

7 September 2022

Taking advantage of bank diversity in Europe

Published in Views. The EUROFI Magazine (issue September 2022)

Margarita Delgado. Deputy Governor of the Banco de España

A business model describes the way a firm operates and how it creates value for its stakeholders. In the banking context, the definition of business models is usually based on a combination of structural banking features, such as the funding configuration or ownership arrangements and business lines (e.g. retail, CIB or asset management).

The EU banking ecosystem comprises 5,179 individual credit institutions with diverse characteristics, operating in a complex mix of 27 Member States with differences in national history, culture, financial markets and local regulatory frameworks.

Over the past decades, the EU banking system has undergone very significant institutional changes, such as the adoption of the euro or the creation of the Single Supervisory Mechanism (SSM) with more than 2,200 consolidated credit institutions under its remit. This is clearly an outstanding example of the coexistence of various business models under a single supervisory authority.

In order to assess banks consistently, the SSM uses a common methodology, with peer comparison as a key component. For this purpose, it has identified 12 different business models for significant institutions, considering three key features:

- 1** Main income source: from traditional lending to trading activities.
- 2** Customer and funding base: distinguishing between the retail deposit base and wholesale market-based funding.
- 3** Size and geographical focus: from a small market to a large international footprint.

There are meaningful differences among the resulting business models in terms of bank size (from €10 billion in average assets for *Small Market Lenders* to €1,500 billion for *G-SIBs and G-SIB Universal Banks*), profitability (from ROE of 3.9% for *Corporate & Wholesale Lenders* to 7.4% for *Universal Banks and Investment Banks*) and risk assessment (best SREP scores for *Asset Managers and Custodians* and worst for *Diversified Lenders*).

The plurality of business models poses challenges for banking regulation and supervision in the Banking Union. Combining homogeneity in banking rules with diversity in business

models is a difficult task and leads to the risk of neglecting important intrinsic characteristics of the broad European banking sector.

EU prudential authorities need to adopt a flexible approach to cater for a variety of business models

Clearly at the SSM we have to find the right balance between horizontal standardisation and banks' singularities. Additionally, proportionality issues need to be taken into consideration in the application of a level playing field.

But the existence of different business models can also be beneficial and even necessary. It makes for a better fit for European economic needs and helps to better meet the demand of the different customer segments. Some credit institutions focus on specific areas or even on social objectives, whereas larger universal banks compete in global markets.

Diversity in business models is also a source of financial stability for the EU banking sector. It reduces systemic risk, makes the sector overall more resilient to economic turmoil and provides room for smaller, more keenly-focused participants, less affected by the moral hazard problem of too-big-to-fail institutions.

We are striving for a complete European Banking Union, with a common regulatory and supervisory framework that will most certainly be beneficial for the functioning of a single market. But this objective has to be compatible with the need to adapt the framework to European economic and banking diversity.

As a general rule, the existing set of business models has to meet European market needs and provide adequate support to finance the economy. But business models – even though their profitability levels differ – also need to be sustainable.

Close scrutiny of how business models are evolving, combined with a flexible approach, is more justified than ever. Given the fast-changing environment, the digitalisation process, the appearance of new players in the financial industry, increasing environmental and demanding regulatory requirements and the new macroeconomic challenges, banks need to adapt their business models to ensure that they remain sustainable over time.

While it is for bank management to define the business models, supervisors need to assess their robustness, profitability and sustainability, to identify potential vulnerabilities at an early stage and address them within the supervisory framework, while remaining neutral regarding management decisions. It is a challenge for both parties to assess the changes and cater for the diversity required.

To conclude, the existence of a range of business models is beneficial for the European financial system and requires a flexible approach from the prudential authorities.