Diversity in the EU banking system

The Chairman noted that there was broad agreement on the need to ensure banking diversity in Europe. European banks should be able to offer business models tailored to the needs of individuals, small and medium-sized enterprises (SMEs), large corporations and start-ups, and to the needs of both young, tech-savvy customers and older, tech-averse customers. Digitalisation has been a game changer for the diversity of the banking system. New players have emerged, and more are on the way.

The first round of contributions considered how to ensure the existence of different banking business models in the EU and how to incorporate the nuances of these business models into the regulatory and supervisory framework, ensuring that the risks are properly assessed, and the business models are sufficiently profitable. The second round of discussions focused on the new legislation and regulation proposed at EU level in the area of digitalisation and the impact these proposals might have on the diversity of the EU banking system.

1. Incorporating the nuances of business models into the regulatory and supervisory framework

1.1 Creating the right regulatory environment for a diversified EU banking sector

1.1.1 Diversity must be supported by strong regulatory and supervisory frameworks

A supervisor stressed that the European banking system is well diversified in terms of size, geographical presence and business model. This contributes to the financing of the economy and the maintenance of financial stability. The proportionality principle is crucial to this diversity by facilitating market entry and allowing new players to grow. While the EU regulatory framework already applies a proportionate approach to some requirements, the full application of a common set of standards to all banks helps raise the resilience of the European banking sector. There should not be a tiered approach to regulation depending on the size of the actors involved but rather, as is the case today, simplified and conservative approaches to be applied to smaller players. The single rulebook is critical to support a strong and effective European supervisory framework.

This is the very purpose of supervision to address the specific risks of each institution's business model, activity and risk profile. Supervision, including the implementation of proportionality, should follow a risk-based approach. Further incorporating differences between business models into the EU regulatory and/or supervisory framework should be considered only to address clear cases of unfair treatment.

1.1.2 Improving and simplifying the EU regulatory framework

An industry representative stated that the EU regulatory framework has made the banking sector very resilient, but its high cost and complexity disproportionately affect smaller players and new entrants. This does not mean deregulation, but smart, fair, simple and forward-looking regulation that takes into account the real risk profile of an institution.

For smaller institutions, the administrative costs of compliance are very high. The large institutions can cope with the high administrative requirements, and the new entrants find it easy because they are starting from scratch, but these regulatory burdens make it extremely difficult for medium-sized banks to grow.

1.1.3 Assessing business model sustainability in an evolving financial landscape

A Central Bank official reminded that the Basel Committee on Banking Supervision (BCBS) in its analysis of the March 2023 turmoil pointed out that one of the main causes was inappropriate and unsustainable business models, including an excessive focus on growth and short-term profitability, fuelled by remuneration policies at the expense of adequate risk management.

It is essential for EU supervisors to understand banks' forward-looking strategies and to assess whether banks will be able to generate sustainable returns. Supervisors need to be able to identify when an institution is 'out on a limb' or outside its risk management framework. Business model supervision was incorporated into the original Single Supervisory Mechanism (SSM) framework through the Supervisory Review and Evaluation Process (SREP), and the European Central Bank (ECB) conducted a thematic review on the topic in 2018. The ECB is business model neutral, and the sustainability of a business model is inextricably linked to an institution's governance.

The ECB is currently stepping up its efforts to understand business model sustainability and structural weaknesses. The ECB's assessment of business model sustainability involves reviewing a bank's framework for designing strategic business plans and forecasting profitability, and then assessing the bank's execution of its strategic plans and its ability to assess whether its plans are working as intended. If there are deficiencies in the bank's governance framework or if the sustainability of the business model is threatened by excessive risk-taking, the ECB may impose measures such as enhanced reporting to the management body, the implementation of action plans or even restrictions on business activities.

1.2 Digital banks require pan European frameworks

An industry speaker argued that the European regulatory framework must evolve with digital banks. Digital banks need a pan-European framework because, unlike traditional banks, they are European from the outset and do not follow the model of growing in a European market before expanding to a pan-European level. This can be done by strengthening the digital single market for financial services, increasing consumer confidence in the banking system and promoting interoperable pan-European payment solutions.

1.2.1 Enhancing the digital single market for financial services

An industry speaker noted that the EU regulatory framework is extensive and difficult to comply with: The EU banking system needs to encourage the emergence of new players. The single market is wonderful in theory, but in practice it does not exist for growing businesses that want to operate across borders. In this context, the first priority is to tackle discrimination in the use of the International Bank Account Number (IBAN). IBANs are rejected in some Member States due to bad practices and non-compliance with Single Euro Payments Area (SEPA) rules. This prevents an emerging player from growing its business outside its home country, which means that bigger players do not emerge to stimulate competition. As Commissioner Mairead McGuinness said, this practice is "a brick in our shoe". The only viable solution is to move to a European IBAN, reaffirming the unity of the single market and allowing consumers and businesses to benefit from the free movement of goods and services.

