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Diversity and proportionality, challenges or opportunities for the European banking sector?

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Abstract. *In the first two parts of this paper we realise a brief context introduction for diversity and proportionality, presenting also some aspects from the relevant related literature. In the third part we provide an analysis using a selection of indicators considered for a group of countries (Germany, France, Poland and Czech Republic). We emphasize the diversity of the banking structures, types and sizes of banks acting in the selected banking sectors under the umbrella of the European banking system. We add also relevant insight and considerations to the analysis, related to the regulatory and supervisory framework, which should accommodate a diverse range of banking structures, addressing also the proportionality principle. The forth part includes findings of our analysis as well as other relevant discussions, related to the impact and complexity of the topics, for policy implementation. The final part includes our concluding remarks.*

Keywords: banks, banking model, customer behaviour, regulations, diversity, proportionality principle, economic development.

JEL Classification: G21, G38, G40, G41, M14, O16.

1. Introduction

Banking represents the most important financing channel for the European economy[(1)]. Europe needs banks with focus on financing the real economy.

Deep and profound changes have taken place since the beginning of the financial crisis, considering as main drivers: the regulatory changes, consumer behaviour developments, technological evolutions, increased competition from non-banking entities.

European and national authorities have developed a new design for the European banking system, in order to insure more resilience, to implement macro-prudential and resolution tools, to develop capacity for reaction to different shocks but also to support investments and growth within Europe. Specific challenges were faced due to a mix of factors, from the complexity of large euro-area banks (taking into consideration their cross-border assets, number of legal entities, operations and activities under various jurisdictions), to the extended presence of small and medium sized banks that build up long term and strong relations with their customers, and also the need to secure the strategic objective to insure financial stability at the macroeconomic level.

Our research approaches mainly the case of the European market and provides qualitative insight for two strategic and complex questions: may diversity, both in national and European banking systems, support a sustainable development for the European economy? Proportionality[(2)] should represent a priority within the regulatory and supervisory framework?

Academia, researchers, authorities and regulators, banking professionals agree on the importance of insuring financial stability, for the economy and for the society.

There are also complex aspects to be harmonised concerning the strategy of the banks, different types of banks with different sizes, doing business at the national and European level, using different mechanisms for funding in cross border banking (intragroup funding or local host country based funding), complex negotiations within the resolutions boards for cross banking in Europe, national banking systems specificities vs. European banking system perspectives, potential arbitrage on different regulations at the national level, new institutions and tools that have been developed and should be carefully implemented.

Considering the important steps that have been done so far since the beginning of the financial crisis in 2008 but also the importance of building up strategic decisions for a long term sustainable development, our study provides insight for future policy actions.

2. Related literature

Within the national banking systems, large banks, mid-sized banks and small banks provide banking products and services to various segments of clientele, being supervised by national and European regulators.

Relevant research focus on large banks, reflecting their role but also the risks induced, especially in a crisis context. Large banks perform functions that if disrupted could seriously damage the financial sector and the real economy (Schoenmaker, 2016).

As the research study elaborated by Allen et al. (2011) reflects, cross border banking transformed the banking sectors and the economies of the central and Eastern European countries, from a state owned, mono-bank systems towards a privately owned, market-based financial systems. While western European countries have been both home and host of large cross border banks, central and eastern European countries have been exclusively host of such banks. Cross-border banking that is neither excessive nor imbalanced, it does not create undue concentration in exposures (at the level of an individual country or at the level of the European Union) and is likely to be beneficial for stability.

Regulations and technology were the most important drivers for change in banking, after the financial crisis. The impact of technological developments is deeply rooted within the structure of every bank, being also linked with the new regulatory framework. Without the use of new technologies, banks may not succeed in complying, staying up-to-date with the permanent changes of regulations (Boella et al., 2013).

The need for a central supervision at the European level, in order to overcome coordination failures was reflected by Goodhart and Schoenmaker (2006). Their paper revealed that Pan-European banks have started to emerge, while arrangements for financial supervision and stability were nationally rooted. This raises the issue who should bear the burden of any proposed recapitalization, for failures that may occur in a large cross-border bank. A recapitalization is efficient if the social benefits (preserving systemic stability) exceed the cost of recapitalization.

As large banks are attracting foreign capital, domestic banks are more committed in attracting domestic capital and savings. Research studies such as McCauley, McGuire and von Peter (2010), Marcin, Schnabl, (2010) emphasize that, when analysing potential risks to financial stability, should be considered that lending by subsidiaries is more stable than direct cross-border lending.

