

1.2 The scope of the EU very detailed regulation must be reviewed

A regulator suggested that the aim of harmonising supervision across the EU has inferred that we produce very detailed regulation and guidelines. But there should really be a discussion about whether the scope of regulation and supervision is correct. The definition of a credit institution is something that has not been harmonised, lending to the public is at the core of this discussion. The concept appears clear, but when considering the details, it is not actually clear.

If the aim of European regulation is simply to prevent bank failures, there might already be the right scope to protect depositors in deposit-taking institutions. However, in the last 20 years there has been an increasing focus on the stability of the credit supply. If the aim of supervision is the stability of credit supply, it does not makes sense to only have macro tools and supervision for credit institutions. It must be asked whether to also include other entities in the scope.

1.3 A stable, predictable, trustworthy regulatory environment is beneficial for all kinds of business models

A regulator suggested that financial innovators and fintechs are needed as they can challenge the old and large banks. Despite what they claim, their business models and risks are not fundamentally different. All banks, be they old, small, traditional savings banks, large, systemically important banks, the new, fast-growing fintechs, are fundamentally the same. A stable, predictable, trustworthy regulatory environment is beneficial for all kinds of business models.

An industry representative raised the importance that politicians and regulators do not fall for populism and consider effects on investment climate when assessing the profit levels and not rush implementation of for example windfall taxes.

1.4 A sustainable bank is a profitable bank with diverse funding

An industry representative remarked that entities with strong buffers are much safer in the current environment. The best buffer is profitability, and the key is long-term profitability. There is also a need for diverse funding. Entities need deposits and market funding. Other buffers include capital, liquidity and credit provisions.

Banks that are built on one thing alone will suffer in the current environment. Predatory lending will also not work. In a world with 0% interest rates, entities can lend to everybody, but in this time they need to be more prudent.

An industry representative noted, from German cooperative banking sector and institutional protection schemes (IPS) perspective, and with regards to an exit door and an instrument for reacting very quickly, action is taken through early preventive measures.

The chair summarised that there should be a full-scope type of supervision, incorporating all of the information and data. There are two legs. There is regulation and supervision to try to reduce the probability of banks defaulting, but there is no regulation nor supervision that can completely avoid the potential default of a bank, which is why all of the legs related to the how to manage crises are needed, which includes an exit door.

1.5 Combining the diversity of business models and consistency

A Central Bank official suggested that the cornerstone of the system is an adequate risk assessment. Recurring profitability is linked to the governance and the business model, as well as the economic environment.

The fundamental objective of supervisors, and of the SSM as a supervisory authority, is to analyse the risks that institutions take, and whether the institutions are properly managed. The joint supervisory teams (JST) are responsible for that assessment. And for them, it is important to be able to identify and understand the reasons behind each figure, structure, ratio or score.

The banks under the supervision of the SSM are quite diverse. So, when dealing with more than 100 institutions there is a need to apply a minimal level of consistency. And that is not definitely a one-size-fits-all approach.

There is also a need for flexible application of supervisory methodologies. It is reasonable to assess similar risks in a similar way, but there are many other factors that can explain differences, such as the business model.

Combining the diversity of business models and this level of consistency is essential. The SSM approach applies this second layer of consistency and benchmarks, but it also strives to apply the right balance between risk-based supervision and consistency. There is an evolutionary process in that respect.

2. Contributions and suggestions on adjustments the SSM could consider

2.1 Going beyond proportionality for sound supervision

2.1.1 When business model supervision is accurate

A regulator pointed out that when it comes to diversity it is very difficult to identify a common trend, as diversity is, by definition, not common. The banking sector across EU member states is a very diverse one. Additionally, defining what exactly constitutes a business model is far from trivial. The viability of individual banks is one of the most important issues. Profitability is also important, but focusing solely on it gives the wrong signal. Very profitable banks can, at the end of the credit cycle, be the most dangerous banks, because they are over-leveraged and the profit is coming from that area.

