Banking model diversity in the Banking Union: added value and challenges

The Chair explained that, despite banking model diversity in the Banking Union, banks probably face common challenges, including profitability issues. The panel would discuss the sustainability of bank business models, what is at stake and the related challenges, especially in the current economic, monetary and competitive environment, the impact of EU banking regulation and supervision on these different banking models and the role of EU regulation and national and EU supervisory authorities.

The session highlighted the following points:

- The diversity of banking business models in Europe increases the resilience and the financing potential of the financial system and satisfies different types of customers and stakeholder needs.
- All banking business models face the same monetary and economic challenges: lasting very low interest rates, the lack of profitability, the digital and climate transitions. These challenges require ambitious strategies adapted to their specificities.
- Sufficient profitability is essential to all banks, but profitability should not be the sole compass for the supervisors. Proportionality in regulation and supervision is of the essence.

1. Banking model diversity is a European asset

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

A Central Bank official suggested that diversity is welcome because diversity increases resilience and the capacity to satisfy diverse client demands.

Another Central Bank official remarked that different capacities can cover different needs. The system becomes more robust and resilient. There is a need to ensure regulation does not discriminate.

An industry representative observed that the US has almost a banking structure as diverse as there is in Europe. When looking at the figures of banks per capita, Europe almost meets the US average. The issue is the difference in profitability. Diversity increases financial stability and leads to a very efficient market. In Europe, the financing needs of all customers are met due to high competition. With different business models, sizes, and ownership structures there is less of the herd behaviour typically associated with concentration. There is a better chance for parts of the financial system to compensate for the failure of heavily affected banks.

The German Savings Banks are at the heart of this diversity in Germany. The 370 financial savings banks within the group with an average balance sheet volume of approximately €4 billion, provide their services everywhere in the country, both in rural areas and urban centres – not only where it is promising the most profit. It is necessary to have players in the industry taking higher risks or being capable of executing complex finance transactions. However, locally or regionally rooted smaller institutions are better equipped to cover the needs of the local economies.

1.2 The diversity is a strength for funding the economy and ensuring financial stability

A regulator stated that diversity is appropriate for the financing and the resilience of the economy from a regulatory point of view. Regulation needs neutral vis-à-vis business structures, business mixes. He suggested that there are different ways of tackling the subject of business model diversity. One is to look at the asset side and the business mix. Another could be to look at the liability side or at the organisational structures of the banks. There is diversity both in what banks do and also in how they do it and how they organise themselves for doing it. Different EU member states historically had different banking structures and that continued over time, probably because regulation was neutral enough vis-à-vis the business model to allow them to continue to flourish, and this should be retained.

A Central Bank official noted that what is at stake is financial stability because business models, or at least the sustainability of business models, is crucial for financial stability. Unprofitable banks entail large risks. They cannot build up capital. They cannot invest. They may even distort the competition. Over the past years, there has been a fixed group, perhaps a small one, of consistently profitable banks in the euro area, and these banks apply a variety of business models. What is essential is that the bank's risk profile remains well managed.

An industry representative underlined that diversity is also good for adaptability, which can be useful in times of uncertainty. Diversity in business models is good for the financial system, but it is not necessarily something natural. When analysing the financial system as a whole, which is the responsibility of regulators and supervisors, there is reliance on benchmarking, cross-analyses and such. This does not naturally lead to preserving diversity, so effort has to be made.

It is not known exactly what financing a greener economy entails, but what is known is that it is going to be expensive, and that is where banks should play a role, and with more leverage than any public money. On that front, the diversity of banking models can help, because banks with more of a regional approach will finance certain things while others will have more of a social approach to what they finance, or a specific industry focus. It is helpful that various parts of the financing needs are tackled by various types of banks. Banks have to be made solid, but it also has to be ensured that they can fulfil their mission, which is to finance the economy.

An industry representative emphasized that banking model diversity increases the resilience of the financial system. It is not the task of the supervisors or regulators to determine or decide which banking industry structure is appropriate. This should be decided by the markets and by banks' clients. Large, pan-European and globally active banks are needed for certain activities that smaller banks cannot pursue due to their size and access to global markets. When it comes to smaller banks proportionate regulation is paramount.

