

6. Business Model Analysis

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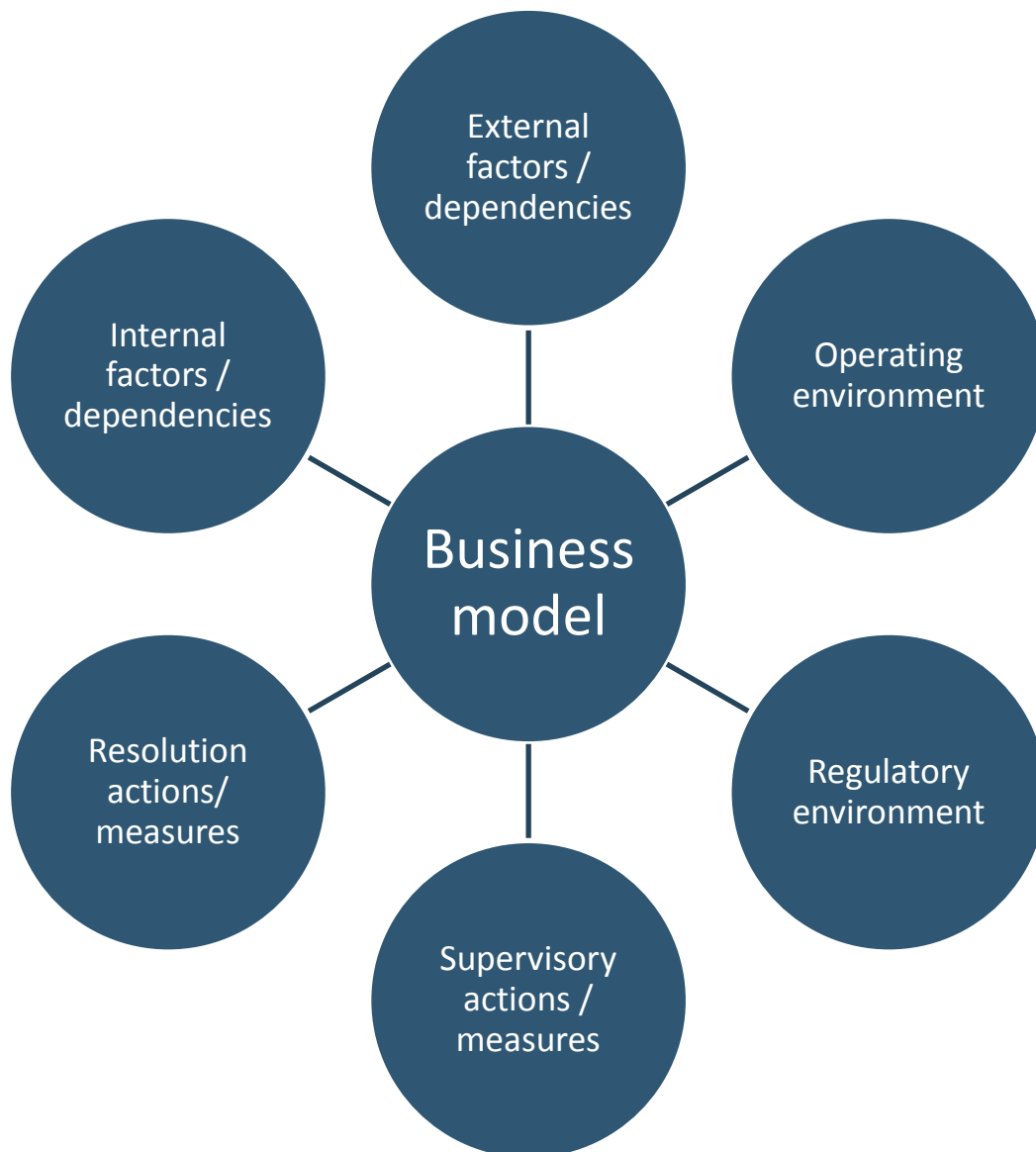
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Outline

1. What is business model and BMA?
2. BMA preparatory stages
 - Preliminary assessment
 - Identifying focus of BMA
 - Assessing business environment
3. BMA elements
 - Analysis of the current business model
 - Analysis of strategy and financial plans
 - Summary and scoring
 - Supervisory measures
4. BMA and assessment of recovery plans

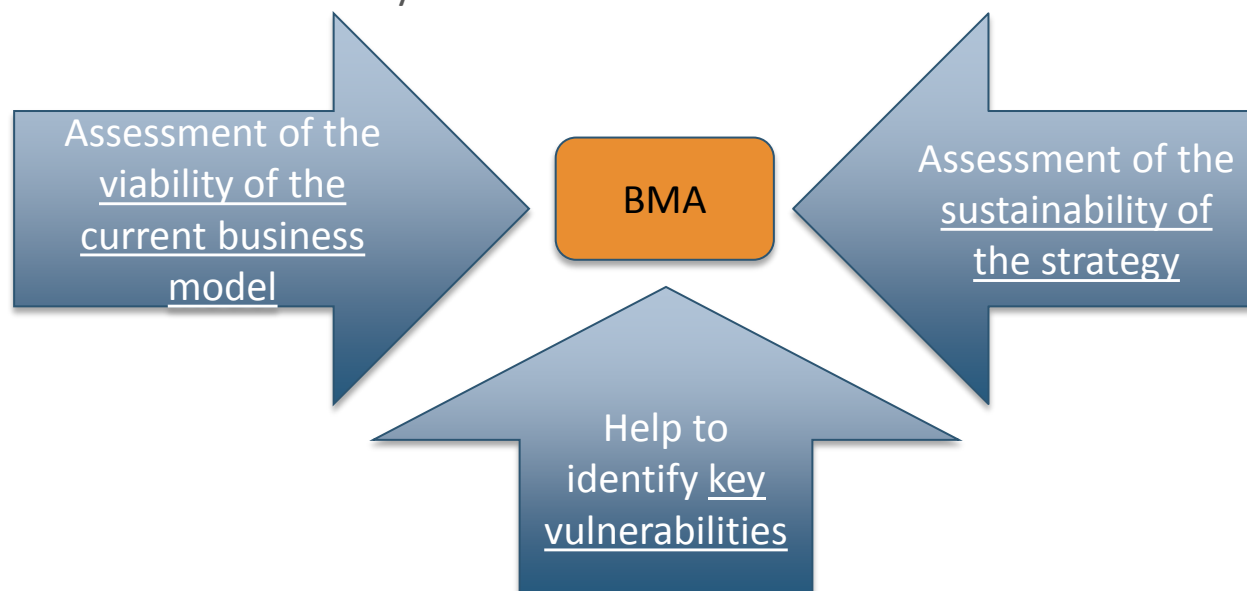
What is business model?

