

Bank diversity in Europe: what evolutions?

The Chair stated that diversity is a way to become more resilient. The question is how to take diversity seriously on regulation and supervision, which raises the question of proportionality. There are also new kinds of aggregation and articulation between entities mainly pushed by digitalisation, and there is a question whether all business models are prepared for the challenges ahead in an equally efficient way.

Three main points emerged from the discussion: (i) European bank diversity is an asset and must be considered under the prerequisite of stability; (ii) The 2024 SREP review and proportionality are essential for the preservation of banking diversity in Europe; (iii) All bank business models need to be prepared for digitalisation challenges.

1. European bank diversity is an asset and must be considered under the prerequisite of stability

1.1 Banking model diversity is a European asset

An industry representative commented that diversity in the banking sector is extremely beneficial for the economy and customers. It leads to a highly competitive banking market, tailor-made financial solutions, and ensures systematic stability. Europe needs national and international champions taking higher risk and executing complex mergers, as well as smaller, locally rooted institutions who are natural partners for private households. The EU financial industry will lead with green, digital and social for at least the next decade.

The Chair noted that the banking union (BU) has sound banks that have proved capable of ensuring that economic agents have access to financing when it is most needed. During the pandemic it was possible to avoid excluding certain groups of economic agents by meeting different financing needs.

1.2 Stability is the cornerstone of bank diversity in Europe

A public representative outlined that after becoming a politician in a national parliament during the financial crisis in 2008, they had come to value diversity when seeing that different models had different chances of surviving. Diversity is valued because the world is uncertain. Developed methods are needed in order to see how resilient banks are in different crises. Resilience should be much more central in regulation and supervision. When making regulation laws the key focus is proportionality. Diversity is essential for resilience but cannot be an excuse for conservatism. Supervisors need to be empowered to be wise and brave at the same time.

The ongoing climate change crisis has not been sudden. A societal and economical change towards sustainability is needed, as well as a vast amount of public and private investment. The return on this investment is highly uncertain, particularly in terms of the date it will pay off. Supervisors do not think the markets work; therefore, market data cannot be used to assess. Climate change is a crisis where a resilient banking sector is needed. The banking stress test shows a concentration of risk among 10% of banks for climate change policies.

2. The 2024 SREP review is key for the preservation of banking diversity in Europe

2.1 The SREP process needs to take diversity more into account

An industry representative observed that more cooperation is needed between supervisors and banks, as banks cannot stick to benchmarks, which are often inappropriate. More consistency and transparency is needed around the sample, as well as the timing of the Supervisory Review and Evaluation Process (SREP). There is a need to enter phase two of supervision to avoid putting the diversity of the business model at stake. The SREP in 2024 should encapsulate the concerns. According to the Wise Persons Group report, the aim of the SREP should be to give more time to the joint supervisory teams (JST) to ensure proper supervision. The SREP assessment should be done every four years, which gives sufficient time for the JST to take the consequences of their recommendations on the diversity of the business model into account.

An industry representative agreed that the SREP process needs to take diversity more into account. It is an assumption by the SSM that a benchmark approach is needed in order to create a level playing field.

2.2 The SREP review in 2024 should be an opportunity to adapt its procedures and processes, and further take specific indicators and quality measures into account

An industry representative noted that on profitability it does not make sense to compare their company to a listed company with a paired ratio of 50%, as their company is not listed and does not have shareholders. An appropriate indicator for cooperative banks could be the residual income after distribution, and the actual capacity to create Common Equity Tier 1 (CET1). The SREP should also focus on qualitative measures, such as the ability to serve customers and small companies.

The Single Supervisory Mechanism (SSM) should elaborate a 'business model adequacy test' that could

apply to JST recommendations. A bank should be able to raise an issue regarding the integrity of its business model to JSTs, who would then have to assess the issue. The actual process should be further defined by the SSM in close coordination with the representatives of cooperative banks.

The Chair added that the way ahead for the work of the SREP will be decided before the end of 2023 and develop in 2024.

