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Abstract

On 15 of December 2016, the ECB published its supervisory priorities for 2017 for banks in the Single Supervisory Mechanism ('SSM'). Through this second annual exercise, the ECB furthers its aim of fostering harmonisation in supervisory practices and increasing transparency throughout the Banking Union. These priorities reveal the ECB's perspectives on the main risks facing the banking sector and will set the tone of its supervisory activities throughout 2017.

These priorities further strengthen a number of initiatives launched last year within the SSM to improve the resilience of Eurozone banks. Three priority areas are identified:

- **Business models and profitability drivers**, which remain important due ultra-low interest rates and weak economic growth across the Eurozone;
- **Credit risk**, targeting high levels of non-performing loans ('NPLs') and the upcoming implementation of IFRS 9 in respect of loan provisioning; and
- **Risk management**, including risk governance, capital and liquidity adequacy, risk data aggregation and reporting (BCBS 239) and outsourcing.

This Briefing Note focuses on the business model analysis, highlighting areas that banks should carefully evaluate to address the requirements in a timely fashion, considering all compliance and associated operational issues.

Introduction

The ECB's SSM priorities are the result of an in-depth assessment of the main risks to which the EU banking sector is exposed. This analysis is conducted by the ECB Banking Supervision function in collaboration with national authorities and joint supervision teams ('JSTs'). Among the supervisory priorities for 2017, banks' business models and profitability drivers remain a supervisory priority for a second consecutive year in an environment where banks continue to face economic, financial, competitive, and regulatory headwinds.

In practice, this priority will manifest itself in **heightened supervisory scrutiny throughout 2017 including in-depth examinations by JSTs** as part of their on-going thematic review of banks' business model and profitability drivers. Those will feed into the Supervisory Review and Evaluation Process ('SREP'), of which the Business Model Analysis ('BMA') is an essential component.

Bank's business models in a challenging environment

The banking sector is still in the midst of an era of fundamental change, which has pushed institutions to rethink and adapt their business models. Some of the drivers are:

- **Economic uncertainty:** Despite modest signs of improvement, the economic landscape in the Eurozone remains challenging amid ultra-low/negative interest rates, low economic growth and high levels of NPLs;
- **Political instability:** Significant uncertainties characterise the current political landscape. In Europe, the possible impacts of the outcome of the UK's referendum on EU membership for supervised banks remains unclear at this stage; while upcoming elections in many European Member States this year could prove highly destabilising amid a broad-based rise of populism;
- **Competitive landscape:** As the digital revolution completely reshapes the provision of financial services and spurs the emergence of new entrants ('FinTech'), the established order in the banking sector is challenged; and
- **Regulatory environment:** In the face of an unrelenting wave of regulatory requirements, and as the post-crisis regulatory agenda nears completion with the finalisation

of Basel III, banks need to continually assess the overall impact on their business models and whether certain activities remain viable.

In certain countries, alarming levels of NPLs have been described as the main risk to banks' profitability. The ECB recently identified¹ as one of the key risks to Eurozone financial stability *an adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries.*

Supervisors will also consider how banks manage risks arising from outsourced activities, which, to the extent those contribute to the competitive position of the bank, would fall under the scope of the BMA. In particular, supervisors will make sure banks don't favour cost optimisation at the expense of proper risk management.

Banks' business models from ECB's point of view

BMA is one of the four components of the SREP. While banks have gained experience in dealing with the SSM SREP over the last two years, this component will once again be the subject of in-depth examinations by JSTs throughout 2017. Supervisors want to understand the rationale for banks' business models and improve their knowledge of the underlying drivers of profitability (e.g. to assess any excessive risk-taking). The BMA focuses on the following elements:

- **Identification of the areas of focus**, including analysis of the bank's main activities, geographic presence and market position;
- **Assessment of the business environment**, including the current and likely future market conditions the bank is subject to;
- **Analysis of the forward-looking strategy and financial plans**, including a review of the assumptions, plausibility and riskiness of the bank's business strategy;
- **Assessment of the business model**, at different time horizons and based on the previous analyses; and
- **Assessment key vulnerabilities**, for example risk concentrations or optimistic economic forecasts.

The analysis results in a score (1 to 4) reflecting the risks the business model poses to the bank's viability and sustainability. Below is a conceptual overview² of the business model review:

The SSM business model review contains 3 phases	
1 Collect information and understand the relevance of business lines	<ul style="list-style-type: none"> • Contribution of business lines to income, profits and risks. • What are the business lines that drive important risk factors? • Reporting. • Any relevant internal or external information.
2 Assess the bank's capacity to generate profits	<ul style="list-style-type: none"> • An automatic score mainly based on the RoA and the cost income ratio. • Comparison of the results to predefined thresholds, and global scores.
3 Exhaustive analysis – supervisor view	<ul style="list-style-type: none"> • Used to adjust the scores of phase 2 above by taking into account bank's specificities. • More than 60 indicators based on normative reports and of supervision allow comparisons between banks.

Consistency between the business model and strategy

Far from being a stand-alone issue, the focus on banks' business models clearly interacts with other supervisory priorities focusing on the integration with decision-making process.

Through the BMA, the ECB intends to **foster the adoption by banks of a genuinely risk-based approach to strategic planning**. In that context, the consistency of the business objectives and strategic decisions with key strategic processes such as the Risk Appetite Framework ('RAF'), Internal Capital and Liquidity Adequacy Assessment Processes, ('ICAAP' and 'LAAP') and budgeting process is key.

In particular, the RAF is a useful instrument to evidence strong Board engagement in the oversight of risk. In this regard, the results of the thematic review on governance and risk appetite showed that **much progress remains to be made** before the RAF is truly embedded into decision-making.

¹ European Central Bank, *Financial Stability Review*, November 2016, p10

² Adapted from SREP methodology booklet

The maturity of ICAAP and ILAAP processes varies by country and there is much to be done to harmonise practices in the Eurozone.

RAF, ICAAP and ILAAP frameworks must be integrated including: **common metrics and consistent calibrations; integrated scenario; and integrated and consistent processes, controls and governance.**

The **Single Resolution Board ('SRB') will also take stock of banks' business models** throughout its resolution planning activities, with the view of identifying critical functions and addressing barriers to resolvability. The ECB and the SRB actively cooperate in this field.

Conclusions

The consequences of having vulnerable business models with inadequate analysis and risk management and poor integration with strategy may give rise not only additional capital or liquidity requirements but also additional supervisory measures tailored to banks' specific weaknesses. Banks' return to sustainable profitability hinges upon their ability to adapt their business mix to the new operating environment. Supervisors will closely monitor this evolution as part of the SREP.

Since the crisis, banks have steadily improved their capital strength – both in terms of quantity and quality of capital components – and liquidity positions. However, banks' profitability remains subdued, particularly compared to the pre-crisis era.

These challenges call for continuous evaluation of banks' business models, including balance sheet composition (both exposures and funding profile), business activity mix, customer base and geographic locations.

Finally, it would be wise for banks to anticipate supervisory actions (e.g. through performing strategic and business risk self-assessment) in order to take timely action.

About Avantage Reply

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Capital Management and Regulatory Reporting), Treasury and Operations within the Financial Services industry.

Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (e.g. CRD, BRRD, MiFID);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

We are available to discuss in more detail the impacts of the SREP BMA framework and its implications on your organisation.

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