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Parallel banking system: Opportunities and Challenges

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Abstract

The main aim of this article is to explicitly present what the parallel banking system is and its activities. The first part of the paper focuses on how this banking system could support real economy and contribute to the regional (and the wider) growth by operating supplementary to the systemic banking system. A special reference is done on the regulation frameworks that are applied on those banks in European Union and in United States. At this point, it is underlined the importance of the appropriate implementation of the proportionality principle by regulators so as to avoid the excessive burden of small regional banks with unnecessary regulation costs. Challenges that local banks may face during their operation and factors that affect the health of regional and cooperative banks are pointed out, as well. They are also presented significant sources of finance from which community banks may raise capital to fund their activities. Moreover, possible strategies that local banks may follow in order to improve their efficiency and strengthen their role in the banking system are proposed. Finally, the relation between regional and cooperative banks with public development banks is set under consideration and their differentiations and their common goals are highlighted.

JEL classification numbers: G20, G21, G23, G24, G28, G29, P51
Keywords: parallel banking system, regional banks, community banks, cooperative banks, development banks, regional growth, proportionality principle, one-size-fits-all rule, dual-regulatory system, allfinanz.

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1 Introduction

After an eight-year period of deep and prolonged recession (2008-2016), European economy starts to grow again. European governments are planning various growth strategies in order to support their people and make their economies strong again. The banking sector may decisively contribute to this difficult effort to pass from a long-term recession to growth e.g. by expanding the credit to households and enterprises or by participating to the funding of great growth projects. However, the difficult economic conditions do not always permit to large systemic banks to play an essential development role. The weaknesses of the central banking system could be mitigated by the establishment of a *parallel banking system* consisting by regional and cooperative banks and public development banks. There are many studies and analyses such that of Hakenes, Iftekhar, Molyneux and Xie (2015), Groeneveld (2017), Castelló, Trias and Arribas (2018) that show the importance of this parallel banking system for real economy.

A first key reason that makes the establishment of regional and cooperative financial institutions necessary is the *funding gaps* resulting by the systemically important commercial banks' inability to finance important social projects and vulnerable groups of population such as small entrepreneurs and households. During the recent financial crisis, the quality and the quantity of the systemic credit institutions' assets considerably deteriorated, reducing the total value of their portfolios. The volume of non-performing loans increased dangerously, leading banks to restructuring, settlements, loan sales and debt write-offs reducing further the value of their portfolios. In addition, the loose lending standards in the recent past in combination with the augmented risk-taking by commercial banks, led banks to impose stricter credit criteria (see Committee on the Global Financial System (2018) - CGFS Paper No60 among others). The stricter lending criteria, the decline of banks' asset value and the more severe capital requirements by regulatory authorities (in order to avoid a new financial crisis) dramatically reduced the systemically important banks' ability to provide loans with a direct negative impact on growth.

The intense *pro-cyclical nature of the private financial system*, characterized by excessive borrowing during periods of expansion (growth) and limited borrowing during recession periods, is another factor that makes the existence of regional and cooperative financial institutions essential. This pro-cyclical nature of demand for banks drives to rejection or to inadequate funding of projects with long-term social benefits such as environmental projects, infrastructure projects etc., especially in less developed regions. Moreover, the lending demand by households, small and medium-sized enterprises, young farmers and new potential entrepreneurs is not fully covered by lending supply of large private banks with significant negative consequences on people's welfare.

The small and medium-sized enterprises, including small family businesses, are directly affected by the limited funding activity of private banks. *Small and medium-sized enterprises (SMEs)* are the backbone of the European economy. In the European Union, SMEs account for 99.8% of non-financial businesses, 66.9% of the total workforce and 57.8% of total value added (see Lang, Signore, Gvetadze (2016) among others). The financial aid to small and medium-sized enterprises is essential for productive growth, job creation, poverty reduction and income support. Nonetheless, SMEs and startups often face serious difficulties in accessing finance. Large banks tend to allocate smaller shares of their assets on lending small and medium-sized businesses due to their increased credit risk and the problem of asymmetry of information in lender-borrower relationship. Information of local businesses is mainly integrated in local economy, a fact that gives to local lenders which have a more complete picture about local businesses, a strong advantage over the large systemic banks.

Apart from households and small and medium-sized enterprises, this limited funding activity of commercial banks may *deprive vital projects with significant socio-economic benefits* from the citizens of a region. Such projects are environmental projects, infrastructure projects, research and innovation (R&I) projects that however require a large initial investment, have a long-term horizon and involve high risk of failure. For these reasons, such projects are not desirable for financing by private sector and private banks that are more interested for less risky projects with short-term profits. A characteristic example is the projects for combating climate change and promoting renewable sources of energy that have important social benefits (much higher than private profits) and fully meet the goal of sustainable green growth, but they are not usually adequately financed because of their long-term nature and the high failure probability.

Another key factor that highlights the importance of regional and cooperative credit institutions is the *significant shrinking of the banking sector* across Europe (see Quarles (2018) among others). For example, in Greece the number of domestic credit institutions declined drastically from 35 in 2009 to 17 in 2017, eight of which are commercial and nine cooperative. Of the eight commercial banks, four are considered "systemically important" and control 96% of bank assets. In addition, the number of branches has decreased by 46% since 2010 and the number of employees by 34% (see European Banking Federation (2018)) and a further reduction follows. Nowadays, banks *tend to become larger* in order to become stronger, cut costs and take advantage by economies of scale, but also motivated by "too-big-to-fail" incentives (a large bank is more protected by a possible bankruptcy since its failure may cause instability of a whole financial system and thus it has the incentive to undertake greater risks in order to have greater returns). This banks’ tendency to become larger in combination with the significant shrinking of the banking sector has a *direct negative impact on customer service*, especially for customers who prefer to have a personal contact with the bank with which they collaborate and for people who live in remote areas. The establishment of regional and cooperative financial institutions, especially in less developed areas, could help in this direction. On the other hand, the fact that large and complex banks exploited the financial security networks and threatened entire economies in combination with the extensive rescue of large banks during the recent financial crisis intensified analysts' attention to the role of small banks in local economies.