Long term sustainable banking business is linked with the evolution of the specific segments within the European landscape, such as Small and Medium sized Enterprises (SMEs). The paper elaborated by Paulet et al. (2014) explored how banks have modified their behaviours since the financial crisis and their influence on credit access for SMEs, these orientations hampering SMEs' access to credit.

Adapting and implementing strong but also flexible risk management strategies, both at systemic and bank levels, represent key points for long term and sustainable contribution of the banking system to the real economy. As Draghi (2017) exposed, the crisis taught us that individual banks and the banking system as a whole needed to be more resilient than they were pre-crisis, thus banking regulation and supervision have become stricter. Moreover, the European regulatory framework places greater emphasis on identifying and addressing system-wide risks, including the establishment of new institutions (such as European Stability and Resolution Board) and the creation of macro prudential instruments assigned to public authorities.

Macroeconomic specific tools and instruments are developed and linked with the typology of banks acting within the banking sectors of every national country within Europe, but also to the cross banking European level and global level. Schoenmaker (2016) reflects that when establishing a basic typology of banks should be considered legal and operational structures, his study focused on the 30 largest banks(3). First argument was that legal and operational complexity is naturally positively correlated with the size of a bank, and, second, euro-area "global systemically important banks" (G-SIBs) and "European systemically important banks" (E-SIBs) represent roughly 60 percent of total banking assets in the Banking Union, channelling the greatest systemic risk. In several jurisdictions, these were the main type of financial institutions requiring public support during crisis. Therefore, for these institutions, the potential resolvability challenge is greater both in terms of feasibility and urgency.

At the European level, the implementation of the Banking Union (with the two functioning pillars, supervision and resolution) influences indirectly the structures and existing business models of the banks.

As EBA Banking Stakeholder Group (2016) reflected in a study, the overall administrative resources and cost of new regulation – such as supervisory costs and new IT systems – have a substantial impact on all banking institutions, and an even more severe impact depending on criteria such as the size and complexity of institutions and their business models. As a result, disproportionate regulation could inhibit small banks from providing finance to the real economy, in order to support innovation and growth.

Proportionality is also considered within the policy tools of the European Banking Authority (EBA). The European Commission (Nava, 2014) has enumerated many areas that are explicitly covered by the Principle of Proportionality, including general provisions, reporting, supervision, internal capital adequacy assessment plans, recovery and resolution plans. These are reflected also via setting materiality thresholds and differentiating reporting requirements across business models adopted by different banks (e.g., cooperative banks).

3. Analysis

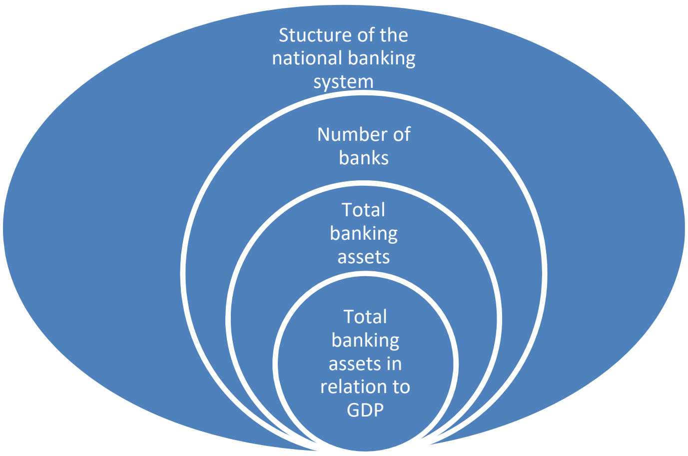
Our research emphasize different theoretical and empirical findings related to banking systems composition and structure in different European countries, reflected via diverse banking business models, types and sizes of banks, banking contribution to the Gross Domestic Product (GDP) of their national countries.

Our analysis provides input for the two main questions, based on two approaches: 1) the structure of the banking sectors, types of banks and their contribution to the economy, for a selection of countries within the European Union; 2) the regulatory and supervisory framework at the European level, allowing the presence in the market of different types of banks, concerning the resolvability, the resolution aspects.

We have researched and analyzed specific macroeconomic and financial/banking indicators, different banking system structures, we have made correlations and selected four representative national banking sectors within the European Union, two from the Western Europe and two from the Central and Eastern Europe: Germany, France, Poland and Czech Republic.

