BANK DIVERSITY IN EUROPE: WHAT EVOLUTIONS?

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Building on the diversity of European banking business models

European Central Bank (ECB) Banking Supervision has often welcomed the diversity of banking business models in the euro area as they contribute to the overall resilience of the European banking system. Nevertheless, recent events outside the European Union have shown that, at individual bank level, concentration that is not strategically and professionally managed can be a risk, with the potential to seriously destabilise not just individual banks but also groups of banks with similar business models.

For the ECB, this is a reminder that strategic steering, risk appetite and development strategies need to be adapted to specific banking models. It is crucial to have strong governance that takes due account of all the features of specific banking business models, including those related to legal form and ownership structures.

In the banking union, we have sound banks that have proved capable of ensuring that economic agents have access to financing, even in times of stress, when it is most needed. Thanks to the euro area's diverse banking landscape, during the pandemic it was possible to avoid excluding certain groups of economic agents by meeting different financing needs. This landscape includes both large, diversified banking groups with various legal forms and geographical scopes able to draw on economies of scale and provide flexible digital solutions to reach clients of all types and local or niche players that offer tailored financing solutions to their clientele.

Even now, against the backdrop of rapidly rising interest rates, we are not seeing any signs of a credit crunch driven by a lack of capacity or willingness to lend on the part of banks. Instead, there is a decrease in demand for credit. This has only been possible because euro area banks are well capitalised overall and have sound risk management and governance in place.

We should not, however, succumb to complacency. More severe economic tests are yet to come. Given the strong emphasis banking supervisors place on preventing difficulties, now would seem an appropriate time to ensure the robustness of each type of business model. Banks can use this current room for manoeuvre to invest in digital transformation, which is the future for all business models. Furthermore, they can enhance their strategic capacity to manage emerging risks, in particular environmental and cyber risks, as well as more traditional risks. The key to ensuring sustainability over the cycle is to react swiftly, before clients and counterparties find themselves in more challenging circumstances. Recent events have highlighted the importance of taking into account not only banks' capacity to generate profits, but also their ability to achieve this in a sustainable manner. That way, banks can retain these profits and will be able to raise capital and additional funding should the need arise.

ECB Banking Supervision, with its continued focus on governance, will keep examining and challenging the way in which individual banks assess the risks they take. In particular, it will look at banks' understanding of underlying risk drivers, exposures and early warning signs. To that end, the Supervisory Review and Evaluation Process (SREP) not only includes assessment stages in which a set of indicators is applied to all banks, but also allows the Joint Supervisory Teams significant discretion in selecting and weighting the relevant indicators based on the specific features of each bank's business model.

For benchmarking purposes, it is important to compare individual banks with relevant peers operating in similar markets and with similar income and funding mixes. We therefore take a multi-faceted approach, by applying classifications of bank business models and country exposure. This assessment is supported by flexible benchmarking tools enabling comparison with various peer groups. The SREP has long been adapted to account for specific business models through the introduction of additional targeted key risk indicators and assessment templates to ensure full proportionality, in terms of intensity and frequency, for smaller banks (less significant institutions) in Europe.

Furthermore, we have pledged to embed agility and a risk-focused approach in this supervision in the long term. To do this, we have decided to introduce a new supervisory risk tolerance framework, specially designed to enable supervisors to better adjust their tools to bank-specific business models. Supervisors will thus be able to focus their efforts where they are most needed and devote more time to addressing the relevant strategic priorities and vulnerabilities for specific banks. We will therefore plan our activities based on a multi-year SREP approach, which will enable our supervisors to calibrate the intensity and frequency of their analyses more effectively, reflecting individual banks' specific vulnerabilities as well as broader supervisory priorities.

This does not mean less supervision, but instead affords a supervisory process that is better focused and more impactful by homing in on the greatest material risks. Concentrating on the specific features of different banking business models will also give us more flexibility to tackle new and emerging risks in the context of a rapidly changing macroeconomic and interest rate environment, in effect mirroring the priorities of banks' own governance structures.

HELMUT ETTL
Executive Director - Austrian Financial Market Authority

Stability as the cornerstone of bank diversity in Europe

When talking about bank diversity in Europe and access to bank financing for different economic agents, it is first necessary to examine the degree of centralization or concentration of the respective banking sector, which vary considerably between the various member states and regions. While some member states have a high degree of centralization in the banking sector, the Austrian and German banking sectors, which in my view are comparable in this context, display a higher degree of decentralization.

