Diversity in the EU banking system

Introduction

The first part of the panel takes stock of where things stand, including risks, benefits and how supervisory authorities and regulations have tried to take bank diversity into account. The second part is around whether digital innovation and digital transformation might impact diversity positively or negatively. It is also tries to anticipate possible developments. The key strategic trade-off is whether it is possible to take account of the diversity of business models without underestimating the risks associated with banks' activities.

1. Diversity is a key strength to be preserved

Diversity of banking business models is a risk-reducing asset which can take many shapes. Digitalisation brings new challenges into the market.

1.1 Diversity is an asset

The Chair stated that business model diversity is a value that allows banks to support the real economy in different ways.

A Central Bank official commented that the ECB values diversity. Diversification is one of the most basic prudential rules. What is true at the level of individual banks is also true at the level of the system. The Single Supervisory Mechanism (SSM) is part of that. The Europeanisation of supervision has led to a reinforced emphasis on a level playing field. The SSM steps out of the consideration of the structures of the different banking systems between countries and sizes and creates a level playing field by creating detailed and prescriptive rules. The perception of the banks is there are more uniform rules.

An official added that diversity is risk-reducing for countries with a strong cooperative sector. They benefit from a good insolvency system, deal with crises efficiently and have brutal bail-in under national insolvency rules. Intervention starts early to prevent crises. Having a stake in others' businesses beyond equity exposure means there is an obligation to help. Taking that into consideration is sometimes tricky because of colleagues on the other side of the debate who do not understand cooperatives banks. Equal treatment is a precondition. But specificities should be considered. The ECB recognising the security of a cooperative structure has been valuable.

1.2 Diversity can have many forms

An official stated that diversity can have many forms. A historical way of thinking about cooperative associations and banks is as capital societies. New diversity comes from platforms stripping the traditional banking model and using it for their own purposes. The ECB recognising how cooperatives and their structures can be risk-reducing is overdue, because in every negotiation of prudential regulation on the banking sector there has been nastiness in the direction of institutional protection schemes (IPSs) and cooperatives, from Basel II to Basel III. Some countries developed cooperative models for historical reasons, whereas in others they are poorly understood. Cooperatives are sometimes viewed as hidden ways for bailout so are viewed with suspicion and believed not suitable for favourable special treatment.

1.3 Is diversity declining? The subject is controversial

1.3.1 Diversity is not declining

A Central Bank official commented that regulation on the proportionality side and supervision on the individual side should be able to capture the specificities of the different banking models. This diversity is not declining in terms of the market share of cooperative and other banks. The number of banks is declining, but they regroup.

1.3.2 Diversity is declining in Europe following a decade of uniformization of supervisory practices

An industry representative noted that diversity declining is not a market share issue but a question of flexibility, pressure from the SSM to behave in a mainstream way, and alignment of different business models. The intention of the SSM is to preserve diversity, but in day-to-day supervision it is not the case. The SSM is a process-driven organisation, so procedures are needed to protect the diversity. The aim is to take on board all business models in benchmarks in order to have more representative samples.

1.4 The formula of 'same risks, same regulation and same prudential requirements' should apply for each model

An official commented that there is a need to understand the reasons for diversity in certain markets and the legislation implemented by supervisors. The overall trend in policy discussions is to support consolidation of the banking groups to make them more resilient and better equipped to be competitive in the internal market and globally. On the other hand, bigger groups and bigger banks pose new risks and issues and boost the necessity to have adequate rules for recovery and resolution. Diversity is important in that and there are different types of diversity. Cooperatives in the past proved to be resilient in many countries, recovered fast from crises and kept growing in several markets. They were crucial to financing the economy and development of member states.

But not for all countries as there are also examples of countries where credit unions haven't proved to be well functioning. This was illustrated by a concrete example of a domestic sector where such institutions report poor economic indicators such as low ROA or high NPLs), thus not indicating to be resilient, sustainable in mid- and long term and contributing to the national market developments. If such entities, in addition, represent only an insignificant share of the credit institutions' assets but require the supervisor to devote energy and capacity to understand the specifics in order to exercise the supervision properly, it is questionable if this is efficient. Banking diversity is beneficial but should not be protected at any price. Regulators need to understand and analyse the reason for a model. What needs to be preserved is the reputation of the whole financial sector. The formula - «same risk, same regulation, same requirements» - must obviously apply to prudential requirements. Long-term sustainability should be required for every model, along with data protection standards and operational resilience. Those optics should be fine-tuned with proportionality. Supervisors should understand the different models and how to handle them, but still keep the main requirements for all, respecting the existing diversity as well protecting the stability and credibility of the whole financial market.