2. All banking business models face the same monetary and economic challenges

2.1 What is at stake

A regulator remarked that there are old challenges, such as the difficulty to reap profits in a very low interest rate environment while at the same time supporting borrowers' creditworthiness. Additionally, cost-income ratios are relatively high. There are also new challenges, namely digital and transition for the environment. The rapid digitalisation of the financial sector can represent either an opportunity or a threat for banks depending on how they tackle it. Sustainable finance will increasingly drive business decisions and will affect banks' current business models. There is also the political situation, which may not help on top of the exit from the pandemic. It is important for banks to think thoroughly about how they want to serve the economies they operate in and to have long-term perspectives.

2.2 The change of the monetary stance on interest rates should improve the sustainability of business models

A Central Bank official noted, regarding low-for-long, that one question is whether this is also something for the future. It is difficult to make a value judgment about what the right price of lending and borrowing is. If interest rates are structurally low, it needs to be driven by either too low investment or too high savings; it could be a mix of both. A tremendous amount of investment is needed, not least in ensuring energy independence and the green transition. If carbon pricing is installed sufficiently, and there is public investment, there could be a case made that the low-for-long environment may change. Many of the resources now used for importing fossil fuels need to be shifted to energy efficiency and renewable energies domestically. That needs to be produced domestically and the carbon pricing can be refunded to taxpayers.

This all comes at a time of running the economy at full capacity and in an inflationary environment; this can boost things further. The current low-for-long environment would likely not continue forever, and that implies challenges and opportunities for the banking system. It is also about how to make a judgment on how banks should price their interest rates. That is their choice, but in a negative interest rate market environment, banks that are not transmitting those negative rates to their customers will feel a squeeze on interest payments. Deposits are probably among the safest of financial products.

A Central Bank official stated that the business environment has been quite challenging due to monetary policy. The outlook is an increase of interest rates, and that would create an entirely new environment for the European banks. If the monetary policy stance changes, the cost block of negative interest rates disappears gradually. At the same time, the interest margin may rise, so the cost comes down and the revenues increase. In two years there may be a completely different picture, because one effect is that most of the banks undergo very substantial structural reforms.

There are very well-structured banks, which enjoy much more friendly environments for their business models. That may be an opportunity for investment in areas like digitalisation.

2.3 Technology is a game-changer for all business models

A Central Bank official explained that increased competitive pressure from the non-financial sector and COVID-19 pandemic further accelerated the process of digitalisation, creating both new opportunities and new risks. Moreover, the increased speed of innovation and the higher interconnectedness among intermediaries and sectors have contributed to widening the traditional definition of IT and operational risk, thus making the industry and supervisors consider cyber risk as one of the top priorities for specific governance and risk management safeguards.

There are at least three major developments in terms of digitalisation. First is a great deal of digital transformation, with all of the issues in terms of letting the chain with third-party providers and such. The second is developing joint partnerships with unregulated firms, which also raises the issues of the scope of regulation supervision. The third is the establishment of some digital platforms where banks change the nature of their business. Banks may become a product of another entity (e.g. big tech) who provides not only services but also the data that underpins the banking business. In terms of banking business model, this is a relevant development, because open banking, smart contract and more sophisticated technology can be relied on, which opens up many opportunities.

Another development to rely more on is very small intermediaries operating outside the banking scope. This is done to reduce the regulatory burden. They can rely on much more agile governance for the intermediaries, such as credit funds and private equity, which is very good for the economy because it complements the channel of funding for the real economy. On the other hand, this lowers the amount of information available and reduces the supervisory tools that can be used.

A regulator noted that economies of scale and scope have been at the root of financial intermediation so far.

However, technology is a complete game-changer, because banks may achieve the same scale or economies of scope through technology without necessarily being big. That probably means that banks need sophistication by being at the edge of technology, to see how they can best provide value to their customers. That is probably the one thing that is important for banks' business models, if they do not want to lose their specificity and be overtaken by new entrants.

