»What is the future for small commercial banks in Europe?[*]« - A European Banking Institute Conference in Ljubljana, Slovenia

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On Friday, October 19, 2018 The Faculty of Law at University of Ljubljana and its Center for Legal and Economic Studies (CLES) hosted the European Banking Institute (hereinafter the EBI) conference, organized under auspices of the Bank of Slovenia and the Faculty of Law. The topic of the conference was the question of the future functioning of small commercial banks in Europe with speakers from seven EU countries and with over two hundred participants, more than half of them being eager students.

Conference was set in motion by **Prof. Franjo Štiblar**, member of the Academic Board at the EBI and Head of the Institute for Legal and Economic Studies from the Law Faculty at the University of Ljubljana and main organizer of the conference at the host University. Next on the floor was **Dr. Thomas Gstädtner**, president of the Supervisory board at the EBI who first thanked both the Law faculty and The Bank of Slovenia for helping with the organization of the conference. He explained the role of the EBI in helping bridge the gap between leading academics, regulators and practitioners and also as an institution whose desire is to bring together young researches, many of whom were present at the conference, and regulators. He concluded his introductory remarks with an emphasis on the importance of small banks in the EU who are often the key players in ensuring the growth of many regional companies, especially the SMEs and consumers.

Prior to the start of the first morning session, participants were greeted by two Slovenian experts in the field of banking. First, **Dr. Primož Dolenc**, the acting governor at the Bank of Slovenia, brought attention to the fact that all Slovenian banks are small in the absolute EU context and thus even our three biggest banks miss the scope of a significant credit institution by quite a large mile. He further explained the current situation in Slovenia and touched upon the particularly difficult situation for smaller banks who were affected more significantly than their larger counterparts by the more vigorous capital requirements enacted in the post-crisis years. Next, **Dr. Miha Juhart**, former dean of the Faculty of Law and current non-executive manager at the Bank Asset Management Company (Slovenian "Bad bank") shared his views of the situation and welcomed everyone to the faculty, which will soon celebrate its 100-year anniversary.

The keynote speaker before was **Dr. Daniela Chikova**, partner at A.T. Kearney who delivered a speech, entitled the Future of Retail Banking. She tested two hypotheses relevant to the cost/income ratio in the functioning of small banks. First, costs have indeed proven to be relatively higher for smaller banks as they sometimes hardly catch up with all the regulatory requirements, covering various aspects of the bank's functioning. Second hypothesis was that smaller banks, aware of this cost inefficiency, undertake in riskier transactions to compensate for their competitive disadvantage due to the lack of economies of scale in their smaller portfolios. However, no definite conclusions in favour of

[*] An event organized under the auspices of Bank of Slovenia and Faculty of Law, University of Ljubljana, Center for Legal and Economic Studies.

this hypothesis were found. Additionally, Dr. Chikova highlighted the contemporary challenges facing the whole of the banking sector that has found itself at the crossroads before fully immersing in the digital era. All institutions will soon have to make further adaptations to the digital generation of customers, to the entry of financial conglomerates and FinTech companies and to the digitalisation of big data and optimization of this data in bank's distribution channels.

Small credit institutions and proportionality: the perspective after the Risk Reduction Package

Following the keynote lecture, it was time for the first session "Small credit institutions and proportionality", chaired by **Dr. France Arhar**, former first governor of the Bank of Slovenia and current adviser to the Slovenian president. First to take the stage was **Prof. Dr. Christos Gortsos** from the Law School of the National and Kapodistrian University of Athens and an Academic Member of EBI. In his presentation he first alluded to the fact that the term »bank« will not be found in the EU legislative acts since the term »credit institution« is used instead and thus we encounter the first difficulty in setting the stage of the conference given its focus on »small commercial banks«. Moreover, principle of proportionality can be defined both from a strictly legal perspective as for example envisaged in the EU treaties and the case-law of the Court of Justice or it can be used in a more economic sense. The current state of affairs in the EU enables both a different set of rules for small credit institutions and their exemption from a set of requirements that the »more significant« credit institutions are burdened with. However, in current times of over-regulation, where the banking sector is particularly burdened with a multitude of guidelines and technical standards, a fine compromise must be found between regulation and effective prudential supervision to complement the regulation. Prof. Gortsos concluded that in his view the increase in prudential supervision is an appropriate step in reducing regulation or at least ensuring there is no over-regulation in the already legislatively loaded sector.