The *technological advancement* and the invasion of *e-banking* in people lives may make the access to banking services even harder for customers, especially for older people who are not familiar with new technologies and e-banking. Regional and cooperative banks may facilitate the access to banking services for those people through personal relationships with their customers on which local banks are specialized.

After that, the concentration of banks in few financial centers has significantly increased the *complexity of the banking system* and the operational distance between the location of the lending strategy of banks and their local branches. This concentration of banks in large financial centers deprives important financial sources by local economies, especially in less developed regions. The situation in poor regions becomes harder if one takes into account that those areas are less attractive for foreign investment and large banks. Thus, in an economically integrated market there are strong outflows of funds from poor to wealthy regions deteriorating further the economic situation of the poor regions. These distortions could be reduced by regional financial institutions that serve less developed areas limiting their serious financing problems.

Finally, the *diversity of the financial system* with commercial and investment banks, saving banks, regional and cooperative banks, non-bank financing mechanisms, FinTech companies, etc. contributes to its stability and efficient operation, but also to the proper function of competition. Limiting the banking system's biodiversity, the banking industry becomes vulnerable to shocks that would affect all banks in the same way and at the same extent (due to the excessive bank uniformity). Banks of different sizes and activities contribute to the *diversification of the banking sector* and the building of a healthy economy. Therefore, the existence and the effective operation of local banks (regional and cooperative) are also essential for the health of the financial system (see Hesse and Čihák (2007), Ayadi, Llewellyn, Schmidt, Arbak, de Groen (2010), Committee on the Global Financial System (2018)-CGFS Paper No60).

2 Preliminary Notes

2.1 Definition and Characteristics of Regional and Cooperative banks

There is not a unique definition for *regional banks*. Typically, regional banks are defined on the basis of their two main features: they are small in size and they are mainly active in the area where they are located. So, a regional bank can be defined as a financial institution with total assets of less than $1 billion that is mainly active in a particular region (see Keeton, Kahn, Schroeder, Weiner (2003) among others). Others define regional banks on the basis on what they are not i.e. they are not "too big to fail". Cleveland's Federal Reserve Bank defines regional banks as companies with assets between $10 billion and $50 billion (see Balasubramanyan, Haubrich, Jenkins and Wallman (2013)). In general, regional banks are differentiated in terms of *size*, *type of market* they serve and *complexity*. Thus, they may be large or small banks, urban or rural, focused on traditional banking products and/or more complex products and services.

On the other hand, *cooperative banks* are private financial institutions that operate under full banking license and they are governed by their members (see Groeneveld (2014, 2015, 2015a, 2015b) among others). Their members are at the same time owners (with relatively small investments), customers, supervisors and stakeholders, with direct or indirect representation at all levels of government. The main objective of cooperative banks is to maximize the wealth of their members/clients. The profit maximization is not their ultimate goal. However, it is necessary for these banks to stay profitable so as to have the ability for capital accumulation, absorption of disruptions, innovation, growth and investments, and mainly to fulfill their social and community commitments.

According to the European Cooperative Banking Association (EACB), the cooperative banking model has the following core values: *accountability, transparency, resilience, proximity, social commitment and solidarity* (see Castelló, Trias, Arribas (2018), EACB (2010), EACB (2016) among others). EACB (2010) adds to the core values the fight against exclusion, the social and environmental concern, the trust and the good governance so as to give a more complete picture of the cooperative banks' commitment to *social responsibility*. Local cooperative banks are usually active in a particular region and thus achieve a high degree of proximity to their customers, especially in remote, small rural areas. Cooperative banks trying to enforce the relationship with their clients and to stay focused on their commitment to promote the socio-economic development, they keep a relatively high number of branches and workers that are quite costly to be maintained. Concerning the governance, Fonteyne (2007) (among other studies) concludes that cooperative banks follow a democratic system based on a widespread participation of their members in decision-making processes. Members or their representatives determine to a large extent the strategic plan of the organization, based on the "one member – one vote" principle, according to which all members have equal voting rights irrespective of the amount of their shares.

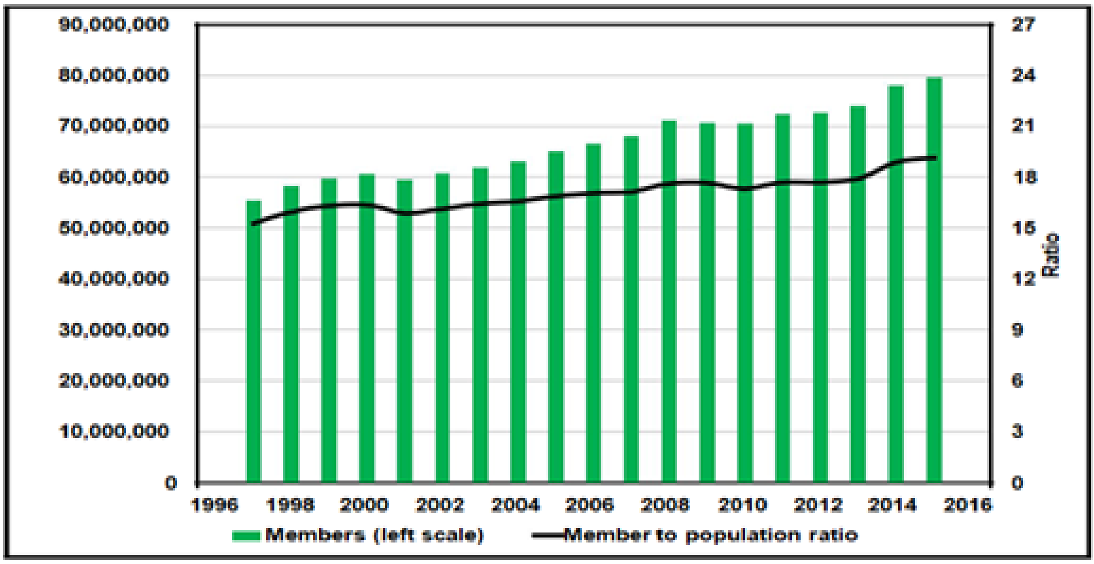
The main mission of regional and cooperative banks is to provide *retail banking* *services* to their members/customers who are usually households, private entrepreneurs and local SMEs. Retail banking activities focus on lending to small and micro businesses through venture capital, offering deposit services, providing various types of guarantees, facilitating access to finance and payment services for their members, financing the agricultural sector, providing simple insurance products, offering (free) financial services. Although local banks tend to expand their activities beyond traditional retail banking, this expansion respects their core values and corporate governance rules.