Due to various confusions on the complexity of the banking structures and their specific indicators, different rules for different jurisdiction, the research develops a working tool – *banking sector puzzle* for each country, in order to analyse, in a comparative and relevant manner, the correlation between the structure of the banking systems and their contribution to the economy of a specific country. The comparative tool includes three relevant indicators: number of banks *(credit institutions and foreign branches),* total banking assets (EUR, billions, for domestic banking groups and foreign-controlled subsidiaries and branches), total banking assets in relation with GDP (%) and a presentation of the structure of a country banking sector, considering the main pillars/typology of banks acting in that specific market.

Figure 1. *Banking sector puzzle – for a specific country*



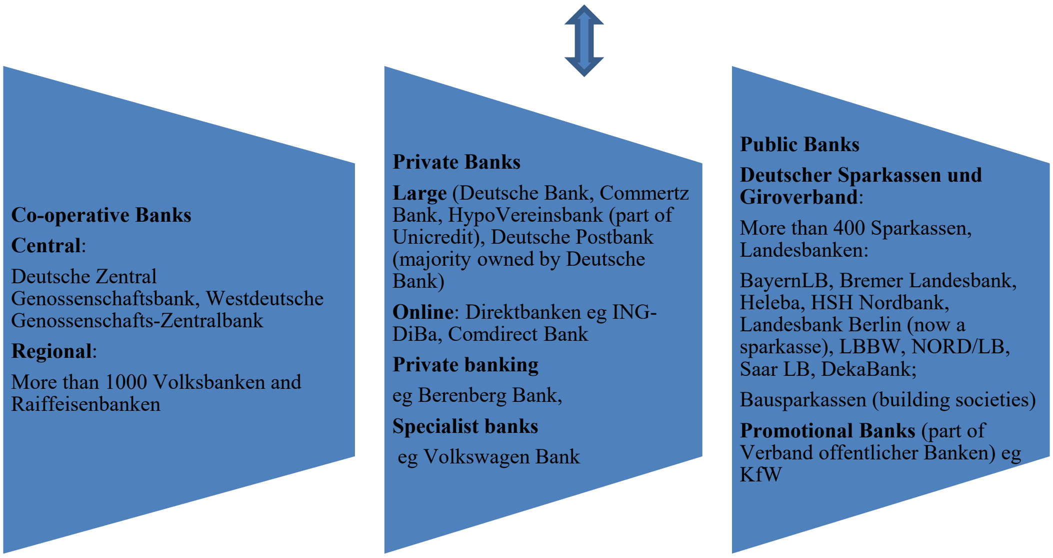
Source: own processing.

3.1. The structure of the banking sectors

Within this part of the paper we have analysed and presented the four selected banking sector and economies (Germany, France, Poland and Czech Republic), reflecting for each country the presence of a diverse typology of banks, using different banking business models, ensuring a specific contribution to each economy.