Next to take the stage was **Mrs. Damjana Iglič**, Director of the Systemic Supervision and Prudential Regulation Department at the Bank of Slovenia. She presented a thorough and systemic analysis of the implementation of the principle of proportionality in the current legal framework, governed by the Single Rulebook. When it comes to proportionality in existing regulation, rules already reflect the size, complexity and systemic importance of a particular credit institution. Small banks are thus in a favourable position due to the less strict corporate governance rules, possible omission of some disclosure and simplified recovery planning. When it comes to supervision, the intensity of supervisory action is based on banks' risk profile and potential impact on domestic economy. Supervisory measures, including Pillar 2 requirements, are tailored to the individual risk profile and characteristics of the bank in question. Small banks are generally less risky than larger ones, so a proportionate approach to regulating and supervising small banks is usually appropriate. However, while the consistent supervision does not mean "one size fits all" supervision, proportionality should not mean that the rules should be less strict on a general level so as to enable smaller banks to hold less capital or liquidity.

Final speaker of the first session was **Mr. Michael Engelhard**, Head of Banking Supervision and Governmental Affairs at the Deutscher Sparkassen - und Giroverband. For introduction, he outlined the current regulatory environment 10 years after the Global financial crisis. He further build upon the presentations of his two predecessors in the panel and brought attention to the fact that the EBA Technical Standard on Supervisory Reporting is the record holder for longest publication in the EU Official Journal (1861 pages). In his view, today's banking regulation is detrimental for smaller banks. First, regulatory landscape is increasingly asymmetric in its impact on banks; second, implementation of regulatory requirements requires fixed costs and third; the rift between too-big-too-fail banks on the one side and too-small-too-survive banks on the other is increasing more and more. He then laid down the main reasons why smaller, regional banks are particularly needed in the Euro Area and play a key role in ensuring diversity and stability of the wider financial system. First, they are better suited to provide SMEs with funding and individually suited solutions; second, peripheral regions are not excluded if more decisions on capital and liquidity allocation are not made by central regions and third, a granular banking system reduces the to-big-to-fail problem. Upon comparing the US regulatory approach to that of the Single Rulebook of the EU, the author provided his ideas for the future of realizing proportionality in banking regulation. One such proposal that ticks all the boxes is the original proposal entitled »Small and Simple Banking Box«, a proposal that is not about lower capital ratios and less stringent liquidity requirements but rather focuses on relief in reporting, disclosure and other administrative or compliance related issues.

Small credit institutions and commercial banking for SMEs and natural persons

First speaker in the second session, also chaired by **Dr. France Arhar,** was **Prof. Dr. Franjo Štiblar**, professor of Economics; Banking, Insurance & Capital markets and Statistics at the Law Faculty of University of Ljubljana. Prof. Štiblar is also a member of the academic board of EBI, former Dean of the Law faculty and is the Head of the Center for Legal and Economic Studies. When it comes to the economic backdrop of the wider legislative framework in the financial services, Prof. Štiblar notes that legislation as a whole is more bank-oriented rather than consumer-oriented and thus favours the oligopoly in supply presented by the banks and does not enhance the polipsony position on the demand side (consumers). The detachment of banks from real life problems faced by natural persons is also one of the reasons for the crisis. Furthermore, banks have become too-big-to -fail, -bail & -manage and less responsive to the needs of SMEs, the population and are less susceptible for environmental considerations. Good banking should predominantly service the real sector: enterprises and consumers. Prof. Štiblar also expressed his criticism of the »Anglo-Saxon business model« where the individual institution's profit maximization is at the forefront while potential negative externalities such as those of environmental, social and ethical nature are not taken into account and even less so internalized by the institution in question. Lastly, the asymmetry of information regarding financial knowledge is too big between banks and consumers and should not be left as it is. What is needed is financial justice that will include a safe, attainable, fair and transparent array of financial options and instruments for consumers and smaller banks should have the upper hand in ensuring it. All of the ideas presented above have culminated in a book entitled Good Banking (in Slovene), which is forthcoming in English in the near future. If non-banks are freely penetrating banking field, then banks should also penetrate nonbanking services.