These banks are among the market leaders of *financial products of social responsibility* (SRI). They are subject to the *regional principle* and therefore do not compete with each other (see Dombret (2017) among others). Choulet (2016) gives a typical example of savings banks that follow the regional principle; that is the German Sparkassen. Those savings banks are mainly active in their region and they do not compete with savings banks of other regions. Apart from this regional focus, their activities do not differ significantly from those of private commercial banks. Transparency, good governance, social responsibility, ethical behavior and capital adequacy are the priorities of these banks.

2.2 The presence of Regional and Cooperative banks in banking systems

Regional banks play an essential role in many European banking systems such that of Austria, Belgium, France, Italy, Portugal, Spain, Sweden and Germany that has a very strong local banking sector (Sparkassen-Finanzgruppe). The United States' banking system also contains a large number of small banks closely linked to local communities. These banks provide a range of financial products and services to a wide range of clients and business sectors such as small and medium-sized businesses.

On the other hand, cooperative banks serve more than 159 million customers today in Europe (see Groeneveld (2017) among others). The increase in their membership exceeds systematically the population growth. This clearly shows the increasing popularity and confidence of customers to the cooperative banking model. Cooperative banks succeeded to regain customers' confidence and attract new members with specialized products and services, conservative risk management and banking models that put members and customers at the heart of the business.

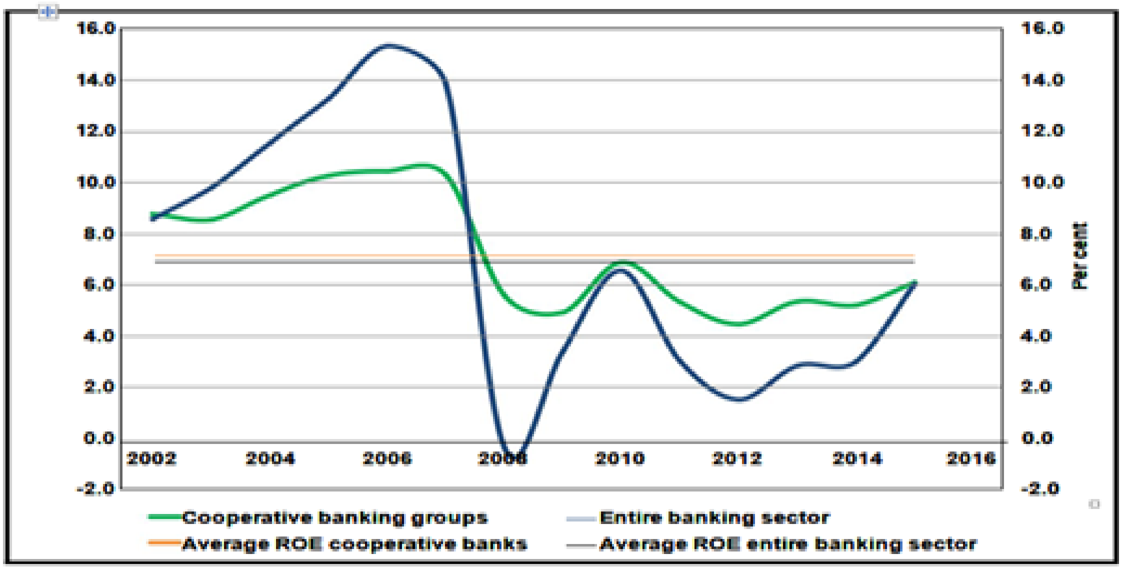


Source: Calculations by TIAS based on data from co-operative banking groups and national demographic statistics.

Figure 1: Numbers of cooperative banks' members and member to population ratio

The *market shares* of *deposits and loans* of regional and cooperative banks have also increased significantly in recent years and remain significantly more stable than other retail banks. More specifically, in Europe, cooperative banks hold about 26% of the deposit market and finance 29% of loans to small and medium-sized enterprises (see Groeneveld (2017), Castelló, Trias, Arribas (2018)).

On the other hand, a major challenge for commercial banks is to increase their *profitability* in a low interest rate environment with increased capital requirements (Basel III) and increasing competition (see Committee on the Global Financial System (2018) - CGFS Paper No61, Gros (2018) among others). Return on equity (ROE), a key indicator for assessing the attractiveness of the banking sector for investors, appears to recover slowly and steadily for all banks. However, in the long run, regional and cooperative banks tend to be more profitable than the broader banking sector with a ROE pursuing a steady course over a long period. This is partly explained by the fact that these banks focus on retail banking activities characterized by relatively stable revenues and a moderate risk profile that contributes to their structural stability. Concerning profitability, Groeneveld (2017) and Ayadi, Llewellyn, Schmidt, Arbak, de Groen (2010) observe that local banks appear to be (on average) more *efficient* than the broader banking sector, in terms of cost-income ratio. Mergers between local banks and great cuts in their operating costs could partly explain this improvement in cost effectiveness.