The characteristics of (de)centralization and concentration, as seen in Austria or Germany, are mostly complementary to the economic structure. In Austria, there is a strong focus on SME financing and regionality plays a crucial role. In Austria, for example, one sector is characterised very strongly by regionality and presence in rural areas, although other sectors are also still present. However, that is not to say that decentralized systems are more stable or more unstable than centralized systems. Austria has experienced both scenarios: previously there were two large cooperative banking sectors, one of which slid into a survival crisis while the other sector proved to be robust and crisis-resistant. Irrespective of whether institutions are organized centrally or decentrally, the orderly functioning of internal checks and balances and regularly checking their stability remains essential.

Decentralization and the focus on regionality also give rise to local or industry-related concentration risks, which centralized institutions can spread or diversify more easily. In this context, supervision must ensure that a sector-wide balancing mechanism is created. In Austria, this role is performed by Institutional Protection Schemes (IPS).

In Austria, cooperative banks were able to operate profitably despite their purely local and regional business models. In terms of profitability, they show a solid midfield development, as there are no long-term major outliers, for example due to the simplicity of the business model. Their solid RoA and continuing cost-income ratio reduction is also evident. However, such banks now also face challenges due to factors such as digitalisation or the increased basic costs of banking.

Digitalisation, in my opinion, is a central factor in maintaining access to bank financing and avoiding exclusion. Digitalisation allows banking services to be offered even in the most rural regions and can promote a comprehensive access to bank financing for different economic agents. However, in contrast, the threat also exists that this benefit will eventually exclude the digital-averse. Additionally, digitalisation is a major challenge, especially for smaller institutions, that are only able to keep up if they are prepared to undergo permanent modernization.

European bank diversity is essential but must be considered under the prerequisite of stability.

Digitalisation and permanent modernization are also necessary to ensure the sustainability of banking business models. A business model – irrespective of whether for a centralized or decentralized bank – is only sustainable if its governance can adapt sufficiently to new circumstances such as digitalization and ESG.

In addition, homogeneous banking rules that apply to all supervised entities are to be supported, but proportional application of these rules is important for maintaining bank diversity in Europe. For example, EBA's 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. These are then implemented by the relevant working groups when drafting or revising the respective regulations. Bank diversity is an asset: for example, Austria did not experience a credit crunch in 2008 and the Austrian banking sector's diversity was one factor that always ensured stable financing.

First and foremost, the aim of supervision is to ensure stability in the diverse European banking sector at all times, and to intervene if necessary. Market exits can and do happen and the supervisor's job is therefore to make sure that market mechanisms function well and that unviable or non-sustainable banks can leave the market without causing disruptions.
A functioning deterrent is also essential: the supervisory rules must be followed and banks must solve their problems, rather than the supervisor having to soften regulations. This approach is essential for credibility and social acceptance of supervision, and, above all, for confidence in a functioning financial market.

GIUSEPPE SIANI
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Consolidation: a complementary perspective

Since the establishment of the EU Banking Union, there have been high expectations regarding the consolidation of banks within the Eurozone. However, despite the potential benefits of such transactions, most consolidation initiatives still take place within Member States and the EU banking sector remains segmented along national lines.

The reasons could be found both in the prudential regulation and European Institutional Architecture. As to the former, CRR-CRD package still provides for national discretions in some key areas, allowing ring-fencing measures; further, waiving certain capital prudential requirements is not possible in a cross-border context. As to the latter, the Banking Union is still incomplete, since the third pillar (EDIS) is still lacking; completing banking union would be the most direct route to foster integration.

The SSM issued in 2020 the Guide on the supervisory approach to consolidation, in order to clarify its expectations and remove potential obstacles to successful deals within the euro area, adopting a neutral stance in the treatment of mergers, without imposing higher P2R to credible integration plans.

In recent years, however, we have witnessed an upswing in consolidation mainly pushed by digitalisation. Two channels emerge in this new context: aggregations based on traditional channels (M&A), and less traditional ones, seizing the opportunities provided by outsourcing key business functions.

Traditional M&A

The digital transformation has fostered financial intermediaries to consider aggregation in order to get the scale, expertise and resources needed. In particular, several reasons make aggregations quite appealing:

- **Increasing technology costs:** The digital transformation requires substantial investments in technology infrastructure and smaller intermediaries may struggle to keep up with these rising costs. By consolidating resources, they can pool their financial strength and technological expertise to effectively invest in digital transformation initiatives.