Dr. Christian Otto, Head of the "Coordination of National and International Off-Site Supervision" Division at Deutsche Bundesbank addressed the audience on the topic of Less significant institutions (hereinafter LSIs) in Germany and their current state and future challenges from a supervisory perspective. He first presented the statistics showing the number of LSIs in each Member State within the SSM and then further elaborated on the specific features of the German banking system. The three pillar system of the German system was presented where the three pillars stand for commercial banks, savings banks and cooperative banks, ranked by their respective number from least to most common. The ongoing favourable economic situation should benefit German banks' earnings situation, while low interest rates and the flat yield curve will continue to present challenge. Competition will also remain high, adding to this will be the new entrants in the process of digitalisation of the sector. Mergers can be one option for small regional banks within their sector but not the sole solution for the challenges ahead. While the German banking sector will maintain its three-pillar-structure, Dr. Otto emphasized in conclusion that the choice of a best-fitting strategy will be the responsibility of each institution's management.

Final speaker in the second session was **Ms. Martina Küster**, representing the Association for German banks. In her speech, Ms. Küster focused on challenges facing the banking sector and demonstrated on the example of the German banking sector why small banks are essential for the functioning of the SMEs. She identified three key characteristics that separate small banks from their larger counterparts. First, they reflect a special corporate structure and different fundamental values such as partnership-based approach with clients and are more in favour of sustainable solutions. Second, they have some key assets different than those of larger banks such as physical proximity in peripheral regions and thus have a better access to so called soft and local information in lending. Third, with the German Mittelstand (SMEs) as their natural counterpart, they form a backbone for the financing of regional economy. Future regulation should ensure that smaller banks continue to exist as they are essential in ensuring diversity of the banking sector.

Current and future challenges from digitalisation for small credit institutions: new distribution channels, data processing, and higher competition (Fintechs, platforms of peer to peer lending shadow banking)

Third session was chaired by **Mr. Marko Bošnjak**, Vice Governor of Bank of Slovenia. In introducing the other three panellists, he also outlined the role of FinTechs both as a progress inducing phenomenon while also being particularly prone to higher risks in the sector. First to present his ideas on current and future challenges from digitalisation for small credit institutions was **Prof.Dr. Santiago Carbo-Valverde,** Economics and Finance at CUNEF Business School (Madrid, Spain) and at the Bangor Business School (UK) and Academic Board Member at the EBI. While the process of digitalisation of the sector helped in creating a wide competitive map with a multitude of distribution channels, small commercial banks should not simply wait inactively for what the ultimate outcome of the revolution in the sector will bring about. Instead, each institution should ask itself what can it get from Fintech, to what extent is it a threat to its business and can the small bank in question become a better bank by combining the new technologies with existing relationships. What is definitely needed is a transformation of the business model that will encompass bank's new digital function by enriching traditional output with valuable big data and will combine such valuable data with new distribution channels brought about with the emergence of FinTech and BigTech.

Second speaker within this session was **Dr. Thomas Gstädtner,** Head of Division in DG Micro-prudential Supervision II at the ECB and President of EBI's Supervisory Board. He focused on the regulatory implications of the digital transformation of the banking industry. He first identified the four main drivers of the digital transformation, namely customer behaviour, increased competition, profitability concerns of established institutions and the overall regulatory framework. These drivers have led to significant changes in three main areas of the industry which are the entry of FinTechs, enhanced (big) data processing and acceleration of transactions through instant payments. To accommodate to rapid technological change, banks must consider a number of aspects and consider the changes required in their corporate governance and operating models to achieve their strategic goals. Not to be ignored are cyber risks. The ECB has recently carried out an in-depth assessment of credit institutions' cyber risks and outsourcing to better understand the IT risk landscape in the banking industry. The ECB's continuing message to banks is that they themselves are solely responsible for taking the appropriate measures to protect themselves from cyber risk and the negative impacts such threats pose.