Source: calculations by TIAS based on data from co-operative banking groups, national supervisory authorities, the ECB, and World Bank.

Figure 2: Return on equity (ROE) of cooperative banking groups and entire banking sector and their averages

In general, the low level of risk taking, the long-term orientation of their activities, the high capital reserves because of their local activity and their stable income contribute to the flexibility of regional and cooperative banks to get adapted more easily to changing circumstances, making them more resilient to financial crises. Moreover, the low risk-taking by regional and cooperative banks may also contribute to the stability of the financial system and drive to high local economic growth rates giving to local banks the flexibility to look for business opportunities and fund the real economy.

2.3 Basic sources of finance for Regional and Cooperative banks

Cooperative and regional banks as financial firms aim at economic success and profitability, but always giving priority to *socially responsible investment* (SRIs). There are various sources from which banks may obtain funds to support such investments with immediate socio-economic benefits for the local community. Fundamental sources of funding for local banks are the retail deposits of their clients-members, the retaining earnings and the equity (see European Bank for Reconstruction and Development (2018)). *Core deposits* are a relatively stable source of funding that provides access to cheap client funds leading to a favorable asset refinancing base.

Despite the stability of retail deposits as a source of funding, a bank must also have alternative ways to raise capital since always exists the risk of a "deposit gap" (the demand for deposits exceeds the offer) or a mass withdrawal of deposits. The differentiation of funding is an important risk management tool for local banks. To limit the dependence on core deposits, cooperative banks can initially address to their *Network Central Institution* (NCI). The central institution has the role of an internal central bank i.e. an intermediary that ensures liquidity within the network and supervises its members. Other common sources of finance are the *debt* i.e. borrowing from interbank market or other credit institutions, the *wholesale deposits*, the *bonds* (covered or not) negotiable in private national or global capital markets and the *share capital* i.e. common and preferred shares (see European Bank for Reconstruction and Development (2018) among others). Finally, banks can access to capital through financial markets such as the Regional and Community Bank Stocks.

The cooperative and regional banking was recently completed by non-banking sources of finance such as the *crowdfunding* i.e. a group of people pool their funds (usually online) to support a company, that is a particularly popular source of finance for companies wishing to raise small amounts of share capital. In the same direction is the *equity crowdfunding* through which small businesses, usually start-ups, can sell a small percentage of their share capital. The *general solicitation* can also help banks raising capital by advertising its intention for recapitalization through mass newsletters, emails, conferences, advertisements in newspapers, social media, the bank's website etc. aiming to attract a wider group of potential investors and companies that may be interested to invest in this project. As Murphy and York (2018) note in their study, the general solicitation and the crowdfunding are two quite useful tools for small businesses and community banks to approach a multitude of potential investors that otherwise could not get informed about bank's operations.

Funds can also be raised through *grants and sponsorships*. The state also offers a wide range of *Public Aid means* e.g. capital grants, interest and tax reliefs to help new businesses and small local banks to finance their projects. Stovall and Vanderpool (2018) in their analysis for S&P Global Market Intelligence, underline that in US a tax reform for supporting community banks led to a direct raising capital and a significant increase of profits. Domestic and foreign capital can be also mobilized through *co-financing* under which a regional bank may finance a part of a project and the co-financing bodies such as commercial banks, governmental agencies, international financial institutions such as the International Finance Corporation and the World Bank may contribute the rest of the project by providing loans and equity, export credits, guarantees, political risk collateral and grants (see European Bank for Reconstruction and Development (2013)).

For lending small and medium-sized businesses, local banks are mainly relied on the retail deposits of their customers/members. *Microfinance Institutions* and *Business Angels* can also contribute in the creation or the development of a small business, by raising funds or offering (free) financial and support services. Two types of capital that are usually used for funding SMEs are the *venture capital*, especially suitable for highly innovative businesses, and the *mezzanine capital* that is an hybrid source of funding between equity and capital, quite useful for startups. At the European level, cooperative banks can also be favored by *EREM CBSI*, a tool offered by the EIB Group (European Investment Bank and European Investment Fund) to financial intermediaries, with an emphasis on cooperative banks, in order to diversify their funding base and increase the number of small and medium-sized businesses that they can finance, contributing in this way to the limitation of the funding gap for SMEs (see Lang, Signore, Gvetadze (2016)).

2.4 Factors that affect the health of Regional and Cooperative banks

Local economic conditions is a first factor that affect banks' health with smaller regional banks (up to $10 billion in assets) to be more influenced by a bad economic situation because of their local nature. Additionally, the *lack of maturity mismatches* on a bank's balance sheet and the *wide spread of yields* may also be a signal of a healthy bank. The changes in the yield curve of large regional banks and the wide spread of their yields give a picture of their health. Healthy regional banks also share *a high return on assets* (ROA) and a *heavier reliance on "hot" money* (investment funds intended for the highest short-term rate of return); but large concentrations of hot money wouldn't describe a strong bank. Healthy banks also share *higher expense ratios* in the sense that they wisely spend high amounts on quality employees and efficient systems. On the other hand, a *runaway spending* may be a cause of failure; that' why regional banks must be careful on their expenses. Finally, regional banks located in *states strongly beaten by the crisis*, with high unemployment rates, the portfolios of which present a *high concentration in commercial real estate* can also be considered as unhealthy.

A basic *bank-rating system* that classifies a bank as healthy (or not) is the CAMELS system (see Balasubramanyan, Haubrich, Jenkins and Wallman (2013)):

(C) Capital adequacy
(A) Asset quality
(M) Management
(E) Earnings
(L) Liquidity
(S) Sensitivity to market risk

A high score at the CAMELS rating system equals a healthy bank.