The Commission and the co-legislator's digital finance strategy, in particular the Digital Operational Resilience Act (DORA) and markets in crypto-assets (MiCA) proposals, head in the right direction because new types of activities and new entrants will be covered by the safety net. That means that there will be more equal competition.

3. There is no one-size-fits-all approach to assessing the sustainability of banks' business models

3.1 Assessing the sustainability of banking business models through different criteria

3.1.1 Adequate governance and risk management is critical

A regulator remarked that the key question is about how to assess sustainability. Depending on the organisational structures, banks may have different profit expectations or constraints. Some of them do not have much of a constraint regarding profits in Europe, because their ownership is not exactly profit-oriented. Some of them do not have much of an issue vis-à-vis funding costs because they can enjoy relatively cheap funding costs.

It is very difficult to draw a line and say that banks in Europe should behave in a certain way. There is a need to go beyond the aggregates and look at individual banks when assessing sustainability and profitability. All possible tools are given to supervisors and banks' governance to decide for themselves what is good for the sustainability of their business models and for supervisors to assess that. Having adequate governance and risk management is critical to ensure the viability and sustainability of any business model. Proportionality in regulation and supervision is also essential.

3.1.2 Regulatory headwinds

An industry representative noted that one concern is that the specific cooperative and mutual business model is not sufficiently understood nor taken into account in EU policymaking and supervision. A 'stakeholder value' approach has merits and an approach exclusively based on 'shareholder value' is inappropriate when shares are not tradable.

This has important consequences as shown in two recent examples:

<u>On Supervision:</u> the SSM intends to benchmark all banks on several aspects, notably profitability (in comparison with global listed institutions). The ECB horizontal Directorates therefore tend to create a one-size-fits-all approach which mixes up models and undermines diversity. This is a question of method: these benchmarks become increasingly important for supervision and should be defined in cooperation with industry and full transparency.

<u>On Resolution:</u> a key piece of the BRRD2 legislation imposes MREL and TLAC on the top of our capital ratios. The European proposal did not initially consider the specificities of cooperative banks where shares have a fixed value and reserves cannot be distributed?

In both cases, the issue is how to avoid an inappropriate standardisation of the various business models.

A Central Bank official stated that benchmarking is a tool; it is not a norm, but it is a very useful tool at the European level, because the benchmarking can be adjusted to more situations that are similar.

Like supervision, it should not be a systematic art but an art of application to the different sizes. Supervisors should not have a picture of an ideal banking system. They are not directing the system to an optimal situation. Supervisors are pushing for more prudence and security than will spontaneously evolve from the system, and for this more room is needed for investment and preparing for the future.

3.1.3 Comparing what is comparable

An industry representative emphasised that the sustainability of banking business models should be assessed through their capacity to generate capital through business as usual, their capacity to cope with the growth of risk-weighted assets and to recapitalise in smooth conditions when facing crisis.

3.2 All business models in Europe face the same profitability challenge

3.2.1 Profitability recovery in 2021

A Central Bank official noted that the results for banks in 2021 (thus before the most recent war shock) were extremely good by European standards. A very broad measure of profitability in the markets is return on equity (ROE) for the listed banks in Europe, which are the ones that can be analysed currently, and it has been at its highest level in 2021 since the creation of the Single Supervisory Mechanism (SSM).

3.2.2 Net interest income has lagged this positive development

A Central Bank official remarked that in Europe the cost to income ratio is 65.6%, which is more than six points greater than the average of the American unlisted banks. The contribution of the net interest income, even for the most important results, is lower than in 2019, so the trend of the net interest income diminishing is still there, even with this significant result. It is almost 6% less than at the end of 2019.

Those are two structural weaknesses seen in all parts of the European banking system. There is a high cost of income on average, though there can be a difference for banks and a great deal of reliance on the net interest income, which continues to shrink. The good news, which supervisors should leverage on, is that the net fees and commission income are growing. The increase in fees was broad-based across different business models, as various fee types increased. This explains the good results of the previous year. That is linked to market fees and asset management.

