Diversity in the European banking system: challenges and prospects

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Reflections on design & implementation of the European Banking Union

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Outline

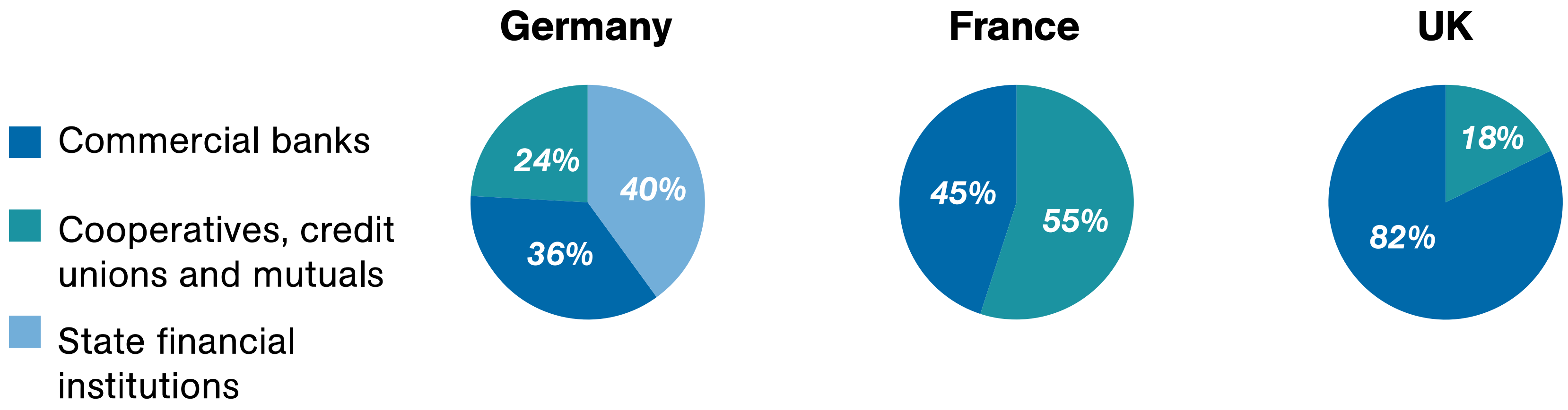
1. Stakeholder Banks in Europe:
- Too important to be neglected
- Yet, too complex to be understood (e.g. the 3 Pillars of Cooperative Banks)

2. Challenges: “Single Company Model” behind EU Regulation
- Lack of Proportionality, Focus on swift capitalization
- Banking diversity under jeopardy

3. Prospects: a “wrong” banking disintermediation in the EU?
- Big Banks: Regulatory arbitrage and underestimated financial risk
- Traditional Banks under regulatory & deflationary burden
- A permanent credit crunch for SMEs in Europe?

1.1 Stakeholder Banks in Europe: Too important to be neglected

Figure 1 – Market shares of deposits in Germany, France and the UK



Source: World Bank (2011)[2]

1.2 … Yet, too complex to be understood

- Difficult to understand the diversity of mission/governance
- E.g. the three pillars of Coop banks' difference

1. While a Plc bank has the sole objective of maximizing profit, a cooperative bank has in whole or in part mutualistic purposes and works for a number of stakeholders, rather than for just one group (shareholders);
2. In a cooperative bank customers may have different incentives than at a Plc. In fact, in coop banks customers, often being both depositors and shareholders, may have incentives to peer monitoring i.e. to provide information that enables the bank to avoid lending to unworthy borrowers;
3. Different governance. Plc bank shareholders count based on the number of shares held. Instead, in the coop bank each shareholder has one vote regardless of the number of shares held (one-head one-vote). This mode of governance raises the bank's democratic accountability and is combined with the mission of the coop bank to the widest audience of stakeholders.