2.5 Regulatory framework for Regional and Cooperative banks

The regulatory framework that is currently applied for all banks in European Union is the *Basel III* (see Basel Committee on Banking Supervision (2014, 2017, 2018)). Basel III is a stricter version of Basel II in terms of capital requirements that additionally introduces non-credit risk requirements such as minimum leverage and liquidity ratios to adequately cover any possible risk (especially liquidity risk) and ensure financial stability. Basel III treats all banks virtually the same. Analyses such that of Alessandrini, Fratianni, Papi and Zazzaro (2016) and that of Bank Governance Leadership Network (2016) observe that the European Central Bank (ECB) as the principal Banking Supervisor applies the *"one-size-fits-all" rule* which practically means that all banks (local and non-local) are subject to the same regulatory framework with no differentiation according to their size, organizational structure, complexity, riskiness, type of intermediation, customer portfolio and regional development. On the positive side, this regulation framework provides the appropriate risk coverage, stimulates organizational changes and gives emphasis to financial stability i.e. ensure that financial institutions (of any size) have sufficient capital to absorb losses and continue their operation during times of adverse economic conditions. On the negative side, this regulation reduces functional flexibility of bank activity and it is unfriendly to local banks; the burden of this regulatory system is asymmetric and penalizing for small banks due to the absence of the proportionality principle i.e. differentiation of the regulatory system according to the type of bank.

On the other hand, in United States the regulation framework is a *dual-regulatory system*. According to this framework, a strict set of regulatory guidelines is applied to large systemic banks that are more dangerous for the financial stability (*Advanced Approaches Banks*) and a less rigorous set of rules with looser controls and lower risk weighting is applied to small community banks the systemic risk of which is much lower than that of the large complex financial institutions. The Federal Reserve focuses on the *"right-sizing" supervision* (see Balasubramanyan, Haubrich, Jenkins and Wallman (2013) among others). The goal is to develop multiple state-of-the-art approaches appropriate for each type of institution. The Board tries to help community banks by eliminating requirements that are relevant only to large, geographically diversified banks e.g. by allowing small, non-complex banking institutions to temporarily operate with high levels of debt (while the Federal Reserve Board generally discourages the use of debt by bank holding companies to finance acquisitions), by exempting them from the Board's risk-based and leverage capital guidelines and by eliminating costly regulatory reporting requirements. Regional banking organizations can perform their own stress tests and evaluate their safety based on company's individual circumstances.

Bernanke (2012), Powell (2015), Yellen (2016) among others note that the aim of the United States regulatory framework is to ensure the financial stability but eliminating the unnecessary costs for the banks. In 2013, regulators developed a community bank guide which outlined the relevant provisions for smaller, noncomplex institutions, compared the new requirements to the previous standards (*New Capital Rule - Community Bank Guide*). The new rule takes important steps toward improving the quality and increasing the quantity of capital for all banks, including small, non-complex community banking organizations, and tries to minimize the potential burden of these changes for establishing a robust and comprehensive capital framework (see Board of Governors of the Federal Reserve System (2013) among others). Moreover, two programs “Ask the Fed” and “Outlook Live” and a new Community Banking Connection website contribute to the effort to improve the communication with community bankers (see Bernanke (2012) among others). These sources of information focus on safety-and-soundness issues that are of practical interest to community bankers and bank board members.

As pointed out, the biodiversity of the financial system contributes to its stability and efficiency. Thus, the existence and the effective operation of local banks are particularly important for the health of the financial system. However, the diversity of a banking system is not protected by considering small and local banks as financial institutions without any risk. There must be a regulation for all banks, systemic and non-systemic, especially nowadays since banks are expanding their operations to markets with high risks. As Committee on the Global Financial System (2018) underlines the recent recession made clear that strong capital positions are necessary for the survival of banks of all sizes. Regulators in order to prevent a possible extreme risk-taking by commercial banks, which could set in danger a whole financial system, imposed additional capital requirements that however limit banks’ profitability.

Without any *regulatory flexibility*, cooperative and regional banks are at risk of becoming too small to survive under the proportionally higher regulatory compliance costs (in comparison with the large banks). Moreover, the increasing competition with various types of financial institutions may oblige local retail banks to turn into commercial financial institutions losing their special nature and depriving the local community by an important social good. The aim of the regulators should not be to treat equally all financial institutions but to equally treat the risks that banks are forced to deal with. (see Groeneveld (2014, 2015) and Stiroh (2018) among others underline that the right implementation of the *principle of proportionality* by supervisors in banks’ regulation, especially in European banking system, becomes crucial for the survival of small local banks. This principle has to do with the proportional implementation of the regulation (especially the rules relating to the capital requirements) according to the size, the scale and the nature of operations of a financial institution, as well as the nature, the scale and the complexity of the risks associated with its business model and its activities. Strict rules must be imposed to global and complex banking institutions that operate internationally, less strict but rigorous requirements must be applied to pan-European banks that undertake complex banking operations and more flexible requirements to local banks whose systemic risk is clearly more limited than that of large international banks.

In the above should be added that cooperative and regional banks are *relatively stable banks* with strong capital reserves and stable incomes. Based on the financial ratios, cooperative and regional banks are generally well-capitalized banks with an average Tier 1 ratio higher than that of the wider banking sector (see EACB (2010), Groeneveld (2017)). Very good credit ratings (AA and AAA for the largest cooperative groups in Western Europe) reflect, among others, this adequacy of capital.