This is a very specific issue that is found across all business models, and it is a weakness of the European banking system, and the ways to address it should be varied. The problem of profitability has to be addressed together. For supervisors that does not mean having an obsession with profitability, because profitability should be linked to risk. For supervisors it is even more important that it is linked to the capital trajectories. Profitability should also be seen in terms of the capacity to retain profit. If there is profit but it is all distributed, then that is not the same as keeping those profits. Profitability is not the alpha and omega, but it is the alpha, and needed in order to get to the omega.

3.2.3 Sufficient profitability is central to all banks

An industry representative remarked that regional or local banks do not have to hide when it comes to profitability. The return on equity of the German Savings Banks is at 5.1%, which in European terms is quite good, and their cost-income ratio is at 67%, which is good. The difference with investment banks is that they have extremely volatile gains. Their profits go up and down but, looking at the average over a decade, DSGV is more profitable. In order to assess an institution's profitability, different time horizons have to be factored in.

With digitalisation banks are forced to adapt because customer needs are developing very quickly. Another challenge is regulation. A recent study by BearingPoint compared the ROE of European banks with the one of the United States. The result was that the ROE of European banks could be 340 basis points higher if they were subjected to the US capital regime instead, and the cost-income ratio could be 260 basis points lower. Supervisors and regulators could work to level those regulatory differences. There is a challenge due to the ECB's interest rate policy. There is now substantial inflation, and the ECB is still applying negative rates and purchasing assets; it is time to return to more conventional monetary policy.

3.2.4 The benefits of bank consolidation in Europe

A Central Bank official noted that it is difficult to assess what the appropriate profitability is. One point on that, related to the structure of banking, is that small banks may face some challenges with respect to compliance and cyber security. It is a kind of business of scale that may hamper their activities and profitability. The term 'consolidation' does not need to be used, but there may be overcapacity and the system may need to be structured differently. That should be market-driven, and a smooth exit should be allowed for banks that cannot keep profitability up in these circumstances.

3.3 Profitability should not be the sole compass for the supervisors

An industry representative emphasised that profitability does not necessarily mean the same for a regionally operating small, non-complex institution as it does for a listed, globally active bank. Simply benchmarking profit overlooks that different business models and differently structured balance sheets result in different profit cycles.

An industry representative noted that there is benchmarking against profitability. When comparing profitability ratios, the right indicator should be the bank's residual income after distribution of the current pay-out to equity holders, which is a significant burden on Common Equity Tier 1 (CET1) generation.

Besides, it is not fair to penalise highly capitalised banks which put a much lower part of their balance sheet at risk and therefore display a lower profitability. This implies looking at the capital required as a fair and equal denominator among banks and remembering that risk and rewards are to be balanced.

The capacity of the bank to recapitalise in times of crisis is a third criteria that should be taken into consideration. Cooperative banks present strong assets in such a situation. They have a stronger attractiveness among investors because their shares are not sensitive to stock market fluctuations. Their high level of reserves cannot be distributed to their members, which is contrary to commercial banks, and that ensures stability of value during crises. There is also the non-dilutive nature of their capital in case of capital increase.

The reality is that for some banks return on equity is a very significant criterion, but it is not for others. Profitability is a means, but it is not the aim for BPCE. The profits BPCE makes typically go to its cooperative shareholders for a 10%, but 90% stays inside the group and is there to finance its growth and to create more stability in its equity. Moreover, it is not subject to going out in the distribution of reserves, for instance, as it would be the case for a listed company. For some business models, profitability is important; for others it is not as important, and it could be argued that for cooperative banks it is against their principles because they were created to provide the best services at the cheapest price, and therefore not primarily to make profits.

The suggestion is not that there is anything opposed to diversity, but the fact that there is a habit of benchmarking. That is not bad in itself, but it may lead to pushing people towards a certain business model rather than others, or towards certain criteria that are fit for some businesses but not necessarily for all of them. Attention has to be paid to preserve diversity when comparing, and not to move from a comparison to having one single view of what the best solution is. Diversity means the value of one particular company is not a value by itself. Rather, it is what it brings to the overall system.