2.3 The SREP should be adapted and take the stakeholder value model and country institutional specificities into account

An industry representative explained that their company is a cooperative bank and has one banking licence. Its business model is different to other business models. The retail banking and leasing part could be compared, but the third significant pillar, being the international Banking for Food strategy, is a niche. The SREP process is currently a one-size-fits-all. If a significant part of the bank is more niche then the SREP process needs to recognise that those banks have a sufficient amount of knowledge about these markets, clients and activities which should be looked at as a risk mitigant. The SREP is currently not taking this on board.

The SREP also needs to be more balanced for cooperative banks. Some cooperative banks are listed on a stock exchange and have issued shares, but most are not, as they are not focusing on the short term. The culture is different for cooperative banks as they are focusing more on the long term, which differentiates them from listed banks within the EU.

The shareholder value model can be characterised by highly innovative use of internal models, complex legal structures, risk taking, and strong profits. In contrast, stakeholder value institutions that strike a balance between creating value for their survival in a highly competitive market by not distributing profits and to bring sustainable and long-term value to the community they serve. The SREP process also needs to take country institutional specificities into account as this drives to a significant part the retail products a bank offers.

A Central Bank official stated that their organisation has tried to align the supervisory methodologies that it applies to significant institutions and less-significant institutions (LSIs) as much as possible, but that does not mean that the same assessment and the same judgment is applied. The horizontal assessment helps the analysts and the JST, but also the banks, because horizontal supervision helps avoid the risk of discrimination towards one specific bank.

2.4 ECB supervision, with its continued focus on governance, will keep examining and challenging the way in which individual banks assess the risks they take

The Chair commented that everybody values diversity, but the issue is how to take it into account. Supervisors are paid to measure the risk of failure. Prudential supervisors try and assess the risk of failure of the institution and the risk of spillovers to other parts of the financial system in a fair and balanced manner.

Specificities need to be taken into account. One important aspect of the cooperative is the personal interface; a future question will be whether to keep that or go to the digital interface.

It is important is to have concrete proposals to see how banks can deal with the benchmark. A comparison of the appropriate benchmark is needed to compare all banks in Europe and to ensure the same level of resilience. It is unclear whether using AI in the customer interface has a different impact.

3. Proportionality is essential to maintain bank diversity

3.1 Proportional application of homogeneous banking rules that apply to all supervised entities is important for maintaining bank diversity in Europe

A regulator stated that a process of dramatic change is ongoing. When looking at the numbers of LSIs supervised in the eurozone there has been a 33% decrease since 2015, from more than 3,000 LSIs in 2015 to around 2,000 in 2021. The consolidation process is especially concentrated in Italy, Germany and Austria. In recent years the issue of enhancing proportionality is at the centre of regulatory considerations; after the last amendment of the European Supervisory Authority (ESA) regulations, all ESAs had to mandatorily establish advisory committees on proportionality. The European Banking Authority (EBA) Advisory Committee on Proportionality is working intensively on the proportional application of regulation by examining different topics for opportunities to create more proportional rules and drawing up concrete proposals.

The Wise Persons Group has given orientation for a reform of the SREP process, which will also give room for new ideas and how proportionality can be introduced in the daily SREP process. The current framework already pays consideration to proportionality, and in close collaboration with the SSM a basic SREP has been developed for the cooperative sector in the regulator's country. The internal governance of the sector is relevant. Checks and balances must be in place at all times. Governance makes a big difference, and a functioning institutional protection scheme (IPS) is essential.

An industry representative commented that small actors will not be onboarded without preserving the cooperative model. Their company is the leading bank for small and medium-sized enterprises SMEs in their country; preserving diversity means ensuring a fair transition everywhere. Proportionality is needed around different business models.

3.2 A diverse banking sector needs truly proportionate banking and regulatory rules as well as proper functioning IPSs

An industry representative observed that over the last 10- or 20-years rulemaking development has become extremely complex and there are many reporting lines. A diverse banking sector needs truly proportionate

banking and regulatory rules, especially when it comes to compliance and reporting. Smaller banks are facing fixed-cost disadvantages associated with the ongoing wave of compliance and reporting requirements. The agreement reached on the EU banking package will lead to additional requirements and burdens that disproportionately affect smaller banks.

A balance between harmonised banking rules and the diversity of business models is lacking in the EU Commission's proposals for a review of the crisis management and deposit insurance framework. IPSs have been highly efficient for decentralised, relationship based banking models in a number of member states, but changes proposed within the crisis management and deposit insurance (CMDI) review would significantly impair the abilities of IPSs that are recognised as a Deposit Guarantee Scheme (DGS).