In the implementation of the principles of the regulatory framework, the *regional dimension* of these banks should be taken into account, as well (see Powell (2015) among others). The risk of their activities and their investment opportunities vary from region to region with banks in less developed areas being heavily burdened. Therefore, the uniform enforcement of capital requirements and regulation rules across all banks contributes to the further strengthening of regional disparities and deepens the inequality among local banks.

In practice, the greatest difficulty that regional and cooperative banks are forced to deal with (in addition to the great capital requirements) is the *complexity of regulatory framework rules* (see Alessandrini, Fratianni, Papi, Zazzaro (2016) among others). Basel III is a complex set of regulation rules, the implementation of which requires high costs for banks especially the small local banks limiting the flexibility of their banking activity. One of the main objectives of the European Banking Authority is to simplify the information process setting clear standards and reducing the compliance costs for banks.

3 Main Results: Basic Roles of the Parallel Banking System, Opportunities and Challenges for Regional and Cooperative banks

3.1 The role of Regional and Cooperative banks for local and wider economic growth

The main contribution of regional and cooperative banks to the total economy is to cover the financial gaps and the weaknesses of the systemic banking system. Local banks are not competitive but they operate supplementary to big systemic banks by supporting remote and rural areas and smaller markets that are not served by large banks. One of the main priorities of local banks is to *stay close to the real economy of a specific region* by offering a wide range of financial products and services (free of charge in some cases), creating in this way stability and wealth in the area.

Both regional and cooperative banks have *a high degree of proximity to their clients*. Their social commitment sets the customer as a priority. Because of their activity in specific regions, they stay close to the local community and they are able to have a deep knowledge of local industries and businesses. The advantage of local knowledge limits the problem of asymmetry of information, inherent in lender-borrower relationships, and gives them the opportunity to offer more specialized products and services corresponding to the needs of their clients. These financial institutions are the most appropriate to deal with economic problems that require close local monitoring and coordination and they are clearly preferred by customers who give great importance to personal contact and long-term relationships with the bank with which they collaborate (see Hinds (2002) among others). The cooperative banks' wide networks often make them the main employers and taxpayers in their regions.

Studies such those of Berger, Iftekhar and Klapper (2004) and Belke, Haskamp and Setzer (2016) highlight the *positive impact of regional banks on local and wider economic growth of a country*. Emphasis is given by these banks to infrastructure and innovation projects with a regional dimension, to projects against climate change ("green" projects) and to projects for promoting entrepreneurship, restructuring viable businesses and supporting start-ups. Strahan and Weston (1998) and Brainard (2015) among others, underline that local banks are key financial intermediaries for *small and medium-sized enterprises' (SMEs) lending*, with an emphasis on micro-enterprises. Small regional banks can reduce funding constraints for SMEs through credit expansion and support them by creating special programs for small and new professionals e.g. customer training for better financial management. Except SMEs' funding, many European cooperative banks such as Grupo Cooperativo Cajamar, Ecology Building Society, Crédit Mutuel, Crédit Agricole, Rabobank are also actively involved in *environmental projects* with subjects as the alternative and renewable energy sources, reduction of carbon emissions, creation of environmental infrastructure, efficient waste management, support of the rural economy (especially rural community banks) and protection of biodiversity. For these purposes, cooperative banks provide loans in favorable terms, motivate for new sustainable and environmental friendly buildings, give housing insurance for renewable energy installations e.g. solar panels, issue green bonds, e.g. Amundi Green Bonds, as an investment solution in the field of energy and climate change, participate in agricultural derivatives, develop methods for the estimation of environmental and economic risks while they play a key role in mobilizing donations and grants for socially responsible actions (see EACB (2017) among others).

Hinds (2002) in his study notes that regional and cooperative banks may also contribute to the mitigation of the *pro-cyclical behavior of private sources of finance*, to the extent that their limited resources allow. The credit expansion of these institutions is moderate in good times and higher during recession periods.

This counter-cyclical behavior offers to the local (and the wider) economy the possibility to finance important projects and groups of population who face great difficulties in accessing finance. Regional banks may also reverse the *strong capital outflows* from poor and less developed regions to economically strong areas by offering external financing to a wide spread of socially responsible projects and by helping less favored areas to attract interregional funding for their actions.

Goodfriend (2000) in his study underlines that regional banks may play an important role in a *system of central banks*, as well, especially in monetary zones such as the Eurozone and the Federal Reserve System. The decentralization enhances credibility and encourages innovative thinking of banks. The collaboration of a central bank as ECB with regional banks may facilitate the communication of its policy message and the collection of specialized information about local economies. Moreover, it enforces and extends the possibility of a central bank to provide emergency credit to financial institutions that need liquidity. The differentiation within a central bank system also offers an extend variety of policy perspectives for banks that is quite important in a complex economy.

Finally, regional and cooperative banks can play an important role in *preventing and dealing with financial crises* (see Hinds (2002) among others). The development of domestic financial markets within which Member States can use their own savings to finance development goals, reducing in this way their dependence on financial development institutions, and the facilitation of Member States to access international financial markets, contributes in this the direction. Local financial institutions are able to provide significant liquidity during a financial crisis and when short-term and low interest rate liquidity issues arise but also contribute in attracting funds from the private sector and offering credit lines to protect countries from unforeseen events (see Craig, Fecht, Tümer-Alka (2015) among others). When a situation of global destabilization arises, local banks may provide fast credit to countries and increase their share in credit co-financing (and reduce it in periods of global expansion).

3.2 Future Challenges for Regional and Cooperative banks

The banking industry is constantly changing. Banks must be able to quickly and effectively respond to a series of emerging challenges that may be complex and quite costly for small regional banks, especially those located in less developed regions. *Operational issues* may be proved quite demanding for small banks. The finding and the keeping of the appropriate qualified staff, such as quantitative analysts and modeling experts, that will run the banking processes in the most efficient way is not an easy task when bank's recourses are limited. The risk management process and the required specialized analyses are also challenging especially for small local banks because of their cost and their complexity.

