Business Model Analysis: The Slow Shift to a New Supervisory Paradigm

23rd January 2018
“The SSM approach to business model analysis”

Stephen Woulfe

Head of Significant Bank Supervision
European Central Bank
“A slow shift to a new Supervisory Paradigm”

Helmut Bauer

Deloitte Senior Advisor and former Chief Executive Director and Head of Banking Supervision at BaFin
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Deloitte Ireland | Dublin

23 January 2018

Supervisory approaches in Europe | Meeting of the AFME SCES (Full Configuration)
SREP overall score measures distance to fail

Economic viability of the business model is at the very core of the supervisory approach
ICAAP

Normative internal perspective

- Ongoing fulfilment of all relevant legal, regulatory and supervisory requirements
- For the projections (covering at least 3 years), this means, e.g., ongoing fulfilment of
  - TSCR (adverse)
  - OCR + P2R (baseline)
- Additional management buffer determined by bank, depending on business model, risk appetite and risk profile

Economic internal perspective

- All risks that may impact the economic viability are covered by capital.
- Economic viability concept (incl. e.g. net present value) is defined internally.
- Institution develop own risk quantification methods.
- Short term risk assessment, no additional projections expected.
- Internal definition of capital.
- Additional management buffer determined by bank, depending on business model, risk appetite and risk profile

Sound governance.
- Full integration in decision making, strategies and risk management.

Sound data quality, data aggregation and IT architecture.
- Thorough independent review and validation.

Mutual Information
**Basel 2**
align regulatory and economic capital – a **risk-sensitive** and **incentives-based** capital regime – internal modelling for capital computation subject to **use test**

Normative  

Economic
Normative

Economic

risk-sensitive incentives-based use test
Intensity and Effectiveness of SIFI Supervision
Recommendations for enhanced supervision

Principles for An Effective Risk Appetite Framework

Guidance on Supervisory Interaction with Financial Institutions on Risk Culture
A Framework for Assessing Risk Culture

2 November 2010
18 November 2013
7 April 2014

Julie Dickson (former SSM supervisory board member)
4. The supervisor uses a variety of tools to regularly review and assess the safety and soundness of banks and the banking system, such as:

(a) analysis of financial statements and accounts;
(b) business model analysis;
(c) horizontal peer reviews;
(d) review of the outcome of stress tests undertaken by the bank; and
(e) analysis of corporate governance, including risk management and internal control systems.
Why it took so long?

Normative

Economic

risk-sensitive incentives-based use test
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Risk Appetite Framework and economic viability

A risk appetite framework allows the firm to identify and determine the relative positions of its risk capacity, risk profile and risk appetite when evaluating and pursuing its strategy and business model and to take corrective action where necessary. In each of the five states illustrated, the firm’s risk profile has changed relative to its risk capacity and risk appetite (e.g. in response to external market conditions).

Note: In practice, for some risks, such as operational risk, the firm may not have a lower limit and trigger.
Financial services regulation: key issues
Business Model Analysis: The Slow Shift to a New Supervisory Paradigm

- Business environment
- Strategy
- Business Model
- Risk Appetite Framework
- Risk Culture
Risk Appetite Framework

Developing risk appetite statements requires business input and understanding across the firm, driven by both top down leadership and bottom up management involvement. The cascading of high level statements down through the business is aimed at developing and implementing a comprehensive and coherent structure. It is also key to enabling transparency and communication of the firm’s risk profile as it creates a firm-specific common risk appetite language.

- Based on the themes from the firm’s **strategic plan and objectives and its business model**, which are approved by the Board, the **risk strategy** is set by the CRO. It articulates the aspirational status of the firm’s risk profile (the firm’s targeted future risk profile).
- Based on the risk strategy, the Board approves the firm’s enterprise-wide **high-level** risk appetite statement, and related measures and limits.
- Board or Senior management provide **direction** to the rest of the firm. The enterprise-wide high-level risk appetite statement, and related measures and limits, are mapped to key risk drivers.
- **Specific** activities that the firm can and cannot do are defined and documented qualitatively in principles and policies to operationalise risk appetite.
- **Quantitative detailed** risk appetite measures and limits are articulated to allow risk appetite to be monitored and controlled in day-to-day risk management processes.
- Top-down articulation of risk appetite statements and limits must be informed at all stages by bottom-up input and engagement. The risk appetite framework must take into account and respond to the firm’s **business dimensions** (such as business model, customer profile, limits and controls, concentrations, competitive position and financials).
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Risk appetite framework links strategy and business model development with risk management across 3LOD, and bank operations.
Business environment analysis (function and process)

**Function** (not necessarily one) with skills and resources for analysis of
- Macroeconomic environment
- Competitive environment
- Other relevant environmental variables (e.g. regulatory, technological, socio-demographic, fiscal, etc.)