A practical solution for the BU is needed that will allow IPSs to continue to function properly. Choosing an IPS is a cost-efficient way to protect depositors and member banks.

3.3 There is a prudential limit to proportionality

A Central Bank official stated that their country has two cooperative groups that have become significant and 117 LSIs that have different business models. Traditional banks can also run businesses with digital processes. There are marketplace lending (MPL) managers, as well as asset managers with a banking licence. In Europe, proportionality has always been driven based on the size as a proxy of proportionality. There is now a definition of a small and non-complex institution; given the digitalisation and the adaptation of the cooperative banks, the question is whether they also become interconnected.

Supervision should be driven by risks and be risk-based. The proportionality regulation sometimes does not match the risk assessment. LSIs are sometimes very significant locally. There is a prudential limit to proportionality, but if a small bank is risky then more intrusion is needed in supervisory terms. An argument could be made that small banks are riskier from a liquidity perspective because they might have less access to the market, which might imply the use of supervisory tools that try to frontload or anticipate negative market development. There is also a business limit to proportionality, because of the importance of data governance. In addition to all the risks that a poor data governance might imply for the customers' relationship, if the reporting system keeps being simplified then the board would not get the information that they need for business purposes, not only for prudential purposes. The discussion needs much more granularity.

A public representative stated that diversity and proportionality are crucial. The business model does not always make a difference. Their country has three large banks, one which is commercial, one which is state owned and one which is cooperative. All three came very short on anti-money laundering (AML) methods. Digitalisation is one of the key developments. A distinction needs to be made between the customers, the clients and the SMEs, as it will lead to more mobility

of bank deposits. Introducing the digital euro as a competitor for banks is desired. Cooperative banking still has very close relations with SMEs, which is a strength and should be maintained.

4. All bank business models need to be prepared for digitalisation challenges

4.1 A business model is sustainable if its governance can adapt to new circumstances

A regulator explained that in their country the cooperative sector was previously profitable compared to other sectors. Cooperative banks had a local banking monopoly through their relationships, but that local monopoly is being eroded due to the fact that people in rural areas now have access to digital banking. Banks are currently trying to pool functions much more and outsource towards centralised institutions within their associations, which is acceptable from a supervisory point of view. The question remains whether it is sufficient to deal with the cost pressure via digitalisation as well as the pressure on the market in rural areas.

A regulator added that digitalisation is a central factor in maintaining access to bank financing and avoiding exclusion. However, digitalisation could eventually exclude digital-averse individuals and is a major challenge for smaller institutions that are only able to keep up if they are prepared to undergo permanent modernisation.

An industry representative stated that digitalisation is one of their group's core strategic objectives. It has one IT provider, which increases the level of information security and cyber resilience. All available channels are provided to get in touch with customers, in line with a fair and non discriminatory access to digital financial services. The EU digital identity and wallet should be introduced very soon, and the digital euro needs to be examined.

An industry representative highlighted that their company is located in the Netherlands, a highly dense country with a very strong digital infrastructure, which helps it to be a frontrunner regarding digital. Digitalisation is coming in waves and Covid has created a significant increase in video calling.

4.2 The increased reliance on outsourcing exposes the banking sector to higher levels of interconnectedness and concentration risk when multiple intermediaries rely on a limited number of service providers

A Central Bank official stated that proportionality is important particularly for LSIs (e.g. the SREP could be applied every two years for LSIs that do not have any problem), but the most important thing is that the reliance on digitalisation reduces differences between significant institutions and LSIs.

Cooperative banks are accessing digital payment systems through a lot of strategic agreement with other

parts of the system. or are relying on providers to handle various functions such as cloud, IT and critical functions. This might expose small banks to the risk of interconnectedness, similarly to Significant institutions.

There has been a concentration of outsourcers; given that the outsourcing does not reduce the responsibility of small and big banks, there is a need to assess the interconnectedness, as well as the ICT and digitalisation-

related issues. There should be much more focus on interconnectedness rather than size.

Running a traditional business with digitalisation implies a great deal of innovation and many structural changes in the P&L composition, that needs to be examined much more, as well as the risk that digitalisation might imply.