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Diversity in European Banking

Why does it matter?

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In the aftermath of the financial crisis, the foundations of several decades of modern and innovative financial systems have suffered serious damage. This has triggered multiple state interventions and led authorities worldwide to revamp the regulatory structures and frameworks. While many voices in academic and policy-making circles have called for a return to more traditional approaches to banking and finance, no one has given attention to the merits of diversity.

Diversity may be perceived by short-sighted financiers as an ideological concept as it is difficult to quantity and thus to quickly extract value from it. But for others, the value of diversity is more than the sum of its parts. The co-existence of diverse and competing elements may serve the same purpose differently, but ultimately the sum may prove to be more beneficial to the economy and the society in the long run.

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 past and new knowledge and by innovation. For competition to work new ideas are 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 and new institutional forms are invented and used to succeed or fail. It is nevertheless challenging to predict what would be the successful financial instruments and institutional forms in the future. It is a process of creative/destructive and dynamic competition that is founded on openness and diversity, which offer an optimal basis for new ideas to come to life and for old ideas to make a come-back.

In the context of banking systems, openness and diversity imply the co-existence of different institutional forms that are made sufficiently strong to withstand the competitive struggle in which different forms of organising banking activities compete with each other.

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

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In Europe, the banking system in several countries resisted the wave towards homogenisation, while adjusting to the new market circumstances to survive the fierce competition. Some systems seem to have weathered the crisis better than others, especially those institutions seeking to provide 'stakeholder value' (STV). In certain countries, primarily Austria, France, Germany and the Netherlands, banking diversity was nurtured in the continuing competitive struggle between shareholder value (SHV) 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.

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

Among the STV institutions, which were first created in the 19th century by well-intentioned people wishing to extend financial services to rural communities, cooperative banks persisted and evolved over a century, despite the general hostility displayed towards these non-listed "*unconventional*" institutions. Although diverse elements exist within the model, its organisational form is unique in some senses. Common characteristics include a membership-driven ownership with one member having one vote, a bottom-up governance approach with a multitude of checks and balances and mutual support, proximity to members-customers which naturally gave them a down-to-earth focus and last but not least retained earnings as the almost exclusive source of capital, which is held by the institution in perpetuity for the benefit of current and future members. At the same time, the competitive struggle drove several institutions to deviate from the traditional cooperative model and to create some hybrid forms to overcome their perceived weaknesses. 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 gives a dividend only if the institution makes a profit.

To benefit from the frenetic race to profits, cooperatives in some countries such as in France also owned non-cooperative entities that specialised in investment banking activities, and 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 crisis. The Italian cooperatives remained unharmed, with high capital positions of more than 8% of Tier 1 ratio, because they resisted the temptation to hold "*once*" highly profitable toxic assets. Equally, the Dutch Rabobank, came through the storm in an even stronger position than before without the support of any public money. 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.

Overall, the crisis was a test for the institutions that were closer to their traditions and core business. 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 performance provides a vivid argument in support of the merits of diversity, analogous to those widely espoused in the world of natural sciences.