- **Fostering innovation:** The digital era has opened up opportunities for fintech startups and technology giants. Intermediaries seek partnerships or consolidation with fintech companies that have advanced capabilities in order to stay competitive and drive innovation.

- **Data Analytics:** The digital transformation has unleashed vast amounts of data. Intermediaries can leverage artificial intelligence to gain insights into customer behaviour and preferences. By aggregating customer data, especially asset management companies can get a more comprehensive view of customers' financial profiles and enable personalized offerings and tailored product solutions.

- **Cybersecurity:** The digital age has also raised increased cybersecurity risks and fraud threats. Cybercriminals are becoming more sophisticated, making it essential for intermediaries to invest in advanced security systems and threat-detection technologies, which may be more challenging for smaller institutions.

Aggregations via outsourcing

Nowadays, outsourcing represents a growing trend in the financial sector, with many intermediaries relying on third-party providers (TPPs) to handle various functions, mainly IT ones. This could constitute a different form of aggregation, maybe with blurred edges and not easy to be immediately identified by supervisors. Similar to the traditional aggregations, external providers can help reduce operational costs by leveraging economies of scale, enabling intermediaries to tap into the specialized knowledge and skills of external providers. Institutions, especially the smallest ones, by leveraging on external relationship could overcome the limit of the size, keep making the business model sustainable over time; no traditional aggregations are thereby strictly necessary.

Furthermore, the evolution in payment systems is introducing new type of intermediaries able to offer innovative payment services, which customers and banks can rely on, with different degrees of involvement. Strategic partnership in this field is growing too, along the lines of the developments in the relative regulatory framework.

We have recently witnessed upswing in consolidation due to digitalization.

However, the increased reliance on outsourcing exposes banking and non-bank sector to higher levels of interconnectedness and concentration risk, when multiple intermediaries relay on a limited number of service providers. The gradual implementation of DORA will help mitigate risks related to TPPs, by requiring institutions to meet specific standards when outsourcing critical functions, considering factors such as concentration risk, interdependencies, cybersecurity and data protection.

Against this background, banking supervision should look at the consolidation from both the perspectives and answer to the question: 'Is it still true that the market does not consolidate?'. We should indeed use both the regulatory and the supervisory available tools to assess the risks and all the issues at stake without creating undue obstacles to successful deals.

KAROLIN SCHRIEVER

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Creating a true level playing field for the EU's diversified banking sector

The EU banking sector has exhibited a remarkable amount of resilience in the face of a multitude of recent and ongoing risk events. Why is it that significant stress in major financial markets and even bank collapses have not spilled over to EU banks? In my view, there are two main factors that contribute to the strong resilience of the EU banking sector.

The first important factor is the demonstrated effectiveness of reforms implemented after the Global Financial Crisis: This relates to structural reform in the shape of the Banking Union with its comparatively streamlined setup of supervisory institutions and with the European Central Bank, the European Banking Authority and the Single Resolution Board at its heart. Banking Union has led to a clear assignment of responsibilities in a way that differs strongly from the sometimes much more complex and overlapping structures seen in other jurisdictions. Apart from structural differences, recent events have also raised attention to the extent of Basel implementation across banking systems, with the EU notably applying the Basel regime and the EU Single Rulebook to all of its roughly 5,100 credit institutions. This is in stark contrast to jurisdictions that have only applied full Basel rules to a dozen of their largest banks.

But the second, equally important explanation for the EU banking sector's resilience is its unique diversity of business models, risk profiles, and customer bases. The financial networks of the savings and cooperative banks in Germany and other Member States largely contribute to this diversity by providing financial services even in less affluent regions alongside larger commercial and international banks.

Looking at the real economy, the diversity of the European banking sector is a direct reflection of the EU's corporate landscape. In Germany, as in many other Member States, regional banks are vital partners for SMEs in their local communities. German Sparkassen have supported state vaccination campaigns during the pandemic and provided more than 450,000 checking accounts to Ukrainian refugees after the brutal Russian invasion of their home country. This very focus on relationship banking and regional commitment is becoming increasingly important in order to successfully tackle the challenges associated with the transformation towards more sustainable economic activity.

The diversity of the European banking sector is a direct reflection of the EU's corporate landscape.