- In short, diversity of <u>mission</u>, diversity of <u>incentives</u> and greater democratic accountability (favored by the one-head one-vote rule) all push the coop bank to adopt a <u>Relationship Banking model</u> → **less credit rationing**

2. Challenges: “Single Company Model” behind EU Regulation

- Difficulties to understand the diversity of mission/governance, typical of stakeholder banks, and belief in the superiority of the “for profit” company model stand behind EU banking regulation:

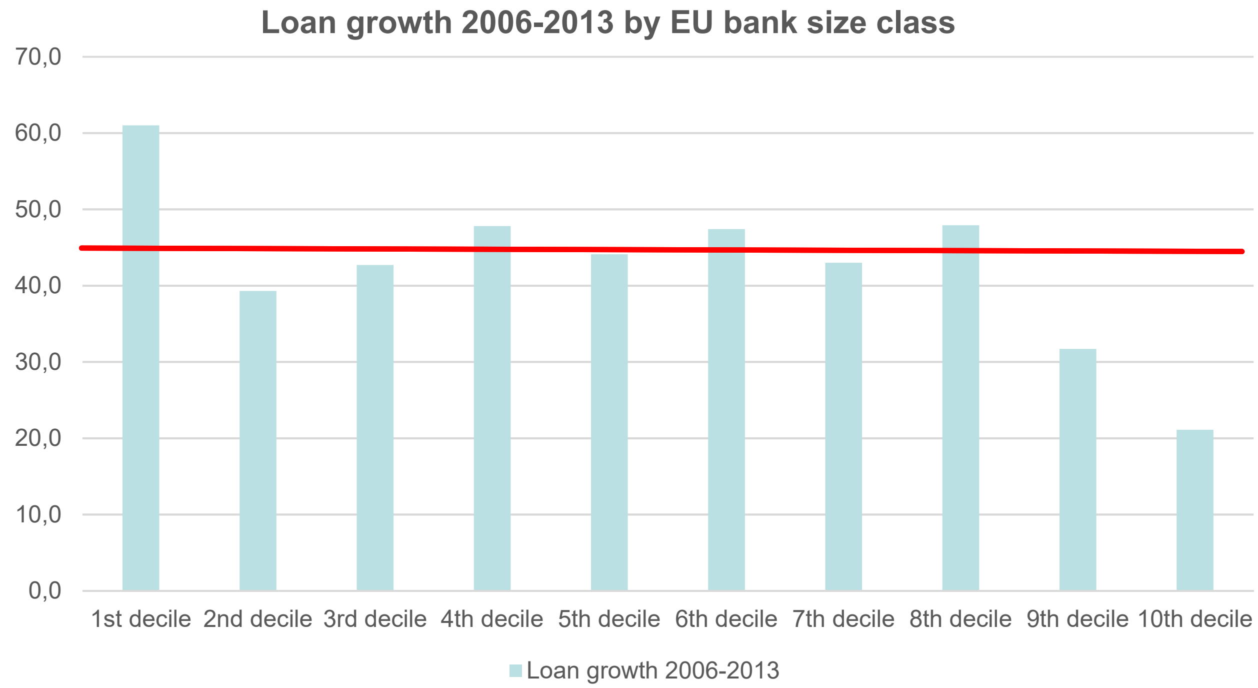
- One-size-fits-all approach → Lack of Proportionality (at odds with the pragmatic tiered US approach);

- Excessive (if not exclusive) reliance on the level of bank capitalization

- Banking diversity is in jeopardy

3. Prospects: a “wrong” banking disintermediation in the EU? – 1

- Big Banks: Regulatory arbitrage and underestimated financial risk
- In spite of regulatory arbitrage via IRB models, big banks are deleveraging by cutting loans … but which types of financial risk are they uploading?



3. Prospects: a "wrong" banking disintermediation in the EU? – 2

- Traditional Banks suffer regulatory & deflationary burden
- Largely due to higher capital levels with little use of IRB models and to lack of Proportionality, the Regulatory burden puts (smaller) traditional – mostly stakeholder – banks under stress
- Traditional/Stakeholder banks' difficulties are further boosted by the deflationary macro environment → near zero interest rates imperil their usual income stream from interest rate spreads
- The (paradoxical) result could be that – in spite of the fanfare on the Capital Markets Union – the European Banking Union ends up provoking a permanent credit crunch for the SMEs with persistent negative and asymmetric macro effects
- So the EBU, which was meant to defuse the pernicious bank-sovereign loop, might turn out into just a new episode of Europe's Twilight Zone of misguided economic policies