Figure 2. *Banking sector puzzle – Germany*

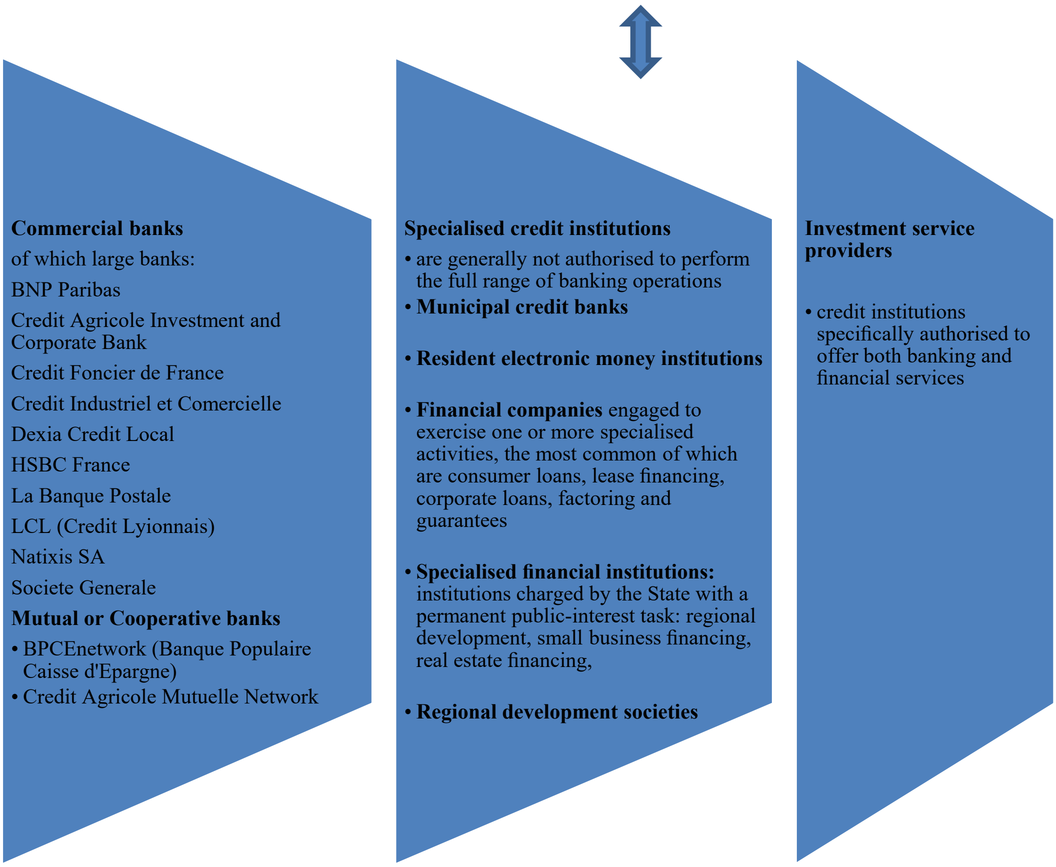
Indicator/Year	2014	2015	2016
Number of banks *(credit institutions and foreign branches)*	1,806	1,773	1,702
Total banking assets (EUR, billions) (domestic banking groups and foreign-controlled subsidiaries and branches)	7,062	6,955	7,084
Total banking assets in relation with GDP (%)	240%	230 %	230%



Source: own processing, data from ECB – Report on financial structures October 2017, *The Banker,* 2016.

Figure 3. *Banking sector puzzle – France*

Indicator/Year	2014	2015	2016
Number of banks *(credit institutions and foreign branches)*	503	507	480
Total banking assets (EUR, billions) (domestic banking groups and foreign-controlled subsidiaries and branches)	7,187	6,940	7,216
Total banking assets in relation with GDP (%)	330%	320 %	330%



Source: Own processing, data from ECB – Report on financial structures October 2017, Banque de France.

Figure 4. *Banking sector puzzle – Poland*

Indicator/Year	2014	2015	2016
Number of banks *(credit institutions and foreign branches)*	66	65	63
Total banking assets (EUR, millions) (domestic banking groups and foreign-controlled subsidiaries and branches)	359,428	375,423	386,825
Total banking assets in relation with GDP (%)	88.8%	89.0%	92.4%

Domestic commercial banks

- Affiliating banks:
- Banks that conduct banking activity
- Foreign owners hold majority stakes in most commercial banks
- The State Treasury controls five banks

Cooperative banks

- Are members of two associated banks
- Due to preparations for the new requirements of the CRD IV package,cooperative established banks are operating within two Institutional Protection Schemes (IPSs)

Branches of credit institutions

- Branches are owned by foreign banks

Source: Own processing, data from European Central Bank, European Banking Federation, The Polish Bank Association.

Figure 5. *Banking sector puzzle – Czech Republic*

Indicator/Year	2014	2015	2016
Number of banks *(credit institutions and foreign branches)*	45	46	45
Total banking assets (EUR, millions) (domestic banking groups and foreign-controlled subsidiaries and branches)	194,652	205,369	222,798
Total banking assets in relation with GDP (%)	126.4%	124.0%	127.9%

Commercial banks

- Are also large banks, medium-sized banks and small banks

Building saving banks

Saving with building societies were introduced in the Czech market upon passing of Act on Saving with Building Societies and State Support of Saving with Building Societies no. 96/1993

Branches of foreign banks

- Entities were controlled mainly by foreign owners, including both banks and branches

Source: Own processing, data from European Central Bank, European Banking Federation, Czech Banking Association, data end of 2016.

As the analysis reflects, the four banking sector/economies accommodate an important diversity of banks, of different sizes, different shareholding structure, different products and services, different business models: cooperative banks (central and regional), commercial banks, private banks, public banks, building saving banks, regional development societies, municipal credit banks, promotional banks.