1.2.2 Solving payments fragmentation

An industry speaker noted that the fragmentation of European payment systems is also limiting the growth of smaller players. There are many different national alternative payment methods (APMs) across Europe. This continued fragmentation hinders competition and limits the benefits for businesses and consumers. This could be addressed by creating a single access point for these solutions, similar to the European Digital Identity Wallet created by the European Digital Identity Regulation (EUDI).

1.2.3 Growing consumer trust in the system

An industry speaker emphasised the lack of a European Deposit Guarantee Scheme (EDIS) makes it difficult for companies to sell their products across borders. Consumers in a new country will be reluctant to trust a new brand if they do not recognise the deposit guarantee scheme (DGS) that covers it. The creation of EDIS and the development of banking union would create a true single market for financial services by building consumer confidence in the system.

1.3 Balancing national interests and the need for a harmonised approach

An official noted that 2024 is the 10th anniversary of the Banking Union project. The aim of the project is to create a single set of rules that will work for all member states of the Banking Union. Diversity in the banking system drives competition and innovation, but this need for diversity has been an obstacle to the realisation of the banking union. Europe has created the SSM and the Single Resolution Mechanism (SRM) but has been blocked in creating EDIS. There are significant differences between the deposit guarantee schemes (DGS) and institutional protection schemes (IPS) that exist in the member states.

The only way forward is to integrate these different entities into the EU regulatory framework, taking into account their unique characteristics and risk profiles. In this context, there remain challenging issues in the current proposal on revision of crisis management and deposit insurance (CMDI) as the Council's negotiating mandate is being loudly criticised that has not fulfilled the obligation to facilitate the resolution of smaller institutions. Ultimately, diversity does not always help to create a unified set of rules.

1.4 The need to assess new EU regulation and day to day supervision

An industry speaker agreed that the regulatory regime should be business model neutral and take a risk-based approach. Supervisors and regulators often appear to support business model diversity at a high level, but the reality of day-to-day supervision is different. Every new decision on the part of regulators and supervisors should be subject to an impact assessment to measure its effect on the financing of the economy and on business model diversity. If this does not happen, nothing will change. These assessments should also take into account cooperative performance, i.e. the diversity of a bank's geographical and social coverage.

1.5 The effects of business model homogeneity

A central bank official explained that the closure of local bank branches can deprive customers of tailor-made financial products. Larger financial institutions offer SMEs a small number of relatively simple products with a correspondingly narrow credit scoring system and an automated customer service model, but smaller institutions are likely to have complex customer interactions and use a wider range of information to make credit decisions, which means they can offer more demand-driven solutions to small businesses.

Decisions that make perfect business and even prudential sense can have a negative impact on customers. To some extent, homogenisation of business models is an inevitable by-product of consolidation driven by perfectly legitimate reasons, especially in markets where consolidation is needed. This homogenisation can increase the robustness of the financial sector if the larger institutions have more diversified portfolios and are therefore more resilient. Nevertheless, institutions and supervisors need to balance the benefits and costs. Frictions in the system should be reduced as much as possible, and there must be healthy competitive pressures in the system to drive customer service levels and innovation.

2. Technological shifts: impacts on business model diversity and key policy priorities

The Chairman explained that some of the EU regulations currently under discussion could have an impact on business models in the banking sector, including Financial Data Access (FiDA) or the Retail Investment Strategy (RIS). After Open Banking, FiDA is the next step towards open data access in the financial sector, which will promote competition and efficiency. FiDA will give consumers and SMEs the right to authorise third parties to access data held by traditional financial institutions. The Retail Investment Strategy should strengthen investor protection by increasing transparency, protecting consumers and ensuring that retail investment products are marketed fairly and offer value for money.

2.1 The digital euro must use a fair remuneration model

One industry representative argued that the digital euro will pose significant challenges to European banks' balance sheets and profitability, especially for small banks without access to capital market funding. Banks need to be paid for their services. It would be a mistake not to pay for the digital euro. Implementing and executing legislation, like KYC, AML and Sanctions is extremely costly. If the digital euro is unremunerated and FiDA forces banks to share data without compensation, the negative impact on banks' revenues will have a corresponding negative impact on financial stability.

Instead of positioning retail banks as utility providers, it is crucial to offer them a proper compensation for the tasks EU banks are required to mandatorily perform as (semi-) public services and that allows them to develop innovative products and services that meet market needs.

Another industry representative noted that the introduction of the digital euro will change banks' business models. It will entail huge costs and banks will have to decide what they can do in the face of these costs. The digital euro introduces another player into the market, which will have a negative impact on banks' revenues. In this context, the remuneration model must provide incentives for banks and payment service providers. At the same time, it must be avoided that the digital euro favours large technology companies in order to monopolise their control of the market.

