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The opinions expressed are his own.

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The approach to business model analysis

It is a pleasure to speak to you today on the approach to business model analysis[1].

Having a meaningful and open dialogue with the supervisors – in fora like this, and not least with Joint Supervisory Teams - is important so that underlying issues are properly understood and can be addressed.

Today I will touch upon three areas: importance, expectations, and engagement.

That is (i) the importance of BMA for ECB/Single Supervisory Mechanism, (ii) our supervisory expectations and analysis we undertake against these expectations, and (iii) constructive engagement with supervisory teams.

The title of today's session 'a slow Shift to a New Supervisory Paradigm' particularly highlights these points – that is, the need of industry for a greater understanding of why we, as supervisors, are prioritising this, what we are seeking to achieve, and how industry can engage effectively.

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[1] I am grateful to Sergio Grittini for a first draft of this speech, and to Micheal O'Keeffe and Sebastian Ahlfled for helpful input and suggestions. I am solely responsible for the views expressed here.

1. Importance of Business Model Analysis

The ECB places considerable importance on business model and profitability drivers. It continues to be one of our four supervisory priorities for 2018.

In this context, we launched a thematic review of banks profitability drivers, which has been run over two supervisory cycles, and due to complete in the coming weeks.

The reason we place such importance on BMA and profitability, is that fundamentally, recurrent profitability facilitates capital accretion, which in turn puts institutions in a stronger position to meet regulatory requirements.

Recurrent profitability will typically also lead to improved market perception for debt and equity. This in turn will lead to reduced funding costs and lower cost of equity. Ultimately, this 'virtuous circle' should ensure the supply of reasonably priced credit to the consumer and economy more broadly.[2]

In broad terms, therefore, business model analysis reveals a bank's key vulnerabilities and the sustainability of its strategic plans.

But as you know the SSM does not run banks. Moreover, we do not favour any specific business model. All business models have their strengths and weaknesses. What we try to do is cast an objective eye over the management of the risks of the banks, which can differ in importance based on a chosen business model.[3]

But as supervisors we look at each business model with an open mind. Likewise, we expect banks to be open and ready to engage with us when we challenge their business models.

However, today, on aggregate, SSM Banks' profitability is under increased pressure, raising concerns on the sustainability of the banks' business models.

Drivers of this persistent weak profitability in some cases are structural, (particularly the emergence of new forms of competitions and a faster transition towards more market-based finance, some through changes in regulations, or other external factors such as Brexit).

Cyclical dynamics such as the legacy NPLs portfolios and the prolonged period of low interest rate environment are also having an effect.[4]

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[2] See Speech by Mr Ed Sibley, Deputy Governor of the Central Bank of Ireland, at the Banking & Payments Federation Ireland (BPFI) National Conference, Dublin, 20 October 2017

[3] See speech by Speech Ignazio Angeloni, Member of the Supervisory Board of the ECB, at the Adam Smith Society, Milan,15 May 2017

[4] Speech by Danièle Nouy, Chair of the Supervisory Board of the ECB, 18. Handelsblatt Jahrestagung on European Banking Regulation, Frankfurt, 24 November 2017

As SSM banks' population are quite diverse, the influences of these drivers on banks' profitability differ across institutions. As a consequence, our assessment goes deep into individual banks' businesses.

The Supervisory review and evaluation process (SREP) includes a review of banks' arrangements, strategies, processes and mechanisms, as well as the evaluation of the risks to which banks are, or might be, exposed.

By identifying major business areas and key vulnerabilities, business model analysis also contributes to the assessment of specific risks to solvency and liquidity, thus supporting the work on other SREP elements.

2. Expectations versus analysis

In essence, our business model analysis boils down to three main steps.

First we try to identify major business areas and key vulnerabilities.

Second we assess current and past profitability.

Third we assess future viability and sustainability.

In the course of these three critical steps we continuously assess our analysis versus a simple expectation:

Can this bank generate sufficient returns within a framework of suitable risk appetite and on the basis of a clear and sustainable funding structure?[5]

When we assess business models, we combine two things: an analysis of hard data and the judgement of experienced supervisors. This helps us to be unbiased, holistic and forward-looking.[6]

Over time, the profitability projections made by the institution are compared to realised data, the projections made by the supervisors and compared to peers.

These comparisons contribute to the assessment of the reliability of the bank's forecasts and strength of its internal business model analysis.

To do all this we use a multitude of tools. However, a considerable advantage – and indeed one of the rationales for establishing the SSM – is peer comparison. Peer groups are built based on several dimensions, including size, complexity, ownership type, geographical footprint, type of business, and

[5] See Banks business models: keeping pace? Statement by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the Seventeenth Annual Conference on Policy Challenges for the Financial Sector, Washington D.C., 1 June 2017

[6] Ibid

funding profile. Where profitability indicators deviate strongly from peers in a given business or by product line these are analysed with special attention.

At this point I could ramble for some time on the intricacies of our approach, the analysis of key metrics, deconstructing banks own projections and volatility components, rebuilding these to understand stability of earnings and capital generation etc; but perhaps it is better to draw on a practical example.

This would also then help address the second theme, our expectations on banks and the analysis we undertake against these expectations.

One of the most relevant examples to pick of course is Brexit.

Back in late 2015 and early 2016, it was clear that the vote would provide us with a real-life scenario which all banks had to deal with.

Our starting point in this case was reasonably simple, and unlike most crisis events there was sufficient time to prepare for the possible outcomes, both for industry and for regulators. Put a plan in place, engage with the banks, and ensure there were no gaps in their risk management.

Internally we worked closely with our counterparts on the central banking side, created structures to manage the assessment and develop an understanding of the various strands where impacts on the banks could be identified. This was after all the most significant structural event in recent history.

So what did we expect of banks?