A business model is the means and methods used by an institution to operate, generate profits and grow. Each business model is unique, though common business model characteristics can be found across institutions



What is BMA?

- BMA is a supervisory activity undertaken by supervisors to help develop a view of:
 - the current business model of the supervised institution, and its viability; and,
 - how the business model may evolve as a result of strategic choices made by the institution and/or the impact of changes to the business environment in which it operates, and therefore its sustainability



NB! BMA does not undermine the responsibility of the management body for organising and running the business. BMA does not aim at introducing supervisory ratings or preferences for various business models

What does BMA focus on?

Essential questions of the BMA:

1. *How is the institution making profits today?*
2. *What are the key drivers of its profitability?*
3. *How does it plan to make profits tomorrow?*
4. *How will the key drivers of profitability change? And what is driving this change?*

Quantitative analysis focuses on:

- profit and loss, including trends and concentrations
- balance sheet (both accounting and risk views), including funding structure, trends and concentrations
- risk appetite (stated and observed)

Qualitative analysis focuses on:

- key external dependencies
- key internal dependencies
- franchise
- areas of competitive advantage
- execution and risk management capabilities

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BMA: the basics

BMA process

1. Preliminary assessment
2. Identifying the focus of BMA
3. Assessment of the business environment
4. Quantitative analysis of the current business model
5. Qualitative analysis of the current business model
6. Analysis of the forward-looking strategy and financial plans (including changes planned to the business model)
7. Forming the supervisory view, including BMA scoring; and
8. Outcomes (supervisory strategy, supporting other elements of SREP, addressing threats to viability and sustainability)

- BMA should be conducted at the same level of consolidation as SREP (group and solo level → importance of colleges)
- BMA can be performed at the level of business lines and then aggregated to the level of a group
- Economic context is very important → macro-economic environment affects both current model and plausibility of the strategy
- Peer group analysis is an important tool → peer groups targeted to business lines and products assessed (not traditionally rigid peer groups)
- BMA results may result in supervisory measures and early intervention measures

BMA: preliminary assessment

- Screening assessment to understand the complexity of institutions
- Focus on identifying:
 - Major business lines
 - Major subsidiaries/branches
 - Major geographies
 - Major product lines
- Tools: balance sheet and P&L analysis looking at 'sources of income' and 'asset structure'

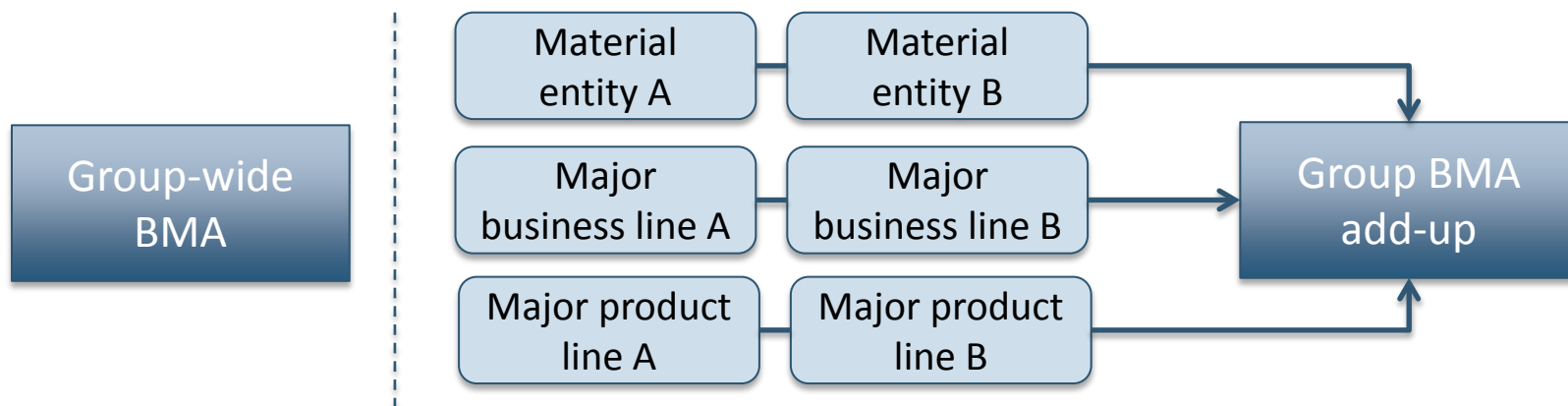
Preliminary assessment

Determination of materiality of certain business lines/products etc.