A comprehensive view on the bank and the viability of its business model is very important, so the SSM is undertaking horizontal comparisons with benchmarking. Business models are already supervised on the basis of proportionality and at individual levels. This is an important exercise, but it is not sufficient – detailed assessments remain essential for individual banks.

In assessing business models, supervisors have to be smart and bold. Supervising banks in line with the standards is easy; but it is much more difficult to argue why a special situation applies for a specific bank.

A diverse banking system in Europe is not, per se, more stable. It can be more stable in that a single event does not affect all players in the same way, but a set route for market exit is essential for greater stability. There is a need for the instruments to take effect very quickly

2.1.2 What proportionality means

An industry representative noted that business models develop on the market. The European regulatory framework should be neutral. It should be more flexible to allow new businesses to reflect existing businesses and support future growth.

The primary concern is for the business models of those, mainly locally operating, banks, which are owned by roughly 18 million members, to be adequately supported in the framework. The rules on institutional protection schemes, the knowledge, and the financial stability granted by the support and monitoring systems have ensured that taxpayers have never had to step in to cover any of losses for more than nine decades. This should also be reflected in the current discussion on crisis management and deposit insurance (CMDI).

The diverse business models contribute to the structural resilience of the European banking market. In some jurisdictions 'proportionate' is used as a synonym for exemptions from regulation. Instead, there should be more flexible regulation. Proportional regulation means appropriate regulation that reflects the size and business model of an institution and does not mean weaker regulation. It means simpler but not weaker regulation.

2.1.3 Supervisors and regulators should be neutral with regard to the business model

The Chair suggested that supervisors and regulators should be neutral with respect to the business model organisation. That has been a longstanding principle of European regulation and supervision. 'Proportionality' can have different meanings. From one perspective, people tend to see the size, even though recent events show that interconnectedness might also matter significantly. There is also proportionality in supervision, which is based on risk, and sometimes supervisors spend a great deal of time on small intermediaries because they might be riskier.

2.2 Benchmarks for banks

2.2.1 Acknowledging banking diversity in Europe through tailored indicators or benchmarks

An industry representative remarked that the industry's concern is about the indicators taken by the supervisor. For instance, Profitability is a ratio that compares results on equity. For some firms a better indicator could be the residual income after distribution: what should be assessed is a bank's capacity to put earnings into reserves. The capacity to serve customers and small companies should also be an indicator for supervisors, and benchmarking should be adapted to the specificity of each banking model.

Regarding governance, the fit and proper procedure has to be adapted to the relevant particularities, such as elective processes. Regarding the different recommendations made on the SREP process, the integrity of the business model should be questioned.

Day-to-day supervision runs contrary to the general recognition of the diversity of business models being an asset for stability. The supervisory procedure should encapsulate a bank diversity suitability test so that recommendations from a joint supervisory team do not question the integrity of a bank's business model.

Regulation itself can lead to numerous unintended consequences on the different business models when the big picture is ignored. The leverage ratio, if applied individually and not globally, tends to favour risky activities, while the net stable funding ratio (NSFR) favours long-term activities. Those indicators would incentivise banks to favour a non-diversified, risky long-term business model. There is a need for more tailored supervision from the SSM.

2.2.2 How the governance framework functions

A Central Bank official noted that the question of the risks should be stressed. No one governance structure is better than another. It is how the governance framework really works what matters. There is a need to distinguish the substance from the form. People do not assess in exactly the same way, because it is human nature to make some differentiations on soft elements that sometimes are not particularly soft.

2.2.3 A greater reliance on information quality

An industry representative highlighted that having more dialogue and communication is a key factor for everyone.

Every business model is unique and has a right to grow. Putting all of these business models in a corset is not the right approach. The mandate of supervisors is to assess the viability of such business, and to assess and monitor the risk. Entities have to organise excellent risk management.

However, it is not only important to look at numbers. It can be asked whether there is a desire to understand the business model behind the numbers. A schematic approach with only statistical data and models could be the only way to handle certain business models.