A stress test scenario was a must have. The short-term volatility was certain; the long-term implications of a leave vote would be much more significant. It could have serious structural implications which would need to be understood. Financial projections by product and business line; would these be materially impacted or not?

Strong governance and a structured approach to the risk assessment. This needed to be driven at a senior level, ideally flowing through to subcommittee level of the board. And of course, we were interested to see whether these stress tests had resulted in any actions being taken.

As you can see, these items do not appear unreasonable.

Banks carrying out their own business model analysis would cover all these basic points, and within the structures of core strategic documents which govern the bank.

The basics of strategy, risk appetite, budgeting and forecasting, which is what all businesses would be reviewing. Stress testing results flowing through the banks ICAAP and ILAAP, helping them identify vulnerabilities and preventative actions.

Discussions at senior level challenging the robustness of the stress tests and deciding on what actions, if any, needed to be taken before the vote took place.

We also expected the banks to identify some additional aspects which we may not have thought of; after all they must have significant resources focused on this.

If I was writing a mid-term report on what we received back it would have said “could do better, further intensive study needed before the exam”.

In part this was due to the “they wouldn’t actually leave” view held in many quarters.

But, it also highlighted the weaknesses in some banks governance processes, and business model analysis, to properly consider a significant risk event which was predictable in nature.

From a supervisory perspective, the engagement was a “success”, banks listened and took action running stress tests and identifying steps to be taken. While markets were volatile for a period of days before and after the vote, the preventative actions taken by banks, supervisory authorities and central banks reduced their exposure to those risks.

Now banks should be diligently working on the next phase of their business model analysis, and execution, in what is still an uncertain environment.

Bringing all this back to how we carry out our business model analysis more generally and “assessing current and past profitability”, supervisors analyse the bank’s capacity to generate profits based on key metrics (e.g. ROA, C/I ratio, recurrent earnings ratio, etc.). The levels and evolution of the bank’s income sources and costs are broken down and analysed.

The readings of these metrics are compared to pre-defined thresholds that represent the SSM’s risk appetite. Such thresholds are calibrated based on expert judgement and historical data analysis, as no regulatory requirement exists. Supervisors complement the assessment of the standard profitability metrics with an assessment of the risks to profitability deriving from various aspects of the P&L and balance sheet.

Looking at the last heading, the SSM defines business model viability as the ability to generate appropriate returns from a supervisory perspective over the next 12 months.

The assessment of sustainability, instead, includes two longer time horizons: three years and through the cycle.

The analysis becomes necessarily more qualitative as the horizon expands. Our supervisory expectation on what we received from the banks on their Brexit preparations was reflective of this.

The bank's own profitability projections should be able to provide detailed bottom-up forecasts of performance for the short-to-medium term (one to three years) and, at least, top-down forecasts for the longer term (two to five years). The assumptions used by the institution to generate forecasts for key drivers should be identified and understood, providing an area for challenge and discussion. Supervisors then assess how the institution has recognised these risks and its capacity to respond to key events or trends.

3. Engagement with supervisors

Perhaps a brief comment on the importance of how banks can engage effectively with supervisors, not just on business model analysis, but more generally.

The nature of our engagement is "intrusive" in line with the principals laid out at the creation of the SSM. It is therefore important for firms to have a structured approach to ensure they can react to the demands of the processes and demonstrate how they are managing their risks.

Having a meaningful and open dialogue with the joint supervisory teams is important. Underlying issues need to be properly understood and addressed.

While it may seem that we request vast amounts of information, it is not because we are bored, or even because we know you don't like these additional requests.

Normally we have a concern and a need for data to provide us with sufficient comfort so as allay that concern or information so that we can make the appropriate intervention.

Such an intervention typically results in actions needing to be taken by a bank.

Implicit in that engagement is for the bank to understand the driver behind the need for the action. Actions should not be undertaken by banks to close open issues on a list, but rather issues should be addressed to improve a banks risk management infrastructure and remediate specific risks.

Sometimes more time could be spent by banks in clarifying the issues to ensure they are implementing the right actions.

Engaging with supervisory teams to more properly understand the improvements that are needed should be done in an open and transparent way.

More recent years have seen a greater emphasis placed on sound governance and the importance of the interconnected nature of critical strategic risk documents.

Documents such as ICAAP and ILAAP (including stress testing), risk appetite, strategy and forecasting; to name a few. Recent thematic reviews on governance and risk appetite looked at this area.

The latest thematic review also looks at elements of these key strategic governance and risk documents.

The importance of, and the need for, interconnectivity cannot be overstated. Nor indeed the fact that the improvement in these documents and the surrounding processes should not be seen as “something to keep the regulators happy”.

Rather these are fundamentals that firms should have in place for themselves, their investors, and their depositors.

It is reasonable to say that this focus is relatively new, differing from country to country in historical emphasis, and that different banks are on different points of the journey in relation to these core strategic documents.

Concluding remarks

Given our somewhat intrusive engagement and heightened supervisory expectations, the need of industry for a greater understanding of why we, as supervisors, are prioritising BMA, what we are seeking to achieve, and how the industry can engage effectively, is important.

From a supervisory perspective, it is important that firms profits are reliable, leveraging upon an appropriate funding and capital structure,

within a framework of a suitable risk appetite (as part of suite of integrated core strategic documents) through a full business and economic cycle.

In doing so it creates the positive virtuous circle I mentioned earlier.

Analysing banks within the SSM benefits from cross boarder peer comparisons and improved benchmarking, a key strength since the creation of the SSM.

As a consequence, the assessment of supervisors is more robust, supervisory strategies better defined and interventions more focused.

So, as you can see, while it may be considered ‘a slow Shift to a New Supervisory Paradigm’, the SSM already places great importance on business model analysis and will continue to do so in the years ahead.

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