Except the operational issues, the *growing competition* with the large banking institutions that offer a wide range of financial services and products, the capital markets, the new types of businesses such as FinTech, shadow banking institutions, the emerging digital players and the technology giants such as Google, Apple, Facebook, and Amazon that offer digital services with high added value, may also put a great pressure on small regional banks and eventually lead them out of the market (see Stiroh (2018) among others).

Additionally, the *technological progress* and the *rapid progress of e-banking* may lead to a significant decline of demand for banking services based on personal relationships on which regional banks are specialized. Small local banks are called to bear the cost of the digitization of products and services that may hurt significantly their profitability. Powell (2015) among others notes that new technologies are quite complex for small local banks and they are related to high risks as the *cyber-security risk*. The cyber-threat is probably one of the most severe risks with which all financial institutions, from systemically important to small regional institutions, have to deal. However, dealing with this risk is quite complex and costly.

Regional banks, in order to correspond to the growing competition and the emerging technological challenges, *expand their activities* from traditional banking products to more advanced specialized services and products such as prepaid cards or credit card add-ons which are often related to higher risks. Community banks that do not have sufficient experience on such complex and difficult-to-understand products and they are not always familiar with the risks related to these products, may have problem in monitoring their performance putting in danger the stability of a whole financial system.

The *bad economic environment* also plays an important role in the profitability of small local banks. Committee on the Global Financial System (2018- CGFS Paper No61) underline that in a very low-interest environment with weak economic recovery rate, the net interest margins, and thus the profitability, of local banks may be significantly reduced. The quality of assets and loans in banks' portfolios may be also remarkably deteriorated in times of adverse economic conditions, according to their lending activity. The "bad" economic environment and the new banking regulation rules, the additional required guarantees and the increased capital requirements of Basel III, put significant burden on regional banks with limited resources reducing further their profitability, with regional banks in less developed areas to be more affected (see Alessandrini, Fratianni, Papi, Zazzaro (2016) among others).

Another issue related to small local and regional banks is the *insufficient diversification* of their portfolios (see Stiroh (2004), Wheelock and Wilson (2012)). A common view in banking cycles is that only very large and well diversified banks will survive and grow in this competitive environment where economies of scale appear to be increasingly important. On the other hand, it must be taken into account that the success of a bank is mainly determined by the efficiency of its internal management, the continuous monitoring of its loans and its ability to improve its resilience under unfavorable economic conditions and not by the implementation of a specific diversification - size strategy.

3.3 Possible Strategies for Regional and Cooperative banks that may enforce their role in banking system

Regional and cooperative banks must have a *clear business strategy* that gives emphasis to their advantages in order to stay competitive and viable. They must be oriented to mainly operate in markets where they have a sustainable competitive advantage and expertise in relation to the systemic banking system. Tetangco (2016), Espenilla (2018), Quarles (2018) are referred to the role of rural banks in real economy; such banks could enforce their potential by expanding to new markets or serve old markets in new ways. This may unlock funding sources at all levels of activation, from production to marketing. In this way, they will be able to fulfill their goals and support the local society and the real economy of a specific region more effectively. In general, some key strategies that could be incorporated into regional and cooperative banks' business model in order to deal with volatility, uncertainty and ambiguity that may arise because of various legal, economic, social and technological factors are the following.

Firstly, local banks must maintain and improve their *retail banking services* so as to be consistent with their key role as funders of the real economy. Along with these retail banking activities, cooperative banks can follow more strongly the *"allfinanz" strategy* according to which they provide a full range of financial services (credit, deposits, insurances and investment services) to both private and corporate clients so as to attract more customers and to achieve multi-product sales, as Rabobank cooperative group in Netherlands (see Groeneveld and Sjauw-Koen-Fa (2009)).

Local banks must also deal with the increasing competition and the evolution of technology. For these purposes, they must adequately invest in *technological innovation* and *human resources*. The investment in staff training, especially for executives, in order to amplify their professionalism in combination with the digitalization of various banking products and services will substantially contribute to attract customers, increase their client base and reduce operating costs. As e-banking services become more complex, regional and cooperative banks are also called to strengthen their internal risk management systems taking into account additional non-financial criteria.

Mergers and *extroversion* are two of the most important strategies that should be adopted by regional and cooperative banks in order to remain competitive. As regards *mergers*, the European Union strongly supports the integration of smaller banks into the European banking sector and the creation of larger, stronger banks. Europe's co-operative banking sector has already reduced its branches by around 3.3% and bank employees by around 4.6%, in recent years (see Castelló, Trias, Arribas (2018), European Banking Federation (2018)). Some of the most important competitive advantages resulting from this consolidation process are the strengthening of the banking operations in a transparent and efficient network, the more efficient allocation of available resources, a cost reduction through synergies and economies of scale, the guarantee of financial stability, the reinforcement of banks' profitability, the access to international markets under better conditions, and the support of growth in a highly competitive retail banking environment (see Llewellyn, Ortner, Stepic, Zapotocky (2002) among others). On the other hand, the merging process results the significant reduction of the number of the local branch networks with a direct negative impact on the customer service and the personal relationship of a bank with its clients, job losses and lack of funding for households and small and medium-sized enterprises since local banks are one of their major funders. Thus, local bank mergers must be done in a way that won't hurt their special nature and emphasize their competitive advantages to support the local society and the real economy. The weakening of local banks would lead to the weakening of an important social asset of the local society with direct negative effects on the socio-economic growth of the region.

Concerning *extroversion*, small and regional banks should adopt a clear expansion strategy in national and especially in international markets from which they could get significant benefits. Such benefits are the more effective risk distribution, the diffusion of knowledge and of best practices among banks, the attraction of foreign capital, the increase of demand for traditional and new banking products that may lead banks to significantly improve their efficiency to meet this growing demand, and the significant increase of the number of clients to which a financial institution will have access strengthening in this way its position in a wider network.