2. Diversity of business models requires striking a balance between horizontal comparisons and paying attention to the specific characteristics of each bank or group of banks, which is not sufficiently the case in Europe

2.1 It is questionable whether there would be the same diversity in business model in Europe if the SSM had existed for 40 or 50 years

An industry representative was not completely reassured by the reality beyond the intention of diversity being encouraged by the supervisor. If the SSM had existed for 40 or 50 years, it might not have been possible to develop cooperatives and other banks outside the classical commercial frame. Today the collective responsibility from regulators and supervisors for a proper risk control framework and profitability is to ensure diversity and encourage it in new players.

2.2 Adapting the EU regulatory and supervisory framework to the diversity of the banking sector is key but challenging

An industry representative added that the SSM needs to encapsulate new metrics in its benchmarks that reflect business models and gave some examples. These new metrics could incorporate the diversity of a bank's client base, such as underserved communities, associations, small and medium-sized enterprises (SMEs), but also the geographical repartition of activity; diversity of activities; and the share of social and fair financing. For example, the Joint Supervisory Teams (JSTs) believe social housing activity is not profitable, but it remains a core activity for some banks. This needs to be encapsulated in the benchmarks as the first step, and then a business model adequacy test should be designed. The SSM could assess the impact of its recommendations according to these new metrics in order to determine if they lead to reduced diversity of geographical activities and communities served. A bank controlled by the JST could then raise whether this is endangering their business model.

The 2024 Supervisory Review and Evaluation Process (SREP) is an opportunity for European policymakers and supervisors to make a difference in the real economy by reviewing how the SSM assesses banks' profitability and sustainability, designs its benchmarks and makes recommendations will be key to ensuring cooperatives have the capacity for local stakeholders. Supervisory tools and indicators should heed cooperative banks. On profitability, an indicator could be the residual income after distribution, and the actual capacity to endogenously create Common Equity Tier 1 (CET1). Supervisors should recognise the specificity and adapt to the samples of banking models. JSTs should not be guided only by standardised benchmarking for banks' profitability, cost and risk management, and governance. Cooperative performance and community impact metrics should be included in the benchmarks.

An industry representative agreed that considering and understanding business models is a precondition for ensuring that risks are properly assessed. The main purpose of cooperatives is to serve members, not to maximise shareholder value. This leads to fewer risks, especially compared to an investment bank. It may require supervisors to invest in assessing and understanding a business model.

2.2.1 Keeping diversity in the current EU supervisory context is challenging

An industry representative highlighted that benchmarking can cast doubt on intentions to preserve banking diversity. Benchmarking is useful but becomes a problem when it becomes rigid. Another drawback is that there is less room for discussing horizontal considerations from the supervisors and understanding their rationale, because it is more complicated to have a contradictory process when the JST is the intermediary between the bank and the SSM horizontal functions. This should evolve with constant dialogue and explanation to better understand what the supervisor wants. The new supervisory risk tolerance framework should be a shift in the right direction, but care will be needed because the usual trend is to go to something that is more standardised. Therefore, it is complicated to keep diversity in this context.

2.2.2 Translating flexibility in day-to-day supervision remains challenging

A Central Bank official noted that Europe has different economic environments with different customer behaviours, financial traditions and history. The single market makes it important to approximate regulations, but flexibility must be allowed. The question is how to translate those ideas into everyday practice. The key is supervisors better understanding the business models. Local authorities could enhance and keep the diversity because they better understand the differences of the banks and can evaluate the tasks. Regulations provide a good or common framework, but the tools a supervisor can use are key. Innovation of local authority tools is also important to understand the risk and keep or enhance the diversity. Local authorities or the EBA could create a bottom-up stress test, collecting granular data and loan data, but it takes time. It is key to show other competent authorities these tools.