Meanwhile, smaller banks are increasingly facing fixed-cost disadvantages associated with the ongoing wave of compliance and reporting requirements. While it is right to apply Basel rules to all EU banks even in contrast to other jurisdictions, there is still a long way to go in taking account the characteristics of individual banks, different business models or network structures. Instead, the agreement reached on the EU Banking Package will yet again lead to additional requirements and burdens that are disproportionately affecting smaller banks. New EBA mandates to ensure proportionality and possible relief in reporting are positive, but they need to lead to concrete relief for smaller banks.

A balance between harmonized banking rules and the diversity of business models is also notably lacking in the EU Commission's proposals for a review of the crisis management and deposit insurance framework. For decentralized, relationship-based banking models in a number of Member States, institutional protection schemes have proven to be highly efficient safeguards ensuring the solvency of their affiliated banks. Not once in the decades-long histories of the Sparkassen's or the German cooperative banks' IPSs had depositors have to be compensated or has a member bank become insolvent.

Changes proposed within the CMDI Review would significantly impair the abilities of IPSs that are recognized as a Deposit Guarantee Scheme. Furthermore, the CMDI Review itself presents as an intermediate step towards a centralized deposit insurance that would eliminate the economic viability of tried and tested IPSs.

Differentiation and necessary adjustments are needed for financial services regulation to allow diversity to thrive. For the further work on Banking Union, this also has to include a practicable solution for IPSs allowing for their continued proper functioning.

In an ever faster changing world, the number of challenges we face continues to grow. In addition to climate change and digitalisation, demographic change, competitiveness and strategic autonomy will become increasingly important for Europe. By driving innovation and adaptability, diversity will allow Europe to keep pace with increasing complexity and dynamism. It also ensures that no one is left behind and that the ever-evolving needs of markets are always matched.

Embracing diversity is therefore the right thing to do. It will make the banking sector more resilient and the economy as a whole a lot stronger. A diverse Europe will be more successful in the long run.

MIKE VELTHAAK
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Acknowledging that EU regulation needs improvement to foster bank diversity

Since the introduction of the Single Supervisory Mechanism (SSM) in November 2014, in response to the global financial crisis and the subsequent European debt crisis, significant improvements in European banking regulation and supervision took place. But we also noticed a rapidly advancing digital transformation of society which creates massive opportunities as it can lead to new business models, the rise of new competitors, better, and/or lower-priced products and services. In this regard, completing the Banking Union is good for the EU customers as network effects create efficiencies of scale, lowering the operational cost of banking.

Still, we are far away from one Banking Union. No progress has been made during the CRR3/CRD6 negotiations to enable banks to move capital and liquidity across the European Union. And EDIS is at gridlock which the recent proposal by the European Commission on the Crisis Management and Deposit Insurance Framework is not going to end.

Nevertheless, bank regulation is not the whole story. Also fiscal, insolvency and conduct law in the EU is still a patchwork of national rules which hampers the full operationalisation of the benefits of scale that digitalisation can offer. Potentially the use of Artificial Intelligence can overcome certain of these challenges. But also consumers still prefer their national banks that understand their culture over those from other countries, even when they can earn more money on their saving account abroad. Potentially the heterogeneous withholding tax regimes in the different Member States do not help either.

So, one can argue that due to the still nationally oriented banking landscape with many member state specific elements, the banking sector across the EU is still diversified but might become less diversified due to digitalisation. In addition, one could also pose that the current EU regulation leads to many unintended consequences for the supervised bank and that certain premises can be disputed on which (international) banking regulation is based upon, like a focus on shareholder value while we know that a significant amounts of banking groups in the EU are stakeholder based.

The shareholder value model significantly drove the international banking regulation in the last 20 year. It can be characterized by highly innovative, use of internal models, complex legal structures, taking risks and making strong profits, all with its main purpose to achieve maximum value to support the share price. In contrast, stakeholder value institutions stive to 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 society or the community they serve.

Certain premises can be disputed on which (international) banking regulation is based upon.

Between stakeholder value institutions governance arrangement differ, with each having their strengths and weaknesses, but with a common determinator that profit maximalisation is not an objective and excessive behaviour can be identified and contained by the stakeholders.

When bank legislation in the EU is changed, non-shareholder banks continuously must provide arguments why the proposed rules are not fit for them and strive for adjustments in the regulation. Sometimes this is successful, like with the IFRS discussion about the distinction between equity and liabilities, but most of the time the banks have the feeling that their model is penalised. Like for example the role of institutional protection schemes and the set-up of the crisis management framework where it seems that continuing as a shareholder banking structure is currently the only way to continue after resolution. Or recently in the CRD regarding fit and proper.