The speaker offered another example about benchmarking. He was often asked why BPCE does not reduce its network of branches as it has so many, which must be expensive. A question often asked is why BPCE does not do what some of its competitors do, why BPCE does not reduce its branches by 50% in those remote parts of France where there are not many people.

It would be against BPCE's nature to do it. As a group of regional banks, BPCE stays in those locations because it thinks that is its nature. It has been done for two centuries and hopes to continue for at least another two centuries. It is keeping those networks and it observes that it is gaining market share. It is gaining market share from digital banks and from national banks that are cutting their networks. It is not that what those banks do is wrong. It is probably right for them, but what BPCE does is different and right for it.

3.4 Proportionality in regulation and supervision is of the essence

3.4.1 Proportionality to risk and not to size

A Central Bank official stated that in terms of business models it is clear that, for small and medium-sized banks, huge regulations that are set up for internationally active big banks are not entirely appropriate. However, from the supervisors' point of view, proportionality means proportionality to risk and not to size. There were some examples in Germany last year and the year before where very small banks were very risky. The appropriateness of regulation and proportionality is a function of risk and not of size.

There is digitalisation of the banks themselves and the competitive environment with big techs and such. Another factor that may drive the change of business models is the huge transformation ahead driven by digitalisation, decarbonisation, automation, structural changes after the pandemic and geopolitical changes. These changes bring about huge investments and financing needs, but those financing needs are probably not the same as classical financial needs, because there are bigger risks and long-term investments; it is not bricks and mortar, so there is not that sort of collateral as is classically available.

That can be a challenge for banks with low-risk appetite because they will probably have to take more risks. They probably have to not only issue loans but also provide equity and such instruments. That is also an issue for supervisors, because they will not lower their standards to allow this financing. Indeed, they may even tighten the standards. The issue for everyone should be that the banking system is able to finance the economy in a stage of transition.

A Central Bank official stated that regulations should be driven by, and be proportional to, risk. There is also a permanent obligation in regulation and supervision to be inspired by what works elsewhere. There are questions of how to tune, whether it can be better and how to be more neutral.

Europe, probably more than elsewhere, has a concentration in some parts of the business models that is completely occupied by low-risk activities. These low-risk activities are somewhat stuck in the middle by changes in regulation, which can be tuned, but nevertheless a leverage ratio that will easily bite earlier for low-risk activities than it would for high-risk activities has been introduced. The output floor has been introduced, which implies that there will be increasing reliance on the outcome of the standardised approach, and there is nothing wrong with that.

It has to be ensured that the standardised approach is continually tuned and revised, and if there is further reliance on that then it also needs to be extremely risk-sensitive and assessed repeatedly. The long transition period should be utilised to go deeper into how the standardised approach is calibrated, as that is becoming more important. There are many other issues that may need to be revisited from time to time.

An industry representative emphasised that proportionality should not be based only on size but also on risk. The European Banking Authority (EBA) has defined more than 50 indicators for assessing the systemic importance of banks. They could be applied in the future to define a two-tiered system, like there is in the US, distinguishing large banks, which are pan-European or globally active, from smaller ones operating on a national scale. That would allow for more targeted, truly proportionate regulation. It is not possible to be more profitable and less risky at the same time; there is a trade-off and that should be kept in mind.

3.4.2 There is a prudential limit to proportionality

A Central Bank official shared the concern about proportionality. There is a prudential limit to proportionality, which is linked to the risk and interconnectedness, and now synergy can be achieved just by being part of a digital platform. A very small firm can have access to a data repository and then assess credit risk through an algorithm, so there has to be caution about saying that small is good; it may be good but it may also be risky. There may be major fragmentation in the system if there are multiple small intermediaries, and that would increase the supervisory challenges.

The right direction is being taken with the digital strategy, but it is key to finalise the discussion on MiCA and DORA. These are crucial steps to give stability to the framework and to enhance the supervisory tools to work together with the market in order to develop the new framework.