**Process**
- **Identify, analyse, monitor** on an ongoing basis the macroeconomic and competitive environment and other relevant environmental variables and determine the sensitivity of the business model to all relevant environmental variables
- Develop, review, and update (stress) scenarios across environmental variables for testing of current business and future strategy
- Communicate findings, feed into strategy/business development and budgeting process

Strategy, Business Model Development (process involving many functions and intelligence)

**Owner:** the board

**Function(s) and process for analysis of current and future profitability**
- **Understand and monitor** on an ongoing basis profit generation by business lines/products, the key drivers, and related interdependencies
- Sound financial projection techniques based upon scenarios aligned to business model
- Demonstrate the courage to quit

Risk Appetite Framework

Real-life spinning of the business model generating a continuous stream of business information to feed into the fine-tuning/development of the business model
“Business Model Analysis – Challenges and Opportunities”

Panel Session
Moderator

- Dr. Margaret Cullen: Director of Executive Education at the Institute of Banking

Panellists

- Helmut Bauer: Deloitte Senior advisor to Deloitte’s Centre for Regulatory Strategy in London and Deloitte’s Banking Union Centre Frankfurt and former Chief Executive Director and Head of Banking Supervision at BaFin

- Stephen Woulfe: Head of Division, Significant Bank Supervision, European Central Bank


- Harry Bhoja: GARP member and previously Head of Risk and Middle Office at Zurich Financial Services

- Sean Smith: Partner, Regulatory Risk, Deloitte
What are the challenges faced by Banks and Regulators in relation to BMA?
What challenges do banks face as part of Supervisory Business Model Analysis?
What are the challenges faced by Regulators when assessing the viability and sustainability of firms’ business models?
What are the key challenges facing Boards in Business Model Analysis?
Where should ownership of Business Model Analysis sit within an organization?
What are the actions firms can undertake to improve business model analysis and strategic decision making?
How can firms best define their approach to business model analysis to stakeholders?
What factors should firms consider when looking to improve the analysis of their business model?
How can banks incorporate technology threats into their business model analysis?
Key Panel Messages

**Peer Groups:** Firms can benefit from identifying peer groups against who they are likely to be benchmarked to better understand regulatory expectations.

**Regulatory Challenges:** Regulators face challenges understanding the drivers behind differences in results of firms’ internal and regulatory exercises, particularly when benchmarking.

**Board Engagement:** Boards should be able to evidence to Regulators that they (1) fully understand business model vulnerabilities; and (2) make informed strategic decisions based on this understanding.

**Roles and Responsibilities:** Clear definition of the responsibilities of stakeholders (particularly across Risk, Finance and Strategy) in assessing the firm’s business model and the link with strategic planning is crucial.
Key Panel Messages

BMA Framework: Firms should have in place policies and processes which (1) define their approach to assessing its business model; (2) outline how this is integrated with other key processes; and (3) illustrate how BMA feeds into strategic decision making.

Strategic Balance Sheet Modelling: Firms should consider whether the implementation of strategic balance sheet management modelling may enhance their ability to deliver sustainable profitability within a suitable risk threshold, supported by appropriate capital/funding structure.

Innovation: Firms should ensure their stress testing scenarios incorporate the threats to their business models posed by disruptive technologies/competitors.
Key Takeaways

1. **Define** and **formalise** your approach to analysing your business model (including peer group analysis)

2. Use this to illustrate how you **embed** and **integrate** key regulatory processes into **strategic decision making**

3. **Review** your business model analysis capabilities to ensure they provides a sufficiently forward looking, **risk adjusted view of profitability**