Insufficient tailored regulation also has implications on banking supervision as supervising banks in line with the standards is easy. But it requires expertise, seniority, and the backing of the senior management to give a supervisor the room to judge and agree – in line with the arguments of the management of a shareholder or stakeholder bank - why a particular situation applies for a specific bank.

Regarding diversity in banking supervision one can also question the design about the scope of direct SSM supervision. Why is the SSM not only supervising the real large international and pan European banks with a balance sheet total of more than EUR 100 million with a clause that the ECB can intervene in local supervision when it sees a significant risk in a non-SSM supervised bank? Including smaller (non-complex) ones currently in scope cost time and precious resources, which cannot be used for more tailors made bank supervision of the more complex banks or to understand the merits of the governance structure of stakeholder banks.

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Working hand in hand to preserve banking diversity by 2030

European countries are increasingly under pressure to put forward solutions to the challenges linked to the environmental, digital, and social transitions, which manifest themselves by important investment needs across all European regions. All stakeholders need to be enrolled, notably local communities and SMEs as they play a central role in our economies. In that regard, preserving the cooperative banking model in the EU financial landscape is key.

Banks are unavoidable when it comes to ensuring that those financing needs are met, especially since only few SMEs and local authorities will be able to finance themselves on capital markets. For banks to be the catalysts of these transitions and changes, two features are necessary: a granular approach and a long-term client relationship. Cooperative banks support their clients in the long run and understand the reality of their territories and local economies. This allows us to provide concrete and continuous support to local communities, their inhabitants and SMEs to accompany them in their transition plans. For example, BPCE is the leading bank for SMEs in France.

Several regulatory and supervisory developments, however, risk undermining the financing of these transitions by weakening the roots of our cooperative banking model. Most notably, the direct supervision by the ECB, whose supervisory processes tend to standardize banking models by referring to common "best practices", challenges the specificities of the cooperative banking model in terms of granularity of banking networks, decentralization of decisions, etc.

The SREP review in 2024 is thus key for the preservation of banking diversity in Europe: its procedures and processes should be adapted to the diversity of banking business models by reviewing how the SSM assesses a bank's profitability and sustainability of its business model, designs its benchmarks, and puts forward its recommendations.

On profitability, for instance, our capacity to put earnings into reserves is comparable to listed groups, even though their net incomes are higher. A better indicator for supervisors could therefore be the residual income after distribution, and the actual capacity to endogenously create CET1. This would be a better indicator, since dividends reduce the profit channeled to CET1 for commercial banks, whereas cooperative banks do not need to pay any cost of equity for their accumulated reserves, and this is not factored in the return on equity.

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

As stated by the Expert Group to the Chair of the Supervisory Board of the ECB, the "ECB's supervisory approach appears to be too capital centric". When assessing the viability of our business model, the SREP should also focus on qualitative measures, such as our ability to serve customers and small companies, as maintaining banking activities in all regions of France is key for our business. Therefore, before each recommendation from JSTs, the supervisor should make sure that the business model of the bank is being considered.

The SSM could thus elaborate a "business model adequacy test" that could apply to JST recommendations. Symmetrically, a bank should be able to raise an issue regarding the integrity of its business model to JSTs (impact of a recommendation), who would then have to assess the issue. The actual process should be further defined by the SSM in close coordination with cooperative banks representatives.

Benchmarks should also not be the gold standard of supervision if they do not recognize in practice the specificity of banking models in Europe, especially those who proved to be sustainable over time. Benchmarks should be made transparent, and supervisors need to adapt samples according to the different business models. The SSM should make sure that the transparency of different benchmarks and the suitably of the samples are the cornerstone of supervisory analysis. JSTs should not be guided only by standardized benchmarking for banks' profitability, cost and risk management, and governance.

Beyond supervision, regulation itself could lead to numerous unintended consequences on the different business models if we don't look at the big picture. For BPCE, it is essential to preserve the DNA of our Group and support our 35 million customers, whether they are individuals, professionals, associations, corporates, or local authorities, over the long term and at every stage of their lives. It is also vital for our economy, and as a result overall – including financial – stability.

For instance, cooperative elective processes are a key part of our identity and legal structure. We believe that Fit and Proper regulations must respect this, especially with regards to the Basel III compromise and the future EBA work on this.

We stand ready with European cooperative banks to work hand in hand with the SSM and regulators to ensure that banking diversity remains an important drive of financial stability in Europe by 2030.