Every national economy has its own specificities, cultural approaches and banking structures. Special relations are developed between the banks and their segments of clientele. Although technological development changes the shape of the banking business, traditional banking development (via network of branches) continues to play a strategic role.

In Germany a strong network of local and regional banking players is supporting the economical activity of the country, registering high levels both for GDP and for the contribution of the banking sector with GDP.

In France, the contribution of the banking sector with GDP is higher than in Germany, but there are less banks than in Germany, France registering almost the same level of GDP. This means that, on average, a bank in France is acquiring higher assets than in Germany.

There is an important difference between the indicators registered within the Western countries and the indicators registered within the Central and Eastern European countries, such as Poland and Czech Republic. The number of banks (credit institutions and foreign branches) is smaller, total banking assets are significantly smaller and also their contribution with GDP is smaller.

Diversity is an important concern of the regulators and supervisors but it can also represent an opportunity in order to foster the contribution of the banking sector to support the real economy in the long term.

3.2. The regulatory and supervisory framework

Bail out for large banks in the context of financial crisis represented an important challenge for authorities and regulators. The new regulatory and supervisory framework developed within the post crisis environment at the European Union's level, included changes of capital and liquidity regulation, risk management, governance and resolution regimes as well as the creation of the Banking Union. European banking supervision (known as the Single Supervisory Mechanism, established in 2014) was the first component of European banking union, as the European Central Bank became the supervisor for the region's largest banking groups and also the overseer to the supervision performed by national authorities to the medium sized and smaller banks. The supervisory requirements influence significantly the business of the banks, imposing entity-level capital and liquidity requirements, geographical ring-fencing, the need to comply with stress test scenarios.

The second pillar of the Banking Union, respectively the resolution(4) regime, was introduced via the Bank Recovery and Resolution Directive(5) (BRRD) aiming to support an orderly exit of troubled banks, with creditors bearing mainly the cost of bankruptcy.

The third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS) is not developed yet, there are ongoing discussion and analysis.

The regulatory framework, including the supervision indicators and reporting, the resolvability scenarios, influences the banks activity and resources, risk management and compliance functions but also the strategy of the banks. The legal and operational structures of banks should facilitate the separation of critical and non-critical bank operations in order to develop capacity to react in an unfavourable situation and to comply to the liquidity requirements (e.g. for each of the subsidiaries located in the euro area), to capital requirements.

The regulatory and supervisory framework at the European Union level, via designing more proportionate banking rules, should support the diversification of financing for the European economy and contribute to a long term and sustainable commitment of the banking system towards the economy.

The size and typology of the banks matters when considering supervisory compliance and resolvability solutions, at the European level acting large banks, medium sized banks but also small banks that need both to comply and ensure operational continuity, as part of a broader financial stability requirements.

Diversity is present within the European banking landscape. The Principle of Proportionality is a relative concept which requires a case-by-case approach, considering the momentum, specific circumstances of each case but also the impact at the system and bank's level.

Schoenmaker (2016) classifies the large euro-area banks according to their number of legal entities, foreign assets and their governance, identifying three groups of banks: domestic banks with a limited number of entities; domestic cooperative banks with more complicated legal and decision-making structures; cross-border banks with complex structures operating in multiple jurisdictions. His study makes relevant policy recommendations, evaluating the obstacles to resolvability that the legal and operational structures of the large euro-area banks could present, assuming that it is possible to liquidate smaller and medium-sized banks through transfer of their relevant activities to other banks.

Regarding the regulatory framework's application, known as the Credit Risk Directive package, may be considered a prime example of the acknowledgement of the diversity of the European Union banking system, explicitly mentioning that its provisions should respect the Principle of Proportionality and that Member States, the Commission and the European Banking Authority will implement and monitor those provisions.

4. Findings and discussions

The analysis for the selected banking sectors reflects that there are differences between Germany and France, Poland and Czech Republic but also between the Western European countries and central and Eastern European countries.

In Germany, considering the year 2016, the banking system was structured on almost 1702 banks, with different typologies and sizes, that booked and managed total banking assets of Euro 7,084 billion, representing approx. 230% in relation with GDP. This diversity of structures existing at the German banking sector impacts also to the guarantee schemes, in Germany functioning three different guarantee schemes: one for sparkassen banks, one for cooperative banks, one for private banks.

In France, considering the year 2016, the banking system was structured on almost 480 banks, with different typologies and sizes, that booked and managed total banking assets of Euro 7,216 billion, representing approx. 330% in relation with GDP.