2.3 Proportionality is essential to maintain bank diversity

An industry representative observed that diversity is closely related to proportionality. The volume of regulation issued over the last decade is impossible for a small bank to fully consider. Thus, one of the main reasons for German cooperative banks merging and giving up their own business is they cannot find or afford enough people to deal with this regulation. There should be a discussion of whether the concepts of a single uniform rulebook and proportionality fit together. There should not be lean supervision and regulation for small banks, but simple can be strong. Proportionality and diversity should come from the supervisor as well as from the industry. A Central Bank official agreed that proportionality is important, but not at the expense of safety. It is the supervisor's job to find the right balance.

2.4 Striking a balance between horizontal comparisons and paying attention to the specific characteristics of each bank or group of banks

A Central Bank official stated that the approach of the SSM is on three levels. There are general indicators to follow for all banks. The benchmarks need to treat all the 110 groups under the remit of the SSM in a comparable way. The ECB's reorganisation tried to reinforce the intermediate benchmark. This groups Global Systemically Important Banks (G-SIBs) with other G-SIBs, to be sure the pure horizontal and the pure individual banks are together at an intermediate level. This has been done without looking at the legal side. Some G-SIBs are cooperatives, some are intermediate banks or specialised banks. More leeway is being given for the individual. The multi-year assessment process means not doing everything for each bank every year. This can only be done by creating a guarantee that more diversity means an additional layer of benchmarking to prevent divergence. It is trying to both go more into the specificities and keep some space. The key for the future is to keep using these three levels of dialogue at the ECB. Mistakes can be made but diversity is valued, and the plan is to give it space.

3. Digitalisation will have a significant impact, but less on the diversity of European banks and more on the individual banks based on their ability to innovate and adjust

3.1 Digital transformation and technical innovation foster diversity as they bring new players with new business models

An official observed that there have been many revolutions from the digital world proclaimed as destroying traditional banking. The situation is now different because of big data. Banks are information enterprises, making money by being delegated monitors, able to extract a yield by dealing efficiently with asymmetric information. There are portals that can collect more data, including credit quality. It is not inconceivable that relationship banking may be less valuable in the future, which is normally a value of small institutions.

Payment used to be a banking business, but now there are payment service providers. The same might be true for lending. Traditional banks could be back-office providers for the uninteresting and least profitable parts of platforms. That may be a different kind of diversity. It is beginning in some parts of the world where financial systems are less developed. It may arrive in Europe via competitors that act on a global level.

3.2 Two types of new entrants (fintechs and GAFAMs) with specific legislative challenges

An official stated that there are two types of new entrants to the market. The first are small fintechs that do not have the capacity to understand and comply with all regulation in order to decide which type of licence they need to obtain in order to operate in the market and to succeed in the licencing process. A 2023 study by the Organisation for Economic Cooperation and Development (OECD) concluded that is why small fintechs do not develop in some countries. New entrants also do not have the data to test their solutions. They do not have clients and their data yet. Those may be attracted quickly online but not without a licence. So, pre-testing may be an issue for a newcomer to the market.

The first question is whether it is to the benefit for the whole market and economy to have these new entrants and help them, for example by creating regulatory sandboxes, and whether the legislative framework in the EU allows all the sectors to operate in a regulatory sandbox. In the payment sector, there are some exclusions from the Payment Services Directive (PSD) based on operating a limited network. But in traditional banking, there is not much space for a regulatory sandbox. The other solution could be a data sandbox allowing prospective market entrants to test their solutions well in advance.

Another type of new entrants are GAFAMs - Google (Alphabet), Apple, Facebook (Meta), Amazon, and Microsoft. They have the data to test solutions and the capacity for IT, regulation and compliance. They can quickly enter the market and become competitors to banks. There were concerns that GAFAMs would come up with digital currencies and regulators had to react. Google and Apple are dominating in the way payment cards are used and have the potential to go further. For legislators, it is about deciding whether to react, for example whether to help the small companies to also enter the market in order to contribute to diversity or say that there are crucial requirements that everybody should fulfil and leave the big players to dominate the market.

