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Banks, Business models and Beyond

Coming back to first principles when approaching bank business models

Fundamentally, the business model of a bank is simple: it is about granting credit and collecting deposits. While banks may look very similar to the public (or to their non-bank competitors!), they are in fact not all the same. This is especially the case in Europe, where the economy remains largely funded by a high number of banks which display many combinations of activities, resources, and organisations.

A good match between these three parameters will ensure that a bank strives in the short term (aka "business model viability") as well as in the long term ("sustainability"). This of course matters for its stakeholders and may warrant change over time due to endogenous or exogenous factors. This is also of direct interest for policymakers willing to ensure an adequate flow of funding to the economy through the cycle. For all these reasons banks business models need to be scrutinised individually and collectively, as recommended by EBA guidelines.[1]

The notion of bank business models is commonly used, but what constitutes a model and distinguishes it from another is not easy to define. Most approaches look at the past performance of certain combinations of activities, resources, and organisations (i.e. types of business models), and of shifts thereof. To assign banks to types of business models, academic studies tend to rely on quantitative approaches: applying clustering methodologies to banks' financial accounts and complementing this with judgmental overlays.[2] As an alternative, EBA staff proposed an initial qualitative categorisation of institutions based on supervisory judgment applied at solo level further validated using quantitative indicators.[3] This offers both more granularity in classifying banks and more flexibility for reflecting national specificities.

Along those lines, certain business models may look "more equal than others" depending on the perspective considered. As shown in EBA's 2021 Risk Assessment Report the average RoE of cross-border universal banks was 6.4% against 5.3% only for local universal banks between 2014 and 2021. On the other hand, during the pandemic, local universal banks experienced a lower profitability decline. Cross-border universal banks tend to benefit from higher net interest income (NII) and higher fee and trading income as a share of equity than competitors from other groups. They however display higher operating expenses due to lower economies of scale when operating across

[1] EBA (2014 and 2021), Guidelines on common procedures and methodologies for SREP

[2] Roengpitya et al (2017), Bank business models: popularity and performance, BIS Working papers; Ayadi (2019), Banking Business Models: Definition, Analytical Framework and Financial Stability Assessment.

[3] Cernov, M., and T. Urbano (2018), EBA Staff Papers.

jurisdictions with different rules. Local universal banks tend to have higher impairment costs presumably due to a lesser geographical and product diversification.

The 2021 EU-wide EBA stress-test seemed to confirm these results. In the adverse scenario, geographically diverse banks had lower capital depletions than banks focused on domestic markets, and banks with higher NII had lower capital depletion than other banks.[4]

Academic studies also analyse the effect of business model migration on bank performance. Banks changing business models tend to increase their profitability, stability, and cost efficiency. Interestingly, it is not entirely clear-cut whether underperforming banks are inclined to switch models.[5]

All in all, lessons should be drawn from such analyses but caution is in order. Indeed, the future performance of a bank cannot simply be inferred from the past performance of any peer group. Moreover, bank business models should also be envisaged from the perspective of the important transformations which are currently underway in the banking sector.

A first such trend is that other financing sources than banks have gradually developed in the EU over the past decade. They may expand further as a Capital Markets Union progresses. Innovation in the areas of digital and information technology is a second game changer. “Bigtechs” increasingly leverage their client databases and IT systems to offer some the financial services which used to be provided by banks. Together with “fintechs”, they are now key components of a banking value chain which so far had been fully integrated by banks. Lastly, the necessary ESG transition will directly affect banks’ activities, resources, and organisations.

Even if these developments suggest a regime change, they do not necessarily mean that “this time is different.” They may simply require looking at bank business models through the prism of first principles: what are banks supposed to provide, whatever the forms they may have taken over time?

Against that backdrop, a viable and sustainable bank business model should meet the three criteria which are at the core of financial intermediation: ensuring a “delegated monitoring” of lenders and borrowers, which requires having better information than the market; providing them liquidity through the cycle (transforming risks, durations, currencies…), which requires having sophisticated risk management and sustainable funding; and performing these critical functions efficiently, which requires reaping economies of scale and scope. The latter does not necessarily mean bigger balance sheet anymore.

[4] EBA (2021), 2021 EU-wide stress test – Results.

[5] BIS (2017); Ayadi et al. (2020), Bank Business Model Migrations: determinants and effects, British Journal of Management.