In Poland, considering the year 2016, the banking system was structured on almost 63 banks, with different typologies and sizes, that booked and managed total banking assets of Euro 386,825 million, representing approx. 92.4% in relation with GDP.

In Czech Republic, considering the year 2016, the banking system was structured on almost 45 banks, with different typologies and sizes, that booked and managed total banking assets of Euro 222,798 million, representing approx. 127.9% in relation with GDP.

As a general remark, ratio of banking sector assets to GDP had been falling since 2008, and this trend stopped and started to be inversed in 2016 for all the analysed countries. An increased reliance on deposit funding may indicate a trend towards retail banking business.

The diversity reflected by the various types and sizes of the banks within the four analysed banking sectors emphasize a diverse approach towards financing the national economies and a specific contribution of each banking sector. Diversity and proportionality converge within the analysed banking sectors. The analysis for proportionality should also take into consideration: business models, customers, portfolio construction and risks, cross border activities.

As the research of Mergaerts and Vennet (2015) reflects, the characteristics of the business model are important determinants of performance, but no specific bank type outperforms in all dimensions. Deposit funding, high asset quality, income diversification and capital adequacy positively affect performance. The research also report substantial variation of business model effects over different bank types recommending that business model considerations should be more fundamentally integrated in the post-crisis regulatory and supervisory practice.

Kok et al. (2016) propose a relevant study suggesting that key determinants for the grouping of banks into different business models primarily relate to bank size, non-domestic exposures and funding profiles but from a balance sheet characteristics perspective, the following business models can be identified: 1) medium-sized universal banks focused on domestic lending; 2) small deposit-takers focused on domestic lending; 3) local or specialised lenders with a significant share of market funding; 4) large universal banks funded by deposits with sizeable domestic exposure as well as sizeable trading assets; 5) medium-sized universal banks with diversified assets largely relying on deposit funding; 6) large international banking groups with internationally diversified assets, a substantial share of market funding and sizeable trading assets; and 7) investment and custodian banks focused on fee and commission income

Different theoretical and empirical models and findings in the field of banking consider that proportionality should take into account also the risks faced by bank customers. Regulatory framework, within the post crisis environment, includes relevant changes and challenges. In accordance with KPMG (2013), an impact analysis of the accumulation of regulation on the Belgian banking sector, given market dynamics, show that banks might attempt to partly transfer the cost of regulation on to customers. As with all costs, banks have to seek to cover the costs of regulation in their margins, the fees they charge, or through increased productivity, considering that costs of regulation impacts firstly the regulated entities.

In accordance with EBA Banking Stakeholder Group (2016), the Principle of Proportionality has several dimensions, which raise different issues with respect to costs and benefits for all stakeholders (including banks and consumers of banking services). The study reflects five dimensions to be considered: 1) objectives of a particular regulation, 2) the totality of regulation (it includes whether the cost-benefit analysis is applied to the totality of regulation), 3) excess complexity, differentiations (relate to, for instance, size, business models, 4) ownership structures of the banks, 5) materiality (whether a particular regulation either applies to institutions to which it should not be applied).

Analysing the regulatory and supervisory developments we do include also a key element that is not so easy to detect directly, but that can be reflected via relevant indicators for an economy and banking sector: trust. Trust is mainly considered when banks, within the post crisis context, are seeking to regain it of their customers. Trust is essential for banking business, not only in the traditional approach but also within the new reality of technological and digital banking, banks being the main channel for financing the European economies and societies. Trust remains a key element considering also the complex relationship management between authorities, regulators, investors, shareholders of the banks, banks and customers, societies as final beneficiaries. A mix composed of: smart debt restructuring of the existing relations and customers exposures, new strategic partnerships based on confidence and more knowledge on consumer behaviour represent catalysers for sustainable banking and sustainable economic development.

We emphasize the strong liaison between trust and accountability, as accountability is a key point within the risk culture of a bank, included also in the evaluation process of the supervisors. When approaching accountability, its relevance should be assumed from the highest level, as reflected by “tone from the top”[(6)] within a bank, emphasizing the top-down approach in the decision making process of a bank but also in maintaining strategic relationships with authorities, supervisors, customers, employees.