3.3 Digitalisation is not a gamechanger for the diversity of the banking sector

An industry representative stated that over the last 15 years regulation has had a bigger impact than digital innovation on the European banking sector. European banks' assets are basically the same but more liquid. The lending book has been de-risked. Much of the riskier lending business has gone into the non-bank financial institution sector. This has led to the price book ratio remaining at 0.6, which is significantly lower than American institutions.

A couple of years ago there was still a belief that digital models would disrupt the traditional banking world and branches would not exist anymore. The nature and the value that branches deliver is changing. In some countries, branches are increasing in number. JP Morgan in the US is a good example. It could be argued Europe is over-banked, but there is innovation in the branch model of serving clients in a differentiated way. Digital is of an enablement factor in terms of reducing costs, improving customer service and analytics. Banking-as-a-service solution platform models are multiplying in the banking world. This impacts banks in general but less so the diversity in business models. The ability to adapt to new innovations and alternative models is more driven by governance and ability to adjust than the type of banking model. There are pockets where others have come in on the payment side, which will go more into the investment space, where traditional banks are at risk of losing fee pools. It has happened less on the credit side, but there is more to see.

An industry representative agreed that digitalisation is not a target per se, but rather a means. Not all clients will switch to GAFAMs, fintechs and online-only services. There is still use of cash in Europe. It is not about switching to a new world but expanding the current world. The needs of customers should not be forgotten by focusing too much on digitalisation.

3.4 Level playing field issues between banks, fintechs and GAFAMs

An industry representative pointed out that banks must have the opportunity to fail in their efforts to innovate. Sandbox approaches should be discussed for new companies, for fintechs but credit institutions as well. This would allow them to experiment with solutions without immediately facing the full regulatory burden. A second example for the dangers of a competitive disadvantage is in the context of financial data access (FiDA). FiDA could allow banks to become a financial home for their customers. Currently, banks are required to open their data stores for GAFAMs, but not vice versa. This is a competitive disadvantage and threatens to further concentrate power and increase strategic dependence on GAFAMs. The third point is the joint impact of EU regulation in the context of AI, which needs good technology and lots of data to train. This impact has to be assessed. With the AI Act and GDPR, companies in the EU might not be able to keep pace with other jurisdictions.

An industry representative underlined that a sandbox should be for all. All institutions can be newcomers in activities and business models and need to be helped.

3.5 Regulatory frameworks need to be technology-agnostic and ensure fair competition

A Central Bank official commented that the starting point is neutrality and trying to foster innovation. The ECB favours the incumbent banks rather than fintechs, but there needs to be a surface to invest in technology to keep pace. This can be an issue for small traditional banks rooted in local identities. Technology is delocalising and favouring scale. A cooperative bank is not only a brand but an identity with heritage values that need to be transposed into an investment for the future, with the ability to scale up.

A Central Bank official observed that innovation is the source of progress and helps competition. The question for supervisors is how to secure the safety of customers equally to traditional banks. It is not an ideal environment if the answer of newcomers is regulatory or supervisory arbitrage. The European Commission Deposit Guarantee Scheme could be important.

3.6 The sandbox approach needs to be rethought to serve the underserved clients

An industry representative stated that what is happening in other industries is often lost. In healthcare, not enough investment happens for a variety of diseases, but healthcare regulators do not ask for more so they can approve earlier because health is impacted. Financial services are about financial health. It is important to keep in mind what the sandbox concept is for. Most digital players that have operated in the financial sandbox world go after attractive and overserved customers, not underserved SMEs or customers in rural parts of Europe where banking services are not as prevalent. The sandbox approach needs to be rethought to serve them.

The Chair concluded that diversity will help address the financing need of the European real economy, but there is uneasiness in the market, despite efforts on the supervisor approach. There have been helpful suggestions on incorporating indicators. Profitability should not be the target, because there might be excess profitability based on commission driven by complex transactions, or revenues from risky activities might be unsustainable. Sustainability of business models should rather be looked at. The benchmarking and how it is implemented is key, but it should not drive the final decision and the supervisory approach should be flexible. Banks' business is changing, as it might be a by-product of something else. Digitalisation can be a game changer, as everything is driven by information and data. Issues also relate to the incomplete and changing regulatory framework. The Digital Operational Resilience Act (DORA) will help to deal with digital challenges.