Identification of peer groups (based on business lines/product lines)

Support categorisation of institutions (proportionality in SREP)

BMA: identifying the focus / scoping (1/2)



- Scoping of BMA is essential, especially in the case of large and complex multinational groups → considering limited supervisory resources
- Scoping is also required for the determination of appropriate peer group for the analysis
- BMA can focus on different parts of the group within the SREP assessment cycle → however, group-wide on business model viability and sustainability of strategy is essential for the purposes of the annual Summary of the Overall SREP assessment
- Different approaches to scoping:
 - Top-down (e.g. focus on materiality based on preliminary analysis)
 - Risk-based / hypothesis about viability and key drivers (e.g. major changes in the metrics, past assessment)
 - Peer analysis driven (e.g. worsening results of peer banks, external drivers)

BMA: identifying the focus / scoping (2/2)

		Criteria	Basis for assessment
Top down	1	1) Materiality of business area	Typically the geography, subsidiary, business or product line generating the most profits for the institution is the most important to its sustainability, and therefore should be prioritised for assessment. 'Riskiness' (e.g. as measured by RWA exposure or actual losses) may also help define the materiality of a business area.
		2) Previous supervisory findings	The findings from previous SREPs may provide indicators of areas within the institution that require further examination from a BMA perspective (e.g. a credit risk review revealing poor controls around CRE lending may lead the competent authority to re-assess the suitability of strategic plans to grow that product line).
Hypothesis about viability driver	2	3) Importance of area to strategic plans	Where an institution has developed a strategic plan to grow an area of the business not previously analysed in depth, competent authorities may wish to conduct a BMA of that business area in order to understand the risks associated with the plan.
		4) Outcome of thematic reviews	The competent authority considers wider thematic issues across the banking sector as a basis for reviewing an aspect of the institution's business model.
		5) Observed changes in the business model	Supervisors might have observed de facto changes in the business model of an institution without the latter declaring any planned changes or releasing new strategic plans. This alone might trigger supervisory interest and requests for explanations from an institution and may prompt the competent authority to conduct a BMA on the relevant area(s).
Peer analysis	3	6) Peer comparison	The atypical performance of a business line compared to peers can form the basis for a BMA (e.g. a small investment banking business line of a bank, not material from a profitability perspective, may still warrant investigation if it has profitability ratios which are significantly different from other business providing similar investment banking services).
		7) Time since previous assessment	If the BMA of an area of an institution has not been conducted – or recently updated – an assessment may be appropriate to improve the overall understanding of the group business model.

BMA: assessing the business environment

- Objective is to understand the relevant current and economic and operating environment, and develop supervisory own views on likely future trends → need to put current model and future strategy into context
- One of few areas in the SREP, where macro-economic risk is assessed

Key areas	Variables (examples)
Macro-economic environment	Interest rates, inflation, GDP / disposable income, unemployment, real estate indicators
Competitive landscape	New entrants, new products, pricing, market shares / volumes
Customer behaviour	Product switch, attrition, channel use
Regulatory trends	Capital / liquidity rules (Basel, CRD), MiFID, EMIR, BRRD, national regulations
Technological trends	Payment platforms (mobile, contactless), data analysis / reporting
Investor appetite	Market sentiment for different types of funding instruments

Outline

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2. BMA preparatory stages

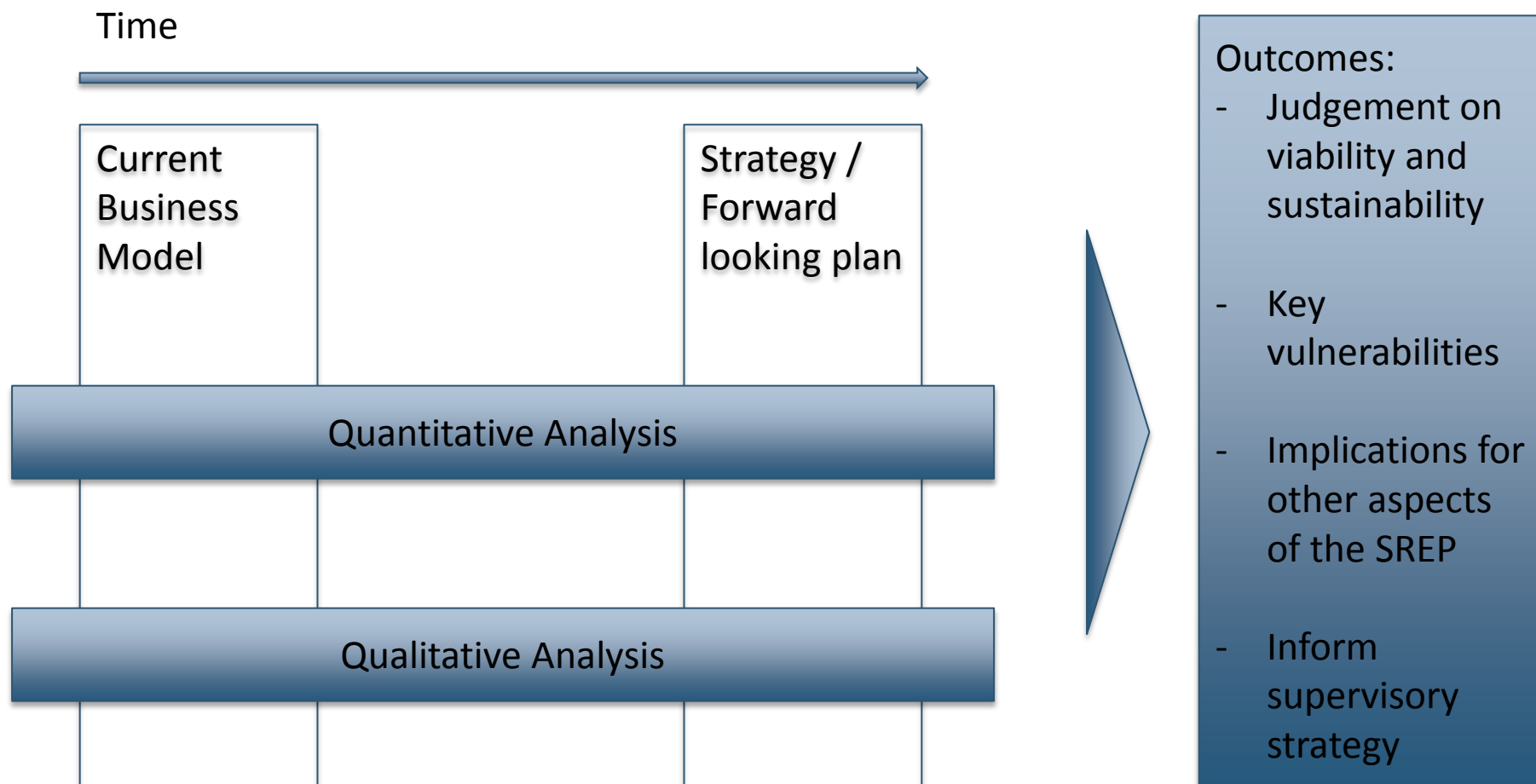
- Preliminary assessment
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3. BMA elements