The approach needs to be further developed and refined, and the indicators used should sufficiently reflect the relevant strengths. There should be stronger dialogue with stakeholders on the approach taken. That could also minimise the administrative burden with respect to unnecessary information being requested.

The Chair agreed that there should be greater reliance on the quality of the information. A bottom-up approach that helps to complement quantitative data is the true value-add of prudential provision.

2.2.4 Proper risk management backed by sound supervision

A Central Bank official remarked that the question is how to incorporate the nuances of the different business models, and whether that should be included in regulation or in supervision. Beyond the refinement of methodologies with different elements, scores, etc., there is a need to assess vulnerabilities and the riskier areas independently of the business model. There is also a need to properly apply supervisory intensity through a multi-year approach meaning to reinforce the supervisory risk-based approach.

Considering the latest financial instability episodes, there was doubtless a significant component of risk management in addition to the weaknesses of regulation and supervision. Therefore, It has to be ensured that risk management and governance are in control, and that strategic decisions are taken based on data.

There is a bidirectional relationship between regulation and supervision. The more proportionality is applied the tougher the supervision should be for the riskier parts. Some business models are less risky than others, and in those cases less supervision should be applied. That process is underway. However, in other situations, there should not be great deal of proportionality where entities are competing in a very complex market with the rest of the institutions. It also has to be ensured that the risks are properly assessed.

2.3 Focuses for regulation and supervision

An industry representative noted that, ultimately, both supervision and regulation are derived from the will of the people through democratic elections and politicians. What is on the regulatory and supervisory agendas is usually what is on politicians' minds. One risk is that the regulatory and supervisory bandwagon is looking in the rear-view mirror when what is needed is to look forward.

There are four issues to highlight. The first is climate change, which is a huge issue. The second is fraud. The new kind of theft involves phishing. The third issue is new technological developments. Innovation is good, but it also creating new risks. The same activity and same risk should have the same regulation. Finally, it is all ultimately about governance. In the end it is about getting the governance right; that is what drives the risks.

A regulator added that there is significant technological transformation currently occurring, with digitalisation, data issues and artificial intelligence. In addition, there should also be a discussion about BigTechs entering the value creation chain of the financial sector. They are not in plain sight currently, but huge issues about who creates the value and who gets the value are apparent in the back end.

A more stable, diverse banking industry requires a great deal of change, including in supervision. However, for example Governance is always needed and cannot be fully digitalised or automated. While it is very easy to say that smart supervisors have to carry out the necessary checks; it is nonetheless a very difficult task, because intervening in the governance process of a bank is a complicated issue and the most severe measure a supervisor can impose, as then it is about management's interactions.

An industry representative remarked that the SSM is made up of many procedures, so dialogue is key, but all of what has been said should be encapsulated in the procedure. There is a SREP review in 2024, which should encapsulate more respect of the diversity of business models.

Closing Remarks

The Chair summarised that there should be respect of the market developments. These might create some tensions on the scope, because there are new players, but what cannot be avoided is respecting market developments in terms of business models or organisations.

Both the public and private sides agree that the risks should be followed. There should be focus on traditional risks and emerging risks. There also needs to be consideration of the safeguards, and there is a hierarchy of profitability buffers.

There is a perception that the SSM does not consider bank specificity properly, which is not true. Many details are considered. However, there should be more dialogue and communication, given also the forthcoming review of the SSM methodologies. There should also be explanation of what is derived from and dependent on the horizontal analysis and what is bank specific, because there is still some miscommunication there. There is an interaction cycle with the banks. First, banks say they are different and so should be treated differently. Once they receive reassurance, they then say that others should be treated like them. That is why the horizontal analysis is needed. It is the usual ongoing interaction between being reassured that the specificities are properly considered and there not being any competitive distortion.

Despite having different cultures, different backgrounds and different experiences, the SSM tries to apply the same methodology, which is the strength of the system. Its strength comes from collective and extensive discussion.