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COMMENTARY

Diversity of the banking sector revisited: Why does it matter post-financial crisis?

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In the aftermath of the financial crisis, the foundations of several decades of modern and innovative financial systems - centred around homogenous behaviours and driven by short-term profit and excessive risk taking - have suffered serious damage and massive unrecovered losses. This has led to exceptionally high levels of state intervention, particularly in Europe, resulting in a major worldwide revamp of regulatory structures and frameworks. While many voices amongst academics and policy makers have called for a return to more traditional approaches to banking and finance and to more stringent financial regulation, very little attention has been given to diversity. Diversity in general and particularly in banking, involves the co-existence of different agendas, with their varying objectives, ownership structures and business models.

Similar to biodiversity, the value of diversity is more than the sum of its parts, which pre-supposes the co-existence of diverse and competing elements that may serve the same purpose, only differently. Ultimately, however, in the long run the sum may prove to be more beneficial to the economy and wider society.

Diversity can be interpreted as a foundation or a corollary of competition, going back to the Austrian economist Joseph Schumpeter. It is a process driven, to a large extent, by knowledge that already exists, by newly acquired knowledge and by innovation. For competition to work, new ideas need to be generated and put into practice, to either flourish or perish. This is largely applicable to financial systems, which evolve over time and - where new instruments, institutional forms and business models are invented and used - succeed or fail, while interacting in an ever-changing environment. It is a process of creativity/destruction and dynamic competition, founded on openness and diversity, offering an optimal basis for new ideas to come to life and for old ideas to make a comeback.

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In the context of banking systems, openness and diversity imply the coexistence of different institutional forms, objective functions and business models that are made sufficiently strong to withstand the competitive struggle in which different forms of organised banking activities compete with each other. Equally, diversity implies a varied contribution of different parts of the financial system to the economy and society as a whole. If one part of the system is weakened, the other parts can still fulfill their functions and hence disruptions are minimised. Diversity also enhances the robustness of the financial system so that it can face uncertainty and external shocks during the cycle. This can be attributed to the capacity of multi-faceted organizations to deal with risks differently because of their diverse nature, business models and objectives. In the same vein, diversity enhances resilience, thereby improving the ability to adapt to an environment hit by major crises.

Over recent decades, consistent with the 'Washington consensus', a trend towards the homogenisation of banking models and institutional forms has prevailed, favouring what is called the shareholder-value (SHV) model. Characterised by highly innovative, complex instruments, big risk and strong profits, its main purpose was to create maximum value for a bank's shareholders. Other models might have been regarded as inferior exceptions to the rule. In the aftermath of the financial crisis, however, the wisdom of this dominant model has been called into question and the merits of alternative models have been reconsidered.

In Europe, two studies of Ayadi et al (2010 and 2011) showed that the banking systems in several countries resisted the move towards homogenisation, while adjusting to new market circumstances, in order to survive fierce competition and drive towards greater efficiency. In these countries, primarily Austria, France, Germany and the Netherlands, banking diversity was nurtured in the ongoing competitive struggle between shareholder value and stakeholder value (STV) institutions. In contrast to SHV institutions, the latter strive to strike a balance between creating value for their survival in a highly competitive market and bringing sustainable value to the society or community they serve. In Canada, diversity prevails in a highly concentrated market, led by the presence of credit unions and cooperative financial institutions.

Inevitably, these two types of institution employ highly divergent governance models. With SHV institutions, there is a tendency for managers to take excessive risks to maximise the rate of return, not only to satisfy shareholders and market expectations, but also to satiate their empire-building ambitions. In STV institutions, governance arrangements differ from one to another, each with its own strengths and weaknesses, but overall, if adequate internal controls are put in place, such as auditing, supervisory committees and systematic bottom-up checks and balances, then extreme behaviour can be identified and contained.

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Among STV institutions, first created in the 19th century by well-intentioned people wishing to extend financial services to rural communities, cooperative banks persisted and evolved over the course of the century. This was despite general hostility displayed towards "unconventional" institutions. Although diverse elements exist within this model, in some senses, its organisational form is unique. Common characteristics included a membership-driven ownership with one member having one vote, a bottom-up governance approach with a multitude of checks and balances, as well as mutual support. A feature of such institutions was a proximity to member-customers. This naturally gave them a down-to-earth focus. Last but not least, they relied upon retained earnings as their almost exclusive source of capital, which was held by the institution, in perpetuity, for the benefit of current and future members.

At the same time, competitive struggle drove several institutions to deviate from the traditional cooperative model and to create hybrid forms. This was done to overcome their perceived weaknesses which were mainly access to capital and the challenge of expanding beyond their own borders. For example, to obtain external funds, several cooperatives in Italy issued shares to non-members but did not grant them voting powers, whereas others, such as in the Netherlands, issued subordinated debt that provided a dividend, but only if the institution made a profit. To benefit from the frenetic race to profitability, cooperatives in some countries, such as in France, also owned non-cooperative entities that specialised in investment banking activities, whilst others, such as in Austria, operated highly profitable activities in Eastern and Central Europe through their central institutions. These new forms succeeded in some cases and failed in others, as was documented during the financial crisis. The Italian cooperatives remained relatively unharmed, although some of them suffered in the recent European crisis. Equally, the Dutch Rabobank, came through the storm in an even stronger position than before, without the support of any public money, although it suffered later on from an unfortunate episode of market rate manipulation. Conversely, France's three cooperative groups recorded significant losses originating from their investment arms, forcing them to accept several billions of euros in public funds. The Austrian cooperatives met a similar fate, due to their risk exposure in Eastern and Central Europe. Six years later, banks recipient of State aid, have restructured their activities with the aim of returning to long-term viability.

The crisis was an opportunity for all types of financial institutions to reconsider their business models and strategies for future development. It proved to be a blessing in disguise and a chance to show their resilience for institutions like cooperative banks that were closer to their traditional core business and which had resisted the temptation for the excessive risk taking of their peers. As was confirmed in Ayadi et al (2010) on data until 2008, "their inherent characteristics allowed them to persevere and in some cases to outperform their "conventional" peers and to bring sustainable value to the economy and society". This conclusion provided the first vivid argument in support of the merits of

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diversity, analogous to those widely espoused in the world of natural sciences: biodiversity.

However, external forces are pushing financial cooperatives to demutualize or restructure which may cast doubt on their future as cooperatives. This is the case for Branche Populare in Italy and Rabobank in the Netherlands and others that may follow suit. Global regulation and dire global macro-economic conditions are important factors that may lead to profound structural changes in the financial sector worldwide. Cooperatives may not resist the wave, however.

Since 2008, the financial and subsequent sovereign crises brought many countries in Europe to their knees. Examples are Ireland, Greece and Cyprus, which were characterized by large, homogenous banking sectors that outweigh their GDP several times over. Besides that, the single supervisory mechanism, an important pillar of the banking union, has been set-up with the European Central Bank becoming the supervisor of EU banks, and more stringent regulations and new structural reforms have been adopted or have been discussed.

The slow macroeconomic recovery in several countries, together with new structures and reforms, are expected to impact upon European banking systems and business models. The diversity hypothesis in banking, which was tested prior to 2008, could uncover new dimensions, post 2008, that are worth exploring.

References

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