- Analysis of the current business model
- Analysis of strategy and financial plans
- Summary and scoring
- Supervisory measures

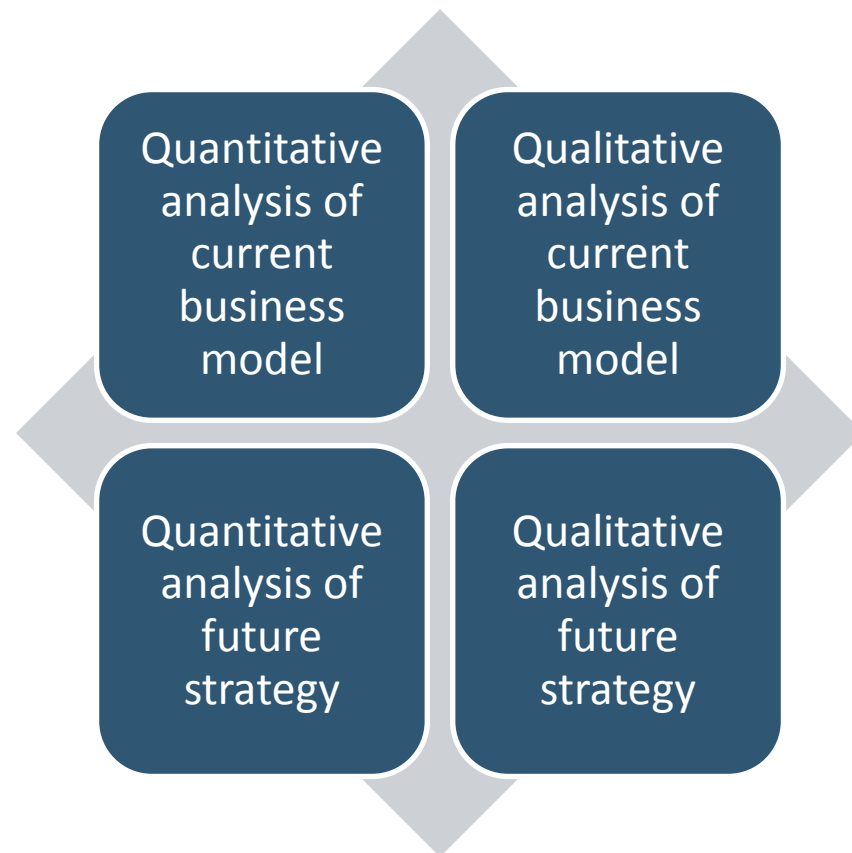
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BMA: high-level approach



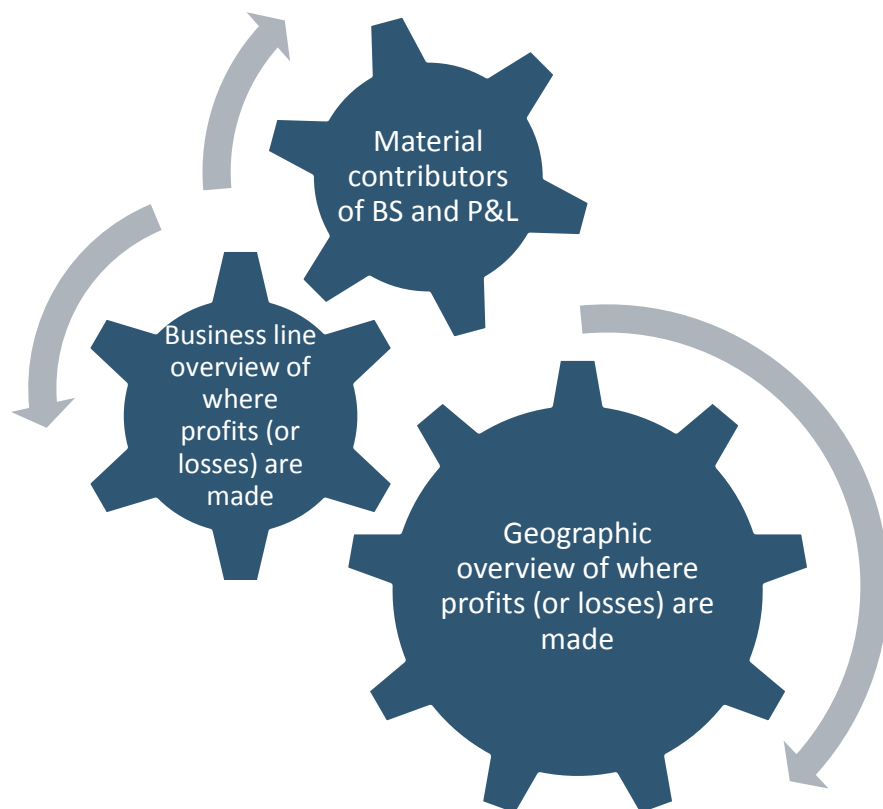
BMA: essential questions and analysis focus

1. *How is the institution making profits today?*
2. *What are the key drivers of its profitability?*
3. *How does it plan to make profits tomorrow?*
4. *How will the key drivers of profitability change? And what is driving this change?*



BMA: quantitative analysis (1/4)

How does the institution make money today?



What are the key drivers of the institution's profitability?

- What are the main aspects driving the financial performance on the institution?
- What are the key financial performance ratios? (See Tables 2 & 3 of Handbook module)
- Balance Sheet Analysis:
 - Asset structure
 - Liability structure / Funding profile
 - Capital base
- Profit and Loss Analysis:
 - Sources of income
 - Sources of costs
 - Sources of impairments

BMA: quantitative analysis (2/4)

How does it plan to make profits tomorrow (in the future)?