To conclude the third session, **Mrs. Anja Rijavec Uršej,** Deputy Director, Department for Payment and Settlement Systems at the Bank of Slovenia spoke on the topic of Banks and FinTech. She first provided a definition of the latter as a technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and also the provision of financial services. She then continued with the analysis of the Slovenian situation where still more than 80% of all transactions occur in cash, challenges for future digitalisation are thus immense. Having a professional background in payment services, Mrs. Uršej emphasized that the provision of payment services is particularly one such area that not only enables banks to have frequent contacts with their users and acquire rich data on user's behaviour but that being innovative in this sector can help improve bank's overall reputation on the market. The final speaker in this session was also at the centre of quite a few questions, particularly aimed at the threat of BigTech companies for smaller banks in Slovenia and questions on regulatory differences across EU Member States when it comes to implementation of directives that otherwise fall within the maximum harmonization category.

Sustainable finance (social, green, ethical) for small credit institutions

The final session's focus was on a topic that does not always get that much attention in the banking industry as it was alluded to by the chair of the session, **Prof. Dr. Katarina Zajc**, professor of Economics and Economic Analysis of Law at the Law faculty of University of Ljubljana. The penultimate speaker of the whole conference was **Prof. Dr. Bart P.M. Joosen** from VU University Amsterdam, also President of the Academic Board of the EBI. In his presentation "Sustainable Finance for Credit Institutions" Prof. Dr. Joosen first shared the G20 insights on perspectives of sustainable finance that suggest that public finance will not suffice to finance the green transformation. Therefore, the majority of investments will have to come from the private sector and it is particularly the alignment of the financial system to serve this need where small commercial banks may come in as an important partner. In his overview of the EU legislative proposals on sustainable finance that will impact the banking sector, he pointed out 1) Sustainability considerations in financial advice; 2) Standards and labels for green financial products and 3) Sustainability in prudential requirements as three areas of potential amendments to existing regulations. The Commission will also explore the feasibility of the amendment of the CRD/CRR framework to include climate and environmental factors in risk management policies and the potential calibration of capital requirements. In presenting the current state of affair in Dutch banking sector, Prof. Dr. Joosen also mentioned that The Dutch Central Bank questions the effectiveness of a green supporting factor in the framework for prudential requirements as a means to boost green lending. Upon finding the outcome of a specific research, the Dutch Central Bank might be willing however, to lower capital buffers for 'green' exposures if the evidence shows that such exposures indeed carry lower risk.

Final speaker, **Mr. Simone Grillo**, member of the Strategy and Communication Office at Banca Popolare Etica, presented his practical experience in a credit institution that truly embodies the key principles of sustainable development and ethical values in its day-to-day operations. Mr. Grillo first presented the business model of this cooperative bank, which operates in Italy since 1999 and in Spain since 2014. The specificity of this credit institution is that it operates on four key principles: participation, transparency, efficiency and most importantly, awareness of the non-economic actions. Banca Etica is also free from the influence of politics and economic-financial power groups, its owners are 40.000 citizens and social organizations. Since it is a "Popular bank", the principle "one head, one vote" rules in the General Assembly that elects the main corporate bodies. They are also the only bank in Italy to publish on the website all the loans granted to legal entities. In addition to ensuring transparency by way of such public disclosure, the institution also asks all customers to sign a declaration of sharing the principles of the Statute and of conformity of the origin of their money to these principles. In their credit policy the economic investigation is paired with a social and environmental assessment of the loan applicant. This evaluation is based on parameters such as democratic participation, transparency, gender equity, respect for the environment and working conditions.

Prior to the closing reception at The Bank of Slovenia, all participants were once again greeted by **Prof. Dr. Franjo Štiblar** who concluded that diversity of the financial sector brought about with the existence of smaller banks is an advantage for the financial sector. Therefore, the answer to the question hidden in the title of the conference can definitely be answered in the affirmative as there certainly is a future for smaller banks in the EU, despite the challenges that lay ahead for the smaller banks and also their much larger counterparts. With this regard, to get optimal legislation for banks, it is important to enhance the dialogue between regulators, supervisors and academics on one side and bank practitioners on the other side.