The regulatory and supervisory framework include a mixed set of objectives, from insuring financial stability to providing the appropriate policies, instruments and tools to address vulnerabilities and risks, both at the system and bank’s level. Diversity of the banking structures at the European level and proportionality in drafting and applying rules and regulations should be also carefully addressed, in order to transform actual challenges (for regulators, bankers, shareholders, customers) into opportunities for the economy and society.

5. Conclusions

Diversity within the European banking landscape is a consequence of the differentiations in the structures of the national economies, differentiations in the regulations of the national banking sectors, differentiations in the segments of customers, diversity of experiences, situations and perceptions, at the national states level.

Diversity represent a challenge for the European regulators and supervisors and an opportunity for customers. Diversity is emphasized both from the business consideration (e.g. different types of banks, different sizes, different banking models, different operational and legal structures) and from the resolution and resolving considerations (e.g. effective application of the provisions of the resolution mechanisms).

Proportionality may also be reflected via the "translation" of diversity into the practice of regulatory and supervisory framework. Imposing similar requirements (e.g. "one-size-fits-all" approach) on small and large banks in certain aspects of financial regulation may result in different and undesired effects, as the smaller banks would face proportionately higher costs, while their systemic significance is low.

If the regulatory framework does not adequately accommodate proportionality, some banks may be closed, and together with them some customers, activities may not be financed anymore (especially smaller companies that are relevant only locally and may not be of interest for larger banking groups). Diversity is important for banks, in order to compete, innovate and better serve their customers, being reflected by a matrix of: specific segments of clientele, activities, operations, specialized products and services, credit and assets markets, different sources of funding, ownership structure.

But diversity and viability of medium sized and small banks business models should be carefully calibrated to suit a long term perspective of the banking business, including the next generation of customers behaviours, mixing traditional relationship banking, via networks of branches, with home banking and digital banking. The medium sized banks and small banks should find, formulate and sustain their competitive advantages and differentiate from the competitors, either larger banks or non-banking competitors: FinTechs, digital companies.

Both concerning the banking sector structures and the regulatory and supervisory framework, European Union is reflecting diverse situations and perceptions in different member states.

The answers for the two main research questions are positive.

But the success in implementation is conditioned by the synergic convergence of different actors, within a new design of bank financing for the European economy. This new design, including macro prudential tools with behaviour and banking culture is drafted and implemented by the regulators, authorities, shareholders of the banks together with their governing bodies and customers and should combine:

- Cooperation and coordination between authorities at the European and member states level and cross-border.
- A gradual approach and specific tools to avoid/mitigate and further accommodate: "too small to care", "too big to fail", "too costly to save", "too complex to resolve".
- Gradual implementation of the regulations in order to offer soundness and stability for the existing business of the banks.
- Long term and valuable bank – customer relationships and experiences; banks should communicate and "translate" the regulatory requirements, educate their customers and provide support for their development, in a sustainable manner, inspire the customer to trust the bank/the banker.
- Operational capacity developed by the banks (and assisted by the regulators), to resist to "shocks", to insure the functioning of critical activities, alternative funding scenarios.
- Banks should strategically adjust their business models, balancing Risk and Reward within the new post crisis reality, formulating and preserving their competitive advantages while developing risk management tools and instruments.

Both diversity of the national banking sectors and proportionality considered within the regulations, if calibrated and harmonized, may offer relevant opportunities for long term and sustainable growth of the European banking sector and economy.

Notes

(1) For example, as alternative financing channels to banking: in two of the leading European economies, Germany and France the stock exchange represent up to 60% from GDP; in USA the stock exchange represent almost, 120% from the GDP, as per the data for 2016.

(2) The Principle of Proportionality regulates the exercise of powers by the European Union; Proportionality is a legal principle that allows (or requires) balancing between competing values. This enables judges to decide whether a measure has gone beyond what is required to attain a legitimate goal and whether its claimed benefits exceed the costs; we will refer to proportionality principle in considering the regulatory framework
The Principle of Proportionality is acknowledged in the Basel Committee on Banking Supervision's core principles for effective banking supervision, Principle 8: "Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable."

(3) Each bank has assets in excess of €150 billion, is supervised by the European Central Bank (ECB) and belong to parent companies headquartered in the euro area. This group includes the eight globally systemically important banks (G-SIBs) that the ECB supervises directly.

(4) The resolution tools in the Bank Recovery and Resolution Directive are the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool.

(5) Bank Recovery and Resolution Directive (2014/59/EU).

(6) Financial Stability Board, "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture A Framework for Assessing Risk Culture", 2014.

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