2.2 New EU legislation must not lead to unfair competition between banks and big techs

An industry representative stressed the importance of considering the scope of new regulations. FiDA could give big tech companies access to the valuable financial data held by banks without giving banks reciprocal access to the data collected by big techs. EUDI aims to open up the EU market for digital services and allow individuals to prove their identity digitally, but it could impose disproportionate costs on banks. EU banks and financial service providers should be able to access the data held by big tech companies. If they cannot, Europe's new digital legislation could weaken the EU banking and payments sector and strengthen non-European conglomerates.

2.3 Open finance data will change the financial system slowly

An industry speaker agreed on the importance of understanding the impact of legislation on different players in the system. Open banking will mean that customer data belongs to the customer. It will create room for innovation and allow new services to be developed. However, existing rules need to be implemented across Europe. The use of open financial data could transform the financial system, albeit very slowly. It will create the potential for new and innovative offerings. To ensure that open finance is a success, it would be useful to bring forward deadlines and set high standards for implementation, including for account switching.

2.4 The impact of the EU's digital legislation should be considered holistically

An industry representative emphasised that EU legislative initiatives should be considered holistically. If legislation is implemented without a holistic perspective, it will not be possible to maintain the diversity and competitiveness of the EU banking sector. Regulation should be risk-based; it should not be used to implement structural policies.

An industry representative agreed on the need to take a holistic view of the EU's digital initiatives. The financial professionals who implement the legislation look at the combination of regulatory effects. To prevent the regulatory framework from weakening the European banking sector, a holistic approach based on well-designed impact studies is essential. Rather than positioning retail banks as utilities, they should be properly compensated for the tasks they are mandated to perform as semi-public services. The European digital regulatory framework should include safeguards to prevent the development of a one-size-fits-all approach and ensure that vulnerable and less digitally literate Europeans are not excluded. While many of these initiatives have positive objectives, it is important to understand exactly how they will affect the EU banking sector. These initiatives should drive efficiency and make customer products more inclusive, but the framework needs to be carefully calibrated to ensure that it does not inadvertently undermine these objectives.

2.5 The conditions to ensuring technology neutral regulation

A central bank official explained that there are several key pillars to ensure that regulation is technology-neutral. First, the regulatory approach should be principles-based. This means focusing on outcomes rather than the means used to achieve them. Of course, this is easier said than done. Market participants want regulators to lay down clear rules for them to follow. Creating effective principles-based regulation requires a clear and thorough understanding of the market. To achieve this level of understanding, regulators and supervisors must constantly monitor market developments and regularly engage with industry stakeholders to understand new and emerging technologies.

Second, the most important pillar of technology neutrality is capacity building within regulators and supervisors. There needs to be greater investment in education and training for supervisors. Third, regulations must be adaptable to technological change. Finally, regulatory expectations should be communicated transparently to market participants.

2.6 Policy measures to address regulatory gaps in relation to non bank activities

A supervisor argued that digitalisation will inevitably change business models. The question is not only how to maintain diversity within the banking system, but also how to deal with financial activities developed by non-banks. European regulations such as DORA and DMA help address some issues. However, further increase of bigtechs' financial activities may create level playing field issues, as these entities are not subject to the same regulatory requirements as traditional financial institutions. This may also raise financial stability risks, including contagion effects, funding access issues and concentration risks. Further policy measures to address such risks could include: close monitoring of the nature and scope of financial service activities developed by non-banks; enhanced regulation and supervision of non-banks, that could include requiring them to group their financial services activities in a dedicated structure subject to relevant prudential requirements and consolidated supervision at EU level; backstop supervisory powers to address specific scenarios, such as excessive concentration of services distributed by platforms; and the development of a harmonised regime for non-bank lending.

A central bank official noted that technology is reshaping the entire financial services landscape. These changes might be positive, but supervisors need to focus on the gaps in oversight that might be created. Increasingly, non-bank financial conglomerates are working in partnership with banks. This shows that banks are embracing technology and trying to make banking more accessible to their customers, but this relationship needs to be carefully calibrated. The bigger question is how to supervise non-banks. In this regard, the key issues are the heterogeneity of licensing requirements across jurisdictions and at cross-cutting points, the transmission of crypto risks to the banking sector, the need for greater cooperation between supervisors, and the potential expansion of the regulatory perimeter.

In this context, the regulatory toolkit should be enhanced to avoid gaps in supervision. The toolkit should be robust and versatile enough to supervise disintermediated, interdependent or distributed ledger-based business models. The need to regulate the big tech conglomerates requires a thorough understanding of the financial activities of large non-banks across jurisdictions and sectors. The ideal response to these challenges would be the creation of global standards for non-bank supervision and the promotion of cross-border cooperation and information sharing among supervisors. There should not be a regulatory "race to the bottom" driven by a myopic vision of innovation and growth at any cost, which will not be good for society. The EU is likely to need to continue to lead the regulatory evolution in the supervision of non-bank financial conglomerates and crypto asset services. Simplification should be prioritised.