In short, the strategic orientations of regional and cooperative banks for the following years should focus on enhancing the mutual coexistence within the wider banking sector, decompressing the regulatory and supervisory pressure and strengthening their special characteristics such as the close relationships with their customers and their strong commitment to the regional long-term economic growth (see Belke, Haskamp and Setzer (2016), Berger, Iftekhar and Klapper (2004) among others).

3.4 Relation between Regional and Cooperative banks with Public Development banks

The role of regional banks in a country can be strengthened by a *Development Bank*. Development banks mainly focus on *productive lending activities*, confirming their role as supporters of socio-economic growth and of regional integration. Public development banks can be seen as an important source of "patient capital". They provide or facilitate the financing of long-term investment projects that create important positive social externalities and they contribute to the reduction of poverty. Such long-term projects are the Research and Development (R&D) projects, the infrastructure projects, the projects that have to do with the reduction of carbon emissions in order to combat climate change and to promote environmental sustainability. Public development banks also try to *cover the gaps* in small and medium-sized enterprises' funding e.g. by facilitating their lending at relatively low interest rates or/and by providing the necessary guarantees. At the same time, development banks act as a stable source of funding (without great fluctuations) for real economy stabilization, business cycle normalization and for avoidance of a deepening of a financial crisis.

Public development banks operate more as development institutions than as typical banking institutions in the sense that they do not usually receive deposits from the public and act as second-tier lenders i.e. they do not directly lend an enterprise or a household but they usually lend other financial institutions and banks that in their turn lend the final customers. Therefore, development banks are not considered significant sources of systemic risk and thus they are not subject to the same regulatory framework as private banks (Basel III). On the other hand, regional banks as typical (smaller) banks undertake all banking activities (deposits, direct lending, etc.) and thus they are subject to the regulatory framework of typical commercial banks and to the requirements imposed by the ECB. The *regional dimension* of the local banks, their main focus on the economic development of a specific region and the *different regulatory framework* applying to the regional and the development banks underline that these two types of financial institutions have essential differentiations.

On the other hand, the coexistence and collaboration between development, regional and cooperative banks have multiple and essential benefits for the real economy. A more diversified financial structure encourages competition among different types of financial institutions, contributes to financial stability and allows different financial organizations to operate complementary between each other to promote economic growth. A typical example is the cooperation between KfW (Germany Development Bank) and the Sparkassen Saving Banks for financing important development projects. Moreover, both local and development banks effectively promote and support long-term and short-term socio-economic sustainable growth (regional and wider) by funding small and medium-sized enterprises (SMEs), viable rural and green projects, infrastructure and innovation projects, etc. The collaboration between regional and national development banks can also contribute to the mitigation of the pro-cyclical nature of private sources of finance that often leads to insufficient funding or to non-realization of vital projects, especially during the periods of economic recession.

4 Conclusion

In recent years, the existence and the effective operation of a parallel banking system become necessary. The *funding gaps* because of the systemic banking system's limited lending capacity especially towards small and medium-sized enterprises (SMEs) and households, the *pro-cyclical nature* of private financial system that deprives vital financial resources from real economy, *the non-financing or the underfinancing of projects* with important socio-economic benefits by large systemic banks because of their long-term risky nature, the *significant shrinking* and the *complexity* of the banking sector and the necessity for a d*iversified financial system* that promotes the healthy competence among financial institutions are some of the most indicative reasons that justify the importance of a parallel banking system consisting by regional and cooperative banks probably reinforced by a public development bank. The *increasing number of clients/members* and the *significant market shares of deposits and loans* of regional and cooperative banks show the augmenting power of these banks in the wider banking system. During the recent crisis, these banks are proved resistant and more stable than the systemically important banks, another fact that confirms the essential role that may play in financial system's stability. Of course, there are various challenges with which smaller local banks have to deal such as the *growing competition* with the large banking institutions and the technological giants such as Google, Apple, Facebook, the *technological progress*, the *digitization* of products and services and the rapid progress of *e-banking* that may be quite costly and complicated tasks for small local banks, the "*bad" economic environment* that burdens more heavily the regional banks located in less developed regions and the *insufficient diversification* of their portfolios that may increase their risk. However, if regional and cooperative banks follow some targeted strategies such as the *improvement* of their *retail banking services* and the *expansion of their activities* in order to provide a full range of financial services, the reinforcement of the *close relationships* with their clients at which they are specialized, the amplification of their role as *key funders of the real economy* especially during recession periods, the adequate in*vestment in technological innovation and in human resources* and staff training and the promotion of *mergers and extroversion* may help them to remain competitive, strengthen their position in the financial market and expand their client base. The significant role of the parallel banking system becomes more and more prominent. Their contribution in socio-economic development, with a more regional perspective, and their main focus on financing projects and groups of population that are not "desirable" by private commercial banks because of their high risk and their long-term horizon make them irreplaceable in financial system. This role may be further enforced by a public development bank that has a clear growth perspective and may support regional and cooperative banks in funding vital long-term projects with significant social benefits such as projects against climate change and R&D projects, in SMEs' lending, in mitigation of the pro-cyclical nature of the private financial system, in diversifying the financial structure and strengthening the financial stability and allowing to various financial organizations to operate complementary so as to promote the economic growth. The collaboration of the KfW (Germany Development Bank) with the Sparkassen Saving Banks for financing development projects in Germany is a characteristic example. In conclusion, the significance of the parallel banking system as a main funder of the real economy and a pillar of the economic growth cannot be argued and despite all possible challenges that community and cooperative banks may face overtime, their presence in the banking system of a country should be strong and robust.

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