- What is the balance sheet mix?
- What are the big strategic bets that the institution is making?
- Where is growth going to come from?
 - Product
 - Segment
 - Business Line
 - Geography
 - Other
- Is the institution building up concentrations? How are these evolving?

How does it plan to make profits tomorrow (in the future)?

- What are the key drivers of the P&L?
- Which P&L items have the most impact on performance?
- How do these tie back to the balance sheet?
 - Volume growth vs. Margin growth
 - Improvement in Impairments
 - Other
- How are the key profitability metrics changing?
 - Net Interest Margin, Cost Income Ratio, Loan loss ratio
 - ROE, CET1
 - Other

BMA: quantitative analysis (3/4)

How does it plan to make profits tomorrow (in the future)?

- How is the funding profile changing and what are the implications from profitability and risk perspective?
 - Change in funding mix
 - Margin management
 - Implications for stability of funding
 - Asset encumbrance
 - Funding concentration
 - Reliance on wholesale funding
 - Use of securitisations

➤ **Link in with assessment of risks to liquidity and funding and liquidity adequacy**

How does it plan to make profits tomorrow (in the future)?

- What is the institution's risk appetite and how is it likely to change ?
- Is the institution moving up (or down) the risk curve?

➤ **Link in with assessment of risks to capital and capital adequacy**

BMA: quantitative analysis (4/4)

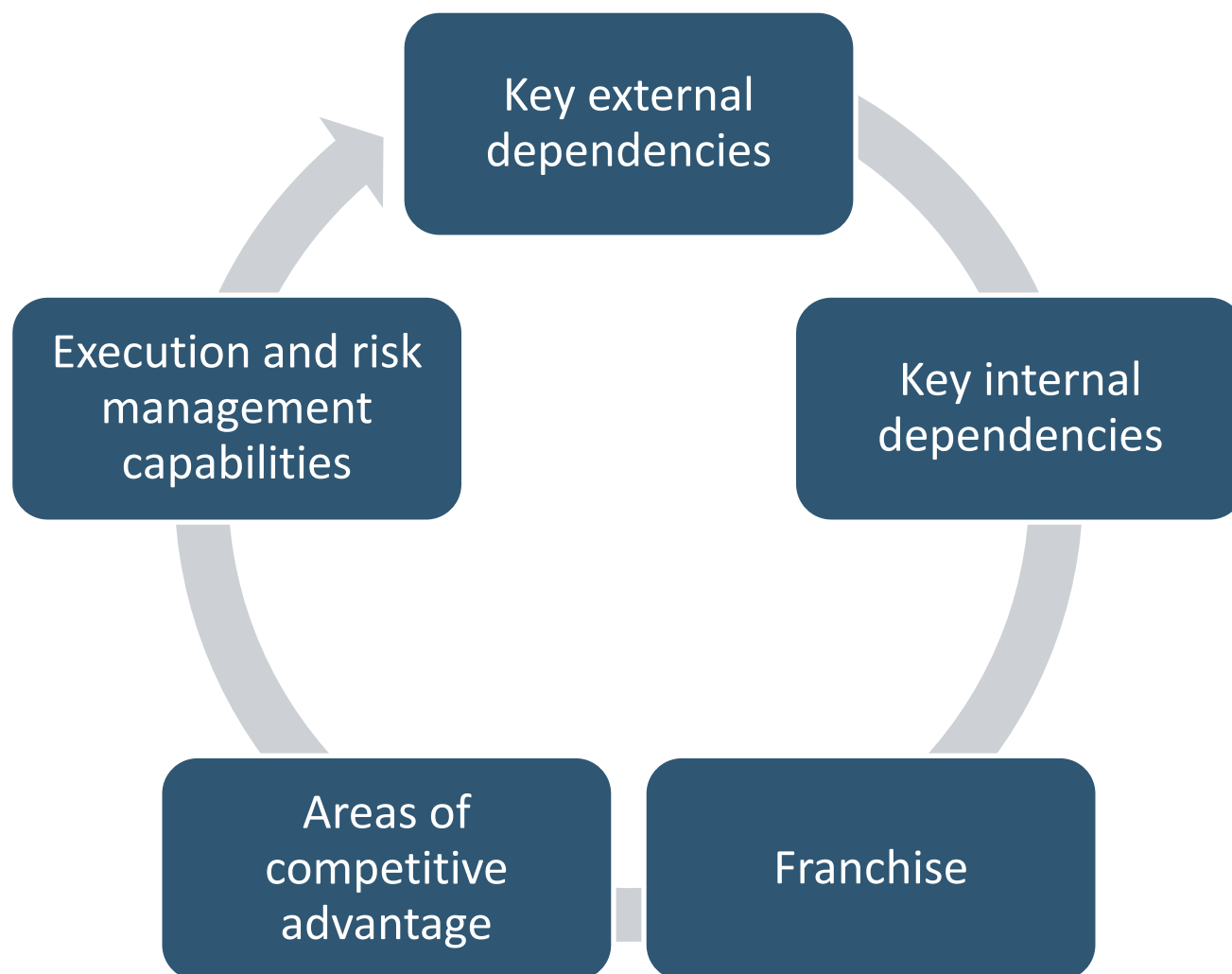
How will the key drivers of profitability change?
And what is driving this change?

- What is the basis for the key drivers of financial performance?
- What are economic assumptions?
 - Base rate
 - GDP
 - Unemployment
 - HPI/CPI
 - Other
- What is market and competitive dynamics?
 - Growth in market/ segment/ product
 - Market share assumptions

Is the institution's plan realistic?

- Forming judgement on plausibility
 - Peer comparison
 - Market growth forecast
 - Long run trend
 - External views/ Analysts
 - Other

BMA: Qualitative analysis (1/4)



BMA: Qualitative analysis (2/4)

Key external dependencies

- What are the strengths and weakness of third party providers? And how institution is dependent on them?
- What are the strengths and weakness of intermediaries and partnerships And how institution is dependent on them?
- What are regulatory changes/drivers affecting institutions?
- How reliable is the support from stakeholders and what are their commitments?

Key internal dependencies

- What are the strengths and weaknesses of internal distribution structures?
- What is the quality and level of investment into IT systems/platforms?
- What is the operational and resource capacity in the institution?
- How effective are distribution channels?

BMA: Qualitative analysis (3/4)

Franchise

- How do you see brand recognition and awareness?
- How do you see the overall brand strength and how susceptible it is to potential reputational shocks? → loyalty of customers

Areas of competitive advantage

- What are the competitive advantages?
What differentiates the institution from its peers?
- What is the (global) network and how it can connect to customers?
- What are the prospects for economies of scale?
- How do you see product mix and proposition and ability for product innovation?

BMA: Qualitative analysis (4/4)

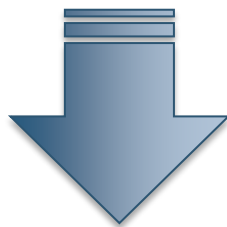
Execution and risk management capabilities

- How do you see ongoing ability of the management, employees and systems to perform their tasks and execute the current strategy, whilst ensuring an appropriate level of internal (risk) control and meeting all governance requirements?
- What is the managements' track record with delivering announced changes / executing strategy?

➤ **Link in with assessment of internal governance and institution-wide controls**

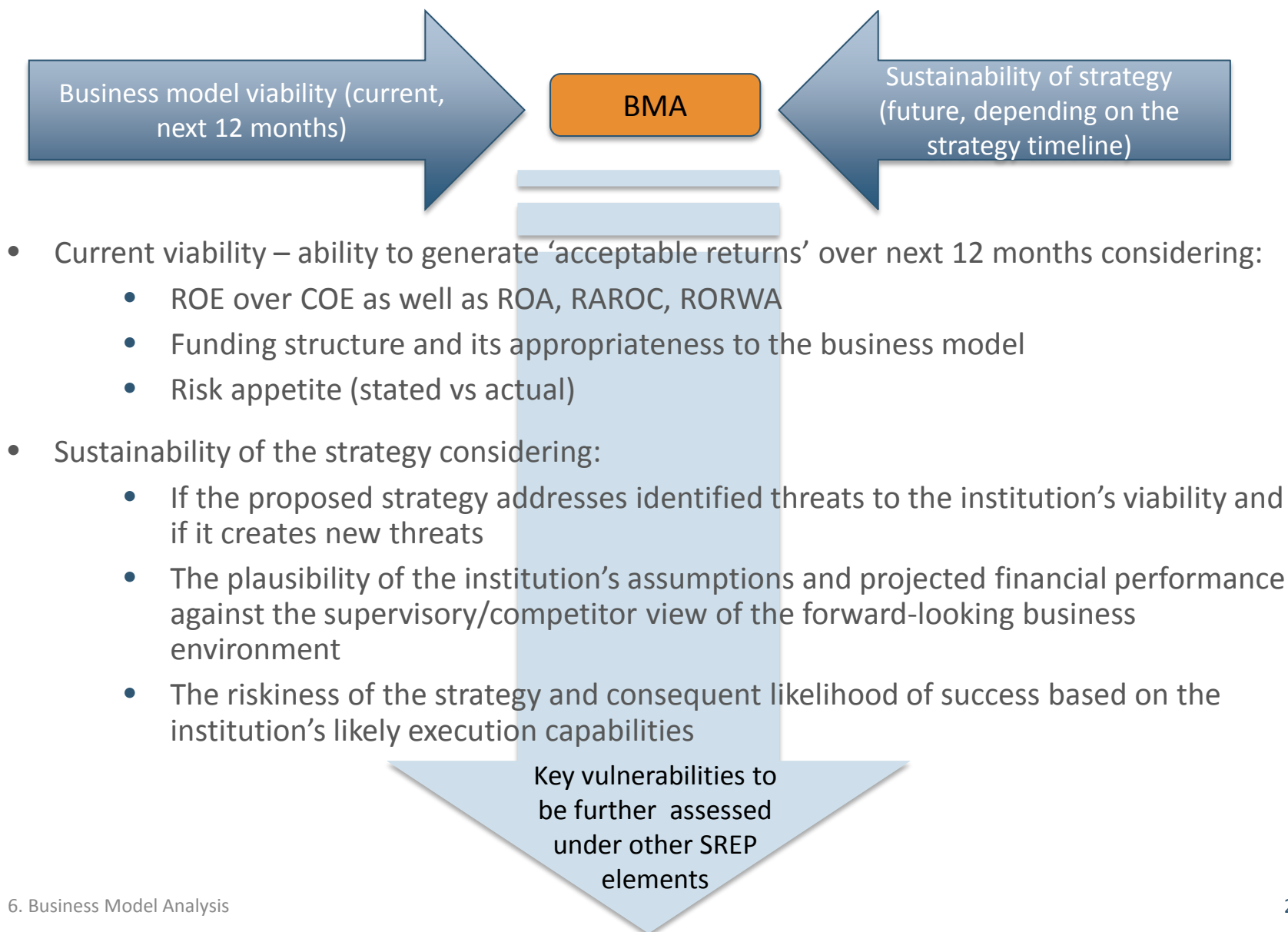
BMA: focus on overall strategy

- Quantitative and qualitative analysis approach apply both to the assessment of current business model and strategy (financial projections)
- But before going into the detailed assessment of the strategic objectives one needs to understand the overall strategy (headlines and supportive narrative):
 - What are the key commitments institution is making (financial and non-financial)?
 - What are key actions claimed?



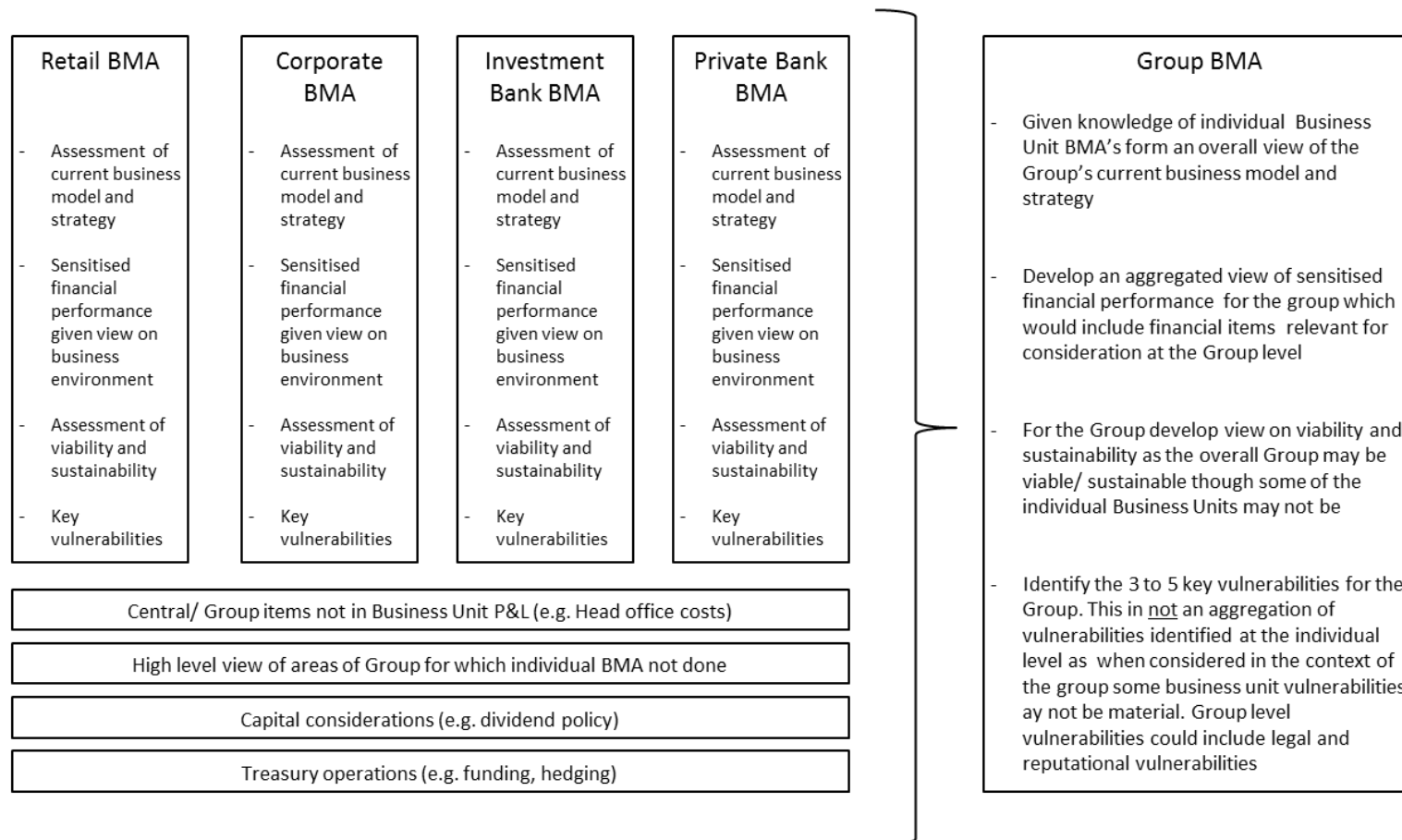
- This would follow by the analysis of:
 - Projected financial performance
 - Success drivers of the strategy, assumptions and ability to deliver

BMA: forming supervisory view



BMA: Group add-up (1/2)

Approach to Group BMA add-up



BMA: Group add-up (2/2)

- Analysis helps develop a forward looking view on risks and vulnerabilities
- View is formed using judgment taking several quantitative and qualitative factors into consideration
- Business line level risk may or may not be material at the Group level
- Implications for other areas such as capital and liquidity can be identified
- Similarly, BMA can help identify barriers to executing recovery options and resolution

BMA: scoring

Score	Supervisory view	Consideration
1	The business model and strategy pose no discernible risk to the viability of the institution	<ul style="list-style-type: none"> • The institution generates strong and stable returns with an acceptable risk appetite and funding structure. • There are no material asset concentrations or concentrated sources of income. • The institution has a strong competitive position in chosen markets and a strategy likely to reinforce this. • The institution has financial forecasts developed on the basis of plausible forward-looking business environment assumptions. • Strategic plans are appropriate given the current business model and management execution capabilities.
...
4	The business model and strategy pose a high level of risk to the viability of the institution.	<ul style="list-style-type: none"> • The institution generates very weak and highly unstable returns, or relies on an unacceptable risk appetite or funding structure to generate appropriate returns. • The institution has extreme asset concentrations or concentrated sources of income. • The institution has a very poor competitive position for its products/services in its chosen markets and participates in business lines with very weak prospects. Strategic plans very unlikely to address the situation. • The institution has financial forecasts developed on the basis of very unrealistic forward-looking business environment assumptions. • Strategic plans are not plausible given the current business model and management execution capabilities.

BMA: supervisory response

- BMA findings will feed into the Overall SREP assessment and may results in the application of supervisory and/or early intervention measures
- Combination of the Overall SREP score of '3' and BMA score of '4' is a trigger for the application of early intervention measures
- Depending on the materiality of findings and urgency of the situation supervisors may apply direct measures to address immediate challenges to viability and sustainability of the business model

Supervisory measure	Explanation
To require the reinforcement of the arrangements, processes, mechanisms and strategies implemented for purposes of ICAAP, internal governance arrangements and development of recovery and resolution plans	General provision to support supervisory actions/measures aimed at improvement of risk management and internal governance arrangements. Can be applied also in relation to financial plan (financial forecasts) being part of the strategy but not being supported by internal capital planning
To require institution to present a plan to restore compliance with supervisory requirements	General provision to support supervisory actions/measures.
To restrict or limit the business. Operations or network of institutions, or to request the divestment of activities that pose excessive risk to the soundness of an institution	Most direct measure, which could be applied based on the business line and/or product level BMA.
To require the reduction of the risk inherit in the activities, product and systems of an institution	Supplementary measure (to previous one) which could be applied based on the business line and/or product level BMA.
Require the institution to remove and replace one or more members of the management if these persons are found unfit to perform their duties	Supplementary measure, to be applied when assessment of current business model and strategy suggests that execution capabilities of management are not enough to carry out the strategy. The choice here is to either (a) change strategy, or (b) change management.
Require changes to the institution's business strategy	Most direct measure, to be applied when strategy is assessed as not sustainable.
Require changes to the legal or operational structures of the institution	Supplementary measure aimed at reducing organisational complexity, which is likely to be used in addition to the measures aimed at reducing risk and/or limiting activities

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Analysis of recovery plans and BMA (1/2)

Institutions should draw recovery plans, which would include among others:

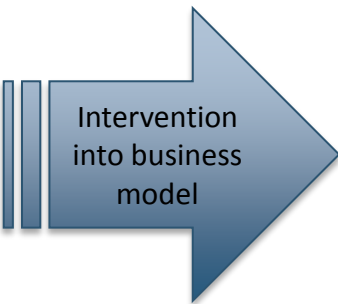
- Analysis of core business lines, critical functions and their mapping to material legal entities/branches
- Choice and analysis of recovery options supported by scenarios

Competent authorities should assess recovery plans, including their completeness, quality and credibility

- If material deficiencies or impediments to the implementation of the recovery plan are identified they need to be addressed

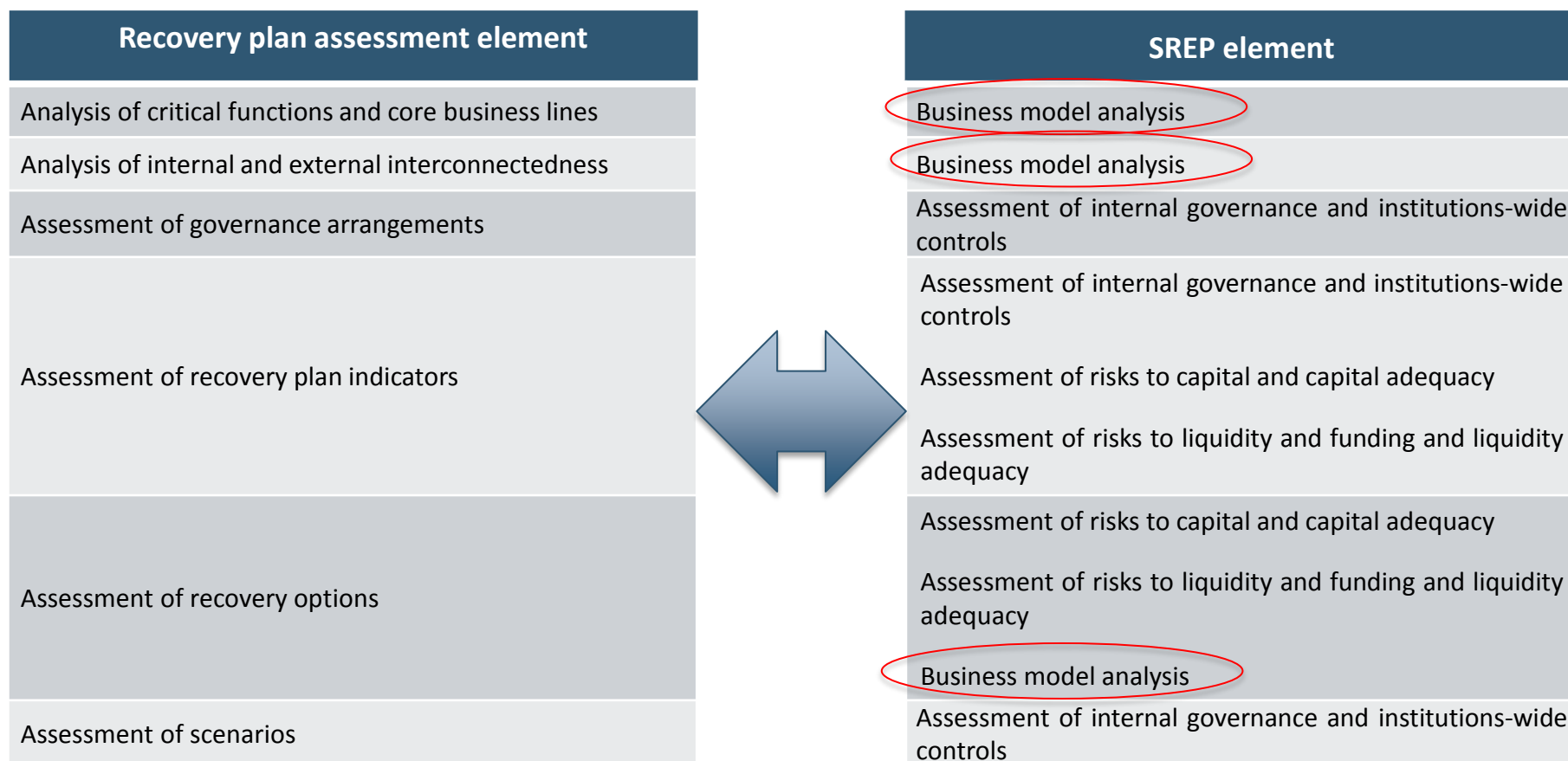
Wide range of measures and powers to address material deficiencies and impediments:

- Ask to make changes and resubmit the plan
- Direct to make specific changes to the plan
- Direct to make specific changes to the business
- Apply specific supervisory measures (reduce risk profile, review strategy and structures, review funding structure, change governance structure etc.)



Intervention
into business
model

Analysis of recovery plans and BMA (1/2)



Example:

BMA: the bank builds its strategy around expansion of certain business lines and investing more in subsidiaries, as well as optimising and centralising their support and IT systems

RP assessment: the bank is planning to downscale the same business lines and divest the same subsidiaries and declares preparatory measures to separate support and IT systems



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